European Securities and Markets Authority

Final Report

ESMA's Technical Advice to the Commission on MiFID II and MiFIR

19 December 2014 | ESMA /2014/1569

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Acronyms and definitions used

ABCP	Asset-backed commercial paper
ABS	Asset-backed security
ADR	Alternative dispute resolution
ADT	Average daily turnover
AIFMD	Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers (AIFMs)
A-IOI	Actionable indications of interest
AMP	Accepted market practice
AOR	Automated order routing
APA	Approved publication arrangement
AVT	Average value of transactions
BIC	Business Identifier Code. An 11-character alpha-numerical code that uniquely identifies a financial or non-financial institution. It is defined by ISO code 9362
BIS	Bank for International Settlements
CBO	Collateralised bond obligation
CDO	Collateralised debt obligation
CDS	Credit default swap
CEBS	Committee of European Banking Supervisors
CEIOPS	Committee of European Insurance and Occupational Pensions Supervisors
CESR	Committee of European Securities Regulators
CCP	Central counterparty
CFD	Contract for difference
CFI	Classification of Financial Instruments
CFTC	U.S. Commodities Futures Trading Commission
Class+	Class of OTC derivatives subject to the clearing obligation
CLO	Collateralised loan obligation
CMBS	Commercial mortgage backed security
COFIA	Classes of financial instrument approach

Coreper	The Permanent Representatives Committee or Coreper (Article 240 of the Treaty on the Functioning of the European Union – TFEU)
Commission	European Commission
CP	Consultation Paper
CRD IV	Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC
CRR	Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012
CSD	Central securities depositary
CSF	Cash settled forward
CT	Consolidated tape
CTP	Consolidated tape provider
DA	Delegated act to be adopted by the European Commission
DEA	Direct electronic access
DP	Discussion Paper
EBA	European Banking Authority
EC	European Commission
ECB	European Central Bank
EEA	European Economic Area
EIOPA	European Insurance and Occupational Pension Authority
EMIR	European Market Infrastructures Regulation – Regulation (EU) 648/2012 of the European Parliament and Council on OTC derivatives, central counterparties and trade repositories – also referred to as “the Regulation”
EOD	End of the day
ESMA	European Securities and Markets Authority
ESMA Regulation	Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority),

	amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC
ETD	Exchange-traded derivative
ETF	Exchange-traded fund
EU	European Union
FC	Financial counterparty
FCD	Financial Collateral Directive – Directive 2002/47/EC of the European Parliament and the Council.
FESCO	Forum of European Securities Commissions
FINRA	Financial Industry Regulatory Authority
FRA	Forward rate agreement
FSB	Financial Stability Board
FX	Foreign exchange
HFT	High frequency trading
ISIN	International Securities Identification Number: a 12-character alpha-numerical code that uniquely identifies a security. It is defined by ISO code 6166
IBIA	Instrument by instrument approach
IOI	Indication of interest
IOSCO	International Organisation of Securities Commissions
IPO	Initial public offering
IRS	Interest rate swap
ISO	International Organization for Standardization
ITS	Implementing Technical Standards
KID	Key information document
KIID	Key investor information document
LEI	Legal entity identifier
LIS	Large in scale
LRIC	Long-run incremental cost
MAD	Directive 2014/57/EU of the European Parliament and of the Council of 16 April 2014 on criminal sanctions for market abuse

MAR	Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse (market abuse regulation).
MiFID or MiFID I	Markets in Financial Instruments Directive – Directive 2004/39/EC of the European Parliament and the Council
MiFID II	Directive 2014/65/EU of the European Parliament and of the Council on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU
MiFIR	Regulation (EU) No 600/2014 of the European Parliament and of the Council on markets in financial instruments and amending Regulation (EU) No 648/2012
MO	Market operator
MMF	Money market fund
MS	Member State
MTF	Multilateral trading facility
MTN	Medium-term note
NCA	National Competent Authority
NDF	Non deliverable forward
NTW	Negotiated trade waiver
NFC	Non-financial counterparty
OIS	Overnight index swap
OJ	The Official Journal of the European Union
OTC	Over-the-counter
OTF	Organised trading facility
PRIIPs	Packaged retail and insurance-based investment products
Q&A	Questions and Answers
RDS	Reference data system
RM	Regulated market
RMBS	Residential mortgage backed securities
RPW	Reference price waiver
RTS	Regulatory Technical Standards
RTS on OTC Derivatives	Commission Delegated Regulation (EU) No 149/2013
RTS on CCP	Commission Delegated Regulation (EU) No 153/2013

SA	Sponsored access
SFI	Structured finance instrument
SFP	Structured finance product
SI	Systematic internaliser
SME	Small and medium sized enterprise
SME-GM	Small and medium sized enterprise – growth market
SMSG	Securities and Markets Stakeholder Group
SOR	Smart order routing
SPV	Special purpose vehicle
TFEU	Treaty on the Functioning of the European Union
TR	Trade repository
UPI	Universal product identifier
TTCA	Title transfer collateral arrangement
TV	Trading venue
UCITS	Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009, on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS)
UTC	Coordinated universal time
WBS	Whole business securitisation

Executive Summary

Reasons for publication

The European Securities and Markets Authority (ESMA) received a formal request (mandate) from the European Commission (Commission) on 23 April 2014 to provide technical advice to assist the Commission on the possible content of the delegated acts required by several provisions of Markets in Financial Instruments Directive (MiFID II) and the Markets in Financial Instruments Regulation (MiFIR). The mandate focuses on technical issues which follow from MiFID II and MiFIR and is available on the European Commission website (here). ESMA was required to provide technical advice by no later than six months after the entry into force of MiFID II and MiFIR (2 July 2014).

Contents

This final report follows the same structure as the Consultation Paper[1] (CP) published by ESMA on 22 May 2014 which is: (1) Introduction, (2) Investor protection, (3) Transparency, (4) Data publication, (5) Micro-structural issues, (6) Requirements applying on and to trading venues, (7) Commodity derivatives and (8) Portfolio compression.

This paper also contains summaries of responses to the CP received by ESMA. The rationale of those items covered already in the CP for which no relevant changes have been introduced, is not developed again in this Final Report. ESMA recommends, therefore, to read this report together with the CP published on 22 May 2014 to have a complete vision of the rationale for ESMA's technical advice.

Next steps

Delegated acts should be adopted by the Commission so that they enter into application by 30 months following the entry into force of the Directive and Regulation, taking into account the right of the European Parliament and Council to object to a delegated act within 3 months (which can be extended by a further 3 months).

[1] http://www.esma.europa.eu/system/files/2014-549_-_consultation_paper_mifid_ii_-_mifir.pdf

1. Introduction

1. On 20 October 2011, the Commission adopted two legislative proposals, a directive and a regulation, for the review of MiFID I. The review is an important and integral part of the reforms adopted at EU level in order to establish a safer, sounder, more transparent and more responsible financial system and to strengthen integration, efficiency and competitiveness of EU financial markets.

2. On 14 January 2014, the European Parliament and the Council reached political agreement on a compromise text. The final legislative texts of MiFID II and MiFIR were approved by the European Parliament on 15 April 2014 and by the European Council on 13 May 2014. The two texts were published on the Official Journal on 12 June 2014 and entered into force on the twentieth day following this publication – i.e. 2 July 2014.

3. On 23 April 2014, ESMA received a formal request from the Commission to provide technical advice to assist the Commission on the possible content of the delegated acts required by several provisions of MiFID II and MiFIR.

4. On 22 May 2014, ESMA published a CP in order to present its views and consult interested parties for the purpose of producing its technical advice to the Commission. The consultation period closed on 1 August 2014 and ESMA received 330 responses. On 7 and 8 July, ESMA also hosted public hearings on this CP which were well attended with around 350 participants.

5. In the preliminary phase of development of the technical advice, and in addition to the CP and open hearing mentioned above, ESMA has requested the views of the Consultative Working Groups of the concerned standing committees and working groups (the majority of the topics falling under the Secondary Markets, Commodity Derivatives and Investor Protection and Intermediaries Standing Committees/Task Forces) and the Securities and Markets Stakeholder Group.

6. In the context of the preparation of MiFID II and MiFIR technical standards and technical advice to the Commission, ESMA launched a public tender[2], in July 2013, and subsequently awarded a contract to an external contractor that is supporting ESMA in (i) preparing an in-depth impact assessment for the technical standards in order to meet the standards of the Impact Assessment Guidelines of the Commission[3]; and (ii) undertaking a data gathering exercise to support the technical advice to be delivered to the Commission for future legal acts.

[2] Invitation to tender n° OJ/16/07/2013 – PROC/2013/005.
[3] SEC(2009) 92.

7. ESMA, in developing the work for the MiFID II and MiFIR technical standards and technical advice, is also taking into consideration the impact assessment accompanying the Commission's proposal of MiFID II and MiFIR.[4]

[4] SEC(2011) 1226 final.

2. Investor protection

2.1. Exemption from the applicability of MiFID for persons providing an investment service in an incidental manner

Background/Mandate

Extract from the Commission's request for advice (mandate)

ESMA is invited to provide technical advice on possible delegated measures clarifying when an activity is provided in an incidental manner. In particular, ESMA is invited to reflect on criteria which would ensure that the investment service has an intrinsic connection to the main area of the professional activity and is of minor and subordinated scope in comparison thereto.

1. Article 2 of MiFID II provides for several exemptions regarding its applicability. Article 2(1)(c) provides that MiFID shall not apply to *"persons providing an investment service where that service is provided in an incidental manner in the course of a professional activity and that activity is regulated by legal or regulatory provisions or a code of ethics governing the profession which do not exclude the provision of that service".* The wording of this provision is identical to MiFID I Article 2(1)(c) – i.e. MiFID remains unchanged in this regard.

2. According to Article 2(3) of MiFID II, the Commission shall adopt delegated acts "*to clarify for the purposes of point (c) of paragraph 1 when an activity is provided in an incidental manner".*

Analysis following feedback from stakeholders

3. The vast majority of respondents agreed with the proposed cumulative conditions to be fulfilled in order for an investment service to be deemed to be provided in an incidental manner. A few comments were made, suggesting:

    i. to limit the exemption to the provision of 'generic advice' and not to the provision of full investment services by professionals. ESMA notes that its mandate only encompasses clarification of the *"incidental manner"* part of the exemption and not the definition or limitation of the general scope of the exemption. Additionally MiFID II (Recital 30 and Article 2(1)(c)) clearly refers to *"investment services"* without any indications for the proposed limitations.

    ii. to exclude the activities performed by help desk and service desk personnel, unless their goals or activities include commercial goals or profit incentives. ESMA considers that the element mentioned above relates to the definition of investment firms (Article 4(1)(1) of MiFID II), which includes the reference to the *"professional basis"* for the provision of investment services and not to the exemption in accordance with Article 2 (1)(c) of MiFID II.

4. On the other hand, a limited number of associations of professionals opposed ESMA's proposed requirements stating they are too restrictive and formalistic and do not consider the quality of the service provided to the client. ESMA considers that the 'quality of service' is not a suitable criterion to govern if a service is provided in an incidental manner.

5. Furthermore, one specific comment made related to paragraph 1(iii) of the draft technical advice where respondents noted that entities are required by principles of transparency to disclose the activities they undertake, even if this is done in certain limited circumstances. ESMA understands the issue and notes that merely informing existing clients of the entity's availability to provide investment services in an accessory way to the main professional activity should not be considered in violation of paragraph 1(iii) of the advice. ESMA has amended the advice to take this issue into consideration.

Technical advice

1. An investment service is provided in an incidental manner if all the following conditions are fulfilled:

   i. a close and factual connection exists, including in temporal terms, between the professional activity and the provision of the investment service to the same client, such that the investment service is regarded as accessory to the main professional activity; and

   ii. the provision of investment services to the clients of the main professional activity does not aim to provide a systematic source of income; and

   iii. the person providing the professional activity does not market or otherwise promote his/her availability to provide investment services, except where these are disclosed to their clients as being accessory to the main professional activity.

2.2. Investment advice and the use of distribution channels

Background/Mandate

Extract from the Commission's request for advice (mandate)

ESMA is invited to provide technical advice on necessary adjustments to the definition of investment advice, in particular on further clarifications with respect to the concept of "personal recommendation" set out in Article 52 of Directive 2006/73/EC, in order to achieve the broadest application of the MiFID II investor protection rules.

1. MiFID I defines investment advice as the provision of personal recommendations to a client, either on request or at the initiative of the investment firm, in respect of one or more transactions relating to financial instruments (Article 4(1)(4)).

2. The MiFID Implementing Directive implements Article 4(1)(4) of MiFID I by specifying the definition of a personal recommendation. In this context, it sets out, inter alia, that *"a recommendation is not a personal recommendation if it is issued exclusively through distribution channels or to the public"* (the MiFID Implementing Directive Article 52, last subparagraph).

3. In its Questions & Answers on "*Understanding the definition of advice under MiFID*"[5], CESR addressed the issue of the meaning of the last subparagraph of Article 52 of the MiFID Implementing Directive. Also in its 2010 technical advice to the Commission in the context of the review of MiFID I, CESR discussed the clarification of the last subparagraph of Article 52.[6]

4. MiFID II confirms the definition of investment advice outlined above in Article 4(1)(4) of MiFID I.

Analysis following feedback from stakeholders

5. A large majority of respondents agreed with ESMA's draft technical advice. These respondents noted that the suggested modification of Article 52 of the MiFID Implementing Directive would clarify that investment advice can be performed through distribution channels in certain circumstances.

6. A minority of respondents did not support ESMA's draft technical advice. These respondents noted that the type of communication channel used to communicate information to clients should not be the only criterion to determine if that information is a personal recommendation or not.

[5] CESR/10-293.
[6] CESR/10-859.

7. Several respondents suggested that the final technical advice clarifies that issuing a recommendation exclusively through a distribution channel to a wide group is an indication that the recommendation is not a personal recommendation. Some respondents also suggested that the final technical advice gives guidance with respect to the circumstances under which an investment recommendation provided through internet based channels should or should not be regarded as investment advice.

8. ESMA does not consider that issuing a recommendation exclusively through a distribution channel to a wide group is necessarily an indication that the recommendation is not a personal recommendation. The circumstances of such a case should be assessed before reaching this conclusion. ESMA confirms its draft technical advice and takes note of the suggestion made and considers that the area of advice through internet based channels may certainly deserve attention in the next future (guidelines or other "Level 3" work).

Technical advice

1. The content of Article 52 of the MiFID Implementing Directive should be confirmed except for the reference to the words *"through distribution channels or"*, which should be removed.

2.3. Compliance function

Background/Mandate

Extract from the Commission's request for advice (mandate)

ESMA is invited to consider and provide technical advice on any necessary updates or improvements to provisions set out in sections I and II of Chapter II of the MiFID I Commission Directive 2006/73/EC in light of the new framework and of the objective to set out an improved framework for effective organisational requirements. In particular, ESMA is invited to provide technical advice on further requirements with respect to the compliance function and to complaints handling aiming at better safeguarding clients' rights and more effective complaints management policies.

1. The relevant provisions in MiFID II are:

   Article 16(2):

   "An investment firm shall establish adequate policies and procedures sufficient to ensure compliance of the firm including its managers, employees and tied agents with its obligations under this Directive as well as appropriate rules governing personal transactions by such persons".

2. The existing compliance provisions of the MiFID Implementing Directive, included in Article 6, are primarily focused on the responsibilities of the compliance function to monitor the policies and procedures in place and to advise relevant persons in the firm. Furthermore, the MiFID Implementing Directive covers the means necessary for the compliance function to fulfil its responsibilities (including having the necessary authority, resources, expertise, access to information), the prohibition of the compliance function being involved in the services they monitor and the ability of the compliance function to act objectively. Article 6 also makes clear reference to the principle of proportionality, stating that in establishing a compliance function investment firms should take into account the nature, scale and complexity of the business of the firm, and the nature and range of investment services and activities undertaken in the course of that business.

3. In September 2012, ESMA published *"Guidelines on certain aspects of the MiFID compliance function requirements"*[7] (compliance guidelines). These guidelines focus on the responsibilities of the compliance function and increasing the effectiveness, and importance, of the compliance function. They specifically focus on:

   i. the responsibilities of the compliance function for monitoring, reporting and advising;

[7] ESMA/2012/388.

ii. the organisational requirements of the compliance function for the standards of effectiveness, permanence and independence;

iii. the extent of interaction of the compliance function with other functions;

iv. outsourcing of the tasks of the compliance function; and

v. approaches for national competent authority (NCA) review of compliance function requirements.

Analysis following feedback from stakeholders

4. A majority of respondents agreed with ESMA's proposals. Many of these respondents noted that including in the MiFID II implementing measures some of the principles set out in the compliance guidelines will give firms more legal certainty as to what is expected from them. Others, while supporting the proposals, wondered about the right level of details of the implementing legislation on this topic. A few of them also suggested that ESMA clarifies, in due time, the interaction between reinforced MiFID II implementing measures and the compliance guidelines. Once MiFID II implementing measures are adopted ESMA will consider the interaction with existing guidelines.

5. A few respondents expressed concerns with respect to ESMA's proposals arguing that 'upgrading' guidelines into the MiFID II Implementing measures was not appropriate and noticed that guidelines, as opposed to delegated acts which are statutory, allow the possibility for NCAs not to comply with them. ESMA notes that all NCAs have declared compliance with the compliance guidelines and therefore considers that the suggested amendments to the current text of the MiFID Implementing Directive does not add an additional burden to the approach already adopted across the EU.

6. A minority of respondents did not support ESMA's proposals and noted that the current regime is satisfactory and should not be modified considering that Article 16(2) of MiFID II is an exact recast of Article 13(2) of MiFID I. ESMA considers that strengthening the current requirements with some of the key principles contained in the compliance guidelines is fully consistent with the objective to harmonise the EU regulatory framework and give further certainty to the market as to the requirements applicable.

7. Several respondents noted that requirement for firms to maintain a *"permanent"* compliance function was not proportionate. ESMA notes that this requirement has been extracted from the compliance guidelines (general guidelines 6) and considers that the feedback statement of those compliance guidelines (paragraphs 50 and 51) as well as the supporting guidelines of general guideline 6 clarifies the practical implications of maintaining a compliance function on a *"permanent"* basis. More specifically, this implies that investment firms should establish adequate arrangements to ensure that the responsibilities of the compliance officer are fulfilled when the compliance officer is absent, and adequate arrangements to ensure that the responsibilities of the compliance function are performed on an ongoing basis.

8. A number of respondents suggested that the final technical advice clarifies that the monitoring of complaints handling should be taken in consideration when establishing the monitoring program referred to in paragraph 4 of the draft technical advice. The technical advice has been amended accordingly.

9. Several respondents also suggested few changes in the draft technical advice such as substituting *"effectiveness"* with *"efficiency"* (paragraph 3(i) of the draft technical advice) and *"comprehensively"* with *"adequately"* (paragraph 4). ESMA notes that the language proposed is already in use in the context of the ESMA compliance guidelines and has not raised any specific issue.

10. A majority of respondents did not suggest any additional MiFID II Implementing measures other than the proposals developed in the draft technical advice. Several respondents suggested however that the advisory aspects of the compliance function be given a more prominent role in the final technical advice. ESMA has not made amendments in this regard as it feels that the advice is already sufficiently clear and balanced on the topic of the overall role and responsibilities of the compliance function.

Technical advice

1. ESMA considers that Article 6 of the MiFID Implementing Directive should be integrated and modified as set out below.

2. Investment firms shall establish, implement and maintain adequate policies and procedures designed to detect any risk of failure by the firm to comply with its obligations under MiFID II, as well as the associated risks, and put in place adequate measures and procedures designed to minimise such risks and to enable NCAs to exercise their powers effectively under that Directive. For those purposes, investment firms should take into account the nature, scale and complexity of the business of the firm, and the nature and range of investment services and activities undertaken in the course of that business.

3. Investment firms shall establish and maintain a permanent and effective compliance function that operates independently and that has the following responsibilities:

    i. to monitor on a permanent basis and to assess, on a regular basis, the adequacy and effectiveness of the measures and procedures put in place in accordance with subparagraph 1 of Article 6(1) of the MiFID Implementing Directive, and the actions taken to address any deficiencies in the firm's compliance with its obligations;

    ii. to advise and assist the relevant persons responsible for carrying out investment services and activities to comply with the firm's obligations under MiFID II;

    iii. to report to the management body, at least annually, on the implementation and effectiveness of the overall control environment for investment services and activities, on the

risks that have been identified and on the complaints-handling reporting as well as remedies undertaken or to be undertaken; and

iv. to monitor the operations of the complaints-handling process and consider complaints as a source of relevant information in the context of its general monitoring responsibilities.

4. In order to comply with points (i) and (ii) of the previous paragraph, the compliance function should conduct an assessment. On the basis of such an assessment, the compliance function must establish a risk-based monitoring programme that takes into consideration all areas of the investment firm's investment services, activities and any relevant ancillary services, including relevant information gathered in relation to the monitoring of complaints handling. The monitoring programme should establish priorities determined by the compliance risk assessment ensuring that compliance risk is comprehensively monitored.

5. In order to enable the compliance function to discharge its responsibilities properly and independently, investment firms should ensure that the following conditions are satisfied:

   i. the compliance function must have the necessary authority, resources, expertise and access to all relevant information;

   ii. the compliance officer must be appointed and replaced by the management body and must be responsible for the compliance function and for any reporting required by MiFID II;

   iii. the compliance function must be enabled to report on an ad-hoc basis directly to the management body whenever it has detected a significant risk of failure by the firm to comply with its obligations under MiFID II;

   iv. the relevant persons involved in the compliance function must not be involved in the performance of services or activities they monitor; and

   v. the method of determining the remuneration of the relevant persons involved in the compliance function must not compromise their objectivity and must not be likely to do so.

6. However, an investment firm shall not be required to comply with point (iv) or point (v) of the previous paragraph if it is able to demonstrate that in view of the nature, scale and complexity of its business, and the nature and range of investment services and activities, the requirement under that point is not proportionate and that its compliance function continues to be effective. In such case, the investment firm must assess whether the effectiveness of the compliance function is compromised by the proposed arrangements. This assessment must be reviewed on a regular basis.

2.4. Complaints-handling

Background/Mandate

Extract from the Commission's request for advice (mandate)

ESMA is invited to consider and provide technical advice on any necessary updates or improvements to provisions set out in sections I and II of Chapter II of the MiFID I Commission Directive 2006/73/EC in light of the new framework and of the objective to set out an improved framework for effective organisational requirements. In particular, ESMA is invited to provide technical advice on further requirements with respect to the compliance function and to complaints handling aiming at better safeguarding clients' rights and more effective complaints management policies.

1. The relevant provisions in MiFID II are:

   Article 16:

   "(2) An investment firm shall establish adequate policies and procedures sufficient to ensure compliance of the firm including its managers, employees and tied agents with its obligations under this Directive as well as appropriate rules governing personal transactions by such persons.

   Article 75:

   1. Member States shall ensure the setting-up of efficient and effective complaints and redress procedures for the out-of-court settlement of consumer disputes concerning the provision of investment and ancillary services provided by investment firms, using existing bodies where appropriate. Member States shall further ensure that all investment firms adhere to one or more such bodies implementing such complaint and redress procedures.

   2. Member States shall ensure that those bodies actively cooperate with their counterparts in other Member States in the resolution of cross-border disputes.

   3. The competent authorities shall notify ESMA of the complaint and redress procedures referred to in paragraph 1 which are available under its jurisdictions.

   ESMA shall publish and keep up-to-date a list of all extra-judicial mechanisms on its website.

2. Following a review of existing organisational requirements already developed in the MiFID Implementing Directive, ESMA noted that requirements in respect of complaints-handling are of a high level nature.

3. Article 10 of the MiFID Implementing Directive text states:

"Member States shall require investment firms to establish, implement and maintain effective and transparent procedures for the reasonable and prompt handling of complaints received from retail clients or potential retail clients, and to keep a record of each complaint and the measures taken for its resolution".

4. On 13 June 2014, ESMA published a Joint Committee Report on guidelines for handling consumer complaints in the securities and banking sectors (complaints guidelines).[8] The guidelines aim to increase market confidence for the benefit of consumers and firms alike and aim to ensure a harmonised approach to handling complaints for all 28 EU Member States and across all financial services sectors.

5. The G20 high-level principles on financial consumer protection, published in October 2011, specifically stated that:

   "Jurisdictions should ensure that consumers have access to adequate complaints handling and redress mechanisms that are accessible, affordable, independent, fair, accountable, timely and efficient. Such mechanisms should not impose unreasonable cost, delays or burdens on consumers. In accordance with the above, financial services providers and authorised agents should have in place mechanisms for complaint handling and redress".

Analysis following feedback from stakeholders

6. ESMA received a relatively large number of responses on this topic. Most of the responses focused on a number of common concerns. A majority of respondents stated that the complaints-handling requirements should not apply to professional clients as respondents argued that such clients are not in need of such protection. Some of these respondents stated the requirements should not apply to *per se professional clients.* A very small number of respondents also raised concerns with applying the requirements on potential clients. They stated that firms should focus on dealing with complaints from their actual clients and not potential clients. A small number of respondents requested that a definition of a complaint be provided.

7. ESMA considers that in the interests of investor protection the complaints-handling requirements should apply to all clients and not only retail clients. ESMA notes that the complaints guidelines considers a complaint should be defined as a statement of dissatisfaction addressed to a firm by a client or potential client relating to the provision of investment services. This concept can prove useful in the application of proposed requirements.

8. A small number of respondents sought clarity on what was meant by requiring firms to provide *"details"* of the complaints-handling process. Many respondents sought clarity on the requirement to inform the relevant NCA on complaints, they queried whether such infor-

[8] JC 2014 43.

mation needed to be proactively submitted or on request. ESMA considers that firms should send information on complaints on a regular basis to NCAs.

9. ESMA considers that the *"details"* of the complaints-handling process should include the firm's internal procedures for dealing with complaints, the contact details of the relevant person/staff who will be dealing with the complaint. ESMA agrees that greater clarity can be provided in the technical advice to capture such information and has amended the advice accordingly.

10. A small number of respondents stated that they did not support the proposal that required firms to advise complainants of their rights to take civil action. ESMA considers that in order to assist investors to take necessary actions and to ensure that clients/potential clients are aware of their options they should be notified of their right to take further action where the complaint has not been resolved to their satisfaction. In the interests of clarity, ESMA when referring to Alternative Dispute Resolution (ADR) entities, considers that such reference is consistent with the obligation for Member States to establish the setting-up of efficient and effective complaints and redress procedures for the out-of-court settlement of consumer disputes in accordance with Article 75 of MiFID II.

11. A number of respondents queried the role of the compliance function in managing the complaints-handling process. They argued that it would interfere with the independence of the compliance function to be responsible for complaints. Some respondents sought clarity on whether the complaints-handling function needed to be separate from the compliance function. A small number of respondents also stated that they were concerned that requiring the firm's management body to endorse the policy was forcing the firm's board to become involved in something that was outside their usual legal mandate.

12. ESMA considers that in order to ensure that the complaints are handled in an independent manner it is important that a complaints management function is established. Furthermore, ESMA considers that, in order to ensure the effectiveness of the overall control environment, the compliance function should be able to perform this role. ESMA considers that the compliance function is particularly suited to perform these tasks and also notes that allowing the complaints management function to be carried out by the compliance function is, especially for small firms, in line with the general principle of proportionality. Furthermore, ESMA considers that, as clarified in paragraph 3(iv) of its technical advice on the 'compliance function', the compliance function shall consider complaints as a source of relevant information in the context of its general monitoring responsibilities. On the issue of endorsement by the management body, ESMA considers that it is important that this body has clear oversight of how the firm proposes to handle complaints. Furthermore, by requiring such endorsement at this level ESMA aims to ensure that the complaints management policy will be of a high quality and robust nature in order to effectively manage any complaints received.

Technical advice

1. Investment firms shall establish and maintain a complaints management policy for clients or potential clients. The complaints management policy shall provide clear, accurate and up-to-date information about the complaints-handling process. This policy shall be endorsed by the firm's management body.

2. Investment firms shall publish the details of the process to be followed when handling a complaint. Such details shall include information about the complaints management policy and the contact details of the complaints management function. This information shall be provided to clients or potential clients, on request, or when acknowledging a complaint. Clients and potential clients should be able to submit complaints free of charge.

3. Investment firms shall establish a complaints management function which enables complaints to be investigated. This function may be carried out by the compliance function.

4. Investment firms shall communicate to clients in plain language that is clearly understood and provide a response to the complaint without any unnecessary delay.

5. Investment firms shall explain to the client or potential client the firm's position on the complaint and set out the client's or potential client's options, where relevant, that they may be able to refer the complaint to an Alternative Dispute Resolution (ADR) entity or that the client may be able to take civil action.

6. Investment firms shall provide information on complaints and complaints-handling to the relevant NCA and where applicable under national law, an ADR entity.

7. Investment firms' compliance functions shall analyse complaints and complaints-handling data to ensure that they identify and address any risks or issues.

2.5. Record-keeping (other than recording of telephone conversations or other electronic communications)

Background/Mandate

Extract from the Commission's request for advice (mandate)

ESMA is invited to provide technical advice on any possible improvements to the current record-keeping obligations, and in particular whether there is a need for any further details on possible arrangements to be established by firms in order to efficiently comply with record-keeping requirements or for a more harmonised approach with respect to the list of minimum records that investment firms are required to keep under the Directive.

1. The relevant provision in MiFID II is Article 16(6):

   "An investment firm shall arrange for records to be kept of all services, activities and transactions undertaken by it which shall be sufficient to enable the competent authority to fulfil its supervisory tasks and to perform the enforcement actions under this Directive, Regulation (EU) No 600/2014, Directive 2014/57/EU and Regulation (EU) No 596/2014, and in particular to ascertain that the investment firm has complied with all obligations including those with respect to clients or potential clients and to the integrity of the market".

Analysis following feedback from stakeholders

2. MIFID II does not make any substantial changes to MiFID I in respect of general record-keeping obligations, other than emphasising that records should enable NCAs to fulfill supervisory tasks and perform enforcement actions under MiFID II and MiFIR as well as under the Market Abuse Directive (MAD)[9] and Regulation (MAR).[10] MiFID II also adds an explicit reference to market integrity in this record-keeping context.

3. ESMA notes that some record-keeping requirements already exist both at Level 2 in the MiFID Implementing Directive and the MiFID Implementing Regulation and at Level 3 which provide for a significant number of record-keeping requirements, as listed below:

   i. Article 7 of the MiFID Implementing Regulation sets out requirements in relation to record-keeping of client orders and decisions to deal and the details that an investment firm shall record, in relation to every order received from a client, and in relation to every decision to deal taken in providing the service of portfolio management;

[9] Directive 2014/57/EU of the European Parliament and of the Council of 16 April 2014 on criminal sanctions for market abuse (market abuse directive).
[10] Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse (market abuse regulation).

ii. Article 8 of the MiFID Implementing Regulation sets out requirements in relation to record-keeping of transactions and the details that an investment firm shall record in relation to the execution of a client order or the transmission of the order to another person for execution;

iii. Article 51(1) of the MiFID Implementing Directive requires that investment firms retain all the records required by MiFID I and its implementing measures for a period of five years. Additionally, Article 51(1) also requires that records in relation to an agreement between an investment firm and its client be retained for at least for the duration of the relationship with the client.

iv. Article 51(2) provides for requirements concerning the medium, the form and the manner in which records should be retained are also provided for; and

v. Article 51(3) of the MiFID Implementing Directive requires that NCAs draw up and maintain a list of the minimum records investment firms are required to keep under MiFID and its implementing measures. In 2007, CESR issued Level 3 recommendations (CESR Recommendations) that list the minimum records that NCAs need to draw up according to Article 51(3) of the MiFID Implementing Directive.

4. In light of the above, ESMA considers that the provisions of Article 51(1) of the MiFID Implementing Directive should be confirmed in the implementing measures of MiFID II.

5. However, ESMA sees benefits in amending Article 7 and 8 of the Implementing Regulation and Article 51(2) and (3) of the MiFID Implementing Directive. The changes to Article 7 and 8 are set out in the Technical Advice. Article 7 shall set the information and details investment firm shall keep and record in relation to any initial client order or decision to deal taken in providing the service of portfolio management as well as orders originated from the activity of dealing for own account. Article 8 shall set the information and details investment firms shall keep and record in relation to the processing of any transaction or client order and decision to deal irrespective they lead to a transaction or not. In respect to Article 51(3), ESMA is of the view that introducing a non-exhaustive list of records (Table) principally based on the 2007 CESR Recommendations (MiFID Level 1 and Level 2) into the MiFID II implementing measures may benefit stakeholders and foster convergence across the EU.

6. Respondents raised a number of concerns relating to the draft proposals, mainly related to the scope of the Table and the ability of NCAs and ESMA to introduce additional records. Respondents argued that the Table should be exhaustive. They argued that by allowing NCAs to set additional records, there would be legal uncertainty regarding which records would be required in different Member States and therefore create potential for regulatory arbitrage. Other respondents argued that there was no need for additional records and what was proposed by ESMA was sufficient.

7. Considering that record-keeping obligations are by nature linked to any activity carried out by a firm and need to reflect any future evolution in the regulatory framework, in order to en-

sure flexibility and the ability to require the recording of activities and situations which may not have emerged so far, ESMA considers that the list included in the table should remain non-exhaustive and NCAs should continue to be able to add additional records to the list above where there is a need under MiFID II. Therefore, the table not a complete statement of record keeping requirements and it should not be relied on as if it were. In addition, ESMA could be required to adopt and update guidelines in order to specify the exact content and the timing for each record and to add new records in the future.

8. ESMA considers that the proposed Table should not include policies and procedures that investment firms are required to keep under MiFID II and its implementing measures (such as, order execution policy, conflict of interest policy, client order handling policy, order placing and transmitting policy, compliance policy and procedures, conflicts of interest policy, remuneration policy and procedures, complaints handling policy and procedures, outsourcing policy and procedures and personal transactions policy and procedures. The Commission will be able to decide whether to include such policies and procedures in the Table.

9. Some respondents stated that the recording obligations of investment advice should be consistent with the suitability guidelines and that the Table should also encompass suitability reports. ESMA agrees that there should be consistency with related obligations and has amended the Table to clarify this point.

10. Some respondents queried whether the requirement to maintain such records would only apply to records created after the implementation of MIFID II. ESMA confirms that the relevant MiFID II provisions will apply from 3 January 2017. However, ESMA notes that the Table presented in the draft technical advice was principally based on the existing CESR list of minimum records issued in February 2007 as a Level 3 Recommendation. Therefore several of the mentioned records would have originated from comparable provisions of MiFID I which are already in place.

11. In this regard, ESMA acknowledges that the revised record-keeping requirement now widens the obligations to MIFIR and MAD; however the Table included in the Technical Advice is only restricted to records required under MiFID II. The records to be kept under MiFIR, MAD and MAR have not been included in the Table.

12. ESMA notes that it is also developing RTS under MiFID II which will include some record-keeping obligations for firms. ESMA is of the view that in light of the difference in timing of the publication of the RTS and the Technical Advice, it would be inappropriate to include the exact content of these RTS in the Technical Advice. ESMA would like to highlight to the Commission that it may wish to include the record-keeping requirements introduced by the RTS in the Table and that the Table may need to be updated accordingly. The Commission may need to ensure that the Level 2 wording aligns with the final RTS wording. To ensure that a consistent taxonomy is achieved between the changes to Art 7 and 8 and the RTS, ESMA has used the same wording as proposed in the RTS. ESMA would like to highlight to the European Commission that it may wish to ensure that the final RTS and Article 7 and 8 align.

13. Some respondents raised issues with the proposal to include the requirement that firms must maintain records in electronic format and the difficulties that this proposal may pose. ESMA notes that its technical advice clearly mentions the relevance of the nature of records in considering the obligation to maintain them in electronic format when appropriate, in particular where the analysis of the data cannot be easily carried out without IT resources.

Technical Advice

1. Article 7 of the MiFID Implementing Regulation should be replaced by the following provision. The additions/amendments proposed are marked in bold; the elements in italics are the ones already requested under the current MiFID Implementing Regulation 1287/2006.

Record keeping of client client orders and decision to deal

An investment firm shall keep in relation to every **initial** *order received from a client and in relation to every* **initial** *decision to deal taken ~~in providing the service of portfolio management~~, to the extent they are applicable to the order or decision to deal in question, immediately record and keep at the disposal of the competent authority at least the following details:*

a. name and designation of the client;

b. name and designation of any relevant person acting on behalf of the client;

c. a designation to identify the Trader (Trader ID) responsible within the investment firm for the investment decision;

d. a designation to identify the Algo (Algo ID) responsible within the investment firm for the investment decision;

e. B/S indicator;

f. instrument identification

g. unit price and price notation;

h. price

i. price multiplier

j. Currency 1

k. Currency 2

l. **initial** *quantity and quantity notation;*

m. **validity period**

n. type of the order;

o. any other details, conditions and particular instructions from the client;

p. *the date and exact time of the receipt of the order or* **the date and exact time** *of* ***when*** *the decision to deal* **was made***.* **The exact time must be measured according to the methodology prescribed under the RTS on clock synchronisation (Article 50(2) MiFID II).**

Where the details specified in the points above are also prescribed under Article 25 and 26 MiFIR, these details should be maintained in a consistent way and according to the same standards prescribed under Articles 25 and 26 MiFIR."

2. Article 8 of the MiFID Implementing Regulation should be replaced by the following provision. The additions/amendments proposed are marked in bold; the elements in italics are the ones already requested under the current MiFID Implementing Regulation.

Record keeping of transactions and order processing

An investment firm shall immediately after receiving a client order or making a decision to deal to the extent they are applicable to the order or decision to deal in question, record and keep at the disposal of the competent authority at least the following details:

a. name and designation of the client;

b. name and designation of any relevant person acting on behalf of the client;

c. a designation to identify the Trader (Trader ID) responsible within the investment firm for the investment decision;

d. a designation to identify the Algo (Algo ID) responsible within the investment firm for the investment decision;

e. Transaction reference number

f. a designation to identify the order (Order ID);

g. the identification code of the order assigned by the trading venue upon receipt of the order;

h. a unique identification for each group of aggregated clients' orders (which will be subsequently placed as one block order on a given trading venue). This identification should indicated "aggregated_X" with X representing

the number of clients whose orders have been aggregated.

i. **the segment MIC code of the trading venue to which the order has been submitted.**

j. *the name and other designation of the person to whom the order was transmitted*

k. **Designation to identify the Seller & the buyer**

l. **the trading capacity**

m. **a designation to identify the Trader (Trader ID) responsible for the execution;**

n. **a designation to identify the Algo (Algo ID) responsible for the execution**

o. *B/S indicator;*

p. *instrument identification*

q. **Ultimate underlying**

r. **Put/Call identifier**

s. **Strike price**

t. **Up-front payment**

u. **Delivery type**

v. **Option style**

w. **Maturity date**

x. *unit price and price notation;*

y. **price**

z. **price multiplier**

aa. **Currency 1**

bb. **Currency 2**

cc. **remaining quantity**

dd. **modified quantity**

ee. **executed quantity**

ff. **the date and exact time of submission of the order or decision to deal. The exact time must be measured according to the methodology prescribed under the RTS on clock synchronisation (Article 50.2 MiFID II).**

gg. the date and exact time of any message that is transmitted to and received from the trading venue in relation to any events affecting an order. The exact time must be measured according to the methodology prescribed under the RTS on clock synchronisation.

hh. the date and exact time any message that is transmitted to and received from another investment firm in relation to any events affecting an order. The exact time must be measured according to the methodology prescribed under the RTS on clock synchronisation.

ii. Any message that is transmitted to and received from the trading venue in relation to orders placed by the investment firm

jj. Any other details and conditions that was submitted to and received from another investment firm in relation with the order

kk. Each placed order's sequences in order to reflect the chronology of every event affecting it, including but not limited to modifications, cancellations and execution;

ll. Short selling flag

mm. SSR exemption flag

nn. Waiver flag

Where the details specified in the points above are also prescribed under Article 25 and 26 MiFIR, these details should be maintained in a consistent way and according to the same standards prescribed under Articles 25 and 26 MiFIR."

3. Article 51(1) of the MiFID Implementing Directive should be confirmed.

4. Article 51(2) of the MIFID Implementing Directive should be amended as follows. The additions/amendments proposed are marked in bold; the elements in italics are the ones already requested under the current MiFID Implementing Directive.

The records shall be retained in a medium that allows the storage of information in a way accessible for future reference by the competent authority, and in such a form and man-

ner that ~~the following conditions are met~~:

a) the competent *authority must be able to access them readily and to reconstitute each state of the processing of each transaction;*

b) it must be possible for any corrections or other amendments and the contents of the records prior to such correction or amendments, to be easily ascertained;

c) it must not be possible for the records otherwise to be manipulated or altered;

d) **it must allow IT or any other efficient exploitation when the analysis of the data cannot be easily carried out due to the volume and the nature of the data; and**

e) investment firms must ensure that the arrangements comply with the record keeping requirements irrespective of the technology used.

5. Article 51(3) of the MiFID Implementing Directive should be replaced by the following provisions.

Investment firms should keep at least the records identified in the table below depending upon the nature of their activities. The list of records identified in the table below shall not be exhaustive and should not be understood as a limitation of the scope of MiFID II, MiFIR, MAD and MAR and the respective implementing measures. The list should be without prejudice to any other record-keeping obligations arising from other legislation. Investment firms should keep any policies and procedures they are required to maintain pursuant to MiFID II, MIFIR, MAD and MAR and the respective implementing measures in writing. These policies and procedures are not included in the table below.

NCAs should be able to require investment firms to keep additional records to the list below.

ESMA may publish and update guidelines specifying the detailed content and the timing of the records specified in the table below and may provide for additional records. The following table sets out the types of records investment firms should be obliged to keep depending upon the nature of their activities:

Nature of obligation	**Type of record**	**Summary of content**	**Legislative reference**
Client assessment			

		Client categorisation	Contents as provided for under Article 24 (4) MIFID II	Article 24 (4) MIFID II Article 28 of the MiFID Implementing Directive
		Client agreements	Records as provided for under Article 25(5) of MiFID II	Article 25(5) MIFID II Article 39 of the MiFID Implementing Directive
		Assessment of suitability and appropriateness	Content as provided for under Article 25(2) and 25(3) of MiFID II and Articles 35, 36 and 37 of the MiFID Implementing Directive	Article 25(2) and 25(3) MIFID II Articles 35, 36 and 37 of the MiFID Implementing Directive
	Order handling			
		Client order-handling - Aggregated transactions	Records as provided for under Article 48 of the MiFID Implementing Directive	Articles 24(1) and 28(1) MIFID II Article 48 of the MiFID Implementing Directive
		Aggregation and allocation of transactions for own account	Records as provided for under Art 48 and 49 of the MiFID Implementing Directive	Article 24 and Article 28 MiFID II Article 48 and 49 of the MiFID Implementing Di-

			rective
Client Orders and transactions			
	Record keeping of client orders or decision to deal	Records as provided for under Article 7 of the MiFID Implementing Regulation.	Article 16(6) MIFID II Article 7 of the MiFID Implementing Regulation
	Record keeping of transactions and order processing	Records as provided for under Article 8 of the MiFID Implementing Regulation.	Article 16(6) MIFID II Article 8(1) and 8(2) of the MiFID Implementing Regulation
Reporting to clients			
	Obligation in respect of services provided to clients	Contents as provided for under Article 40 to 43 of the MiFID Implementing Directive	Article 24(4) MIFID II Article 40 to 43 of the MiFID Implementing Directive
Safeguarding of client assets			
	Client financial instruments held by an investment firm	Records as provided for under Article 16(8) of MiFID II and under Article 16 of the MiFID Implementing Directive	Article 16(8) MiFID II Article 16 of the MiFID Implementing Directive

		Client funds held by an investment firm	Records as provided for under Article 16(9) of MiFID II and under Article 16 of the MiFID Implementing Directive	Article 16(9) MiFID II Article 16 of the MiFID Implementing Directive
		Use of client financial instruments	Records provided for under Article 19 of the MiFID Implementing Directive	Article 16(8) to (10) MIFID II Article 19 of the MiFID Implementing Directive
	Communication with clients			
		Information about Costs and associated charges	Contents as provided for under Article 33 of the MiFID Implementing Directive	Article 24(4)(c) MIFID II Article 33 of the MiFID Implementing Directive
		Information about the investment firm and its services, financial instruments and safeguarding of client assets	Content as provided for under Articles 30, 31 and 32 of the MiFID Implementing Directive	Art 24 (4) MIFID II Articles 30, 31 and 32 of the MiFID Implementing Directive
		Information to clients	Records of communication	Article 24(3) MIFID II Article 27 of the MiFID Implementing Directive

		Marketing communications (except in oral form)	Each marketing communication issued by the investment firm (except in oral form) as provided under Article 24(2) of the MiFID Implementing Directive	Article 24(3) MIFID II Article 24(2) of the MiFID Implementing Directive
		Investment advice to retail clients	(i) The fact, time and date that investment advice was rendered and (ii) the financial instrument that was recommended (iii) the suitability report provided to the client	Article 25(6) MiFID II
		Investment research	Each item of investment research issued by the investment firm in a durable medium	Article 24(3) MIFID II Article 24(1) of the MiFID Implementing Directive
	Organisational requirements			
		The firm's business and internal organisation	Records as provided for under Article 5(1)(f) of the MiFID Implementing Directive.	Article 16(2) to (10) MIFID II Article 5(1)(f) of the MiFID Implementing Directive
		Compliance reports	Each compliance report to management body	Art 16 (2) MIFID II Articles 6(3)(b) and 9(2) of the MiFID Implementing Di-

			rective
	Conflict of Interest record	Records as provided for under Article 23 of the MiFID Implementing Directive.	Article 16 (3) of MIFID II Article 23 of the MiFID Implementing Directive
	Inducements	The information disclosed to clients under Article 24(9) of MiFID II.	Article 24(9) of MiFID II Article 26 of the MiFID Implementing Directive
	Risk management reports	Each risk management report to senior management	Article 16(4) MIFID II Articles 7(2)(b) and 9(2) of the MiFID Implementing Directive.
	Internal audit reports	Each internal audit report to senior management	Article 16(5) MIFID II Articles 8(d) and 9(2) of the MiFID Implementing Directive
	Complaints-handling records	Each complaint and the complaint handling measures taken to address the complaint	Article 16(2) MIFID II Article 10 of the MiFID Implementing Directive.

		Records of personal transactions	Records as provided for under Article 12(2)(c) of the MiFID Implementing Directive	Article 16(2) of MIFID II Article 12(2)(c) of the MiFID Implementing Directive.	

2.6. Recording of telephone conversations and electronic communications

Background/Mandate

Extract from the Commission's request for advice (mandate)

ESMA is invited to provide technical advice on the effective organisational requirements that firms need to establish, implement and maintain in order to ensure full compliance with the telephone recording and electronic communications requirements, having in mind the importance of such records which may constitute crucial, and sometimes the only, evidence to demonstrate the development of firm-client relationships and to verify compliance by firms with their obligations under MiFID II as well as to detect and prove the existence of market abuse. Such organisational requirements should address the possible involvement of the management body and the compliance function, the storage requirements, including providing legal clarity on the beginning of the period of time for the records retention.

1. The relevant provisions in MiFID II are:

   Article 16(7):

   "Records shall include the recording of telephone conversations or electronic communications relating to, at least, transactions concluded when dealing on own account and the provision of client order services that relate to the reception, transmission and execution of client orders.

   Such telephone conversations and electronic communications shall also include those that are intended to result in transactions concluded when dealing on own account or in the provision of client order services that relate to the reception, transmission and execution of client orders, even if those conversations or communications do not result in the conclusion of such transactions or in the provision of client order services.

   For those purposes, an investment firm shall take all reasonable steps to record relevant telephone conversations and electronic communications, made with, sent from or received by equipment provided by the investment firm to an employee or contractor or the use of which by an employee or contractor has been accepted or permitted by the investment firm.

   An investment firm shall notify new and existing clients that telephone communications or conversations between the investment firm and its clients that result or may result in transactions will be recorded.

   Such a notification may be made once, before the provision of investment services to new and existing clients.

   An investment firm shall not provide, by telephone, investment services and activities to clients who have not been notified in advance about the recording of their telephone commu-

nications or conversations, where such investment services and activities relate to the reception, transmission and execution of client orders.

Orders may be placed by clients through other channels, however such communications must be made in a durable medium such as mails, faxes, emails or documentation of client orders made at meetings. In particular, the content of relevant face-to-face conversations with a client may be recorded by using written minutes or notes. Such orders shall be considered equivalent to orders received by telephone.

An investment firm shall take all reasonable steps to prevent an employee or contractor from making, sending or receiving relevant telephone conversations and electronic communications on privately-owned equipment which the investment firm is unable to record or copy.

The records kept in accordance with this paragraph shall be provided to the client involved upon request and shall be kept for a period of five years and, where requested by the competent authority, for a period of up to seven years".

2. On 29 July 2010, CESR delivered technical advice to the Commission on investor protection and intermediaries issues as part of MiFID Review process.[11] The advice of most CESR members was that the existing discretion in Article 51(4) of the MiFID Implementing Directive should be replaced by a minimum harmonisation recording obligation in relation to records of telephone conversations and electronic communications. Those CESR members considered that such a regime would be an important step forward in terms of certainty, investor protection and deterrence of market abuse. The rationale for introducing the requirements was as follows:

   i. to help deter and detect market abuse and to facilitate enforcement in this area. Records can provide additional material about the facts of a case that may not be available through other sources (such as documents and oral testimony). In particular, recordings often help to show the intention behind trading and the knowledge of the person at the point at which they trade, which are matters that are often not easily established, but may be crucial in a successful enforcement case;

   ii. to assist the NCA in assessing an investment firms' on-going compliance with conduct of business obligations and, in particular, with the requirements in MiFID on information to clients and potential clients, on best execution and on client order-handling; and

   iii. to ensure that there is evidence to resolve disputes between an investment firm and its clients over the terms of transactions, being in some cases the sole evidence to be relied on in the event of a dispute.

[11] CESR/10-975.

Analysis following feedback from stakeholders

Controls and oversight

3. In its draft technical advice, ESMA proposed internal control and oversight arrangements to ensure compliance with MiFID II requirements on recording of telephone conversations and electronic communications. The majority of respondents did not oppose the control and oversight measures proposed and considered that additional measures were not required to reduce the risk of non-compliance with requirements in this area. However, some respondents asked that ESMA include some provisions to address the MIFID II notification requirement to clients that calls are being recorded. ESMA agrees, and has proposed an additional requirement in the revised technical advice.

4. On the MiFID II requirement to notify clients that the call is being recorded, the SMSG noted that there *"is no provision on the language requirement when the notification is made before each call, which by the way is the best system in terms of informing clients and protecting private life"*. They went on to state that *"for investments firms which have a large international client base, or to make it simpler who describe themselves as being in the private banking sector, the notification requirement is satisfied when the notification is made in the language of the majority of the clients as well as in English. A notification in all languages spoken by the clients of the investment firms would be burdensome and excessive. An indication that a notification in two languages is sufficient would create legal certainty for these firms"*. ESMA notes the SMSG comments on the language requirements of the notification to clients and confirms that the notification provided to clients should be provided in line with technical advice on the requirements for information to be fair, clear and not misleading. This advice proposes that information to clients shall be consistently presented in the same language throughout all forms of information and marketing materials that are provided to each client.

5. A number of respondents expressed views on the explanations provided by ESMA in the "Analysis" section of the CP on the types of telephone conversations and electronic communications. In the "analysis" section of the CP, ESMA also noted that, taking into account MiFID II, some internal calls should be subject to the recording requirement, notably where the internal call in question "relates to or is intended to result in transactions" in the provision of investment services subject to the telephone recording obligation. This view aligns with Recital 57 of MiFID II which sets out that: "such records should ensure that there is evidence to prove the terms of any orders given by clients and its correspondence with transactions executed by the investment firms, as well as to detect any behaviour that may have relevance in terms of market abuse, including when firms deal on own account". A number of respondents stated that the proposals would be too onerous. These respondents also stated that the requirements went beyond MiFID II as they considered that Article 16(7) meant that only conversations relating to the "concrete" order should be recorded and that there was no need to record internal calls. Other respondents stated that the ESMA advice is not clear on this aspect. ESMA considers that in order to meet the obligations established under MiFID II and to ensure that there are no gaps in the continuity of the relevant conver-

sations, internal calls that result or may result in the transactions must be recorded. ESMA has amended the advice to clarify this.

6. ESMA also noted in the explanatory analysis of the CP that the recording rules do not apply to the service of investment advice, but clarified that conversations and communications will need to be recorded when they result or may result in the provision of the services of reception and transmission of orders, execution of orders on behalf of clients and dealing on own account. A number of respondents commented on the coverage of investment advice under the telephone and electronic recording obligations. Some (especially consumers' representatives) stated that by not explicitly requesting the recording of investment advice ESMA was not considering the general duty to keep records of all services. Others (from industry) mentioned that ESMA's view was vague and, considering that conversations with clients may take place over a period of time and via various mediums, it would be potentially very broad. ESMA confirms that the general record-keeping obligations apply, in accordance with Article 16(6) of MiFID II, to all services and activities provided. However the specific obligation regulated under Article 16(7) applies to telephone conversations or electronic communications relating to transactions concluded (and conversations and communications that are intended to result in the conclusion of transactions) when dealing on own account and the provision of client order services that relate to the reception, transmission and execution of client orders. However, ESMA wishes to clarify that, while the provision of investment advice is not subject to these obligations, conversations and communications that result or may result in the provision of the services mentioned above are, and by virtue of this, may include investment advice.

7. A large number of respondents (investment firms and trade associations) stated that ESMA should clarify that firms should be allowed to prevent client orders from being received by telephone conversation (in order to avoid costly recording and storage fees). ESMA considers that the choice whether to provide investment services via telephone that is a commercial decision for each firm to make and should not be part of the technical advice. ESMA also notes, that if a firm chooses to operate this business model, it must have in place arrangements to ensure that any conversations and communications which are subject to the recording requirement are appropriately recorded under these requirements.

8. A small number of respondents requested that clarity be provided that only the receiving firm needed to record the call. ESMA notes this suggestion but it considers that MiFID II is clear on which services are captured by the Article 16(7). ESMA considers that in order to ensure the calls are consistently recorded and to prevent firms from inadvertently neglecting to record calls, the most consistent approach would be to require all firms, even when part of a transaction chain, to record all relevant calls.

9. Another respondent requested clarity on the meaning of the expression "technology neutral" used in the CP. ESMA considers that the requirements should be complied with irrespective of the technology used. In this respect, ESMA considers that it is not useful to provide more details on the technology to be used to record electronic communications since any such detail could quickly become outdated as technology evolves.

10. On the question of monitoring compliance with the recording requirements, the majority of respondents agreed that there should be periodic monitoring of records to ensure compliance with the recording requirements and wider regulatory requirements. However, a large number of respondents sought clarity on what was meant in the technical advice where it stated that firm should "*periodically monitor the records of all transactions…*"; others requested deletion of this sentence. They stated that it was too onerous and costly to require firms to monitor "all transactions", and provided an alternative suggestion that firms monitor transactions based on the firm's risk based monitoring programme established by the compliance officer or on an appropriate samples of records. One respondent (trade association) suggested that periodic monitoring was not suitable and that non-exhaustive quality control should be the aim. A number of respondents suggested that the monitoring could be conducted by external compliance officers or professionals associations. A number of respondents stated that these requirements would mean that the recording of the conversations and the subsequent monitoring of those conversations would mean that employees would feel *"constantly monitored"*. A number of respondents raised concerns with the term "wider regulatory requirements" – respondents argued that the use of this text in paragraph 7 of the advice created legal uncertainly and should be amended.

11. ESMA is of the opinion based on supervisory experience, that it is necessary to include an explicit requirement on firms to monitor their telephone records and electronic communications to ensure compliance with the recording requirements and their wider regulatory requirements. Monitoring of records can identify breaches either through intentional actions or errors. It can be a strong deterrent and useful source of evidence when things go wrong. However, ESMA agrees that firms should adopt a proportionate risk based approach to monitoring such records.

12. A number of respondents also stated their concerns that the recording provisions were in conflict with EU and national data protection frameworks. The European Court of Justice cases on data retention (C-293/12 and C-594/12) were referred to on numerous occasions.

13. The SMSG in its advice to ESMA also raised concerns about ensuring privacy of personal information about employee and referred to the E-Privacy Directive and the Data Protection Directive. They stated that "these legislations do not prevent the recording of telephone conversations and electronic communications, but do limit the circumstances in which recordings can be made and place necessary safeguards around the handling of the recordings".

14. The SMSG stated that it "would like to draw the attention of ESMA on the need for investment firms to ensure the privacy of the employee while at the same time being compliant with the MiFID recording obligations". The SMSG stated that "it is also aware that sometimes a recorded transaction takes more than one hour, but the real transaction takes only 1-2 minutes in this hour phase. This creates additional costs for investments firms and, although, this is unavoidable since it is required by MiFID II, ESMA should keep in mind this concern."

15. ESMA acknowledges these concerns but notes that the recording obligation has been introduced and regulated in MiFID II.

Face-to-face conversations

16. Article 16(7) subparagraph 7 of MiFID II provides for the provision of orders through other channels. Communications made by *"other channels"* must be in a durable medium, and include the documentation of client orders made at meetings. The content of relevant face-to-face conversations with a client may be recorded by using written minutes or notes. ESMA proposed that where relevant face-to-face conversations taking place with clients in respect of the client order services listed in Article 16(7) subparagraph 1 of MiFID II, firms are required to document the content of these conversations. ESMA proposed to set out the minimum required information.

17. A large number of respondents (investment firms and trade associations) did not propose any additional information to the list proposed by ESMA. However, several respondents also stated that the ESMA proposal went beyond MiFID II as far as it requires *"minutes of meetings"* which, in MiFID II, are optional and can be replaced by other form of recording. A number of respondents requested that ESMA provide guidance on what was mean by *"other relevant information about the transaction*". Others stated that this text should be replaced with text stating: details of the order including *"amount and type of instrument*". A number of respondents also stated that the recording of such minutes only applies where according to Article 16(7) orders are *"placed"* and not where conversations may result in transactions. They requested that the text be amended to state that records only be recorded where the conversation has resulted in in *"reception, transmission and execution of an order".* A number of respondents stated that the recording of face-to-face conversations did not need to be provided on a separate document. ESMA notes these comments and has clarified the advice to clearly set out the content and format of the information to be recorded from the face to face meetings and the other relevant information. ESMA notes that such information should not be confused with the requirement to record the content of the advice as set out in the section on record keeping (other than recording of telephone conversations and electronic communications) and in the requirements to have a suitability report.

18. On the issue of whether clients should sign the minutes or notes there was very strong opposition to this requirements. The respondents stated: that it was unprofessional to request clients to sign a copy of internal notes, that clients would have to wait to receive them, that it would unnecessarily pressurise clients into thinking that they were bound to proceed with an order, that it was over-burdensome on firms, and that it made face to face recording unequal to telephone recording. Two respondents (consumer bodies) stated that client should not be required to sign such notes/minutes as it would mean that the liability for mistakes or mis-information was being transferred from the firm to the client (but they suggested that investment firms should hand out minutes or notes to the client and clients should sign only the receipt of that minutes or notes). A small number of respondents supported the requirement. ESMA agrees with the arguments put forward by the consumer bodies and

proposes that the minutes or notes should not be signed as it could undermine investor protection.

Storage and retention

19. On the question on retention and storage a large number of respondents supported ESMA's proposals in this issue. A number of respondents (consumer bodies) stated that the proposals should also require investment firms to inform clients: that services and conversations are being recorded; how the recording is being made; and that a copy of the recording will be available on request for a period of at least five years. A number of respondents queried whether the proposals meant that clients could access their records upon request and proposed instead that there should only be a *"reasonable effort"* requirement on firms to provide such records as they could be costly to locate. ESMA agrees that clients should be notified about the existence of the records and has revised the technical advice to include information regarding such notifications to clients.

20. A number of respondents raised concerns with the term *"accessible"* – respondents argued that greater clarify needed to be provided on what was meant by this word in paragraph 11. ESMA considers a reasonable interpretation of accessible means that the firm should be able to retrieve the records without delay and has slightly amended the advice to reflect this.

21. A large number of respondents also raised concerns with the MiFID II provision which allows a retention period of up to seven years. These respondents stated that ESMA should clarify under what circumstances NCAs can request that such records be held for an additional two years, and that the requirement does not allow NCAs to extend the retention period for all records. ESMA wishes to clarify that extended retention only relate to records relating to telephone records and electronic communications. ESMA considers that it is up to each NCA to determine whether records relating to telephone conversations and electronic communications should be retained for a period of seven years on a case by case basis, in specific circumstances. A number of respondents also stated that that the proposals to be "retained in a format that does not allow the original record to be altered or deleted" goes against the existing MiFID Implementing Directive which currently allows for "corrections" to be easily *"ascertained".* ESMA does not agree and intends to maintain the existing advice as it believes this is important to ensure that the type of records covered under this part of the advice are not tampered with.

Technical advice

Control and oversight

1. Investment firms shall establish, implement and maintain effective organisational arrangements to ensure compliance with the requirements to record telephone conversations and electronic communications.

2. Investment firms shall ensure that the management body has effective oversight and control over the policies and procedures relating to the firm's recording of telephone conversations and electronic communications.

3. Investment firms shall establish, implement and maintain an effective recording of telephone conversations and electronic communications policy, set out in writing, and appropriate to the size and organisation of the firm, and the nature, scale and complexity of its business. The policy shall include the following content:

   i. the identification of the telephone conversations, including relevant internal telephone conversations and electronic communications that are subject to the recording requirements; and

   ii. the specification of the procedures to be followed and measures to be adopted to ensure the firm's compliance with Article 16(7) subparagraph 3 and Article 16(7) subparagraph 8 where exceptional circumstances arise and the firm is unable to record the conversation/communication on devices issued, accepted or permitted by the firm. Evidence of these circumstances must be retained in a medium that is accessible by the NCA.

4. Investment firms shall ensure that the arrangements to comply with recording requirements are technology neutral. Firms must periodically re-evaluate the effectiveness of the firm's measures and procedures and adopt any such alternative or additional measures and procedures as are necessary and appropriate. At a minimum, this shall occur when a new medium of communication is accepted or permitted for use by the firm.

5. Investment firms must keep and regularly update a record of those individuals who have firm devices or privately owned devices that have been approved for use by the firm.

6. Investment firms must educate and train employees in procedures governing the Article 16(7) requirements.

7. Investment firms shall have in place requirements to ensure compliance with the recording and record-keeping requirements in accordance with Article 16(7) and Recital 57 of MiFID II and their wider regulatory requirements. The firm shall periodically monitor the records of transactions and orders subject to these requirements including relevant conversations, to monitor compliance with the regulatory requirements. Such monitoring shall be risk based and proportionate.

8. Investment firms shall be able to demonstrate to the relevant NCA the policies, procedures and management oversight of these recording rules.

Notification to clients

9. Before investment firms provide investment services and activities relating to the reception,

transmission and execution of orders to new and existing clients, firms must inform the client:

i. that the conversations and communications are being recorded; and

ii. that a copy of the recording of these conversations with the client and communications with the client will be available on request for a period of at least five years.

This information shall be consistently presented in the same language(s) as that used to provide investment services to clients.

Face-to-face conversations

10. Investment firms shall record in a durable medium all relevant information related to relevant face-to-face conversations with clients. The information recorded is at the discretion of the firm but must include at least the following:

    i. Date and time of meetings;

    ii. location of meetings;

    iii. identity of the attendees;

    iv. initiator of the meetings; and

    v. relevant information about the client order including the price, volume, type of order and when it shall be transmitted or executed.

Storage

11. Records shall be stored in a durable medium, which allows them to be replayed or copied and must be retained in a format that does not allow the original record to be altered or deleted.

12. In addition, records shall be stored in a medium so that they are readily accessible and available to clients on request.

13. Firms shall ensure the quality, accuracy and completeness of the records of all telephone recordings and electronic communications.

Retention

14. The period of time for the retention of a record begins to run from the date that the record is created.

2.7. Product governance

Background/Mandate

Extract from the Commission's request for technical advice (mandate)

ESMA is invited to provide technical advice on detailed product governance arrangements for investment firms manufacturing and distributing financial instruments (and structured deposits) in order to avoid and reduce, from an early stage, potential risks of failure to comply with investor protection rules. Strengthening the role of the management bodies or of the compliance function, should be duly considered. The technical advice should also specify the obligation for manufactures and distributors to regularly review their product governance policies as well as the products they manufacture, offer or recommend, and refer to any appropriate actions to be taken by manufacturers or distributors.

As these requirements are also relevant for investment firms offering or recommending investment products manufactured by firms which are not captured under MiFID II (non-MiFID entities/third-country firms), ESMA should consider what reasonable steps the distributor should take in order to ensure that investors' interests are similarly protected.

In developing its technical advice, ESMA should ensure there is sufficient clarity regarding the respective obligations of investment firms when acting as manufacturers, distributors or both.

1. The relevant provisions in MiFID II are:

   Recital 71:

   "Member States should ensure that investment firms act in accordance with the best interests of their clients and are able to comply with their obligations under this Directive. Investment firms should accordingly understand the features of the financial instruments offered or recommended and establish and review effective policies and arrangements to identify the category of clients to whom products and services are to be provided. Member States should ensure that the investment firms which manufacture financial instruments ensure that those products are manufactured to meet the needs of an identified target market of end clients within the relevant category of clients, take reasonable steps to ensure that the financial instruments are distributed to the identified target market and periodically review the identification of the target market of and the performance of the products they offer. Investment firms that offer or recommend to clients financial instruments not manufactured by them should also have appropriate arrangements in place to obtain and understand the relevant information concerning the product approval process, including the identified target market and the characteristics of the product they offer or recommend. That obligation should apply without prejudice to any assessment of appropriateness or suitability to be

subsequently carried out by the investment firm in the provision of investment services to each client, on the basis of their personal needs, characteristics and objectives.

In order to ensure that financial instruments will be offered or recommended only when in the interests of the client, investment firms offering or recommending the product manufactured by firms which are not subject to the product governance requirements set out in this Directive or manufactured by third-country firms should also have appropriate arrangements to obtain sufficient information about the financial instruments".

Article 16:

"(3) An investment firm shall maintain and operate effective organisational and administrative arrangements with a view to taking all reasonable steps designed to prevent conflicts of interest as defined in Article 23 from adversely affecting the interests of its clients.

An investment firm which manufactures financial instruments for sale to clients shall maintain, operate and review a process for the approval of each financial instrument and significant adaptations of existing financial instruments before it is marketed or distributed to clients.

The product approval process shall specify an identified target market of end clients within the relevant category of clients for each financial instrument and shall ensure that all relevant risks to such identified target market are assessed and that the intended distribution strategy is consistent with the identified target market.

An investment firm shall also regularly review financial instruments it offers or markets, taking into account any event that could materially affect the potential risk to the identified target market, to assess at least whether the financial instrument remains consistent with the needs of the identified target market and whether the intended distribution strategy remains appropriate.

An investment firm which manufactures financial instruments shall make available to any distributor all appropriate information on the financial instrument and the product approval process, including the identified target market of the financial instrument.

Where an investment firm offers or recommends financial instruments which it does not manufacture, it shall have in place adequate arrangements to obtain the information referred to in the fifth subparagraph and to understand the characteristics and identified target market of each financial instrument.

The policies, processes and arrangements referred to in this paragraph shall be without prejudice to all other requirements under this Directive and Regulation (EU) No .../2014, including those relating to disclosure, suitability or appropriateness, identification and management of conflicts of interests, and inducements".*

Article 24:

"(1) *Member States shall require that, when providing investment services or, where appropriate, ancillary services to clients, an investment firm act honestly, fairly and professionally in accordance with the best interests of its clients and comply, in particular, with the principles set out in this Article and in Article 25.*

(2) Investment firms which manufacture financial instruments for sale to clients shall ensure that those financial instruments are designed to meet the needs of an identified target market of end clients within the relevant category of clients, the strategy for distribution of the financial instruments is compatible with the identified target market, and the investment firm takes reasonable steps to ensure that the financial instrument is distributed to the identified target market.

An investment firm shall understand the financial instruments they offer or recommend, assess the compatibility of the financial instruments with the needs of the clients to whom it provides investment services, also taking account of the identified target market of end clients as referred to in Article 16(3), and ensure that financial instruments are offered or recommended only when this is in the interest of the client".

2. Article 9 of MiFID II is also relevant insofar it requires the management body to define, approve and oversee a policy as to services, activities, products and operations offered or provided, in accordance with the characteristics and needs of the clients of the firm to whom they will be provided.

3. Other relevant work has also been taken into consideration in the development of these proposals, as set out below:

   i. In November 2013, the European Supervisory Authorities issued an Article 56[12] Joint Position on "*Manufacturers' Product Oversight and Governance Processes*[13]" setting out high-level principles applicable to the oversight and governance processes of financial instruments. These principles cover in particular the responsibilities of manufacturers and producers in setting up processes, functions and strategies for designing and marketing financial instruments, as well as at reviewing the life cycle of products.

   ii. In December 2013, the International Organisation of Securities Commissions (IOSCO) published a report entitled "*Regulation of retail structured products".*[14] This report includes a toolkit setting out regulatory options for IOSCO members to use in their regulation of retail structured products, with the goal of enhancing investor protection. The toolkit has five sections that are organised 'along the value chain' of the retail structured

[12] Regulation (EU) No 1095/2010, available at: http://www.esma.europa.eu/sl/system/files/Reg_716_2010_ESMA.pdf
[13] JC-2013-77, available at: http://www.esma.europa.eu/system/files/jc-2013-77_pog_-_joint_position_0.pdf
[14] FR14/13, available at: http://www.iosco.org/library/pubdocs/pdf/IOSCOPD434.pdf

product market, from issuance to distribution to investment. The tools cover the following areas:

- a potential overall regulatory approach to retail structured products;
- potential regulation of the design and issuance of the products;
- potential regulation of the disclosure and marketing of the products;
- potential regulation of the distribution of the products; and
- potential regulation of post-sales practices.

iii. Lastly, in March 2014, ESMA published an Article 29(1)[15] opinion on "Structured Retail Products - Good practices for product governance arrangements".[16] The opinion sets out non-exhaustive examples of good practices aimed at facilitating a more consistent framework for SRPs across Europe, with the intention of improving investor protection by illustrating arrangements that investment firms could put in place to improve their ability to deliver on investor protection (taking into account the nature, scale and complexity of their business). In particular the opinion sets good practice examples relating to:

- the complexity of the Structured Retail Products (SRPs) investment firms manufacture or distribute;
- the nature and range of the investment services and activities undertaken in the course of that business, and
- the type of investors investment firms target.[17]

Analysis following feedback from stakeholders

4. A large number of respondents suggested that the final technical advice clarifies the respective scope of the term 'manufacturer' (considering in particular, the absence of definition in MiFID II and the use of such term in PRIIPS) and 'distributor' (with a few respondents suggesting that only firms providing advice be considered as 'distributor'). ESMA is of the view that Article 16(3) sub-paragraph 2 of MiFID II takes an intentionally broad approach to

[15] Regulation (EU) No 1095/2010, available at: http://www.esma.europa.eu/sl/system/files/Reg_716_2010_ESMA.pdf
[16] ESMA/2014/332, available at: http://www.esma.europa.eu/system/files/2014-332_esma_opinion__structured_retail_products_-_good_practices_for_product_governance_arrangements.pdf
[17] It also highlights that, when an investment firm distributes a SRP manufactured by a firm which is not a MiFID firm, it is a good practice for that firm to take all reasonable measures to verify that the manufacturer of that SRP ensures investors' interests in a similar way to the good practices contained in the opinion.

'manufacturers'[18] which aims at ensuring that the requirements apply to a large scope of firms and situations. The technical advice now clarifies that for the purpose of the product governance requirements investment firms that 'create, develop, issue and/or design investment products' should be considered as "manufacturers" (paragraph 1 of the draft technical advice). This includes investment firms advising corporate issuers on the launch of new securities. 'Distributor' refers to an investment firm that offers and/or recommends investment product and services to clients. In this context, 'offers' has a wide application and is to be read in a broad sense. ESMA wishes to clarify that where investment firms 'create, develop, issue and/or design investment products' to be launched on the primary market, the product governance rules for manufacturers apply. Where this firm is also involved in the distribution of such products, these product governance rules for manufacturers should apply in addition to the rules which would apply to them as distributors. Where such investment products are then distributed by other investment firms to clients, e.g. through placements or on the secondary market, the product governance obligations for distributors apply. ESMA considers that additional definitions are not needed. Concerning the role of distributors, the suggestion to include only investment firms providing advice would not be in line with MiFID II which does not limit distributors' obligations to firms only providing certain investment services. In paragraph 6 of this section, ESMA sets out how the respective obligations of the manufacturer and distributor can interact in the development of the target market.

5. A number of respondents suggested that the final technical advice clarifies the respective responsibilities of the manufacturer and the distributor in the definition of the 'target market' and clarifies the level of granularity expected from manufacturers when identifying the 'target market'. Some respondents also suggested that further guidance be provided as to how the determination of the 'target market' should be documented by investment firms. ESMA considers that it would be inappropriate to specify in too much detail the level of granularity that is required, since this will vary according to the specific circumstances. For simpler, more mainstream investments, such as ordinary shares, it is likely that the target market will be identified with less detail. In many cases, it is understood that such products can be considered to be compatible with the mass retail market. For more complicated, less mainstream investments, such as contingent convertible securities or structured products with complicated return profiles, the target market should be identified with more detail. In this context, the criteria used to define the target market and determine the appropriate distribution strategy must be relevant for the product. These criteria must make it possible to assess which clients fall within the target market, for example to assist in ongoing product reviews after the product is launched. The analysis of the target market for the purposes of product governance arrangements is distinct from and does not replace the suitability/appropriateness assessments which are conduct of business rules that take place for each specific transaction concluded by a given investor in relation to a given product.

[18] Article 16(3) sub-paragraph 2 refers to "An investment firm which manufactures financial instruments for sale to clients".

6. Manufacturers designing products that are distributed through other investment firms should identify the target market on a theoretical basis. This means they would determine the product's compatibility with a target market without specific knowledge of individual clients but with a more general view of how the specificities of the product would be compatible for certain types of investors, considering their knowledge of the financial markets and their past experiences with similar products and investors. Distributors should use the manufacturer's more general target market assessment together with existing information on their clients to identify their own target market for a product, that is the group of clients to whom they are effectively going to offer the product through the provision of their services. They should also determine how they should distribute the product to their target market taking into account the manufacturer's target market assessment and intended distribution strategy. If the investment firm acts as both the manufacturer and distributor, there is no need to duplicate the target market assessment and distribution strategy exercise, although the firm should ensure the single target market assessment and distribution strategy exercise is sufficiently detailed to meet the relevant manufacturer and distributor obligations in this area. If the manufacturer is not subject to MiFID and no target market was identified, the distributor needs to identify the appropriate target market for the respective investment product.

7. A number of respondents also stated that information on the appropriate sales channel for the product should be an obligation of the distributor and not the manufacturer. ESMA notes that MiFID II requires investment firms which manufacture financial instruments to assess whether the distribution strategy is consistent with the target market. ESMA has also clarified in the technical advice that distributors need to assess whether the distribution strategy is consistent with the identified target market. Going forward ESMA considers that there may be scope for future Level 3 work to assess target market criteria.

8. Several respondents suggested that the final technical advice clarifies if and when product governance requirements should apply to management companies and investment undertakings subject to UCITS and AIFMD (i.e. when these are not performing MiFID investment services pursuant to Article 6(3) of UCITS and 6(4) of AIFMD respectively).

9. ESMA wishes to note that the product governance requirements set out in MiFID II are intended to apply to investment firms authorised under MiFID II. However, it should also be noted that they equally apply to other supervised entities subject to MiFID, such as UCITS management companies and alternative investment fund managers, when such entities are authorised to perform MiFID investment services (pursuant to Article 6(3) of UCITS and Article 6(4) of AIFMD respectively) and only in connection to the performance of such services. Such UCITS management companies and alternative investment fund managers that distribute; or manufacture and distribute UCITS or AIFs to investors will only be directly subject to the requirements applicable to the investment services they provide. ESMA has amended the technical advice to clarify the information distributors should gather in such cases. Going forward ESMA considers that the EC should consider the possibility to align the relevant UCITS and AIFMD articles with the product governance obligations for manufacturers.

10. Several respondents expressed the view that the term ‘investment services” when referring to the obligations of the distributors (paragraphs 17 and 18 of in the draft technical advice) should be deleted as it adds to the provisions of MiFID II. Respondents also suggested that the final technical advice clarifies the scope of the term ‘investment product’ compared to the term ‘financial instrument’ as defined in MiFID II. ESMA notes that the term ‘investment product’ is used in MiFID II and considers that reference to investment products is appropriate (in particular, it emphasizes the inclusion of structured deposits since the manufacturing phase). Concerning the reference to investment services in the context of the manufacturers and distributors’ obligations, ESMA considers that such terms should be maintained in the technical advice since it requires investment firms to assess whether certain products are adequate for distribution via certain channels (for instance some distributors may consider that certain products need to be distributed via advisory services). Similarly, when investment firms provide investment services such as electronic trading service platforms they should assess whether the distribution strategy is appropriate for the intended target market.

11. Several respondents suggested that the final technical advice clarifies that ‘execution-only’ trading on the secondary market should not be considered as ‘distribution’ and should therefore be out of scope of the product governance rules. These respondents, together with others considering that the primary market and secondary market operate in very different ways, disagreed with the possibility to apply distributor requirements to the distribution of products available on both the primary market and the secondary market. However, a minority of respondents, including consumers and investors associations, did not support any limitation to the application of product governance obligations noting that the exclusion of secondary markets from the scope of the product governance rules would not provide investors with the required level of protection. The SMSG also supported the application of the requirements to both the primary market and the secondary market. ESMA is of the view that in keeping with MiFID II and in the interest of investor protection, that product governance rules should apply irrespective of the type of service provided and of the requirements applicable at point of sale. This means that where investment firms provide execution-only brokerage platforms they will be subject to the distributor product governance obligations. In such cases when having to identify a target market, they will, having considered the information provided by the manufacturer, and, as explained above, identify the target market taking into account the product and the investment service through which the client can invest in the product. For more *“plain vanilla*” products this process will be relatively simple given that many of these products can be compatible with the needs and characteristics of the mass retail market. The product can be distributed to this market without need to further refine the target market. For complex products, the distributor would be expected to consider the existing appropriateness information they possess about their clients in identifying the target market.

12. A significant number of respondents suggested that shares and bonds be excluded from the scope of the product governance rules. They expressed the view that these are not ‘manufactured’ by the issuer and are not issued for designated target market. Nevertheless, a few respondents, including consumers and investors associations, noted that including products

such as shares and bonds was crucial from an investor protection standpoint considering that such products are out of the scope of PRIIPS. ESMA agrees with the views expressed by consumer associations and considers that both the manufacturer (when applicable) and the distributor requirements should apply with respect to shares and bonds.

13. A majority of respondents agreed with ESMA's proposal to require distributors to put in place a written agreement with non-MiFID manufacturers (or third country firms) when distributing a product for which no reliable information is publicly available.

14. A majority of respondents disagreed with ESMA's proposal to require distributors to periodically inform the manufacturer about their experience with the product. These respondents noted that imposing such an information requirement would trigger extra-costs for distributors which would be disproportionate compared to the expected benefit and may lead small distributors to limit the number of manufacturers they work with in order to limit their reporting burden which would restrict the range of investment products offered to investors. A minority of respondents, including most consumer associations, agreed with ESMA's proposal noting that such reporting would be even more efficient if it includes feedback on clients' viewpoint and experience. ESMA is of the view that such reporting can be beneficial for the functioning of product governance obligations. This does not mean that distributors need to report every sale to manufacturers, or that manufacturers must confirm that each transaction was distributed to the correct target market. Relevant information could include, for example, information about the amount of sales made outside the target market, summary information of the types of client, a summary of any complaints received or by posing questions suggested by the manufacturer to a sample of clients for feedback. The obligation is for distributors to provide the data that is necessary for the manufacturer to be able to review the product and check that it remains consistent with the needs, characteristics and objectives of the target market as defined by the manufacturer itself. ESMA also considers that, it should be possible for distributor to use the scenario analysis of products conducted by manufacturers in order to comply with their obligation to provide fair clear and not misleading information to clients.

15. A majority of respondents noted that distributors should not be legally required to take a predetermined type of action in cases where they became aware of an event that could potentially affect the risk of the identified target market. These respondents noted that distributors should remain enabled to take any action they deem appropriate on a case by case basis. A minority of respondents, including all consumer associations, suggested however potential actions to be taken by distributors in such circumstances. These actions include:

    i. informing investors;

    ii. reconsidering distribution methods (including refraining from distributing a product or a range of products, as applicable);

    iii. offering investors the possibility to terminate the investment without any costs;

iv. informing the manufacturer; and

v. informing the relevant NCA.

16. A majority of respondents noted that manufacturers should not be legally required to take a pre-determined type of action in cases where they become aware that products are not sold as envisaged. These respondents noted that manufacturers should remain enabled to take any action they deem appropriate on a case by case basis. A minority of respondents, including consumer associations, suggested additional actions to be taken by manufacturers. These actions include:

    i. contacting the distributor to discuss a modification of the distribution process;

    ii. terminating the relationship with the distributor; and

    iii. informing the relevant NCA.

17. ESMA is of the view that firms should take 'appropriate action' where they become aware of an event that could potentially affect the risk of the identified target market but that there should be no pre-determined action to be taken in all cases. The actions suggested by respondents may be appropriate in some cases but there should be flexibility for firms to decide what steps they need to take based on the circumstances of the case.

18. It is possible that some products may be distributed to clients outside the manufacturer's target market. Distributors remain responsible for meeting the required standards for distribution and it may be that such sales remain suitable/ appropriate. However, if a manufacturer observes a trend (across the market or at specific distributors) for sales outside the target market, they may wish to consider if it is necessary to take action. It may be that the original target market is too narrow, for example, or this could be an indication of problems with the product or the way in which it is being distributed, requiring additional action.

Technical advice

1. The requirements set out below apply in a way that is appropriate and proportionate, taking into account the nature of the investment product, the investment service and the target market for the product.

Product governance obligations for manufacturers

2. The proposals set out below shall apply to investment firms manufacturing investment products (financial instruments and structured deposits) – i.e. those firms that create, develop, issue and/or design investment products.

3. The investment firm shall maintain procedures and measures to ensure the design of the

product complies with the requirements relating to the proper management of conflicts of interest (including remuneration). In particular, when an investment firm develops a new product, it shall be reviewed to ensure that the product design, including the product features, does not adversely affect clients or lead to problems with market integrity by enabling the firm to mitigate and/or dispose of its own risks or exposure to the underlying assets of the product, where the investment firm already holds the underlying assets on own account.

4. An analysis of potential conflicts of interests shall be conducted each time a product is generated. In particular, the analysis shall look at whether the product creates a situation where the client may be adversely affected if they take:

   i. an exposure opposite to the one previously held by the firm itself; or

   ii. an exposure opposite to the one that the firm wants to hold after the sale of the product.

5. The firm shall also consider whether the product may represent a threat to the orderly functioning or to the stability of financial markets before deciding to proceed with the launch of the product.

6. A firm shall ensure that relevant staff possess the necessary expertise or receive the appropriate training to understand the characteristics and risk of the products they want to manufacture before new products are manufactured.

7. A firm shall ensure that the management body has effective control over the firm's product governance process. In this regard, information about the products a firm manufactures and its distribution strategy shall be systematically included in compliance reports to the management body and made available to NCAs on request.

8. Investment firms' compliance function shall oversee the development and periodic review of product governance arrangements in order to detect any risk of failure by manufacturers to comply with their obligations.

9. Where investment firms collaborate, including with an investment firm based in a non-EEA Member State or a non-MiFID firm, to create, develop, issue and/or design a product, they shall outline their mutual responsibilities in a written agreement.

10. When manufacturing products, the firm shall identify the potential target market for each product and be able to specify the type(s) of client for whose needs, characteristics and objectives the product is compatible. As part of this process, the firm shall identify any groups of investors for whose needs, characteristics and objectives the product is not compatible. Where investment firms work together to manufacture a product, only one target market assessment is required.

11. The target market must be identified at a sufficiently granular level to avoid the inclusion of any groups of investors for whose needs, characteristics and objectives the product is not

compatible. Manufacturers designing products that are distributed through other investment firms have to ascertain the needs and characteristics of clients for whom the product is compatible based on their theoretical knowledge and past experience of the product, the financial markets and the needs, characteristics and objectives of potential investors.

12. Investment firms shall undertake a scenario analysis of their products. These tests shall assess the risks of poor investor outcomes posed by the product and what circumstances might cause these outcomes to occur. They could, for example, assess the product under negative conditions covering what would happen if, for example (the following list is non-exhaustive and other tests may be appropriate):

    i. the market environment deteriorated;

    ii. the manufacturer or a third party involved in manufacturing and or functioning of the product experiences financial difficulty or other counterparty risk materialises;

    iii. the product fails to become commercially viable; or

    iv. demand for the product is much higher than anticipated, putting a strain on the firm's resources and/or on the market of the underlying product.

13. Investment firms shall consider whether the product meets the identified needs, characteristics and objectives of the target market, checking for example that (the following list is not exhaustive):

    i. the product's risk/reward profile is consistent with the target market; and

    ii. product design is driven by features that benefit the client and not by a business model that is dependent on poor client outcomes.

14. Investment firms shall consider the charging structure proposed for the product, checking for example that (the following list is not exhaustive):

    i. product costs and other charges are compatible with the needs, objectives and characteristics of the target market;

    ii. charges do not undermine the return expectations of the product. For example, it is unlikely to be appropriate for a tax advantaged financial product to have costs or charges that equal, or exceed, the expected tax benefit for investors. It is important, during the product design process, that the firm ensures that the fees do not remove almost all the tax advantages; and

    iii. the charging structure of the product is appropriately transparent for the target market (e.g. it shall not be too complex to understand or disguise charges).

15. Investment firms shall ensure that the provision of information and details about an invest-

ment product to distributors is of an adequate standard to enable distributors to understand and sell the product properly. This shall include information about the appropriate sales channel for the product, the product approval process and the target market assessment. Firms that distribute remain subject to the overarching disclosure requirements in Article 24 of MiFID II.

16. Investment firms shall review the investment products they manufacture on a regular basis, taking into account any event that could materially affect the potential risk to the identified target market.

17. Firms shall determine how regularly to review their products based on relevant factors (for example, innovative investment strategies that rely on complicated investment structures shall be reviewed more frequently than simpler and longer-established strategies). Investment firms shall review investment products: prior to any further issue or re-launch; if they become aware of any event that could materially affect the potential risk to investors; and at regular intervals to investigate whether the products function as intended.

18. When reviewing existing products, the firm shall consider if the product remains consistent with the needs, characteristics and objectives of the target market and consider if the product is being distributed to the target market, or is reaching clients for whose needs, characteristics and objectives the product is not compatible. As part of this review, the firm shall make its best effort to identify crucial events that would affect the potential risk or return expectations of the product. For example the firm could consider cases such as (the following list is not exhaustive):

    i. the crossing of a threshold that will affect the return profile of the product (for instance if a reference index has decreased by 5%, the return rate of the product will fall from 10% to 1%); or

    ii. the solvency of certain issuers whose securities or guarantees may impact the performance of the product.

19. The firm shall make its best effort to identify crucial events that would affect the potential risk or return expectations of the product and, when such an event occurs, firms shall take appropriate action. This action could include (the following list is not exhaustive):

    i. the provision of any relevant information on the event and its consequences on the product to the clients, or the distributors of the product if the firm does not offer directly the product to the clients;

    ii. changing the product approval process;

    iii. stopping further issuance of the product;

    iv. changing the product to avoid unfair contract terms, or if they become aware the prod-

uct is not being sold as envisaged (for example, if a product was designed for a niche market of sophisticated investors but is being sold to a much larger group of clients), investment firms may need to consider whether the sales channels through which the products are sold are appropriate;

v. contacting the distributor to discuss a modification of the distribution process;

vi. terminating the relationship with the distributor; or

vii. informing the relevant NCA.

Product governance obligations for distributors

20. The obligations for distributors shall apply to investment firms when deciding the range of products (financial instruments and structured deposits) issued by itself or other investment firms and services they intend to offer to clients. These proposals also apply to distributors selling investment products issued by entities that do not fall under MiFID scope (e.g. if they distribute bonds issued by a car company). In such circumstances the distributor shall determine the target market for the respective investment product, even if the target market was not defined by the manufacturer.

21. When deciding the range of investment products and services that will be offered, investment firms shall have in place adequate product governance arrangements to ensure that products and services they intend to offer are compatible with the needs, characteristics, and objectives of an identified target market and that the intended distribution strategy is consistent with identified target market. In this regard, investment firms shall identify and assess appropriately the circumstances and needs of the clients that they intend to focus on, so as to ensure that clients' interests are not compromised as a result of commercial or funding pressures. As part of this process, the firm shall identify any groups of investors for whose needs, characteristics and objectives the product or service is not compatible. Distributors shall use information on their own clients and the information obtained from manufacturers to identify the needs, characteristics and objectives of the group of clients to whom they are going to offer the product or service, as well as define how they are going to distribute it. The distributor shall consider the information provided by the manufacturer in accordance with Article 16(3) subparagraph 4 of MiFID II in determining the target market and distribution strategy. When an investment firm acts both as a manufacturer and a distributor, only one target market assessment shall be required. This obligation shall apply without prejudice to any assessment of appropriateness or suitability to be subsequently carried out by the investment firm in the provision of investment services to each client.

22. When deciding the range of investment products and services that will be offered and the respective target markets, investment firms shall maintain procedures and measures to ensure compliance with all applicable MiFID requirements including those relating to disclosure, suitability/appropriateness, inducements and proper management of conflicts of interest. In this context, particular care shall be given when distributors intend to offer new prod-

ucts or there are variations to the services they provide.

23. Investment firms shall periodically review and update product governance arrangements already put in place in order to ensure that they remain robust and fit for their purpose, taking appropriate actions where necessary.

24. Firms shall review the investment products they distribute and the services they provide on a regular basis, taking into account any event that could materially affect the potential risk to the identified target market, to assess at least whether the product or service remains consistent with the needs of the identified target market and whether the intended distribution strategy remains appropriate. If distributors become aware that they have mis-judged the target market for a specific product or service or that a given product or service no longer meets the circumstances of the identified target market (e.g. if the product becomes illiquid or very volatile due to market trend changes), they shall reconsider the target market and/or update the product governance arrangements already put in place as appropriate.

25. Distributors shall provide the manufacturer with sales information and, if necessary, information on the above reviews to support product reviews carried out by manufacturers.

26. Investment firms' compliance function shall oversee the development and periodic review of product governance arrangements in order to detect any risk of failure by distributors to comply with their obligations in this chapter.

27. Investment firms shall ensure that relevant staff possess the necessary expertise or receive the appropriate training to understand the characteristics and risk of the products that will be distributed and the services provided as well as the needs, characteristics and objectives of the identified target market.

28. Investment firms shall ensure that the management body has effective control over the firm's product governance process to determine the range of investment products that will be distributed and the services provided to the respective target markets. In this regard, information about the products a firm distributes and the services provided shall be systematically included in compliance reports to the management body and made available to NCAs on request

29. When investment products are manufactured by investment firms that fall under the MiFID scope, distributors shall obtain information to gain the necessary understanding and knowledge of the products they intend to offer in order to ensure that these products will be distributed in accordance with the needs, characteristics and objectives of the identified target market. When the manufacturer is an investment firm under MiFID, this obligation shall be considered as complementary to the duty of manufacturers of making information on products available to distributors.

30. When investment products are manufactured by third-country firms or non-MiFID firms including UCITS management companies and AIFMs, distributors shall take all reasonable

steps to ensure that the level of product information obtained from the manufacturer is of a reliable and adequate standard to ensure that products will be distributed in accordance with the characteristics, objectives and needs of the target market. Where all relevant and material information is not publicly or otherwise available, the reasonable steps required of the distributor include an agreement with the manufacturer or its agent that the manufacturer or its agent will provide all relevant information. Publicly available information may only be accepted if it is clear, reliable and produced to meet regulatory requirements. For example, with regard to securities, disclosure requirements in the Prospectus Directive or in the Transparency Directive may be acceptable. This obligation is relevant for products sold on primary and secondary markets and shall apply in a proportionate manner, depending on the degree to which publicly available information is obtainable and the complexity of the product.

31. Where different firms work together in the distribution of a product or service, the final distributor in the chain (i.e. the firm with the direct client relationship) has ultimate responsibility to meet the product governance obligations but the intermediate distributor firm(s) must:

    i. ensure that relevant product information is passed from the manufacturer to the final distributor in the chain;

    ii. similarly, if the product manufacturer requires information on product sales in order to comply with their own product governance obligations, the intermediate firm must enable them to obtain it; and

    iii. apply the product governance obligations for manufacturers, as relevant, in relation to the service they provide.

2.8. Safeguarding of client assets

Background/Mandate

Extract from the Commission's request for technical advice (mandate)

ESMA is invited to provide, taking into account the above considerations, technical advice on governance and organisational arrangements concerning the safeguarding of client assets and the prevention of unintended use of client financial instruments, on measures to ensure an appropriate use of TTCA when dealing with non-retail clients, on arrangements to be adopted with respect to securities financing transactions, on how to further strengthen the due diligence requirements, including diversification, for firms depositing client funds, on recording and disclosure requirements with respect to inappropriate custody liens or similar rights, to the extent this is allowed or required by certain regulatory regimes, over client assets as well as on measures aiming to increase the effectiveness of segregation requirements.

1. The following MiFID II provisions are relevant:

   Article 16:

   "(8) An investment firm shall, when holding financial instruments belonging to clients, make adequate arrangements so as to safeguard the ownership rights of clients, especially in the event of the investment firm's insolvency, and to prevent the use of a client's financial instruments on own account except with the client's express consent.

   (9) An investment firm shall, when holding funds belonging to clients, make adequate arrangements to safeguard the rights of clients and, except in the case of credit institutions, prevent the use of client funds for its own account.

   (10) An investment firm shall not conclude title transfer financial collateral arrangements with retail clients for the purpose of securing or covering present or future, actual or contingent or prospective obligations of clients.

   (…)

   (12) The Commission shall be empowered to adopt delegated acts in accordance with Article 89 to specify the concrete organisational requirements laid down in paragraphs 2 to 10 of this Article to be imposed on IF's and on branches of third-country firms authorised in accordance with Article 41 performing different investment services and/or activities and ancillary services or combinations thereof".

2. In developing its proposals, ESMA has considered the Commission Consultation, the recently published Recommendations Regarding the Protection of Client Assets[19] by IOSCO, and the consultation document of the Financial Stability Board (FSB) on the Application of the Key Attributes of Effective Resolution Regimes to Non-Bank Financial Institutions.[20]

3. The IOSCO recommendations establish 8 principles applicable to firms and their regulators, which relate to:

   i. appropriate record-keeping;

   ii. regular statements to clients;

   iii. arrangements to protect clients' rights;

   iv. consideration of risks of placing client assets in foreign jurisdictions;

   v. risk disclosure to clients;

   vi. controls in the event of waiving or modifying client assets protections;

   vii. regulators' oversight of compliance; and

   viii. regulators' considerations when assets are placed in foreign jurisdictions.

4. ESMA considers that it would be useful to incorporate these recommendations, to the extent they are relevant, into the arrangements of safeguarding client assets.

5. The provisions relating to the safeguarding of client assets contained in the MiFID Implementing Directive (Articles 16 to 20) are as follows:

   i. Article 16 relates to both client financial instruments and funds, covering organisational requirements. These include maintaining accurate records and accounts that distinguish client assets from the firm's own and those of one client from those of another, conducting reconciliations between internal and third-party records, separate identification of client and firm assets held at third parties, and measures to adequately protect any assets held;

[19] Recommendations Regarding the Protection of Client Assets, IOSCO, January 2014, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD436.pdf

[20] See Key Attributes of Effective Resolution Regimes for Financial Institutions, FSB, October 2011, available at http://www.financialstabilityboard.org/publications/r_111104cc.pdf and Application of the Key Attributes of Effective Resolution Regimes to Non-Bank Financial Institutions: Consultative Document, FSB, August 2013, available at http://www.financialstabilityboard.org/publications/r_130812a.pdf

ii. Articles 17 and 18 relate to the depositing client financial instruments and funds at third parties, ensuring appropriate due diligence in their selection, and that such third parties and their jurisdictions are subject to appropriate oversight;

iii. Article 19 places restrictions on the use of client financial instruments by investment firms, including requirements for client consent and organisational arrangements; and

iv. Article 20 requires external audits for investment firms.

6. Based on this, ESMA is advising the Commission on the following:

i. governance arrangements concerning the safeguarding of client assets;

ii. inappropriate use of title transfer collateral arrangements (TTCAs) for non-retail clients;

iii. securities financing transactions and TTCA

iv. securities financing transactions and collateralisation;

v. considering diversification of an investment firm's holding of client funds as part of due diligence requirements;

vi. intragroup deposits of client funds;

vii. inappropriate security interests, liens or rights of set-of over client financial instruments and funds and recording liens and other encumbrances;

viii. segregation of client financial instruments in third-country jurisdictions;

ix. preventing unauthorised use of client financial instruments; and

x. making information readily available to insolvency practitioners.

7. In order to strengthen investor protection in this area, ESMA is providing advice on the introduction of additional requirements in respect of both client financial instruments and client funds. ESMA is advising that firms should have proper and specific governance in place to ensure the safeguarding of client assets. Further, ESMA advises addressing concerns around inappropriate lending of, and liens over client assets; and restricting any inappropriate activity in this area; increasing disclosure to clients; and addressing, through diversification, the contagion risk to client funds that occurs when held in one institution or exclusively in a group bank.

Analysis following feedback from stakeholders

Governance arrangements concerning the safeguarding of client assets

8. While many respondents had a mixed reaction, supporting the establishment of a distinct function for safeguarding client assets but not supporting the instituting of a single officer (and in one or two other instances, vice versa), on balance a majority of respondents disagreed with the draft technical advice to appoint a single officer. Of uppermost concern to those who opposed ESMA's view is that the safeguarding of client assets is already carried out by the firm's compliance function and that this will impose an unnecessary additional burden on firms.

9. Other respondents who supported the appointment of a single officer requested that ESMA clarifies that it will be permissible for the safeguarding officer to hold other responsibilities; that this requirement will be subject to the principle of proportionality so as not to disadvantage small firms; whether a single person could be appointed where several investment firms are part of the same group.

10. ESMA disagrees that the appointment of a single officer will impose an unnecessary burden on firms. The appointment of a single, dedicated officer in a larger-sized firm would be proportionate in order to ensure effective oversight of client assets. In a smaller-sized firm however, the appointment of a single officer would not preclude that officer from carrying out existing roles.

11. This requirement does not oblige investment firms to establish a distinct function with sole responsibility for oversight of the safeguarding of client assets, although some may find it effective to do so. To the extent that the safeguarding of client assets already takes place within investment firms, there should be existing in-house expertise to discharge their safeguarding duties with minimal additional impact. In addition the principle of proportionality continues to apply which allows all firms to comply with MiFID provisions in a manner which is appropriate to the size of firm, which would also mitigate the impact on firms of complying with this obligation. ESMA would also like to note that, in accordance with existing Article 6(3)(c) of the MiFID Implementing Directive and subject to the proportionality test, relevant persons involved in the compliance function must not be involved in the performance of services or activities they monitor. ESMA is not proposing any change to that requirement.

12. As stated in the CP, ESMA agrees that the single officer should be of a sufficient level of skill and authority in order to discharge their duties effectively and without impediment. Therefore ESMA has clarified this within the final technical advice itself.

Inappropriate use of title transfer collateral arrangements (TTCAs) (for non-retail clients)

13. While, overall, firms were supportive of restricting TTCAs in relation to retail clients, the majority of respondents were opposed to restricting the use of TTCAs for non-retail clients arguing that these parties are able to comprehend the risks of collateral arrangements and

that treating professional clients in an equivalent way to retail clients is not consistent with MiFID's tiered protection provisions. Some respondents argued that including these provisions in the MiFID II implementing measures has no legal basis in MiFID II. Others supported the objective of preventing the use of TTCAs to avoid client asset segregation but clarified that it would be inappropriate to prohibit the use of TTCAs when it is widely used as part of industry standards or to comply with market rules.

14. In relation to the ESMA proposal to consider the appropriateness of TTCAs used with clients by means of the relationship between the client's obligations to the firm and the client assets subject to TTCA, the majority of respondents did not support it. Some argued that such a requirement would impact the risk processes of firms without necessarily ensuring the effectiveness of client assets segregation. Several respondents suggested relying on existing high-level requirements to act honestly, fairly and in good faith and to provide information that is fair, clear and not misleading. Others argued that demonstrating the appropriateness in practice may prove problematic, especially because TTCAs are not always agreed between the client and the custodian but directly between counterparties and the custodian receives instructions without being necessarily involved in these agreements.

15. A few respondents mentioned that they already use TTCAs only when it is deemed suitable but they opposed legislative intervention on this aspect or clarified that their assessment is general and not client-specific.

16. Others emphasised that taking client assets provided as margin payments by TTCA may be mandated by CCPs and to manage credit risk of clearing members' clients.

17. A number of respondents opposed the specific situations identified by ESMA where taking client assets by TTCA is not appropriate (paragraph 3 of the draft technical advice). Some mentioned that in high volume volatile markets, margin calls are unpredictable and have to be made daily, so to avoid this many non-retail clients transfer larger amounts of assets as collateral in order to cover future or contingent liabilities. Others argued that any transfer of collateral should also cover market or systemic shocks. Other respondents would welcome clarification that repo transactions, securities lending and other transactions that take client assets by TTCA under standard agreements do not constitute indiscriminate use of TTCAs. A few respondents felt that paragraph 3(iii) of the draft technical advice would undermine existing prime brokerage agreements between hedge funds and prime brokers where clients typically provide a contractual right to use their assets.

18. A majority of respondents supported the use of risk disclosures. Respondents largely recognised that risk disclosures were necessary in order for clients to make informed decisions on whether to proceed with a transaction. However, several respondents qualified their support by saying that such risk disclosures needed to be generic.

19. ESMA wishes to clarify that the reference to 'appropriateness' in the CP in discussing TTCAs clearly has a distinct meaning and purpose from the use of the term 'appropriateness' under Article 25 of MiFID II which is aimed at establishing the knowledge and experi-

ence of clients in relation to non-advised services. The use of the term in the technical advice in the area of the safeguarding of client assets is seeking to ensure that firms can demonstrate a robust link between the TTCA and the client's liability.

20. ESMA further notes that the requirement for a robust link between collateral transferred under a TTCA and a client's liability does not preclude the taking of appropriate security against a client's obligation. The TA is not a prohibition on the use of TTCAs. Investment firms would, for example, remain able to require sufficient margin, and where appropriate, to do so by a TTCA. In doing so, an investment firm could take into account, among other things, market volatility and the type of business undertaken as this would be regarded as a reasonable precaution and may be convenient for the client.

21. ESMA also wishes to clarify that the technical advice does not prevent compliance with legal requirements under EU legislation such as EMIR and does not prohibit the appropriate use of TTCAs in the context of contingent liability transactions or repos for non-retail clients.

22. The ability of firms to enter into TTCAs with clients does not reduce the need to obtain clients' prior express consent to use client assets, as under Article 19.

Securities financing transactions (SFTs) and TTCAs

23. A number of respondents, called on ESMA to explicitly state and clarify in its TA that any form of securities lending transactions is not a TTCA in the meaning of Article 16 (10) and should remain possible for all clients including retail clients. Some of these respondents highlighted the widespread use of SFTs and their role in creating and maintaining liquid markets and argued that securities lending transactions used to collateralise i.e. to cover a present, future, actual or contingent or prospective obligation and are different from those used to conclude SFTs under Article 19 of the MIFID Implementing Directive.

24. Some of these respondents suggest that ESMA make it clear that retail clients should still be able to enter into transactions under Article 19 of the MIFID Implementing Directive (stock lending and repo transactions) subject to an appropriateness test.

25. If ESMA is disinclined to permit retail clients to enter into these transactions under Article 19, then several respondents requested that ESMA specify what alternatives are acceptable legal arrangements. Other respondents highlight, that the use of alternative legal mechanisms to allow retail clients to enter into SFTs, such as pledging and security interest, would introduce legal uncertainty and carried their own risks.

26. ESMA notes that arrangements which are prohibited under Article 16(10) of MiFID II will prevent the segregation of client assets and therefore runs a risk of client losses, which is the risk that Article 16(10) intends to prevent. Further, preventing retail clients from transferring the title of their financial instruments will not prevent models such as pledging. Therefore, TTCA should not be allowed for retail clients under the MiFID II implementing measures.

27. Although not expressly raised by respondents, ESMA notes that Article 19(2) of the MIFID Implementing Directive could be amended to clarify that client consent is required for the use of client financial instruments by any person at all.

Securities financing transactions (SFTs) and collateralisation

28. While a number respondents did agree with ESMA's proposal or did say that it was 'good practice' to collateralise SFTs for non-retail clients – indeed almost all respondents said that they currently take collateral to cover SFTs – the majority of respondents were opposed to mandating it in legislation beyond retail clients, emphasising that:

    i. non-retail clients are by nature, sophisticated and experienced and will be well versed in the potential risks of such transactions, as recognised by the MiFID tiered system of client classification; and

    ii. industry standard agreements for repos, securities lending and derivatives margining already provide for provisions with regard to collateralisation between non-retail counterparties and provide adequate legal certainty.

29. Several respondents stressed the need for consistency with other EU legislation i.e. EMIR and future SFT Regulation (which will include measures on disclosure).

30. Some trade associations cautioned that monitoring of collateral is only possible in certain circumstances: where the investment firm is party to a SFT, is agent for conclusion of a SFT, where there is a tripartite agreement with the external borrower, the client (lender) and the investment firm. Outside these instances, the investment firms cannot monitor the collateral process that is otherwise agreed bi-laterally with client and third-party borrower because the investment firm's role here is limited to executing the underlying settlement instructions.

31. Almost all firms support the proposal in relation to demonstrating prior express consent from non-retail clients and believe that in the absence of such evidence, uncertainty is created which impacts on the speed and accuracy of resolving legal ownership during insolvency events. However, most of these respondents argued that consent should be given once at the start of the commercial relationship, before the initial relevant transactions/series of transactions takes place.

32. Although, as some respondents noted, more sophisticated clients may understand the risks of entering into SFTs without receiving collateral, ESMA notes that almost all respondents reported that they currently take collateral in relation to SFTs for non-retail clients, and that this was good practice. Therefore it seems logical to cement good practice.

33. ESMA understands feedback that investment firms may be unable to monitor collateral if they are not party to an SFT agreement. The technical advice covers investment firms who are party to such an agreement. Where an investment firms is acting on a client instruction

to lend securities should and where this constitutes consent to entering into the transaction, the investment firms should still evidence this in line with Article 19 of the MiFID Implementing Directive.

34. ESMA notes feedback urging consistency with other legislation, and does not see any contradiction in the measures proposed. Currently, collateralisation of SFTs is not foreseen as a requirement in other legislation and MiFID is the appropriate place for legislation governing the investment firm-client relationship.

35. ESMA notes the support for recording client consent. ESMA believes this could be given by a client at the outset of a relationship, as long as it is sufficiently clear that the client has consented to use of their securities in accordance with Article 19 of the MiFID Implementing Directive. The term *recorded* does not prescribe a legal requirement of form. A record is any evidence permissible under national law.[21] In the final technical advice, ESMA has clarified the requirements around consent using a single wording for all client types.

Considering diversification of investment firm's holding of client funds as part of due diligence requirements

36. A majority of respondents were in favour of this proposal for the reasons cited in the CP, i.e. that a client should not be exposed to concentration risk. However, a number of respondents requested the following main aspects be considered further before the technical advice is finalised:

    i. that the provisions around diversification do not apply to credit institutions;

    ii. that in considering diversification investment firms should be guided largely by the principle of proportionality and that no specific percentage/quantitative threshold should be set; and

    iii. whether the diversification requirements could be waived if a client requests their funds to be placed within an intragroup entity.

37. ESMA notes the support of respondents for this proposal. However, there is no proposal to change the current position for credit institutions. Under Article 18(1) of the MiFID Implementing Directive, credit institutions are exempt from the requirements regarding depositing of client funds in relation to deposits they hold.

38. The technical advice on considering diversification does not set a specific percentage for diversifying funds. Each firm should make its own considerations, appropriate to its particular circumstances, so that implementing this measure will be proportionate for each firm.

[21] See Recommendations Regarding the Protection of Client Assets, IOSCO, January 2014, Principle 6, page 6.

39. Regarding waiving the requirement if a client requests to place client money within an intragroup entity, ESMA notes that such an exemption might allow investment firms to circumvent the measure in this technical advice by requiring this in its standard terms and conditions. ESMA considers the need for firms to consider diversification of client funds to remain. However, the need to consider diversification does not prevent an investment firm from holding client funds in a credit institution within its group (subject to the following requirement). Therefore ESMA has not changed the technical advice in this respect.

Intragroup deposits of client funds

40. Respondents were for the most part opposed to the 20% intragroup deposit limit and favoured an approach which relies on improving compliance with the existing MiFID provisions. While some respondents did offer support, this was done mainly on a qualified basis.

41. Those firms opposing the 20% limit cited a number of arguments against this limit but mainly:

    i. that it should be the decision of the investment firm to safeguard its clients' funds;

    ii. that there is a strong case for holding cash with a bank group if it has a better credit rating than other banks and/or there are benefits in terms of coordination;

    iii. that there are fundamental issues associated with the diversification of client funds into multiple different credit institutions - including additional costs and the unnecessary complexity; and

    iv. that imposing such a limit would lead to concerns regarding liquidity and loss of deposit balances by credit institutions and would compromise the ability of credit institutions to offer financing solutions to the real economy.

42. A number of respondents raised the issue with the practicality of a 20 % limit when the level of client funds can vary constantly intra-day. Other firms, already subject to similar requirement at national level, explained however that they keep a lower balance of funds with intragroup depositaries in order to avoid breaching the legal threshold.

43. It was suggested that, should ESMA recommend an intragroup limit of 20%, it should be introduced on a "comply or explain" basis, where investment firms would have the option of explaining to their national competent authorities what alternative measures they have put in place to safeguard client funds. The following situations were commonly cited as justified exemptions from the intragroup limit:

    i. small firms dealing with small balances of client funds. Under these circumstances a de minims threshold should apply, because it would not be proportionate to require a firm to diversify small amounts of funds across multiple banks; this would only generate additional costs for the client without added benefit

ii. a period of market upheaval or market stress. It should then be appropriate for a firm to make a judgment call on where they place client funds in order to offer better protection for its clients. Respondents also made the related point that if the affiliated credit institution was significantly sounder in the event of serious market turbulence, it would be sensible for a firm to be able to place client money at that institution in excess of 20%

iii. where a client explicitly demands for his funds to be deposited in such an institution.

44. ESMA acknowledges the concerns around the 20% limit on intragroup deposits of client funds. However, ESMA's view is that as part of normal, existing, due diligence firms should be examining the credit worthiness of credit institutions considered for selection for placing client funds.

45. ESMA notes the operation of a 20% limit on intragroup deposits in a Member State and particularly the ability of firms to successfully operate a buffer to absorb intra-day movements. For the reasons stated in the CP, ESMA maintains that a cap of 20% is proportionate and practicable and notes that the technical advice includes possible exceptions to this obligation (paragraph 13 of the technical advice).

Inappropriate security interests, liens or rights of set-off over client financial instruments and funds and recording liens and other encumbrances

46. Mainly qualified support was offered for the draft technical advice to protect client assets from appropriation by third parties seeking to recover debts from the firm. While many firms and trade associations accepted the proposal in principle they sought explicit reassurance that whenever such liens are a requirement of the local law or, while not being a requirement under the local law, form part of the rulebook of the local market infrastructure (CCP, CSD or SSS[22]) and therefore are not negotiable, they should not be prohibited.

47. Concerning risk warnings to clients, the majority of respondents offered qualified support for a risk warning citing a number of contingencies, especially that any such warning should be in a generic format. On the other hand, some consumer representatives argued that such a warning should not be 'general' but should be related to the specific financial instrument.

48. On recording, the majority of respondents expressed the view that security interests should be properly recorded in the client contracts and that any additional separate records of security interests would be duplicative, onerous and costly. Some trade bodies were concerned about the extensive monitoring and review of existing procedures and agreements with third parties, especially for investment firms being active in multiple jurisdictions which would have to take place.

[22] Security Settlement Systems.

49. The technical advice does not prevent a firm's compliance with requirements under applicable local law. Therefore such custody liens required by applicable law would not be considered inappropriate in accordance with the ESMA's technical advice. Responding to feedback on security interests, liens or rights of sett-off that are part of the requirements of third parties in third country jurisdictions, ESMA believes that firms should be able to agree to these only where the rules in question are subject to oversight and endorsement under applicable law. Firms should not agree to such requirements simply because a third party wishes to impose them. In order to clarify this, the technical advice has been amended to refer to 'applicable law' as the situation in which an investment firms can enter into an agreement that would otherwise be prohibited.

50. ESMA considers that any risk disclosure should be sufficiently tailored to clients. Too general a risk warning may not adequately alert customers to the specific risks they face when liens are extended over client assets by third parties.

51. On recording such security interests, liens or rights of set-off, ESMA considers that in order to be transparent to clients, these should be recorded in client contracts and that they should also be recorded in the firm's accounts in order to reflect these agreements and ensure that accounts are operated accordingly.

52. ESMA has amended the title of this section and the technical advice for clarification and to reflect existing language in the MiFID Implementing Directive (Article 32).

Segregation of client financial instruments in third country jurisdictions

53. Opinions are divided over whether reliance on 'other equivalent measures' should only be limited to financial instruments deposited with a third party in third-country jurisdictions due to reasons of applicable law or market practice. While a number of respondents support the proposal, others were concerned that the draft technical advice did not take proper account of other legislative requirements particularly Article 38 of the Central Securities Depositories Regulation (CSDR) (which allows omnibus accounts – accounts holding the assets of more than one client) and Article 39 of EMIR (governing clearing segregation). Some mentioned that there are problems with the legal enforceability of non-statutory equivalent measures because contractually imposed segregation will not withstand the effect of local insolvency laws where those laws do not recognize the effects of segregation. Others emphasized that equivalent measures may deliver the same results as segregation of accounts also in the EU.

54. On risk control measures and disclosure around the use of 'other equivalent measures', the topic was not extensively discussed in the responses. Most respondents strongly opposed additional risk controls although opinion was rather more split on the issue of risk disclosure to clients. In terms of additional risk control measures, the most common counter argument was that existing due diligence efforts supported by legal opinion was adequate and therefore any enhancement to these requirements would generate little added benefit but would increase the cost to firms.

55. On disclosure, respondents (including many large investment firms) emphasised that where in certain non-EU jurisdictions the local insolvency laws would not recognise the effects of such segregation, clients need to be informed of such risks, but largely stressed that the disclosure needed to be generic and in a standardised format should be sufficient to this end.

56. The segregation referred to in this section is segregation under MiFID, between the assets of the client and of the firm and of the third party. Responding to comments about the use of omnibus accounts, EMSA notes that these are not prevented under MiFID. As noted by some respondents, under EMIR and CSDR, omnibus accounts are also possible. CSD participants and clearing members (including MiFID investment firms) are required to offer clients a choice between omnibus client segregation and individual client segregation at the CSD or CCP in question. When carrying out transactions foreseen under EMIR for clients, if an investment firm is subject to Commission Delegated Regulation (EU) No 149/2013 and if it complies with this regulatory framework, an investment firm may pass client assets to a CCP. The requirements under MiFID and under EMIR and CSDR are not contradictory; the latter two cover specific situations.

57. As stated above, ESMA considers that any risk disclosure should be sufficiently tailored to clients. Too general a risk warning may not adequately alert customers to the specific risks they face when liens are extended over client assets by third parties.

58. In line with the previous section on inappropriate security interests, liens or rights of set-off, ESMA has deleted the reference to 'market practice' in the technical advice, as this term could lead investment firms to agree to inappropriate conditions imposed by a third party. Accordingly, firms should only be permitted to rely on 'other equivalent measures' where, in a third-country jurisdiction, they are unable to comply with the usual segregation requirements because of applicable law in that jurisdiction.

Preventing unauthorised use of client financial instruments

59. Most respondents offered qualified support although some large trade associations were not in favour of this measure on the grounds that it would present significant operational challenges and would be costly to implement. Respondents highlighted the following qualifications:

    i. a requirement to have systems in place to 'prevent' shortfalls is impractical and may end up being breached daily given that shortfalls can occur for various reasons (often as a result of third party action or error) in business with a high volume of transactions;

    ii. the emphasis should be on addressing and remediating shortfalls quickly rather than 'preventing' them. Preventing (rather than detecting) the use of one client's financial instruments to settle the transactions of another client, will have far reaching implications for the operation of the omnibus accounts which should continue to be allowed; and

iii. several Respondents mentioned the need to take into account the interaction of these MiFID changes with CSD regulation (and future regulatory technical standards under Article 6(2) of CSDR) to avoid inconsistent or overlapping regulation.

60. ESMA notes that trades can fail for reasons outside of the control of the firm. The technical advice aims to ensure that firms appropriately address this risk, and to ensure that investment firm's systems and controls adequately guard against the unauthorised use of client financial instruments. The technical advice has been amended to clarify that this addresses unauthorised use. ESMA notes that the technical advice does not prevent the use of omnibus accounts and, the technical advice does not contradict CSDR. This legislation applies to market infrastructures, and while there is an interaction with investment firms, MiFID is the logical place for legislation addressing the relationship between the client and the firm, as is the case in the technical advice.

Making information readily available to insolvency practitioners and relevant authorities and strengthening record-keeping requirements

61. A majority of respondents agree with the proposal for firms to keep accessible records in order to reduce uncertainty around asset ownership and reduce delays in returning financial instruments in the event of insolvency and think that the information outlined in the draft technical advice is suitable for these purposes. Indeed several respondents confirmed that they currently maintain the information outlined in the draft technical advice and that this information is easily accessible by a competent person.

62. A minority of respondents did argue that existing record-keeping requirements are sufficient or that insolvency administrators, national competent authorities and resolution authorities already have full access to all the books and systems of an investment firm and therefore no need for any additional requirements are needed in this area. A number of respondents also urged that ESMA waits for the outcome of other working groups (including IOSCO, FSB CPMI) which are also discussing similar issues, before finalising requirements in this area.

63. ESMA notes the majority of respondents agreed with the proposal, and that many already hold the information in a way that is easily accessible. ESMA disagrees with respondents who argued against the proposal on the grounds that existing record-keeping requirements are sufficient. While the information included in the technical advice should be held by the firm in any case, the proposal is to ensure that it is easily and quickly accessible in insolvency. There is typically some delay in accessing books and records at this time, and the technical advice remains unchanged to reflect that such delay and the risks highlighted in the CP should be countered by the measures outlined.

Technical advice

Governance arrangements concerning the safeguarding of client assets

1. Investment firms shall appoint a single officer of sufficient skill and authority with specific responsibility for matters relating to the firm's compliance with its obligations regarding the safeguarding of client instruments and funds.

2. In accordance with the MiFID proportionality principle, investment firms shall decide where it is appropriate for the officer appointed under (1) to be dedicated solely to this task, or to have additional responsibilities.

Inappropriate use of title transfer collateral arrangements (TTCAs) for non-retail clients

3. Article 16(10) of MiFID II prohibits firms from concluding TTCAs with retail clients for the purpose of securing or covering present or future, actual or contingent or prospective obligations. For non-retail clients, investment firms shall not conclude TTCAs without proper consideration.

4. TTCAs are not appropriate where:

   i. there is only a very weak connection between the client's obligation to the firm and the use of TTCAs, including where the likelihood of a liability arising is low or negligible;

   ii. the amount of client funds or financial instruments subject to TTCAs far exceeds the client's obligation, or is even unlimited if the client has any obligation at all to the firm; or

   iii. firms insist that all clients' assets must be subject to TTCAs, without considering what obligation each client has to the firm.

5. Investment firms shall consider and be able to demonstrate that they have properly considered the use of TTCA in the context of the relationship between the client's obligation to the firm and the client assets subjected to TTCA by the firm.

6. Where using TTCAs, Investment firms shall highlight to clients the risks involved and the effect of any TTCA on the client's assets.

Securities financing transactions and TTCAs

7. While some transactions permitted under Article19 of the MiFID Implementing Directive may require the transfer of title, it shall not be possible to make use of Article 19 to effect arrangements that are prohibited under Article 16(10) of MiFID II.

Securities financing transactions and collateralisation

8. Investment firms shall adopt specific arrangements for retail and non-retail clients to ensure that the borrower of client assets provides the appropriate collateral and that the firm monitors the continued appropriateness of such collateral and takes the necessary steps to maintain the balance with the value of client assets.

9. Where an investment firm enters into arrangements for securities financing transactions under Article 19(1)(a) of the MiFID Implementing Directive, the express prior consent of the client shall be clear, recorded in writing, and affirmatively executed by signature or equivalent. In addition, Article 19 should clarify that prior client consent is required for use of client assets by any person.

Considering diversification of an investment firm's holding of client funds as part of due diligence requirements

10. An investment firm that deposits client funds at a third party in accordance with Article 18(1) of the MiFID Implementing Directive shall consider the diversification of these funds as part of their due diligence in the selection, appointment and periodic review of that third party (as set out in Article 18(3) of the MiFID Implementing Directive).

11. Where an investment firm has transferred client funds to a transaction account in order to make a specific transaction, such funds shall not be subject to a requirement to diversify.

Intragroup deposits of client funds

12. Where an investment firm deposits client funds at a third party (as per Article 18(1) of the MiFID Implementing Directive) and that third party is within its own group, an intragroup deposit limit of 20% of such funds shall be imposed.

13. However, an investment firm shall be allowed not to comply with the previous paragraph if it is able to demonstrate that, in view of the nature, scale and complexity of its business, and also the safety offered by the third parties considered in the previous paragraph, and including in any case the small balance of client funds it holds, the requirement under the previous paragraph is not proportionate. Investment firms shall periodically review the assessment made in accordance with this paragraph and should notify their initial and reviewed assessment(s) to NCAs.

Inappropriate security interests, liens or rights of set-off over client financial instruments and funds and recording liens and other encumbrances

14. *Security interests, liens or rights of set-off* over client assets that enable a third party to dispose of these assets in order to recover debts that do not relate to the clients or provision of services to the clients shall not be permitted except in cases where this is required by applicable law in a third country jurisdiction.

15. Where a firm is obliged to enter into agreements that create such *security interests, liens or rights of set-off*, the firm shall disclose this information to clients so that they are informed of the risks associated with these arrangements.

16. Where *security interests, liens or rights of set-off* are granted by the firm over client assets, or where the firm has been informed that they are granted, these shall be recorded in client

contracts and the firm's own accounts to make the ownership status of client assets clear, e.g. in the event of an insolvency.

Segregation of client financial instruments in third country jurisdictions

17. Investment firms shall only be permitted to rely on 'other equivalent measures' as outlined in Article 16(1)(d) of the MiFID Implementing Directive when they are unable to comply with the segregation requirements in third country jurisdictions, due to reasons of applicable law. In these cases, Member States shall be responsible for specifying the necessary 'other equivalent measures' to be taken.

18. A specific disclosure shall be made to clients when relying on 'other equivalent measures' under Article 16(1)(d) of the MiFID Implementing Directive to make clients aware they do not benefit from the provisions envisaged under MiFID in these instances.

Preventing unauthorised use of client financial instruments

19. Investment firms shall take appropriate measures to prevent the unauthorised use of client financial instruments. These measures may include (but are not limited to):

    i. the conclusion of agreements with clients on measures to be taken by the investment firms in case the client does not have the provision on its account on the settlement date (e.g. borrowing of the corresponding securities on behalf of the client or unwinding the position);

    ii. the close monitoring, by the investment firm, of its projected ability to deliver on the settlement date and the putting in place remedial measures if this cannot be done; and

    iii. the close monitoring and prompt requesting of undelivered securities outstanding on the settlement day and beyond.

Making information readily available to insolvency practitioners and relevant authorities and strengthening record-keeping requirements

20. Investment firms shall make information readily available to NCAs, insolvency practitioners and those responsible for the resolution of failed institutions, including the following information:

    i. related internal accounts and records (reconciliations, client ledgers, cash books etc.) that readily identify the balances of funds and instruments held for each client;

    ii. where client funds are held by the investment firm in accordance with Article 18 of the MiFID Implementing Directive, details of the accounts where client funds are held (bank or qualifying money market fund) and the relevant agreements with those entities;

    iii. where financial instruments held by the investment firm in accordance with Article 17 of

the MiFID Implementing Directive, details of accounts opened with third parties and the relevant agreements with those entities;

iv. details of third parties carrying out any related (outsourced) tasks;

v. key individuals of the firm involved in related processes, including those responsible for oversight of the firm's requirements in relation to the safeguarding of client assets; and

vi. relevant client agreements.

21. The record-keeping requirements in existing Article 16 of the MiFID Implementing Directive should also state that records shall be maintained in such a way 'that they may be used as an audit trail', in line with IOSCO Principle 1.

2.9. Conflicts of interest

Background/Mandate

Extract from the Commission's request for advice (mandate)

ESMA is invited to provide technical advice to consider further improvements of the existing conflicts of interest framework, including the establishment of a requirement for periodical review of conflicts of interest policies or clarifications with respect to the last resort nature of disclosure which should not be over-relied on by firms nor used as a measure to manage conflicts of interests. However, for those situations where the organisational and administrative arrangements established by firms proved insufficient to prevent and manage conflicts of interests so as to ensure with reasonable confidence that risks of damage to client interests will be prevented, ESMA should also consider how to further strengthen the content and quality of the information provided to clients to enable them to make an informed investment decision with respect to the service in the context of which the conflict of interest had arisen. With a view to establishing appropriate criteria for determining the types of conflict of interest whose existence may damage the interests of the clients or potential clients of the investment firm, ESMA should assess the need to update or expand the minimum criteria set out in Article 21 of Commission Directive 2006/73/EC.

ESMA should also provide technical advice on whether the current requirements concerning the management of conflicts of interests that might arise from the production and dissemination of investment research continue to appropriately protect the objectivity and independence of financial analysts and of the investment research they produce.

1. The following MiFID II provisions are relevant to this topic:

   Article 16(3), subparagraph 1:

   "An investment firm shall maintain and operate effective organisational and administrative arrangements with a view to taking all reasonable steps designed to prevent conflicts of interest as defined in Article 23 from adversely affecting the interests of its clients".

   Article 23:

   "(1) Member States shall require investment firms to take all appropriate steps to identify and to prevent or manage conflicts of interest between themselves, including their managers, employees and tied agents, or any person directly or indirectly linked to them by control and their clients or between one client and another that arise in the course of providing any investment and ancillary services, or combinations thereof, including those caused by the receipt of inducements from third parties or by the investment firm's own remuneration and other incentive structures".

(2) Where organisational or administrative arrangements made by the investment firm in accordance with Article 16(3) to prevent conflicts of interest from adversely affecting the interest of its client are not sufficient to ensure, with reasonable confidence, that risks of damage to client interests will be prevented, the investment firm shall clearly disclose to the client the general nature and/or sources of conflicts of interest and the steps taken to mitigate those risks before undertaking business on its behalf".

The disclosure referred to in paragraph 2 shall:

(a) be made in a durable medium; and

(b) include sufficient detail, taking into account the nature of the client, to enable that client to take an informed decision with respect to the service in the context of which the conflict of interest arises."

Analysis following feedback from stakeholders

2. The large majority of respondents supported ESMA's proposal to require firms to periodically review their conflicts of interest policy. However, a large number of firms and trade associations noted that the requirement to do so at least annually is too rigid and unpractical. These respondents highlighted that the proportionality principal should apply and suggested either to require the review to be done at least every two years, or to require firms to apply a risk-based approach and to update their conflicts of interest policy when something relevant occurs. ESMA considers that it is appropriate to retain the proposal to review the conflicts of interest policy at least annually. ESMA considers that requiring an annual review of the conflicts of interest policy is the minimum frequency for which firms need to re-assess whether there are conflicts that may adversely affect their clients. Requiring an annual review is entirely consistent with the technical advice that the compliance function should report to the management body, at least annually, on the implementation and effectiveness of the overall control environment for investment services and activities and on the risks that have been identified. The annual review is also consistent with the obligation provided by the current MiFID Implementing Directive requiring investment firms to review on an annual basis their execution policy and RTO/placing policy.

3. On the topic of disclosure some respondents noted that:

   i. ESMA's advice to disclose *"the risks to the client that arise as a result of the conflict"* seems to go beyond Article 23(2) of MiFID, that instead requires firms to *"clearly disclose to the client the general nature and/or sources of conflicts of interest and the steps taken to mitigate those risks before undertaking business on its behalf"*. ESMA disagrees and notes that the disclosure of risks arising as a result of the conflict is essential for clients to understand the nature of the conflict of interest itself. Furthermore, Article 23(3) already requires disclosure to include sufficient detail of the relevant conflict.

ii. There should be no obligation to provide information in a durable medium to professional clients and eligible counterparties. ESMA notes that the use of durable medium is required by Article 23(3)(a); the same article also requires to take into account the nature of the client but does not exclude the use of durable medium for non-retail clients.

4. Firms and trade associations responding to the consultation did not suggest additional situations to be added to those identified in Article 21 of the MiFID Implementing Directive and noted that the current text is comprehensive enough. On the other hand, consumer organisations noted that Article 21 of the MiFID Implementing Directive does not sufficiently take account of the ban of commission for independent financial advice established by MiFID II and suggested stating in the technical advice that all kind of inducements lead to conflicts of interest and adjusting Article 21(e) to include all forms of commissions and not only those that go beyond standard commissions. ESMA confirms that all inducements, including standard commissions, are subject to inducements rules and refers to previous CESR documents on this topic (CESR 07-228b – p 4).

5. The majority of respondents agreed that the distinction between investment research and marketing communications drawn in Article 24 of the MiFID Implementing Directive is sufficiently clear. After further analysis, however, ESMA has found it useful to clarify that while Article 25(2) of the MiFID Implementing Directive is specific to investment research, Article 25(1) should apply to any type of recommendations in accordance with Article 24 of the MiFID Implementing Directive.

6. On the topic of whether the additional organisational requirements listed in Article 25 of the MiFID Implementing Directive and addressed to firms producing and disseminating investment research are sufficient to properly regulate the specificities of these activities and to protect the objectivity and independence of financial analysts and of the investment research they produce, some respondents:

   i. noted that the Article contains numerous terms that are subject to interpretation and would strongly benefit from being more clearly defined. These include ‘closely affected’ used in relation to ‘related financial instrument’, and ‘with reasonable confidence’ used in relation to disclosure requirements;

   ii. highlighted that it would be useful to amend Article 25(2) of the MiFID Implementing Directive in order to require ‘Chinese walls’ to be set up between financial analysts and other staff, including firms’ relevant persons;

   iii. suggested ESMA to consider:

      a. organisational arrangements regarding potential positions held, *previously* to the release of a given piece of investment research, by financial analysts and other relevant persons, on their own behalf or on behalf of the investment firm or a client; and
      b. organisational arrangements regarding other potential business relationships of the firm or analysts with the issuer to which the investment research relates (for in-

stance, where the firm provides investment banking services to the issuer or where any person within the firm serves on the board of the issuer).

7. On the views expressed in point a) ESMA notes that as this terminology was already used in existing implementing measures without major issues having been raised so far in their application, there is no need to further define the terms. In any case, should any issue emerge, ESMA will be able to tackle any application aspects through other instruments available to ESMA, such as guidelines.

8. On the views expressed in b), ESMA proposes that Article 25 of current Implementing Directive should be complemented with an explicit obligation that would require physical separation between the financial analysts involved in the production of the investment research and other relevant persons whose responsibilities or business interests may conflict with the interests of the persons to whom the investment research is disseminated.

9. On the views expressed in c), ESMA acknowledges the value of the suggestion made but wishes to state that, as they refer to very specific situations, any future work in this area would be more appropriately dealt with through other instruments available to ESMA, such as guidelines, and not in the MiFID Implementing measures.

10. The SMSG agreed with ESMA's draft technical advice. In addition, the SMSG emphasised that disclosure remains a limited tool and strong supervision and enforcement of the new firm-facing requirements relating to, for example, inducements and product governance, is essential. The SMSG further noted that ESMA, within the scope of its supervisory convergence powers, should make sure that NCAs conduct checks in order to assess the situation 'on the ground', especially as this is a new requirement, and do not rely only on disclosure, even if strengthened.

Technical advice

1. ESMA considers that Article 22 of the MiFID Implementing Directive on conflicts of interest policies should be amended by inserting new provisions in relation to the disclosure of conflicts of interest. The following proposals are not intended to replace the existing provisions on conflicts of interest, but rather to clarify or supplement the existing regime.

2. Investment firms shall ensure that disclosure to clients, pursuant to Article 23(2) of MiFID II, is a measure of last resort that can be used only where the effective organisational and administrative arrangements established by the investment firm to prevent or manage its conflicts of interest in accordance with Article 23 of MiFID II are not sufficient to ensure, with reasonable confidence, that the risks of damage to the interests of the client will be prevented.

3. When disclosure of specific conflicts of interest is required, the disclosure shall clearly state that the organisational and administrative arrangements established by the investment firm

to prevent or manage that conflict are not sufficient to ensure, with reasonable confidence, that the risks of damage to the interests of the client will be prevented. The disclosure to clients must be made in a durable medium and it must also include a specific description of the conflict of interest that arises in the provision of investment and/or ancillary services, taking into account the nature of the clients to whom the disclosure is being made. That description must explain the general nature and/or sources of conflicts of interest, as well as the risks to the client that arise as a result of the conflict and the steps undertaken to mitigate these risks, in sufficient detail to enable that client to make an informed investment decision.

4. Member States shall require investment firms to assess and periodically review - at least annually - the conflicts of interest policy established in accordance with this article and to take all appropriate measures to address any deficiencies. Over reliance on disclosure of conflicts of interest must be considered a deficiency in an investment firm's conflicts of interest policy.

5. On the topic of investment research, ESMA considers that:

   i. Article 25(1) of the MiFID Implementing Directive should also apply to recommendations covered under Article 24(2) of the MiFID Implementing Directive.

   ii. Article 25(2) of the MiFID Implementing Directive should be amended by inserting new provision to require a physical separation between the financial analysts involved in the production of the investment research and other relevant persons whose responsibilities or business interests may conflict with the interests of the persons to whom the investment research is disseminated. This provision should also require that when considered not appropriate to the size and organisation of the firm and the nature, scale and complexity of its business, the investment firm shall be able to demonstrate it has put in place appropriate alternative information barriers.

2.10. Underwriting and placing – conflicts of interest and provision of information to clients

Background/Mandate

Extract from the Commission's request for technical advice (mandate)

ESMA is invited to provide technical advice on possible organisational, conflicts of interest and conduct of business requirements that could better address the specificities of underwriting and placing process and activities.

1. The MiFID II provisions relevant to the topic of underwriting and placing are as follows:

   Article 16(3):

   "An investment firm shall maintain and operate effective organisational and administrative arrangements with a view to taking all reasonable steps designed to prevent conflicts of interest as defined in Article 23 from adversely affecting the interests of its clients."

   Article 23:

   "(1) Member States shall require investment firms to take all appropriate steps to identify and to prevent or manage conflicts of interest between themselves, including their managers, employees and tied agents, or any person directly or indirectly linked to them by control and their clients or between one client and another that arise in the course of providing any investment and ancillary services, or combinations thereof, including those caused by the receipt of inducements from third parties or by the investment firm's own remuneration and other incentive structures.

   (2)Where organisational or administrative arrangements made by the investment firm in accordance with Article 16(3) to prevent conflicts of interest from adversely affecting the interest of its client are not sufficient to ensure, with reasonable confidence, that risks of damage to client interests will be prevented, the investment firm shall clearly disclose to the client the general nature and/or sources of conflicts of interest and the steps taken to mitigate those risks before undertaking business on its behalf.

   (3) The disclosure referred to in paragraph 2 shall:

   (a) be made in a durable medium; and

   (b) include sufficient detail, taking into account the nature of the client, to enable that client to take an informed decision with respect to the service in the context of which the conflict of interest arises.

(4) The Commission shall be empowered to adopt delegated acts in accordance with Article 89 to:

(a) define the steps that investment firms might reasonably be expected to take to identify, prevent, manage and disclose conflicts of interest when providing various investment and ancillary services and combinations thereof;

(b) establish appropriate criteria for determining the types of conflict of interest whose existence may damage the interests of the clients or potential clients of the investment firm".

2. ESMA has identified previous work which is also relevant for this topic, notably, the Commission Consultation on Review of MiFID in December 2010 and IOSCO's "Market Intermediary Management of Conflicts that arise Securities Offerings - November 2007", and CESR's Responses to Questions 15-18 and 20-25 of the European Commission Request for Additional Information in Relation to the Review of MiFID.

Analysis following feedback from stakeholders

3. ESMA received numerous comments on the topic of 'Underwriting and placing – conflicts of interest and provision of information to clients'. Respondents have given input on both the background/analysis section and the draft technical advice included in the relevant chapter of the CP. While ESMA has reviewed and considered all comments received, it has however chosen to summarise here only those that directly refer to the technical advice to the Commission.

General

4. Some respondents noted that ESMA's draft advice does not make a distinction between shares/equity securities and bonds/debt securities. These respondents highlighted that there are great differences in these markets and that ESMA's advice seems tailored only to equity/IPO markets.

5. ESMA acknowledges that market practices may vary depending on the financial instrument concerned. However ESMA does not consider that the advice is tailored only to equity/IPO markets. The Commission's mandate requested ESMA to consider requirements that would address the conflicts of interest that arise due to the specificities of the underwriting and placing process. The requirements attach to the service provided rather than the financial instrument. ESMA clearly set out that the requirements apply where the firm provides the following investment services and ancillary services under Annex I of MiFID II: underwriting and placing of financial instruments and/or placing of financial instruments on a firm commitment basis; placing of financial instruments without a firm commitment basis; advice to undertakings on capital structure, industrial strategy, and related matters and advice and services relating to mergers and the purchase of undertaking; and services relating to underwriting.

6. The SMSG noted the inclusion of provisions in the CP relating to the issue of self-placement. The SMSG strongly welcomed the inclusion of such proposals. It also provided ESMA with some proposed changes to strengthen the technical advice. These proposals are set out below (in some cases the SMSG refers to regulatory initiatives in this area taken at national level):

   i. Amend technical advice paragraph 11 from "*Such procedures may include consideration of refraining from engaging in the activity, where conflicts of interest cannot be appropriately managed so as to prevent any adverse effects on clients*" to "*Such procedures must include consideration of refraining from engaging in the activity, where conflicts of interest cannot be appropriately managed so as to prevent any adverse effects on clients*".

   ii. State that in the case of financial instruments other than shares, issued by credit institutions, the information provided to investors shall include additional information on the differences between the financial product offered and bank deposits in terms of yield, risk and liquidity.

   iii. Insert a stronger statement, with more precise requirements, in relation to self-placement by financial institutions when this is the result of a regulatory requirement or has been requested by the national banking regulator.

   iv. State that where the result of the assessment is that a product is not appropriate, the contractual document should include, along with the client's signature, a hand-written representation that they have been warned that the product is inappropriate or that its appropriateness cannot be assessed for the lack of data. Besides, investment firms shall keep a specific register to record all of these clients warned.

   v. State that investment firms should establish appropriate procedures and controls regarding product governance, remunerations and staff training.

   vi. The SMSG also proposed that ESMA set up a working group to consider the establishment to Level 3 work in this area.

7. ESMA notes these suggestions and considers that:

   i. In relation to the suggestion to strengthen the draft Technical Advice by requiring that firms "must" – rather than "may" – consider refraining from the activity if they feel the conflicts of interest cannot be appropriately managed, ESMA agrees and has amended the advice to reflect this.

ii. In relation to the additional information proposed, ESMA considers that it could be applied to all financial instruments issued by investment firms[23] or other group entities where those instruments are included in the calculation of prudential requirements specified in directives and regulations applicable to investment firms (such as CRD/R IV or the pending BRRD). Information on the different treatment in terms of coverage under the deposit guarantee scheme and yield, risk, liquidity should be provided to the client.

iii. Where self-placement has come about due to regulatory requirements or being requested by a national banking regulator, ESMA wishes to remind stakeholders that regardless of any prudential requirements on firms to raise capital, the MiFID obligations in respect of conduct of business and conflicts of interests apply. ESMA also notes that a statement was recently issued by the Joint Committee specifically in the area of self-placement.[24]

iv. Where a financial instrument is not appropriate, ESMA recalls that the investment firm should warn the client accordingly and agrees that the record of this disclaimer should be maintained by the firm. ESMA has made these amendments in the chapter on "Appropriateness".

v. In relation to suggested enhancements to firms' processes around product governance, remunerations, and staff training, ESMA considers that the advice in the section on Product Governance, Remuneration and Compliance function addresses the concerns raised by SMSG.

vi. In relation to Level 3 work, ESMA agrees that further guidance, pertaining to the arrangements and controls that firms would need to have in place before engaging in "self-placement" could be developed as part of future ESMA guidelines, and could be useful in clarifying expectation in this area.

Advising to undertake an offering

8. Respondents highlighted that the roles of underwriter and corporate finance adviser are distinct and in numerous situations underwriters do not have any further role beyond placing/underwriting a portion of securities. Respondents therefore suggested redrafting this section of the advice, and the following on pricing, in order to make this distinction clear.

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[23] It is worth recalling that several MiFID II requirements (as already under MiFID I) apply to credit institutions providing investment services or activities by virtue of Article 1(3) of MiFID II. Therefore, reference to investment firms also encompasses credit institutions in relation to all the requirements mentioned in Article 1(3) (which includes MiFID organisational requirements and conduct of business rules).

[24] http://www.esma.europa.eu/content/Placement-financial-instruments-depositors-retail-investors-and-policy-holders-Self-placemen

9. ESMA agrees and notes that the focus of these requirements is to ensure that where the services of underwriting and placing are provided, the process is managed in an appropriate way which respects the interests of the different actors. The risk of conflicts of interest to arise in the provision of these services is most acute where the firm offers a large number of different products and services to the client, in particular where the firm provides advice in addition to underwriting and placing. ESMA has therefore updated the Technical Advice to reflect this.

10. Furthermore, the following specific comments were made:

    i. the requirement to provide information on the relevant individuals involved in the production of corporate finance advice on the price and allotment appears to be a mere formalism with little to no added value for issuer clients; ESMA notes the concerns however, ESMA believes that it is important that the client is aware of the departments within the firm which may be involved in the production of advice on the price and allocation and is in a position to make an informed decision on whether to proceed. ESMA has amended the advice accordingly.

    ii. information on how the firm intends to manages conflicts of interest should be provided to clients only on request. Respondents noted that the topic of conflict of interest management and disclosure is already clearly regulated by MiFID I and that this further requirement seems redundant ESMA considers that it is important that firms disclose to issuer clients, particularly at the start of a relationship, information about how it intends to address and manage the conflicts of interest that may arise. It is therefore beneficial to add this specific requirement within this section of the implementing measures notwithstanding the general conflicts of interest provisions that may address the point.

Pricing

11. Respondents, while noting that pricing is not an exact science and that, with hindsight, many legitimate factors can be considered to explain why an issue was under-priced or over-priced, more specifically:

    i. suggested clearly excluding ‘placing of blocks’ from the scope of the advice;

    ii. noted that paragraph 4(i) of the draft technical advice which states that investment firms should have in place internal arrangements that ensure that the pricing of the offer does not promote the interests of other clients or the investment firm’s interests, which are distinct from the issuer client’s interests; and paragraph 4(ii) which states that investment firms should have in place internal arrangements that manage or prevent a situation where individuals ordinarily responsible for providing services to the firm’s investment clients are involved directly in decisions about corporate finance advice to the issuer client on pricing should be more precise as the current drafting does not explain what is expected of firms;

iii. noted that the definition of the price of the offering is fruit of an iteration process and it is therefore difficult, if not impossible, for the underwriter to provide the issuer client with clear information on the "timings involved";

iv. noted that the CP suggested that firms providing underwriting services will determine the price of an issue and proposed amendments to the advice that would clarify the role of the issuer client in the determination of the price at which it is willing to proceed with an issue.

12. ESMA notes the responses around the specific arrangements in paragraphs 4(i) and 4(ii), however ESMA is not inclined to draft prescriptive requirements in this area and considers that it is each firm's responsibility to determine what arrangements are necessary and proportionate in relevant circumstances. ESMA also notes the concerns around providing clear information relating to the timings involved in the pricing process, however, it seems reasonable to keep the issuer client generally informed of timings, even if the precise timings evolve over time in an iterative process. ESMA, however, has removed *"ordinarily"* from the technical advice in paragraphs 4 and 7 in order to more precisely clarify firms' obligations. ESMA has also amended the advice by making reference to the *"recommendation"* (instead of the "*determination*") of the price of the offering by the investment firm.

13. ESMA considers that while block trading may involve a placement of shares, this Advice pertains to the issuance of securities and is not intended to address the specific case of block trades.

14. In relation to the requirement for underwriters to discuss with the issuer client any hedging strategies, ESMA received mixed replies and while respondents noted that this is already common practice on the market they also noted that this should not be required by regulation.

15. In relation to stabilisation measures it was noted that these are already regulated by the Market Abuse Regulation and that information to client issuers could not be precise as measures are taken only after the offering and will depend on market conditions existing at the time.

16. ESMA notes the responses that discussion of hedging strategies is already common practise, and that stabilisation is covered by MAR. However ESMA considers that this information will be beneficial to issuer clients, and does not consider it burdensome to require firms undertaking such strategies to provide such information to relevant clients.

Placing

17. Respondents stated that underwriting fees are a fair remuneration of the market risk taken by the underwriter and therefore should not be considered as an inducements pertaining to Article 24(9) of MiFID II. ESMA agrees that pure underwriting fees, that is fees received by investment firms which are only performing all or part of the underwriting to the issuer client,

should not be subject to the requirements on inducements paid by third parties. However, fees received in situations where the investment firm also places the financial instruments issued to its investment clients must comply with requirements on inducements in Article 24(9) of MiFID II.

18. Respondents also commented on the topic of the 'allocation policy' and noted that while lead-managers engage issuers on their allocation policies, the requirements included in ESMA's draft technical advice place an unnecessary additional burden on firms since an issuer's decision to mandate a lead-manager to undertake a placing will not depend on the lead manager's allocation policy as these are quite standard across the industry. ESMA rejects this proposal. NCAs supervisory experience has shown that firms were unable to show clear allocation policies and produce justification for their allocation recommendations in all cases.

Lending and provision of credit

19. Some respondents commented that the current wording of the draft Technical Advice strongly implies that where a firm has previously extended credit to an issuer, the firm should consider refraining from providing the services of underwriting and placing. They argued that this was contradictory to the conflict of interest requirements to identify and manage conflicts, and disclose them as a last resort. They also argued that an implied requirement to refrain from the activity would inhibit lending, particularly to SMEs.

20. ESMA acknowledges that the regime allows firms the flexibility to make arrangements to identify and manage conflicts of interest that may arise, and has updated the technical advice to remove the implication that refraining from acting was required of firms in all cases. Refraining from acting in a situation may still be considered as a measure to manage a conflict of interest.

21. Some respondents also expressed concerns that a requirement for full sharing of client information between areas of the firm responsible for different corporate finance activities relating to the issuer client could require them to breach information barriers set up to manage the flow and use of confidential information.

22. ESMA acknowledges this potential risk and has updated the advice to specify that the sharing of information requirement is intended to apply in cases where it would not breach such barriers.

Record-keeping

23. Respondents stated that the requirement to keep a *"complete audit trail between the movements registered in clients' accounts and the instructions received by the investment firm*" would be extremely complex to implement as it seems to require a complete and continuous audio, video and documentary recording of the interaction between the underwriter and the issuer. Respondents therefore suggested clarifying that only the essential steps of the pro-

cess need to be documented. Respondents also suggested clarifying that firms need to justify and record the final allocation for each 'issuer client' and not for each investor.

24. ESMA notes the concerns around the burdensome scope of providing a complete audit trail for each transaction, and has updated the advice to emphasise the need to keep records of the *"material"* steps. However, ESMA believes it is important for firms to be able to evidence and justify the steps they have taken throughout the process, including justifications of the allocations for each investment client. NCA supervisory experience has shown that firms have often been unable to articulate the reasoning behind allocation recommendations.

Oversight

25. Finally respondents noted that keeping record of all 'potential' conflicts of interest arising from underwriting and placing activities seems highly impractical.

26. ESMA acknowledges the broad nature of conflicts that could occur in potential underwriting and placing operations. ESMA has updated the advice to narrow the scope of the requirement so that it will apply only to actual services provided.

Technical advice

Proposed new Organisational requirements to be issued under Article 16(3) of MiFID II and/or Provision of Information requirements to be issued under Article 24 of MiFID II

1. Article 16(3) of MiFID II requires a firm to maintain and operate effective organisational or administrative arrangements, with a view to taking all reasonable steps designed to prevent conflicts of interest (as defined in Article 23 of MiFID II) from adversely affecting the interests of its clients. The potential for conflicts of interest to arise in the underwriting and placing process is significant, particularly where an investment firm or related group entities offer a large number of products and services to clients: therefore, the establishment of organisational arrangements specific to underwriting and placing is important.

2. ESMA therefore proposes that the following organisational arrangements and/or provision of information requirements shall be placed on firms.

Advising to undertake an offering

3. In cases where the firm is advising the corporate finance strategy and providing the service of underwriting and placing, the investment firm, before it accepts a mandate to manage the offering, shall have arrangements in place to ensure that it explains to the issuer client:

    i. the various financing alternatives available from the firm, and an indication of the level of transaction fees associated with each;

    ii. the timing and the process the investment firm will take in respect to how it will reach its

corporate finance advice in respect to pricing the offer;

iii. the timing and the process the investment firm will take in respect to how it will reach its corporate finance advice in respect to placing of the offering;

iv. details of the targeted investors, to whom it is planned to offer the securities;

v. the job titles and departments of the relevant individuals involved in the production of corporate finance advice on the price and allotment; and

vi. how it intends to manage conflicts of interest that may arise in circumstances where it places the relevant securities with investment clients of the firm or with its own proprietary book.

Pricing

4. Investment firms shall have in place systems, controls and procedures to identify and manage the conflicts that arise in relation to possible under-pricing and over-pricing of issues and involvement of relevant parties in this process including 'book building'. Specifically:

   i. investment firms shall have in place internal arrangements that ensure that the pricing of the offer does not promote the interests of other clients or the investment firm's interests, in ways that conflict with the issuer client's interests; and

   ii. investment firms shall have in place internal arrangements that manage or prevent a situation where individuals responsible for providing services to the firm's investment clients are involved directly in decisions about corporate finance advice to the issuer client on pricing.

5. In addition, investment firms shall provide clients with information about how the investment firm determines its recommendation as to the price of the offering and the timings involved. Specifically:

   i. investment firms shall discuss with the issuer client any hedging or stabilisation strategies it plans to undertake with respect to the offering, including how these strategies may impact the issuer clients' interests; and

   ii. investment firms shall take reasonable steps to keep the issuer client informed on developments relevant to the pricing during the offering process.

Placing

6. Investment firms shall have in place internal arrangements that prevent placing recommendations from being inappropriately influenced by any existing or future relationships.

7. Investment firms shall have in place internal arrangements that manage or prevent a situa-

tion where individuals responsible for providing services to the firm's investment clients are involved directly in decisions about recommendations to the issuer client on allocation.

8. An investment firm must not accept third party payments that are in conflict with the conditions of the inducements regulations in Article 24(9) of MiFID II. In the context of underwriting and placing, the following practices would be considered abusive (this list is not exhaustive):

   i. an allocation made to incentivise the payment of a large amount of fees for unrelated services provided by the investment firm ('laddering'). For example, very high rates of commissions paid to the investment firm by an investment client, or an investment client providing very high volumes of business at normal levels of commission as compensation for receiving an allocation of the issue;

   ii. an allocation made to a senior executive or a corporate officer of an existing or potential issuer client, in consideration for the future or past award of corporate finance business (spinning); and

   iii. an allocation that is expressly or implicitly conditional on the receipt of future orders or the purchase of any other service from the investment firm by an investment client, or any entity of which the investor is a corporate officer.

9. Investment firms shall have in place an allocation policy that sets out the process for developing allocation recommendations. This allocation policy shall be provided to the issuer client before agreeing to undertake a placing. The policy shall set out relevant information (to the extent it is known at that stage) about the proposed allocation methodology for the issue.

10. The investment firm shall invite the issuer client to participate in discussions about the placing process so that the investment firm can take the interests of the issuer client into account, for example by obtaining the issuer client's agreement to its proposed allocation per type of client for the transaction in accordance with the allocation policy.

Retail advice/Distribution

11. Investment firms shall have in place systems, controls and procedures to identify and manage the conflicts of interest that arise where investment firm provides investment services to an investment client to participate in a new issue, where the investment firm is in receipt of commissions/fees in relation to arranging the issuance. Commissions/fees received in such circumstances must comply with Article 24(9) of MiFID II. This shall be documented in the investment firm's conflicts of interest policies, and reflected in the firm's inducement arrangements.

12. Investment firms that engage in the placement of financial instruments issued by themselves (or other group entities) to their own clients, including their existing depositor clients

(in the case of credit institutions) or investment funds managed by entities of their group, must have in place clear procedures for the identification and management of the potential conflicts of interest that arise in relation to this type of activity. Such procedures must include consideration of refraining from engaging in the activity, where conflicts of interest cannot be appropriately managed so as to prevent any adverse effects on clients.

13. When disclosure of conflicts of interest is required, investment firms shall explain the nature and source of the conflicts of interest inherent to this type of activity, providing details about the specific risks related to such practices so as to enable clients to make an informed investment decision.

14. Where investment firms engage in the offering of financial instruments issued by themselves (or other group entities) to their clients, where those instruments are included in the calculation of prudential requirements specified in directives and regulations (such as CRD/R IV or the pending BRRD), they shall provide such clients with additional information explaining the differences between the financial instrument and bank deposits in terms of yield, risk, liquidity and any protections provided by the Deposit Guarantee Scheme Directive.

Lending/Provision of credit

15. In circumstances where any previous lending or credit to the issuer client by the investment firm (or a group entity) may be repaid with the proceeds of the issue, investment firms shall have arrangements in place to identify and manage any conflicts of interest that may arise as a result.

16. If the investment firm acted as arranger and the steps it took to manage the conflicts of interest were not sufficient to ensure that the risk of damage to the client would be prevented, the investment firm shall disclose to the client the specific conflicts of interest that have arisen in relation to the activities of the investment firm (or group entity) acting in their capacity as a credit provider, and the activity of the investment firm in acting as arranger for the securities offering.

17. Where one entity within a group is acting as a credit provider, and another is acting as arranger for a securities offering, the investment firm's conflict of interest policy shall require that full information shall be shared between the different entities, in relation to the issuer's financial situation, provided this would not breach existing information barriers set up by the firm to protect the interests of a client.

Record-keeping

18. Investment firms shall keep records of the content and timing of instructions received from clients. A record of the allocation decisions taken for each operation shall be kept to provide for a complete audit trail between the movements registered in clients' accounts and the instructions received by the investment firm. In particular, the final allocation made to each investment client shall be clearly justified and recorded. The complete audit trail of all material

steps in the underwriting and placing process shall be made available on request to NCAs.

Oversight

19. Investment firms shall have in place a centralised process to identify all underwriting and placing operations of the firm and keep a record of this information, specifying the date on which the firm was informed of potential underwriting and placing operations.

20. The firm shall identify all potential conflicts of interests arising from other activities of the investment firm (or its group), and implement appropriate management procedures. In some cases, if the conflict of interest cannot be managed by procedures or arrangements, the only way to manage the conflict would be for the investment firm not to engage in the operation.

2.11. Remuneration

Background/Mandate

Extract from the Commission's request for advice (mandate)

ESMA is invited to provide technical advice on appropriate requirements aiming at ensuring that the design, the implementation and the oversee of remuneration policies and practices do not influence or interfere with firms' duties to act in the best interest of clients and in particular with the requirements set out in Articles 16(3), 23 and 24. ESMA should for instance consider criteria for the design of remuneration policies and remuneration structures, the need to establish or reinforce certain internal procedures to ensure the involvement of the compliance function and of the management bodies in the definition, approval or oversee of remuneration policies. Such arrangements should encourage responsible business conduct, fair treatment of clients as well as the avoidance of conflict of interests in the relationships with clients.

1. The remuneration of staff involved in the provision of investment services to clients is a crucial investor protection issue. ESMA has recently published Guidelines in this area on the basis of MiFID I (Remuneration Guidelines).[25]
2. Although remuneration issues are not specifically mentioned in MiFID I and its implementing measures, the importance of these issues is highlighted in MiFID II.
3. Article 9(3)(c) of MiFID II introduces a new, explicit requirement on the management bodies of investment firms to "*define, approve and oversee […] a remuneration policy of persons involved in the provision of services to clients aimed at encouraging responsible business conduct, fair treatment of clients as well as avoiding conflicts of interest in the relationships with clients*".
4. Whereas the current requirement on investment firms to "*maintain and operate effective organisational and administrative arrangements with a view to taking all reasonable steps designed to prevent conflicts of interest […] from adversely affecting the interests of its clients*" will be maintained under Article 16(3) of MiFID II, Article 23(1) of MiFID II highlights the issues related to remuneration by requiring firms to "*take all appropriate steps to identify and to prevent or manage conflicts of interest […] including those caused by […] the firm's own remuneration and other incentive structures*".
5. In addition to these broadly framed organisational requirements, Article 24(10) of MiFID II will provide that an investment firm "*which provides investment services to clients shall ensure that it does not remunerate or assess the performance of its staff in a way that conflicts with its duty to act in the best interests of its clients. In particular, it should not make any ar-*

[25] Guidelines on remuneration policies and practices (MiFID) – Final report (ESMA/2013/606).

rangement by way of remuneration, sales targets or otherwise that could provide an incentive to its staff to recommend a particular financial instrument to a retail client when the investment firm could offer a different financial instrument which would better meet that client's needs".

Analysis following feedback from stakeholders

6. Respondents were generally supportive of ESMA approach regarding the scope of the remuneration requirements. However, a large number of respondents suggested that the final technical advice gives more guidance as to which individuals in an investment firms should be subject to the remuneration requirements. Notably, a few respondents noted that the expression "*all relevant persons who can have a material impact*" would lead to the application of the remuneration requirements to an unduly large number of people. ESMA considers that the broad definition of the scope proposed in the technical advice will allow sufficient flexibility for investment firms to adapt the provisions to suit their individual organisations.

7. A significant number of respondents noted that the draft technical advice was, at least in some respects, not aligned with the remuneration requirements set out by UCITS, AIFMD and CRD. A few respondents suggested that ESMA, with EBA, considers issuing harmonised guidance on remuneration requirements for the benefits of firms subject to UCITS, AIFMD or CRD in addition to MiFID. ESMA would like to recall that the issue of the interaction between MiFID and other regulatory frameworks has been dealt with in the context of the Remuneration Guidelines. ESMA considers that these Directives aim at tackling different policy concerns (MiFID requirements on remuneration are conduct-focused) and does not believe that there are major consistency issues with the effect that the different requirements are complementary rather than conflicting.[26] ESMA considers that the adoption of future guidelines might certainly be possible should specific application issues arise.

8. Several respondents noted that the application of the requirements not only to the 'remuneration' but also to the 'related incentives' would make the implementation of the requirements in firms' remuneration policies rather difficult. Several respondents strongly opposed to the inclusion of 'career progression' as part of the 'non-financial remuneration' expressing the view that such criteria is not easy to monitor adequately. ESMA notes that 'career progression' is already inserted in the definition of 'remuneration' provided in the Remuneration Guidelines together with 'non-financial' incentives. ESMA is of the view that it is important that these forms of incentives are covered in the MiFID II implementing measures.

[26] In particular on the relationship with CRD IV and the ratio between the fixed and the variable components of the remuneration introduced by CRD IV, ESMA clarified that MiFID applies in relation to the provision of investment and ancillary services while CRD IV targets staff whose professional activities have a material impact on firms' risk profile. Where certain individuals are captured by MiFID rules (when providing investment services to clients) and CRD IV (due to their role in institutions), the former will apply without prejudice to the latter.

9. A majority of respondents supported ESMA's approach regarding variable remuneration. However, a large number of respondents expressed the view that maintaining an "*appropriate balance between fixed and variable components*" of the remuneration would not guarantee an enhanced level of protection for investors. Many of these respondents also disagreed with the suggested balance between 'commercial criteria' and 'criteria reflecting compliance with applicable regulations' in paragraph 6 of the draft technical advice. Some respondents also noted that the expression *"partly based on"* was too vague and could lead to diverse interpretations. ESMA has made a number of amendments to the technical advice, in particular with respect to variable remuneration, and considers that the advice is now sufficiently clear. ESMA also notes that, as stated in the ESMA Remuneration Guidelines, when determining the remuneration for tied agents, firms may take the tied agents' special status (usually as self-employed commercial agents) and the respective national specificities into consideration. However, in such cases, firms' remuneration policies and practices should still define appropriate criteria to be used to assess the performance of relevant persons. Such assessment should be based on qualitative criteria encouraging the relevant persons to act in the best interests of the client.

Technical advice

1. ESMA considers that the future delegated act should include the definition of remuneration provided in the ESMA Remuneration guidelines.

Scope

2. The provisions below shall apply to all relevant persons who can have a material impact, directly or indirectly, on investment and ancillary services provided by the investment firm or on its corporate behaviour, regardless of whether the clients are retail or professional, to the extent that the remuneration of such persons and similar incentives – including non-financial remuneration such as in-kind benefits and career progression – may create a conflict of interest that encourages them to act against the interests of any of the firm's clients.

Design criteria

3. Investment firms shall define their remuneration policies under appropriate internal procedures taking into account the interests of all the clients of the firm, with a view to ensuring that clients are treated fairly and their interests are not impaired by the remuneration practices adopted by the firm in the short, medium or long term. In particular, remuneration policies and practices shall be designed in such a way so as not to create incentives that may lead relevant persons to favour their own interests or the firm's interests to the potential detriment of any client.

Governance

4. The design of the investment firm's remuneration policy shall be approved by the manage-

ment body of the firm after taking advice from the compliance function.

5. The day-to-day implementation of the remuneration policy and the monitoring of compliance risks related to the policy shall be the responsibility of the senior management of the investment firm.

Variable remuneration

6. Remuneration and similar incentives shall not be solely or predominantly based on quantitative commercial criteria, and shall take fully into account appropriate qualitative criteria reflecting compliance with the applicable regulations, the fair treatment of clients and the quality of services provided to clients.

7. An appropriate balance between fixed and variable components of remuneration shall be maintained at all times, so that the remuneration structure does not favour the interests of the investment firm or its relevant persons against the interests of any client.

2.12. Fair, clear and not misleading information

Background/Mandate

Extract from the Commission's request for advice (mandate)

ESMA is invited to provide technical advice to specify the conditions for information to clients to be fair, clear and not misleading while taking into account the objectives of the Directive.

1. Article 24(3) of MiFID II states "*All information, including marketing communications, addressed by the investment firm to clients or potential clients shall be fair, clear and not misleading. Marketing communications shall be clearly identifiable as such".*

2. No changes have been introduced in this area since the MiFID I. Article 24(13) of MiFID II specifies that *"The Commission shall be empowered to adopt delegated acts […] to ensure that investment firms comply with the principles set out in this Article when providing investment or ancillary services to their clients, including (a) the conditions with which the information must comply in order to be fair, clear and not misleading"*.

3. In providing advice to the Commission, it should also be considered that one of the objectives of the MiFID review was to improve, where appropriate, the treatment of non-retail clients. In its advice on fair, clear and not misleading information in accordance with Article 24(3) of MiFID II, ESMA has taken this evolution into account in order to propose targeted improvements to the regime applicable to professional clients, where appropriate.

4. The existing Article 27 of the MiFID Implementing Directive, "*Conditions with which information must comply in order to be fair clear and not misleading",* applies only to retail or potential retail clients.

Analysis following feedback from stakeholders

5. ESMA received the following comments on the draft technical advice on information addressed to or likely to be received by retail clients or potential retail clients:

   i. On the proposed requirement to "*always give a fair and prominent indication of any relevant risks and not reference any potential benefits of an investment service or financial instrument without also giving a fair and prominent indication of any relevant risks*" some firms and trade associations noted that the use of the term 'always' is too broad and gives rise to uncertainty as this provision is intended only for 'pre trade information'. ESMA understands this concern and amended the technical advice to clarify that information on the risks is not required where information is provided to clients and potential clients but only in cases where benefits are referenced.

   ii. On the other hand some respondents stated that the current drafting incorrectly opposes 'benefits' to 'risks' and that investors should not only be informed of risks but also of

‘drawbacks’ and ‘weaknesses’ of the product. ESMA believes that the advice is sufficiently clear on this point.

iii. On the proposed requirement to *“use a font size in the indication of relevant risks that is at least equal to the predominant font size used throughout the information provided, as well as a layout ensuring such indication is prominent”,* various respondents stated that ESMA’s advice is overly prescriptive and should only require ‘equal prominence’ of the messages. These respondents noted also that the use of different fonts can enhance readability of information and that some Member States have codified in national law that specific information must be given in a typographically emphasised manner. ESMA notes that the advice does not require the use of the same font size across the document, but only that relevant risks are not presented in a font which is smaller than the predominant size used in the text. This does not appear to be overly prescriptive or to limit the use of typographical choices which can further enhance readability.

iv. On the proposed requirement to *“consistently present [the information] in the same language throughout all forms of information and marketing materials that are provided to each client”* respondents:

   i. Asked ESMA to clarify if ‘same language’ should be interpreted as ‘language used in a Member State’ (for example, French or English) or as ‘terminology’ (requiring therefore consistent terminology across all informative documents). ESMA confirms that the advice does not refer to the use of terminology.

   ii. Noted that this proposed requirement needs to take into account that the Prospectus Directive allows the use of different languages in certain circumstances. ESMA considers that information requirements under MiFID are different from the obligations regulated under the Prospectus Directive and underlines that the proposed technical advice does not imply that firms need to translate prospectuses provided to clients.

   iii. Should allow clients to consent to the use of more than one language, as this would be preferable for cross-border transactions and/or bilingual clients. ESMA understands the comment and has clarified in the technical advice on this point.

v. On the proposed requirement for the information to be *“up-to-date, relevant to the method of communication used”*, respondents noted that this requirement needs to take into consideration the inevitable time-lag which occurs between a development which requires an update to the documentation, and the necessary changes actually being made. ESMA believes the advice on the topic is already sufficiently clear and does not need to be amended.

6. On the use of performance scenarios, various firms and trade associations:

i. asked ESMA to make a clear distinction, in its advice, between equity/non-equity instruments. On this issue, asset managers noted that they are already under the obligation to display three future scenarios under the UCITS IV Directive and that these are helpful when dealing with products with a complex risk/return profile;

ii. suggested basing the proposed performance scenarios on a 'what-if' approach and not requiring the use of probabilistic methods which would be much more costly and complex to implement.

7. Consumer associations, on the other hand, noted that performance scenarios can be misleading if not probability weighted and suggested that only the most probable scenarios are displayed. In this regards, some of these consumer associations criticised the use of the terminology *"positive"* and *"negative"* scenarios.

8. ESMA understands the different suggestions made, but notes that the proposal made is additional to the requirement in Article 27(6)(b) which requires that information on future performance is based on reasonable assumptions supported by objective data. This obligation should be sufficient to deliver on the expected results suggested by some respondents.

9. The majority of respondents supported the principal that information to professional clients should be fair, clear and not misleading, but noted that the same disclosure requirements should not apply to professional and retail clients. More specific comments included the suggestions:

i. to clarify that eligible counterparties are excluded from the scope of this advice. ESMA confirms that its advice on the topic does not refer to eligible counterparties but also recalls that Article 30(1) of MiFID II requires that communication with eligible counterparties is fair, clear and not misleading.

ii. to amend or delete the suggested requirement that information to professional clients *"shall not reference any potential benefits of an investment service or financial instrument without also giving a fair and prominent indication of any relevant risks"* as respondents noted that, under MiFID, professional clients are assumed to possess the necessary experience, knowledge and expertise to make their own investment decisions and properly assess the risks that they incur. ESMA underlines that it is not proposing to apply for professional clients the same requirements to be applied to information addressed to or likely to be received by retail clients, but only the three items listed in paragraph 4 of the advice. For this reason, ESMA believes the suggested approach is sufficiently balanced, and in line with the spirit of Recitals 86 and 104 of MiFID II, and does not need to be amended.

iii. to amend the suggested requirement on 'up-to-date' information by making a distinction between 'information sent to professional client and information made available to them'. ESMA believes the advice on the topic is already sufficiently clear and does not need to be amended.

Technical advice

1. The content of Article 27 of the MiFID Implementing Directive should be modified in the areas below.

2. Information addressed to or likely to be received by retail clients or potential retail clients:

   i. shall always give a fair and prominent indication of any relevant risks when referencing any potential benefits of an investment service or financial instrument;

   ii. shall use a font size in the indication of relevant risks that is at least equal to the predominant font size used throughout the information provided, as well as a layout ensuring such indication is prominent;

   iii. shall be consistently presented in the same language throughout all forms of information and marketing materials that are provided to each client, unless the client has accepted to receive information in more than one language; and

   iv. shall be up-to-date, relevant to the method of communication used.

3. Where the information contains information on future performance, in addition to those already required by Article 27(6) of the MiFID Implementing Directive the following condition should be satisfied: the information provided should be based on performance scenarios in different market conditions (both negative and positive scenarios), and should reflect the nature and risks of the specific types of instruments included in the analysis.

4. Information addressed to or likely to be received by professional clients or potential professional clients:

   i. shall not reference any potential benefits of an investment service or financial instrument without also giving a fair and prominent indication of any relevant risks;

   ii. shall not disguise, diminish or obscure important items, statements or warnings; and

   iii. shall be accurate and up-to-date, relevant to the method of communication used.

2.13. Information to clients about investment advice and financial instruments

Background/Mandate

Extract from the Commission's request for advice (mandate)

ESMA is invited to provide technical advice on future requirements concerning the provision and content of information to clients, including, where applicable, in relation to the type of investment advice and the range of financial instruments, the provision of a periodic suitability assessment or of information on financial instruments and in particular their complexity. ESMA should also consider possible improvements to the general information requirements set out in the Commission Directive 2006/73/EC. MiFID II introduces a number of additional requirements relating to the information to be provided to investors and potential investors, in particular when investment advice is provided and in relation to the charac-teristics of financial instruments (whether they are intended for retail or professional clients).

1. The following provisions in MiFID II are relevant to this topic:

   Article 24(4):

   "Appropriate information shall be provided in good time to clients or potential clients with regard to the investment firm and its services, the financial instruments and proposed investment strategies, execution venues and all costs and related charges. That information shall include the following:

   (a) when investment advice is provided, the investment firm must, in good time before it provides investment advice, inform the client:

   (i) whether or not the advice is provided on an independent basis;

   (ii) whether the advice is based on a broad or on a more restricted analysis of different types of financial instruments and, in particular, whether the range is limited to financial instruments issued or provided by entities having close links with the investment firm or any other legal or economic relationships, such as contractual relationships, so close as to pose a risk of impairing the independent basis of the advice provided;

   (iii) whether the investment firm will provide the client with a periodic assessment of the suitability of the financial instruments recommended to that client;

   (b)the information on financial instruments and proposed investment strategies must include appropriate guidance on and warnings of the risks associated with investments in those instruments or in respect of particular investment strategies and whether the financial instrument is intended for retail or professional clients, taking account of the identified target market in accordance with paragraph 2".

2. The MiFID Implementing Directive includes several provisions on information to clients, including general requirements and requirements on specific aspects (Articles 28 to 34 of the MiFID Implementing Directive). Different sections of this technical advice deal with suggested measures arising from modifications in the MiFID II text (compared to MiFID I) or from the identified need to improve the existing implementing measures. In particular, specific sections of this paper address information about investment advice, financial instruments, costs and associated charges and safeguarding of client assets. Where appropriate, ESMA is proposing the extension of detailed information requirements to non-retail clients (eligible counterparties and professional clients). Improved disclosure to clients is also suggested in other specific areas, such as conflicts of interest and best execution.

Analysis following feedback from stakeholders

Information about advice (independent or not, range of financial instruments and periodic assessment of suitability)

Information provided about whether investment advice is independent or not

3. While a large number of respondents agreed that it is appropriate for firms to inform the client if the advice is provided on an independent or non-independent basis, the majority of respondents noted that ESMA's draft technical advice was over-prescriptive and gave potential negative connotations to non-independent advice. ESMA has modified its advice taking this comment into account.

4. More specifically, the majority of respondents noted that the introduction of quasi-similar requirements for independent and non-independent advice would blur the distinction between the two types of advice, therefore going against the spirit of the MiFID II text. These respondents therefore suggested applying the requirements set out in the draft ESMA technical advice only to the provision of independent advice. ESMA disagrees as it considers its advice in line with the MiFID II text.

5. Trade associations also noted that a distinction should be made with regard to categories of clients and that the information set out in the draft ESMA technical advice should be mandatorily provided only to retail clients. ESMA disagrees, as it believes that information set out in the ESMA advice is relevant for professional clients too. ESMA also notes that the requirements set out in Article 24(4) of MiFID II apply to relationships with both retail and professional clients.

6. Consumer organisations supported the draft technical advice, although not fully, as they noted that the advice should explicitly require firms to inform clients that a ban of commissions is the basis for independent advice. ESMA notes that the proposed advice to the Commission referred to the *"type and nature"* of restrictions applicable to independent advice which includes the ban of inducements. ESMA has therefore clarified this aspect.

Information about the broad or restricted analysis of different types of financial instruments

7. With regards to the provision of information on the different types of financial instruments on which the advice is provided, the majority of respondents noted that at most, the information regarding broad or restricted analysis should be of a general nature and be provided as a generic description of the investment firm's selection process. It was also suggested to enable firms to provide this information to clients on the firm's website. This issue was specifically raised by asset management firms who noted that the provision of too detailed information would not be effective, and would need to be updated very frequently, putting a high burden especially on smaller firms.

8. Furthermore, some respondents opposed the notion that financial instruments not having close links with the investment firm generally better meet the client's profile or need and noted that the provision of information to clients on this topic might be misleading. These respondents asked ESMA to focus only on the provision of information that is relevant for the client and suggested therefore deleting this requirement.

9. ESMA considers that the purpose behind the MiFID II requirements is to ensure that the basis of the advice is fully transparent to clients so that they can immediately discern the scope of the advice. In ESMA's view therefore, it is not sufficient for firms to express in general terms the scope (restricted or broad) of products considered. For investors to have full understanding and confidence in the advice received they must have appropriate detail on proportion of the number of financial instruments analysed by the firm. On the other hand, having considered the responses received, ESMA has amended the technical advice to further distinguish the requirements applicable to the provision of independent and non-independent advice. Furthermore ESMA notes that its advice does not imply that financial instruments recommended by entities without close links to the firm are necessarily better but that the client should be able to understand the links and therefore the possible conflicts of interest that may be present when advice is provided to them.

Information about the periodic assessment of suitability

10. Various trade associations and firms responding to the consultation noted that the advice to provide *"the frequency and extent of the periodic suitability assessment"* included in paragraph 6(i) is misleading and should be redrafted as it MiFID II does not impose on-going suitability assessments by firms. ESMA agrees that no obligation of on-going monitoring of suitability is imposed by MiFID II but it considers that the proposed draft technical advice was sufficiently clear in this respect.

Information about financial instruments

11. Approximately half of the respondents welcomed the ESMA proposals to expand the content of Article 31 of the MiFID Implementing Directive on information to be provided on financial instruments. However various detailed comments were provided on the specific proposals included in the CP and respondents noted that the technical advice should:

i. clarify that firms may rely on disclosure already provided to clients through the UCITS KID or the PRIPS KIID. In this regard asset managers noted that the provision of information which is already contained in another regulatory document would be redundant and could be a source of confusion for clients;

ii. be modified in order to either clarify that the information to be provided should take into account the client's categorisation, and/or to explicitly give professional clients and eligible counterparties the possibilities to opt-out from being provided this information;

iii. specify that the provision of information on 'general scenarios' is acceptable to comply with the obligation to provide information on the performance of the financial instruments, with no need to adapt the scenarios to the specific circumstances of the client;

iv. not require firms to try to estimate a time frame for the sale of financial instruments as this might create some mislead expectations in clients;

v. clarify what is meant by 'legal nature and status of the financial instruments';

vi. clarify that, in line with Recital 84 of MiFID II, firms may provide the information *"as part of or an annex to the contract"*.

12. ESMA has noted the comments above and amended the advice where relevant and appropriate. In particular, ESMA notes that:

i. Article 34 of the MiFID Implementing Directive already aimed at ensuring the coordination between the UCITS regulatory framework and MiFID by requiring that a simplified prospectus complying with the UCITS directive should be regarded as appropriate information on the risk, cost and charges of the financial instrument. ESMA considers that this provision could be confirmed in relation to PRIIPS KID (and UCITS KIID). In relation to the costs of the financial instrument, it is however appropriate to consider Recital 78 of MiFID II, commented in the section of this document dedicated to disclosure on costs and charges.

ii. Concerning clients' categorisation, ESMA would like to recall that Article 24(4) of MiFID II applies to all categories of clients (including eligible counterparties by virtue of Article 30 (1) of MiFID II) and that the ESMA advice is only proposing modifications to the existing Article 31 of the MiFID Implementing Directive which already allows firms to take into account the client's categorisation (Article 31(1)) and the level of knowledge (Article 31(2)).

iii. On information on functioning and performance of the instruments in different market conditions, ESMA confirms that this information is referred to the financial instrument in general.

iv. On paragraph 8 of the draft technical advice, ESMA acknowledges that it is difficult for a firm to know ex ante the specific timeframe for exit or re-sale of a financial instrument. ESMA considers that a firm should not set out in advance the exact timeframe for exit but should provide the client with at least an indication of whether the instrument could be disposed of over a certain timeframe (for instance inside a year) in order for the client to be able to return to a situation where initial costs have been recovered based on the expected performance of the product. In view of the comments received ESMA will amend the technical advice to make clearer the obligations on firms in this regard.

v. On the legal nature of the financial instruments ESMA intended to refer among other possible things, whether the financial instrument takes the form of equity or debt; whether it is callable by the issuer; whether it is perpetual; conversion terms; the party liable for contingencies; the ownership of the instrument etc. ESMA deleted the reference to the *"status"* of the financial instruments.

vi. Concerning Recital 84 of MiFID II, the ESMA technical advice is not inconsistent with it. At the same time, ESMA would like to recall Recital 45 of the MiFID Implementing Directive which states that, in some cases information on the type of a financial instrument is sufficient while in others the information needs to be product-specific.

13. In response to ESMA's question on possible additional information requirements to be added to the MiFID Implementing Directive, the only suggestions received were in relation to information on safeguarding of client assets. ESMA notes that this topic has been dealt with in section 2.8 of the advice.

14. Finally, ESMA has deleted paragraph 10 of the draft technical advice, as it was inconsistent with Article 24(5) of MiFID II which allows Member States to decide whether the information referred to in paragraphs 4 and 9 of Article 24 may be provided by firms in a standardised format.

Technical advice

Information about advice

Information provided about whether investment advice is independent or not

1. Investment firms should inform clients about the nature and type of the advice provided to them. Investment firms should explain in a clear and concise way whether and why investment advice could qualify as independent and the type and nature of the restrictions that apply, including the prohibition to receive and retain inducements.

2. Where both types of advice are intended to be proposed or provided to the same client, investment firms should (i) explain the scope of both services to allow investors to understand the differences between them; and (ii) avoid presenting itself in general as an independent investment advisor. To this end, firms should avoid in their communications with

clients, giving undue prominence to its independent investment advice services over its non-independent investment services.

Information about the broad or restricted analysis of different types of financial instruments

3. When an investment firm intends to provide investment advice on an independent or non-independent basis it must explain to the client the range of financial instruments that may be recommended, including its relationship with the issuers or providers of the instruments.

4. Investment firms should provide a description of the types of financial instruments considered, the number of financial instruments and providers analysed per each type of instrument according to the scope of the service, and, when providing independent advice, how the service provided satisfies the conditions for the provision of independent advice and the basis of the selection process used by the investment firm to recommend financial instrument(s).

5. When the range of financial instruments assessed by the investment firm providing independent advice includes the investment firm's own financial instruments or those issued or provided by entities having close links or any other close legal or economic relationship with the investment firm and other issuers or providers, the investment firm should distinguish, for each type of financial instrument, the proportion of the financial instruments issued or provided by entities not having any links with the investment firm.

Information about the periodic assessment of suitability

6. Where the investment advice service includes a periodic assessment of the suitability of the recommendations provided, investment firms should disclose:

   i. the frequency and extent of the periodic suitability assessment and where relevant, the conditions that trigger that assessment;

   ii. the extent to which the information previously collected will be subjected to re-assessment; and

   iii. the way in which an updated recommendation will be communicated to the client.

7. Investment firms that provide a periodic suitability assessment should consider reviewing the suitability of the recommendations given in order to enhance the service at least annually. The frequency of this assessment should be increased depending on the risk profile of the client and the type of financial instruments recommended.

Information about financial instruments

The content of Article 31 of the MiFID Implementing Directive should be modified in the areas below.

8. Article 31(1) should provide for an additional requirement for investment firms to inform clients about the functioning and performance of financial instruments in different market conditions (including both positive and negative conditions).

9. Article 31(2), relating to the description of risks, should specifically address the risk of financial instruments involving impediments or restrictions for the disinvestment (for example as may be the case for illiquid financial instruments or financial instruments with a fixed investment term). Information on impediments or restrictions should include an illustration of the possible exit methods and consequences of any exit, possible constraints and issues and the estimated time frame for the sale of the financial instrument before recovering the initial costs of the transaction.

10. Article 31(4) should be modified to require that where a financial instrument is composed of two or more different financial instruments or services, the investment firm shall provide an adequate description of the legal nature of the financial instrument, the components of the instrument and the way in which the interaction between the components affects the risks of the investment. In the case of financial instruments that incorporate a guarantee or capital protection, the information shall specify the scope and nature of such guarantee or capital protection. When the guarantee is provided by a third party, the information about the guarantee shall include sufficient detail about the guarantor and the guarantee to enable the retail client or potential retail client to make a fair assessment of the guarantee.

11. Article 34 should be modified by replacing the reference to the UCITS simplified prospectus with the reference to the UCITS KIID and to the PRIIPs KID and by clarifying that where sufficient information on costs and charges is included in the KID/KIID, it should be regarded as appropriate for the purposes of providing information to clients under MiFID II.

2.14. Information to clients on costs and charges

Background/Mandate

Extract from the Commission's request for advice (mandate)

ESMA is invited to provide technical advice on measures specifying the requirement to provide information on all costs and associated charges set out in Article 24(4)(c). In particular, ESMA should provide technical advice on:

- the costs and charges to be disclosed to clients as well as their aggregation, which could be expressed both as a cash amount and as a percentage;

- the format and timing of disclosure (ex-ante and ex-post) of information on costs and charges, including methodologies to calculate ex-ante costs;

- appropriate modalities to provide such information to professional clients and eligible counterparties;

- the scope of investment firms subject to this obligation bearing in mind the objective to ensure such important information is provided on the broadest possible basis and bearing in mind situations where more than one investment firm provides investment or ancillary services to a client;

- the requirements to be met by firms when providing their clients with information on the cumulative effect of costs on return in order to increase the client's understanding and awareness of the cumulative effect of costs and charges on their investment.

In developing its advice, ESMA should consider how these requirements could apply to communications to eligible counterparties, taking into consideration that MiFID II extends some of the investor protection requirements to the relationship with eligible counterparties (Article 30). Recital 104 of MiFID II reminds that the "financial crisis has shown limits in the ability of non-retail clients to appreciate the risk of their investments. (…) To that extent, it is appropriate to extend some information and reporting requirements to the relationship with eligible counterparties". Reference is also made to requirements in the area of safeguarding of client financial instruments and funds.

1. Article 24(4) of MiFID II has clarified the MiFID I provisions relating to information to clients on costs and charges. Article 33 of the MiFID Implementing Directive already requires investment firms to provide information on costs and charges to be paid by clients. Article 24(4) of MiFID II sets additional requirements with regard to information about costs and also clarifies some existing requirements. This article now reads as follows:

   "Appropriate information shall be provided in good time to clients or potential clients with regard to the investment firm and its services, the financial instruments and proposed investment strategies, execution venues and all costs and related charges. That information shall include the following:

[…]

c) the information on all costs and associated charges must include information relating to both investment and ancillary services, including the cost of advice, where relevant, the cost of the financial instrument recommended or marketed to the client and how the client may pay for it, also encompassing any third-party payments.

The information about all costs and charges, including costs and charges in connection with the investment service and the financial instrument, which are not caused by the occurrence of underlying market risk, shall be aggregated to allow the client to understand the overall cost as well as the cumulative effect on return of the investment, and where the client so requests, an itemised breakdown. Where applicable, such information shall be provided to the client on a regular basis, at least annually, during the life of the investment".

2. Article 24(5) of MiFID II continues by requiring that information *"shall be provided in a comprehensible form"* and determines that "Member States may allow that information to be provided *"in a standardised format"*.

3. Article 33 of the MiFID Implementing Directive already requires information on costs and charges to be provided to clients, including information on the total price to be paid by clients including related fees: "*the total price to be paid by the client in connection with the financial instrument or the investment service or ancillary service, including all related fees, commissions, charges and expenses, and all taxes payable via the investment firm…".* Notwithstanding the detail of Article 33 of the MiFID Implementing Directive, the text could still result in different applications by investment firms because of certain ambiguities in the drafting. For instance, Article 33:

   i. refers to all related fees, commissions, charges or expenses, but it does not provide any further specification that could help the common understanding and application of these items; and

   ii. emphasises the possibility that other costs related to transactions may arise for the clients that are not imposed by the firm (i.e. this could imply that costs arising from third parties may be excluded from disclosure).

4. The MiFID Implementing Directive provides that, except in specific cases, information to clients on costs has to be provided in good time before the provision of the investment or ancillary service.

5. The new regime on information about costs and charges includes requirements on any kinds of third party payments paid or received by the firm in connection with the service provided to the client. Article 24(9) of MiFID II refers to the conditions that third party payments must comply with and the requirement to disclose such payments. It states: "*the existence, nature and amount of the payment or benefit […] or, where the amount cannot be ascertained, the method of calculating that amount, must be clearly disclosed to the client, in a*

manner that is comprehensive, accurate and understandable, prior to the provision of the relevant investment or ancillary service".

Analysis following feedback from stakeholders

Scope – retail clients, professional clients and eligible counterparties

6. A large majority of respondents disagreed with ESMA's proposal to apply the implementing measures on cost disclosure, suggested in the draft technical advice, to all categories of clients with the possibility for professional clients and eligible counterparties, in certain cases, to opt-out from the application of the detailed requirements. These respondents noted that ESMA's suggested approach:

   i. conflicts with the recently approved PRIIPs Regulation that explicitly focuses only on disclosure of costs to retail clients;

   ii. is disproportionate and difficult to apply to the high-speed transactions that take place with professional clients and eligible counterparties;

   iii. should be tailored to the needs of professional clients and eligible counterparties and not blur the lines between client categories by applying the same rules to all. On this point, a few respondents highlighted that Recital 104 of MiFID II, while stating that it is appropriate to extend some information and reporting requirements to the relationship with eligible counterparties, on the other hand limits this to information and reporting requirements concerning more complex financial instruments and transactions.

7. The large majority of respondents suggested that an opt-in mechanism by professional clients and eligible counterparties would be more proportionate. A few respondents highlighted that Article 30(2) of MiFID II already allows eligible counterparties and professional clients the possibility – either on a general form or on a trade-to-trade basis – to be treated as retail clients if they so wish.

8. A minority of respondents, composed by consumer organisations and investment professionals, supported the ESMA proposal to apply the implementing measures on cost disclosure to all categories of clients and noted that full cost disclosure is of the utmost relevance, for example, to the operations of life insurers and pension funds since costs at any point of the value chain impact performance for end beneficiaries and investors.

9. ESMA notes the arguments developed by respondents. On the reference to PRIIPs, ESMA notes that, differently from MiFID, the PRIIPs regulation targets retail investors and their needs while MiFID covers different categories of clients. ESMA shares the arguments developed by some respondents concerning the position of some financial institutions (for instance, institutional investors) who, in turn, serve retail investors and who, therefore, should be able to have access to all relevant information to act in their clients' interest or to comply with their regulatory obligations vis-à-vis their clients. Furthermore, the provision in Article

30 of MiFID II that allows investment firms authorised to execute orders on behalf of clients and/or to deal on own account and/or to receive and transmit orders, to bring about or enter into transactions with eligible counterparties without being obliged to comply with the obligations under Article 24, does not cover paragraphs 4 and 5 of Article 24 on disclosure of appropriate information on the investment firm and its services, the financial instruments and proposed investment strategies, execution venues and all costs and related charges.

10. Therefore ESMA considers that detailed information on costs and associated charges should be made available also to professional clients and eligible counterparties. However when providing investment services to professional clients and eligible counterparties, investment firms shall be able, with some exceptions, to agree a limited application of these detailed requirements. In this respect, ESMA would like to underline that the exception of financial instruments embedding a derivative, which was already included in the consultation paper, aimed at addressing financial instruments which are most likely to be re-sold to retail investors. This would leave broad margins of flexibility to investment firms to agree on a limited application of the detailed information requirements with professional clients and eligible counterparties for a large number of financial instruments. ESMA has modified its technical advice to the Commission to clarify that eligible counterparties which, in turn, intend to distribute these financial instruments to their clients should not be able to agree a limited application of these detailed requirements with the investment firms providing services to them.

Scope – point of sale disclosure (ex-ante)

11. Respondents generally supported ESMA's proposals on the scope of ex-ante point of sale disclosure, however ESMA received several specific comments on the draft technical advice as respondents:

    i. noted that firms should not be required to provide any additional information about the financial instrument that is not already provided by the product manufacturer and/or disclosed in the UCITS KIID or will be required in the PRIIPs KID;

    ii. noted that the final technical advice should be drafted in order not to overwhelm clients with information they are not able to understand;

    iii. noted that it is important to clarify – in line with Article 8(3)(f) of the PRIIPs Regulation – that manufacturers will not be obliged to disclose any costs imposed by the distributor; and

    iv. asked ESMA to clarify what is meant by "*full*" point of sale disclosure.

12. The respondents that explicitly disagreed with ESMA's proposals:

    i. stated that the broad interpretation of the wording of Article 24(4)(c) seems to go beyond the MiFID II requirements. Various of these respondents specifically noted that the proposed treatment of portfolio management services is inappropriate as it is in the fi-

duciary nature of the service that investments are not "*recommended or marketed"* to clients but all decisions are taken by the portfolio manager;

ii. stated that third party payments (inducements) cannot be regarded as costs borne by the client and should therefore not be aggregated in the cost disclosure provided to clients.

13. The SMSG welcomed the introduction of Article 24(4)(c), subparagraph 2 of MiFID II, that requires that "*all costs and charges*" shall be aggregated in order to allow the client to understand the overall cost as well as the cumulative effect on return of the investment. The SMSG supported the approach adopted by ESMA.

14. ESMA agrees with the need to have as much consistency as possible between the application of MiFID II and the PRIIPs regulation as far as disclosure on costs and charges is concerned. On the other hand, ESMA notes that the timing and the legal nature of the two regulatory work-streams is different; for this reason, in its technical advice, ESMA defers to the Commission in order to solve any issue of inconsistency between relevant information on costs and charges regulated under MiFID II and the PRIIPs regulation. ESMA also acknowledges that information on the cost of the service provided is different from the information on the product but it disagrees with the comment that third party payments (inducements) should not be regarded as costs borne by the client.

15. Concerning the comment suggesting that ESMA is providing a too broad reading of MiFID II, ESMA notes that MiFID I and its implementing directive already require disclosure of costs and associated charges for all services provided by the investment firm (without excluding any service) which include all fees, commissions, charges and expenses. It is clear, in ESMA's view, that one of the core objectives of the review of MiFID is to strengthen investor protection which, in this area, means to provide clients with a more detailed and granular picture than the one resulting from the existing obligations in order to make clients fully aware of costs and charges they incur in the provision of MiFID services. However, as also noted by some respondents, good disclosure is not simply about provisions of more information. Providing clear and accessible information is essential to delivering fair outcomes for consumers. For this reason, ESMA agrees that insights on consumer behaviour, and on the way consumers process information, should be taken into account in order to effectively design disclosure for clients. On the application of these obligations to portfolio managers, ESMA has already clarified that, irrespective of the service provided and both for ex-ante and post-sale disclosure, firms may provide information on costs and charges at a *"service*" level rather than at an "*individual financial instrument*" level. Under a different viewpoint, as also clarified in the section of the draft technical advice covering the methodology of calculation of ex-ante figures, when actual costs are not available, investment firms may make reasonable assumptions about these costs. The application of these principles provides sufficient flexibility to adapt to different situations and services provided.

16. On the topic of third party payments, ESMA notes that MiFID II sets the conditions for the acceptance of third party payments by investment firms (inducements) under Article 24(9).

In accordance with this article, an investment firm should provide its clients with information on the existence, nature and amount of third party payments and benefits received, or, where the amount cannot be ascertained, the method of calculating that amount. In addition, Article 24(4)(c) of MiFID II requires that information about third-party payments is provided to clients in the context of information on costs and associated charges. Therefore ESMA considers that third party payments received by investment firms shall be identified separately in the disclosure. Consistent with this approach, ESMA also considers that rebates born by financial instruments that are intended to remunerate the investment or ancillary service provided by the investment firm should also be identified separately in the disclosure". As provided for in Example 4 of the CP, it should be clear to the client what part of the costs he paid for the financial instruments are rebated to the broker providing the investment service.

Scope of post-sale periodic disclosure

17. The majority of respondents agreed with ESMA's suggestion that post-sale information should be provided where the investment firm has established a continuing relationship with the client. A large number of these respondents, however, asked ESMA to clarify what is intended by "*continuing relationship*". Respondents noted that the current drafting would make "*one-off*" services very difficult to identify in practice and suggested limiting the obligation of post-sale periodic disclosure to situations where there is a specific contractual agreement between the investment firm and its clients.

18. ESMA does not consider that a narrow interpretation of these obligations would be appropriate. ESMA considers that annual ex-post disclosure is crucial for investors in order to improve transparency for clients on the associated costs of their investments and to assess the performance of their investments against the relevant costs and charges over-time. ESMA has acknowledged already in the CP that there are situations in which the ex-post aggregated information should not be required, such as execution of orders on one occasion or advice on a particular transaction. ESMA has also indicated that, in order to alleviate the burden arising from the new obligations, this ex-post periodic disclosure may be made by building on existing reporting obligations. Nevertheless, ESMA has amended the technical advice in order to use a terminology more in line with the MiFID II text and has clarified that the reporting obligation applies to firms when they have/ or have had an ongoing client relationship during the year.

19. The SMSG suggested that clients receive annually a report with the following summary on the first page:

Investment (€)		Yield before costs & expenses		Costs & expenses		Net yield (after initial as well as on-going commission)	
At beginning of the period	At end of the period	€	%	€	%	€	%

20. ESMA notes that Article 24(5) of MiFID II requires that the information about costs and charges shall be provided in a comprehensible form and that Member States may allow that information to be provided in a standardised format. For this reason, ESMA appreciates the SMSG suggestion, but considers that in line with Article 24(5) of MiFID II Member States have discretionary powers with regard to the format that can be used to disclose relevant information. For this reason, ESMA wishes also to emphasise that the examples provided for in the CP and in the table as suggested by the SMSG are for illustrative purposes only and do not represent a prescribed format. Moreover ESMA considers that it is important that before any illustration is formally introduced, it should be adequately consumer tested.

Costs and charges to be aggregated

21. With regards to the list of costs and charges to be disclosed to clients, that where presented in Annex 2.14.1 of the CP, respondents raised the following comments:

    i. with regards to consistency with other Directives and Regulations, respondents highlighted that it is essential that requirements on cost disclosure in the MiFID implementing measures are consistent with and directly based on the requirements set out for the UCITS KIID and PRIIPS KID,

    ii. on the topic of transaction costs, firms noted that it would be technically impossible for them to 'personalise' transaction fees and that these transaction costs are caused, to a high degree, by the underlying market risk (which determines for example, high bid ask spreads) and should therefore not be included in the required compilation of costs and charges disclosed to clients;

    iii. on the topic of on-going charges on financial instruments, respondents stated there should be no obligation to disclose cash amounts of on-going charges at product level as it is impossible to stipulate ex-ante the level of costs as these will depend on market developments, on the decision of the client to hold the product or not, etc. and it would be misleading to present these on-going costs in cash terms as disclosing specific numbers exhibits only a spurious accuracy;

iv. on the disclosure of marks-up embedded in the transaction price, respondents noted that these are to be considered profit margin and do not fall under costs and charges for clients and therefore disclosure to clients should not be required;

v. on the specific voices of costs included in the table respondents asked ESMA to clarify various of the terms used, as these are judged to be not precise enough. Amongst these, respondents specifically questioned the exact meaning of 'switching costs', 'broker commissions', 'structuring fees' and 'costs and charges that are performed by the manager of the financial instrument'. Respondents also noted that these terms can be particularly difficult to apply to OTC derivative transactions.

22. On the topic of consistency between MiFID II and other Directives and Regulations in general, ESMA would like to refer to paragraph 14 above. With regard to consistency between MiFID II and other Union law, in terms of costs and charges that should be disclosed, ESMA notes that Article 24(4)(c), subparagraph 2 of MiFID II requires that "*all costs and charges*" shall be aggregated. ESMA also notes that the implementation of the requirement to provide information about all costs and charges should take into account Recital 78 of MiFID II. This recital states that where sufficient information in relation to the costs and associated charges of the financial instrument itself is provided in accordance with other Union law that information should be regarded as appropriate for the purpose of providing information to clients under MiFID II. However, investment firms or credit institutions distributing that financial instrument should additionally inform their clients about all the other costs and associated charges relating to their provision of investment services in relation to that financial instrument.

23. That being said, currently there is an inconsistency between MiFID II (which requires all costs and charges be disclosed) and the UCITS Directive which does not oblige UCITS providers to disclose precise quantitative information about transaction costs. ESMA notes that it is likely that the PRIIPs KID will require the PRIIPs manufacturer to disclose information about the transactions costs for all packaged retail investment products and that, therefore, investment firms should be able to rely on the information provided by the PRIIPs manufacturer. ESMA is mindful of the fact that the PRIIPs Regulation will not apply to UCITS providers until at least three years after the date from which PRIIPs is to have effect – if at all. During this period UCITS providers will not be obliged to provide information on transaction costs. Therefore, during this period and in line with Recital 78 of MiFID II, ESMA is of view that where such transaction costs have not been provided by a UCITS management company, the investment firms themselves should liaise with UCITS management companies to obtain the relevant information. ESMA, however, believes that as transactions costs are linked to the product itself, rather than to the service provided, the issue of their disclosure could be better addressed, following the necessary consultations, in implementing measures related to PRIIPs and UCITS, rather than MiFID II.

24. On the topic of transaction costs, ESMA notes that transactions costs should be understood as costs incurred in order to acquire and dispose of investments. ESMA acknowledges that in some markets (bond market, derivatives market, foreign exchange market) these transac-

tions costs are embedded in the bid-ask spread. ESMA agrees that transaction costs which are embedded in the bid-ask spread of the financial instrument are difficult to quantify, however ESMA views that the clients have the right to full disclosure when it comes to costs and charges. Moreover it should be clear that practices where there is 'netting' of costs are not excluded from the obligation to provide information on costs and charges.

25. Moreover ESMA disagrees that the transaction costs are caused by the underlying market risk and therefore should not be included in the required compilation of costs and charges disclosed to clients in accordance with Article 24(4)(c) of MiFID II. ESMA notes that the underlying market risk should be understood narrowly and relates only to movements in the value of capital invested caused directly by movements in the value of underlying assets. For these reasons, ESMA considers that transaction costs may be estimated on a best effort basis and that the estimation should be based on reasonable underlying assumptions.

26. On the topic of on-going charges on financial instruments ESMA notes that many fund managers apply an ad valorem calculation of on-going charges at product level, therefore levying a fee based on a percentage of assets under management, which means that costs increase as the value of assets under management grows. Although it is true that the on-going charges at product level depend on the value of the assets, ESMA considers that it is nevertheless possible for investment firms providing services to clients to make estimations, based on reasonable assumption in order to provide their clients with ex-ante information on for these costs, expressing them both as a cash amount and as a percentage.

27. ESMA disagrees that the disclosure of mark-ups and mark-downs should not be required. ESMA is of the view that the costs and charges disclosure is underpinned by the fundamental principle that every difference between the price of a position for the firm and the respective price for the client should be disclosed including mark-ups and mark-downs. ESMA considers this approach to be consistent with the principle established by a 2007 Commission "*questions and answers*" document, in which the Commission sets out its view that Article 33 of the MiFID I Implementing Directive obliges investment firms to inform their clients on all costs and associated charges related to the provision of investment services, including mark-ups charged by the firm for the execution of orders.[27]

28. On the specific costs included in the table provided for in Annex 2.14.1, ESMA has clarified various terms used through reference of footnotes.

29. In paragraph 56 of the CP, ESMA set out proposals for the costs and charges disclosure to be provided on a generic basis as long as the investment firm ensures the costs and charges are representative of the costs the client would actually occur. It is clear from the consultation responses that this proposal has been interpreted in a number of different ways by stakeholders. ESMA has therefore set out the position below.

[27] http://ec.europa.eu/yqol/index.cfm?fuseaction=question.show&questionId=166.

30. Recital 78 of MiFID II states that where sufficient information in relation to the costs and associated charges in respect of a financial instrument is provided in accordance with Union law that information should be regarded as appropriate for the purposes of providing information to clients under this Directive. It is ESMA's interpretation that this is primarily referring to the UCITS KIID and PRIIPS KID. While the UCITS KIID requires the costs to be disclosed in percentage terms, the PRIIPs regulation goes further and requires an investment manufacturer to disclosure costs both as a percentage and as a monetary amount. To calculate the monetary amount of costs associated with a financial investment, investment manufacturers will need to calculate these costs based on an assumed investment amount. As such, and in line with recital 78, ESMA considers that investment firms will also be able to base the MiFID II costs and charge disclosure on this assumed investment amount – rather than the actual amount which the client is investing.

31. However, both the PRIIPs and MiFID II disclosure, even if based on an assumed investment amount, should accurately reflect the true costs and charges the client will pay. For example, if an investment firm offers a range of ongoing services with different charges associated with each service, the firm should disclose the costs associated with the service the client subscribed to. It would be misleading for the firm to disclose the cost of the cheapest service it provides, if the client had subscribed to the most expensive. Likewise, if the client subscribed to the cheapest service, it would also be misleading to disclose the cost of the most expensive service.

32. For the avoidance of doubt, ESMA would like to emphasise that the only information that can be provided on a generic basis, is the assumed investment amount. All other information should reflect the true costs and charges the client will pay. In the case of ex-ante information, where the disclosure provided to the client is based on reasonable assumptions, the disclosure should be accompanied by an explanation stating that projection is based on assumptions and may deviate from costs and charges that will actually be incurred. ESMA would also like to recall that, as clarified in the CP, ex-post disclosure on all the relevant costs and charges should instead be provided on a personalised basis.

Methodology for the calculation of ex-ante figures

33. In relation to the methodology for the calculation of ex-ante figures, the majority of respondents encouraged ESMA to ensure consistency between the methodologies to be used for MiFID, accounting standards (GAAP/IFRS) and PRIIPS/UCITS regulatory frameworks.

34. Respondents also noted that although actually incurred costs are to be used as a proxy for the expected costs and charges, more volatile costs such as transaction costs and/or performance fees should not be taken into account.

35. ESMA disagrees that certain volatile costs should not be taken into account when providing information about costs and charges. Article 24(4)(c), subparagraph 2 of MiFID II requires that *"all costs and charges"* shall be aggregated and does not distinguish between volatile costs and costs that are known in advance. ESMA agrees that volatile costs are difficult to

quantify accurately, as these costs are contingent upon future events. Transaction costs for example depend on the volume of trading and the rates applicable in the market where the trading takes place. Nevertheless ESMA considers that investors should receive information about all costs and charges (including volatile costs such as transaction costs and performance fees). These volatile costs should be estimated on a best effort basis. As noted above, the estimation should be based on reasonable assumptions, and should be accompanied by an explanation stating that these estimations are based on assumptions and may deviate from costs and charges that will actually be incurred.

Cumulative effect of costs on the return

36. Commenting on ESMA's suggested approach to the disclosure of the cumulative effect of costs on return, some respondents appreciated the flexibility granted in the proposal regarding the format of presentation. On the other hand, other respondents encouraged ESMA to require information to be provided in a standardised format in order to support investors to compare products.

37. Several comments were made on the technological complexity, and related costs, of aggregating costs and charges on annual basis. The issue of complexity in calculations was linked, for example, to the anticipation of "*spikes or fluctuations in the costs*".

38. Numerous respondents also highlighted that the advice on the topic should consider that it could be misleading to compare cumulative costs of (i) products with no fixed maturity, for which a return cannot be anticipated, and that have on-going charges to (ii) products with a fixed maturity and on-off costs for clients.

39. ESMA would like to mention that the draft technical advice on this point did not intend to prescribe any specific model to illustrate the cumulative effect of costs on return.

Technical advice

Scope – retail clients, professional clients and eligible counterparties

1. The following detailed information on costs and associated charges should be made available to retail clients, professional clients and eligible counterparties.

2. When providing investment services to professional clients, investment firms shall be able to agree a limited application of these detailed requirements, except in the following situations:

   i. when the services of investment advice or portfolio management are provided, or

   ii. when, irrespective of the investment service provided, the financial instruments concerned embed a derivative.

3. When providing investment services to eligible counterparties, investment firms shall be

able to agree a limited application of these detailed requirements, except when, irrespective of the investment service provided, the financial instruments concerned embed a derivative and the eligible counterparty intends to offer them to its clients.

Scope – point of sale disclosure (ex-ante)

4. The obligation to provide a full point of sale disclosure, where aggregated information about the costs related to the financial instrument and the costs related to the investment or ancillary service is provided, should apply to investment firms in the following situations:

   i. when the investment firm recommends or markets financial instruments to clients; or

   ii. when the investment firm providing any investment services is required to provide clients with a KID/KIID in relation to the relevant financial instruments, in accordance with relevant Union legislation.

5. If the investment firm does not recommend or market a financial instrument to the client and is not obliged to provide the client with a KID/KIID in accordance with relevant Union legislation, the investment firm has to inform the client about all costs and charges relating to the investment and/or ancillary service provided.

6. When more than one investment firm provides investment or ancillary services to the client, each investment firm should provide information about the costs of the investment or ancillary services it provides. An investment firm that recommends or markets to its clients the services provided by another firm, should aggregate the cost of its services together with the cost of the services provided by the other firm. An investment firm should only take into account the costs associated to the provision by other firms of other investment or ancillary services (in addition to the costs associated to the services provided by itself) if it has directed the client to these firms.

Scope of post-sale periodic disclosure

7. Investment firms should be obliged to provide annual post-sale information about all costs and charges related to both the financial instrument(s) and investment and ancillary service(s) if they have recommended or marketed the financial instrument(s) or they have provided the client with the KID/KIID in relation to the financial instrument(s) and they have/ or have had an ongoing client relationship during the year.

8. Investment firms should be allowed to provide aggregated information on costs and charges of the investment services and the financial instruments together with any existing periodic reporting provided to clients.

Costs and charges to be aggregated

9. Costs and charges listed in the Annex to this chapter should be aggregated both for ex-ante

and ex- post disclosure to clients.

10. Investment firms should aggregate:

    i. all costs and associated charges charged by the investment firm or other parties where the client has been directed to such other parties, for the investment services(s) and/or ancillary services provided to the client; and

    ii. all costs and associated charges associated with the manufacturing and managing of the financial instruments.

11. Third party payments received by investment firms in connection with the investment service provided to a client shall be regarded as part of the cost of the service provided to the client and identified separately (i.e. it should be clear to the client what part of the costs paid are rebated to the investment firm providing the investment service).

12. The aggregated costs and charges should be totaled and expressed both as a cash amount and as a percentage.

13. Investment firms should be allowed to provide clients or prospective clients with separate figures comprising:

    i. aggregated initial costs and charges;

    ii. aggregated on-going costs and charges; and

    iii. aggregated exit costs,

14. In relation to UCITS, the Commission should consider the possibility to require the disclosure of product costs and charges that are not included in the UCITS KIID. In line with Recital 78 of MiFID II, where transaction costs have not been provided by a UCITS management company, the investment firms should calculate and disclose these costs (for example, by liaising with UCITS management companies to obtain the relevant information).

Timing of disclosure and methodology

Point of sale disclosure of information (ex-ante disclosure)

15. The (potential) clients should be allowed enough time to consider material information when they make their investment decisions. Therefore the aggregated information about all costs and charges should be provided to clients or potential clients in good time.[28]

[28] Recital 83 of MiFID II clarifies what constitutes the provision of information provided in good time.

Methodology for the calculation of ex-ante figures

16. The methodology for calculating ex-ante cost figures should be based on the principle that the investment firm should use actually incurred costs as a proxy for the expected costs and charges. If actual costs are not available, the investment firm should make reasonable estimations of these costs.

17. Investment firms shall review ex-ante assumptions based on the ex-post experience and should make adjustment to these assumptions, if necessary.

Post-sale periodic disclosure of information (ex-post disclosure)

18. Information about costs provided on a regular basis during the life of the investment should be based on costs incurred and should be provided on a personalised basis.

Cumulative effect of costs on the return

19. An investment firm should be obliged to provide its clients with an illustration showing the cumulative effect of costs on return when providing investment services. Such an illustration should be provided at the point of sale. When providing the illustration the investment firm should ensure that the illustration meets the following high level requirements:

    i. the illustration shows the effect of the overall costs and charges on the return of the investment;

    ii. the illustration shows any anticipated spikes or fluctuations in the costs; and

    iii. the illustration is accompanied by an explanation of what the illustration shows.

Annex 2.14.1.: Identified costs that should form part of the costs to be disclosed to the clients[29]

Table 1 - All costs and associated charges charged for the investment service(s) and/or ancillary services provided to the client that should form part of the amount to be disclosed

Cost items to be disclosed		Examples:
One-off charges related to the provision of an investment service	All costs and charges paid to the investment firm at the beginning or at the end of the provided investment service(s).	Deposit fees, termination fees and switching costs.[30]
On-going related to the provision of an investment service charges	All on-going costs and charges paid to investment firms for their services provided to the client.	Management fees, advisory fees, custodian fees.
All costs related to transactions initiated in the course of the provision of an investment service	All costs and charges that are related to transactions performed by the investment firm or other parties.	Broker commissions[31], entry- and exit charges paid to the fund manager, platform fees, mark ups (embedded in the transaction price), stamp duty, transactions tax and foreign exchange costs.
Any charges that are related to ancillary services	Any costs and charges that are related to ancillary services that are not included in the costs mentioned above.	Research costs. Custody costs.
Incidental costs		Performance fees

[29]It should be noted that certain cost items appear in both tables but are not duplicative since they respectively refer to costs of the product and costs of the service. Examples are the management fees (in table 1, this refers to management fees charged by an investment firm providing the service of portfolio management to its clients while in Table 2 it refers to management fees charged by an investment fund manager to its investor) and broker commissions (in Table 1, they refer to commissions incurred by the investment firm when trading on behalf of its clients while in Table 2 they refer to commissions paid by investment funds when trading on behalf of the fund).

[30] Switching costs should be understood as costs (if any) that are incurred by investors by switching from one investment firm to another investment firm.

[31] Broker commissions should be understood as costs that are charged by investment firms for the execution of orders.

Table 2 - All costs and associated charges related to the financial instrument that should form part of the amount to be disclosed

Cost items to be disclosed		Examples:
One-off charges	All costs and charges (included in the price or in addition to the price of the financial instrument) paid to product suppliers at the beginning or at the end of the investment in the financial instrument.	Front-loaded management fee, structuring fee[32], distribution fee.
On-going charges	All on-going costs and charges related to the management of the financial product that are deducted from the value of the financial instrument during the investment in the financial instrument.	Management fees, service costs, swap fees, securities lending costs and taxes, financing costs.
All costs related to the transactions	All costs and charges that incurred as a result of the acquisition and disposal of investments.	Broker commissions, entry- and exit charges paid by the fund, marks up embedded in the transaction price, stamp duty, transactions tax and foreign exchange costs.
Incidental costs		Performance fees

[32] Structuring fees should be understood as fees charged by manufacturers of structured investment products for structuring the products. They may cover a broader range of services provided by the manufacturer.

2.15. The legitimacy of inducements to be paid to/by a third person

Background/Mandate

Extract from the Commission's request for advice (mandate)

ESMA is invited to provide technical advice on:

- the conditions under which investment firms providing investment advice on an independent basis and portfolio management fulfil the requirement to not accept and retain any monetary or non-monetary third party fees commissions or benefits as well as on the definition and conditions for acceptable minor non-monetary benefits;

- the conditions under which payments and non-monetary benefits, paid to or provided by investment firms providing all other investment or ancillary services, are not deemed to meet the requirement of enhancing the quality of the relevant service to the client;

- disclosure and organisational arrangements to be complied with by investment firms in order to meet the requirements set out in Article 24(7), (8) and (9).

1. MiFID I contains requirements for third party payments in the context of Article 26(b) of the MiFID Implementing Directive, regulating inducements. The essential requirements for the legitimacy of inducements to be paid by/to a third person (other than payments by or on behalf of the client) are:

    i. disclosure of the existence, the nature and amount of the fee, commission or benefit, or, where the amount cannot be ascertained the method of calculating that amount prior to providing investment or ancillary services;

    ii. the third party payment must be designed to enhance the quality of the relevant service to the client; and

    iii. the third party payment must not impair compliance with the firm's duty to act in the best interest of the client.

2. CESR published recommendations on the topic of inducements in 2007[33] and 2010.[34]

3. MiFID II aims to strengthen the current MiFID requirements for third party payments and benefits. To this end MiFID II distinguishes between the rules that apply to the investment services of portfolio management and investment advice on an independent basis and to all investment services.

[33] CESR/07-228b 'Recommendations on Inducements under MiFID' May 2007.
[34] CESR/10-295: 'Inducements: Report on good and poor practices' April 2010.

4. Recitals 74 and 75 of MiFID II state that:

   "(74) In order to strengthen the protection of investors and increase clarity to clients as to the service they receive, it is also appropriate to further restrict the possibility for firms providing the service of investment advice on an independent basis and the service of portfolio management to accept and retain fees, commissions or any monetary and non-monetary benefits from third parties, and particularly from issuers or product providers. This implies that all fees, commissions and any monetary benefits paid or provided by a third party must be returned in full to the client as soon as possible after receipt of those payments by the firm and the firm should not be allowed to offset any third-party payments from the fees due by the client to the firm. The client should be accurately and, where relevant, periodically, informed about all fees, commissions and benefits the firm has received in connection with the investment service provided to the client and transferred to him. Firms providing independent advice or portfolio management should also set up a policy, as part of their organisational requirements, to ensure that third party payments received are allocated and transferred to the clients. Only minor non-monetary benefits should be allowed provided that they are clearly disclosed to the client, that they are capable of enhancing the quality of the service provided and that they do not, or could not be judged to, impair the ability of investment firms to act in the best interest of their clients.

   (75) When providing the service of investment advice on an independent basis and the service of portfolio management, fees, commissions or non-monetary benefits paid or provided by a person on behalf of the client are allowed only as far as the person is aware that such payments have been made on that person's behalf and that the amount and frequency of any payment is agreed between the client and the investment firm and not determined by a third party. Cases which would satisfy this requirement include where a client pays a firm's invoice directly or it is paid by an independent third party who has no connection with the investment firm regarding the investment service provided to the client and is acting only on the instructions of the client and cases where the client negotiates a fee for a service provided by an investment firm and pays that fee. This would generally be the case for accountants or lawyers acting under a clear payment instruction from the client or where the person is acting as a mere conduit for the payment".

5. Article 24(7)(b) and 24(8) of MiFID II state that when an investment firm provides investment advice on an independent basis or portfolio management, it shall not accept and retain fees, commissions or any monetary or non-monetary benefits paid or provided by any third party or a person acting on behalf of a third party in relation to the provision of the service to clients. Minor non-monetary benefits that are capable of enhancing the quality of service provided to a client and are of a scale and nature such that they could not be judged to impair compliance with the investment firm's duty to act in the best interest of the client should be clearly disclosed and are excluded from this provision.

6. Article 24(9) of MiFID II states that investment firms are not regarded as fulfilling their obligations under Article 23 or Article 24(1) where they pay or are paid any fee or commission, or provide or are provided with any non-monetary benefit in connection with the provision of

an investment service or ancillary service, to or by any party except the client or a person on behalf of the client, other than where the payment or benefit:

i. is designed to enhance the quality of the relevant service to the client; and

ii. does not impair compliance with the firm's duty to act honestly, fairly and professionally in accordance with the best interest of its clients.

7. Article 24(9) of MiFID II also states that:

"The existence, nature and amount of the payment or benefit referred to in the first subparagraph, or, where the amount cannot be ascertained, the method of calculating that amount, must be clearly disclosed to the client, in a manner that is comprehensive, accurate and understandable, prior to the provision of the relevant investment or ancillary service. Where applicable, the investment firm shall also inform the client on mechanisms for transferring to the client the fee, commission, monetary or non-monetary benefit received in relation to the provision of the investment or ancillary service.

The payment or benefit which enables or is necessary for the provision of investment services, such as custody costs, settlement and exchange fees, regulatory levies or legal fees, and which by its nature cannot give rise to conflicts with the firm's duties to act honestly, fairly and professionally in accordance with the best interests of its clients is not subject to the requirements".

Analysis following feedback from stakeholders

Minor non-monetary benefits

8. In its May 2014 CP, ESMA proposed to introduce an exhaustive list of non-monetary benefits that can be considered minor and are therefore acceptable in accordance with Articles 24 (7)(b) and (8) of MiFID II. In the analysis part of the CP, ESMA explained the conditions under which research may be permissible as a minor non-monetary benefit, taking into account that research is often received by a portfolio manager from a broker with whom they execute orders on behalf of clients.

9. Concerning the establishment of an exhaustive list of non-monetary benefits, most respondents disagreed with the ESMA proposal. Among them, many consider that setting an exhaustive list of permitted benefits would be rigid and would risk omitting relevant items. Some respondents mention that introducing an exhaustive list in delegated acts would not be compliant with MiFID II since delegated acts should only develop "*criteria*" for the assessment of inducements. A few respondents proposed additional benefits to be included in an indicative (non-exhaustive) list, notably: participation in promotional events to enhance knowledge of funds; travel or accommodation expenses to participate in training events; database or IT systems for the maintenance and management of information on financial instruments (ISINs, fund names, etc) or market; software to calculate and report portfolios'

performance. The introduction of a simple monetary value set in legislation (e.g. less than 100 Eur) or proposed by ESMA, without any list, was also proposed.

10. Few respondents, including some representatives of investors, supported the exhaustive list since those respondents favour a strict interpretation of the requirements or because such a list would help increasing clarity and consistency in the application of the directive.

11. ESMA considers that the establishment of a list of non-monetary benefits does not go beyond MiFID II. First, the proposed advice clearly includes "*criteria*" (benefits should be reasonable and proportionate and of a limited scale) and, on the basis of these criteria, it identifies specific items and give certainty on the application of these criteria. Second, the empowerment for the adoption of delegated acts is broad and does not exclude the possibility to propose an exhaustive list of benefits. Furthermore, ESMA notes that some of the items mentioned by respondents are already included in the proposed list (such as the benefits linked to the participation in training events). Nevertheless, in order to take into account the concerns raised by respondents, ESMA has modified the technical advice by introducing an element of flexibility in the advice for the Commission; therefore the exhaustive list proposed in the technical advice could be supplemented through guidelines adopted by ESMA.

The treatment of research

12. Concerning the treatment of research (when received as a benefit, for instance by a portfolio manager from a broker with whom they execute orders on behalf of clients), the large majority of respondents did not agree with the ESMA proposal. Many argued that research cannot be qualified as an inducement for a number of reasons:

    i. the provision of research is a service and it is also classified as autonomous MiFID ancillary service;

    ii. reception of research by portfolio managers is in the interest of clients since it helps portfolio managers to carry out their fiduciary obligations to clients by making their investment decisions more effective and allocating efficiently investors' money;

    iii. only research (or other services) provided for free or at an undervalue could qualify as a benefit (and so an inducement) but this is not normally the case for research

    iv. inducements under MiFID essentially target problems arising from the distribution of financial instruments and research is never mentioned in MiFID II as an inducement.

13. In line with this reasoning, some added that, by classifying research as an inducement, ESMA advice would not be in line with MiFID II. They also argued that research should rather be dealt with in the context of conflict of interest requirements which would provide a sufficient basis to tackle the issues raised by the reception of research out of dealing commissions. Few respondents also mentioned best execution requirements.

14. Other respondents mentioned that any intervention in this area would be unbalanced since it would be limited to the MiFID context without tackling similar issues arising in the context of the management of UCITS and AIFs.

15. The SMSG shared the concerns expressed by other respondents that labelling investment research as an inducement may lead to sever unintended consequences, especially on research on SMEs which MiFID II rightfully aims at the same time to support. Consequently, the SMSG advises ESMA to delete the part of the ESMA advice relating to investment research.

16. Several respondents argued that the ESMA proposal could lead to a number of unintended consequences: massive increase of costs for active managers in the EU and competitive disadvantage of smaller asset managers and raising barriers to entry for new asset managers; reduction in the quality and diversity of investment research with negative impact on small and specialised research providers and on the coverage of SMEs; international unlevel playing field among EEA and non-EEA players (especially in US and Asia-Pacific), the latter being allowed to continue receiving research; uncertain consequences in terms of VAT application.

17. Some respondents also disputed the distinction (paragraphs 13 and 14 of the ESMA CP) between publicly available and tailor made/bespoke research. Some argued that tailor made/bespoke research is the one enhancing the quality of the service provided and is needed to serve clients' interest. Others argued that the distinction could favour low-value research and that, consequently, if research is an inducement, no research should qualify as (permitted) minor non-monetary benefit. A few suggested the need clarify the ESMA proposed advice between these paragraphs of the CP and the advice part (paragraph 5) where reference to personalised information is included.

18. In this respect, ESMA notes that tailor made/bespoke research is the one which may have high value and may unduly influence the behaviour of the recipient. The circumstance that it may be used in the interest of clients and may improve the quality of the service provided to them does not reduce its potential, when provided by brokers to portfolio managers, to possibly affect compliance with portfolio managers' obligations to act in the best interest of their clients when selecting and using the services of the brokers to whom orders on behalf of clients are directed.

19. Notwithstanding the criticism, many respondents recognised that the reception of research by portfolio managers from a broker may raise concerns of compliance with the overarching requirements to ensure fair treatment of clients. However, these respondents suggested that there are arrangements already in place that may effectively tackle these concerns.

20. One of the frequently mentioned mechanisms is the use of commission sharing agreements (CSA) between portfolio managers and brokers which was proposed as an effective way forward. CSA would ensure that cost of research and cost of execution are unbundled, with the executing broker retaining a set proportion of dealing commissions in a separate ac-

count and directing payments to providers of investment research on the basis of indications received from asset managers. Ex-ante contracts between managers and research providers could be in place to cover the provision of research services. The use of CSA would foster competition on the quality of research and on its pricing. Furthermore, CSA could be associated with additional measures and controls such as use of research budget not influenced by trading volumes, separate internal governance process for research spend, separation of trading and investment functions; some of the suggested measures could be included in Level 3 measures (e.g. guidelines). Some stakeholders also emphasized that CSA would be consistent with ESMA's view, expressed in the CP (paragraph 15), that portfolio managers and independent advisors could separately acquire third party research to fulfil their needs.

21. Specific features could additionally identify quality research which would be admissible (including research being original and not merely repeating or repackaging previous information or stating what is commonplace or self-evident and comprehending an analysis/elaboration of data aimed at reaching significant conclusions). Meaningful and complete disclosure should complement the proposed measures above.

22. Again in terms of way forward, few respondents mentioned that, in order to qualify as *"minor*" non-monetary benefits, research could be assessed against quantitative criteria (proportion of total costs or of assets under management).

23. ESMA disagrees with the comments made by respondents on the legal qualification of research, in the circumstances indicated above, as an inducement. The definition of inducements is broad (monetary and non-monetary benefits) and is not limited to distribution issues. The current dominant model in the market to pay for research makes use of indirect payment structures by simply bundling payments for research into transaction costs of the broker. The qualification of this method of paying for research as an inducement is in line with a long standing classification in the regulatory arena, for instance, CESR and the Commission clearly mentioned research in the context of inducements. While MiFID II does not include any elements to change the definition of inducements, it changes the conditions under which inducements are allowed by prohibiting portfolio managers and firms providing independent advice to accept and retain inducements other than minor non-monetary benefits. The classification of research as an ancillary service is not relevant in this context because the issue to be addressed is which payment structures for research may fulfil the conditions to be admissible in accordance with MiFID II.

24. However, in order to address concerns expressed by respondents, ESMA has clarified in which circumstances the receipt of research does not qualify as an inducement in accordance with Article 24(7)(a) and (8) of MiFID II and is therefore permissible. In doing so, ESMA has elaborated on the suggestions to allow for commission sharing agreements. ESMA also notes that, in several regulatory areas, the UCITS and AIFM regulatory framework have been built on the basis of MiFID requirements. For this reason, while this advice is clearly adopted in the context of MiFID II, the Commission will be able to assess any extension of the proposed regulatory approach from MiFID II to the UCITS and AIFMD context. ESMA

considers that such an extension would be appropriate, in order to ensure a level playing field between different categories of asset managers.

25. ESMA advises the Commission to clarify the conditions under which the receipt of research does not qualify as an inducement under Article 24(7)(a) and (8) of MiFID II and is therefore permissible to be received by investment firms, including portfolio managers and firms providing independent investment advice, in relation to the services they provide to their clients. ESMA considers that the commission sharing arrangements (CSA's) have elements that address the conflict of interests between brokers and portfolio managers in respect of research. However, the conditions under which such arrangements are currently operated often do not entirely address the conflicts of interests at stake. The current use of CSA's by industry still enables amounts charged for research by the investment firm to be determined by the volume of transactions of the investment firm with the executing broker, although some investment firms apply budgets to control the total amounts accrued in CSAs. Also, CSAs do not guarantee a fair allocation of research costs to the client's portfolio.

26. ESMA has therefore formulated additional requirements which are aimed at further limiting these conflicts of interest. The key purpose of this proposal is to make clear how the receipt of third party research by portfolio managers and independent investment advisors interacts with the prohibition to accept and retain inducements, except for minor non-monetary benefits. ESMA proposes that the MiFID II Implementing measures should permit investment firms to accept third party research only where they pay for it directly or from a ring-fenced research account that is funded by a specific charge to their clients (subject to certain conditions, as detailed below). The proposal makes clear that there should be no payment for third party research linked to the payments made for execution of orders. This will address the potential inducements and conflict of interest issues that currently exist for portfolio managers when they receive third party research linked to execution arrangements with the broker. The proposed approach will also create more transparency over spending on research to improve outcomes for consumers.

27. If the portfolio manager (or independent investment advisor) chooses to pay directly for research out of its own resources either by absorbing the costs of research themselves or by increasing their headline fee (annual management charge or advice fee), then they may do so subject to requirements on general disclosure and managing conflicts of interest. Investment firms that spend small amounts on research may prefer this method of paying for it in order to limit their administrative burden.

28. However, the proposal also allows flexibility for the portfolio manager (or independent investment advisor) to use a research payment account to buy research, which can be funded by a specific charge to the client's portfolio. In order for an investment firm to make use of this optional process to fund research, a number of more detailed requirements on the governance of this account and spending are prescribed below. These requirements are aimed at ensuring that investment firms remain accountable to their clients.

29. Finally, ESMA also suggests high-level provisions to indicate that brokers[35] will need to price and supply execution and research services separately to enable portfolio managers (and independent investment advisors) to meet the new restricted approach to inducements. Brokers will also need to consider any potential conflicts where they offer a number of different services under MiFID.

30. ESMA notes these proposals are made for the purpose of MiFID II and are therefore mainly aimed at investment firms managing individual portfolios of clients (portfolio management). Similar investment management services are provided in relation to collective investment schemes that fall under the UCITS directive and AIFMD. These activities are however not in the scope of MiFID II. ESMA therefore advises the Commission to consider the possibility of aligning the relevant provisions that fall under UCITS and AIFMD with the MiFID II implementing provisions on this topic. ESMA notes that the proposed regime sets out the conditions under which third party research does not qualify as an inducement. Therefore the arrangements can also be used by investment firms providing other investment services than portfolio management and independent advice to adequately manage conflicts of interests arising out of inducements. For the sake of simplicity, reference to investment firms in the technical advice normally indicates those firms providing the service of portfolio management to clients (which, in most cases, is the situation in which the issue of the treatment of research arises).

31. ESMA considers that a useful additional requirement could be placed on those investment firms who offer execution of orders and research services to price and supply these services separately. This would ensure transparency in the market, allowing investment firms to better demonstrate their compliance with the inducements requirements and wider conflicts of interest provisions, and allow competent authorities to more easily detect any poor practices.

Inducements - Quality enhancement

32. A specific section of the ESMA draft technical advice dealt with the conditions to meet the requirements concerning the admissibility of inducements and in particular the requirement that permissible inducements are designed to enhance the quality of the relevant service to the client. In line with the Commission's request for advice, ESMA listed some circumstances and situations to consider in determining whether the quality enhancement test is not met (paragraph 10 of the draft technical advice). It also indicated situations in which inducements could be considered acceptable, notably when wider access to suitable financial instruments is ensured or non-independent advice on an on-going basis is provided (paragraph 11 of the draft technical advice).

[35] The term "broker" indicates investment firms providing the service of execution of orders on behalf of clients.

33. The majority of respondents do not agree with one or more of the circumstances and situations identified in paragraph 10 of the draft technical advice. Most of them consider that these circumstances would introduce a de facto ban of inducements going beyond MiFID II. Most respondents focused on investment advice and emphasized that the ban of inducements is only foreseen, in MiFID II, when independent advice is provided while non-independent advisors are not precluded from receiving them. Most of these respondents expressed the concern that the ESMA proposals would decrease investor protection by reducing broad investors' access to advice; it was argued that investors are not ready to pay for advice and that the ESMA approach, by de facto banning commissions, would encourage a situation in which only wealthier investors would or could receive advice. Some added that the interpretation of the conditions to accept inducements should not change in MiFID II compared to MiFID I since the legislative text has not changed. Others emphasized the need not to favour 'closed architecture' models. Several respondents also expressed the view that the relationship between paragraph 10 and 11 of the draft technical advice was not clear.

34. Most of the respondents opposing the ESMA's approach focused on paragraphs 10(i) and (ii). Concerning paragraph 10(i) (use of fees and commissions to pay or provide goods or services that are essential for the recipient firm in its ordinary course of business), many respondents claimed that it is unclear and difficult to apply and it should be deleted or limited to non-monetary benefits. Concerning paragraph 10(ii) (additional or higher quality service above the regulatory requirements), many respondents claimed that MiFID II regulatory requirements will be so high that it would be difficult to go beyond them; a proposed solution would be to classify some of them as indices of quality enhancement rather than legal obligations.

35. Concerning paragraph 11, most of these respondents would welcome and be satisfied with the clarification that it should be interpreted as an exception to paragraph 10. A few of them, however, disagreed with the reference to the "*wider range of suitable financial instruments*". Some propose to modify paragraph 11 by deleting the reference to "*suitable*" financial instruments or by criticising the reference to a "*wider range*" of financial instruments since this would not be in line with MiFID II which requires a broad and diversified basis of financial instruments only for independent advice.

36. Few respondents, including some consumers' and investors' representatives, support ESMA's proposals or suggest stricter solutions (this includes situations in paragraph 11 not overriding paragraph 10 or being cumulative - wider choice of suitable financial instruments and on-going provision of advice). The importance of proper supervision is also mentioned.

37. As possible way forward, several respondents suggested alternative positive situations complying with the quality enhancement test such as: providing for an additional or higher quality service above the regulatory requirements; giving an annual aggregate or a personalised report on costs and charges; alerting the client on specific gain/loss thresholds; building-up of an efficient and high quality infrastructure for services, including the qualification of firms' employees; provision of generic advice about a type of financial instrument (asset al-

location, financial planning); post-sale assistance; contacting clients at least once a year on a personalised basis to ensure services/products still matches the client's profile (periodic suitability); client information (maintenance of internet portals with market data, charts, events calendar, currency converter, yield calculator, etc.). Some proposed that payments to remunerate distribution networks should not qualify as inducements.

38. The SMSG shares some of the concerns mentioned above. In particular, the SMSG advice requests that ESMA adopts an approach of the regime of inducements for non-independent advisers aimed at minimising the risk of negative impact on the "open architecture" model. The SMSG also underlines that the political compromise in MiFID II did not imply a ban of inducements in the context of non-independent advice; while acknowledging that this is also the view of ESMA, the SMSG suggest that this is made clearer by clarifying paragraphs 10 and 11 of the draft technical advice. Similarly to other respondents, the SMSG that access to investment advice should remain widely available to retail investors.

39. ESMA considers that its draft technical advice is fully compliant with MiFID II and does not introduce any de facto ban of inducements. The only objective of the draft technical advice, in line with the Commission's request for advice, is to identify situations in which quality enhancement is not fulfilled. ESMA notes that the legislative framework covering inducements has changed between MiFID I and MiFID II. First, MiFID II has introduced a ban of inducements in certain situations where no ban was foreseen in MiFID I; this indicates the stricter approach taken to the regulation of inducements in MiFID II because of their potential to affect the ability of firms to comply with their overarching obligations vis-à-vis clients. Second, by regulating in MiFID II requirements which, in the current MiFID, are included in the MiFID Implementing directive, the new directive has not replicated the content of recital 39 of the MiFID Implementing directive which identified compliance with the quality enhancement criterion in cases in which simple investment advice or general recommendations were provided. In this respect, ESMA notes that the Commission request for advice has clearly indicated that "*the quality enhancement criterion*" should be *"strictly construed"*.

40. On the other hand, ESMA understands the concern of many respondents that the future implementing measures should not have the undesired and unintended effect of reducing clients' access to investment advice nor they should discourage the so-called "*open architecture*". At the same time, the quality of the services provided to clients is important and, for this reason, acceptance of inducements should be compliant with the relevant MiFID II requirements concerning inducements and provide an enhancement of the service provided to the client.

41. For these reasons, ESMA has modified its technical advice by merging the content of paragraphs 10 and 11 of the ESMA draft technical advice and deleting the situation identified in paragraph 10(i). The advice makes clear that the inducements received should be proportional to the additional or higher quality services provided and lists a wider number of positive situations justifying the receipt of inducements than the ones included in the ESMA consultation paper. Taking into account the results of the consultation, these situations aim, inter alia, at encouraging the provision of (and clients' access to) high quality non-independent

advice, the assessment of a wide range of financial instruments (in line with the concerns on not discouraging open architecture) or the provision of post-sale services by firms to clients. The full list of these situations and the various ways in which they can be combined are included in the technical advice.

Disclosure requirements

42. While ex-ante disclosure of inducements was normally accepted, some respondents suggested that it should be made on a generic basis (for monetary benefits, maximum percentage of the amount invested as entry fees and, when relevant, an annual percentage of the amount invested).

43. Concerning non-monetary benefits several respondents argued that it should not be contemplated because it would be very difficult to allocate them to individual clients. Some of these respondents specifically focused on minor non-monetary benefits. They argued that disclosure of minor non-monetary benefits would be inconsistent with the logic behind requirements on conflicts of interest (where disclosure is only a last resort possibility) or suggest that these benefits should be disclosed in a summary manner.

44. ESMA considers that disclosure on a generic basis would not be compliant with the requirement to be comprehensive, accurate and understandable. ESMA also notes that MiFID II has not restated the possibility, currently foreseen by the MiFID I implementing directive, to provide clients with summary disclosure. On non-monetary benefits, disclosure is required by MiFID II (both for minor and non-minor benefits). However ESMA considers that minor non-monetary benefits should only be disclosed to the client in a generic way (summary description of the benefit without any assessment of their value).

45. The majority of respondents also rejected ESMA's proposal to require ex-post disclosure in the following circumstances:

    i. where an investment firm was unable to ascertain on an ex-ante basis the amount of any payment or benefit it was to receive and instead disclosed the method of calculating that amount (paragraph 7(ii) of the draft technical advice;
    ii. at least once a year, as long as on-going inducements are received by the firm in relation to the services provided to the relevant client (paragraph 7(iii) of the draft technical advice).

46. These respondents considered that ex-post disclosure goes beyond MiFID II (which would only require ex-ante disclosure). Furthermore, they suggested that a wrong link would be made between Article 24(9) of MiFID II on inducements and Article 24 (4) on costs and charges since costs and charges are different from commissions and other monetary benefits received by the firm. Some could accept ex-post disclosure provided that it is generic, on an aggregate (and not individual) basis and through general communication means such as web-sites or emails.

47. A minority of respondents, including representatives of investors and consumers, supported the overall ESMA approach to inducements' disclosure.

48. Some respondents also recalled the importance to avoid information overload for investors. Others suggested that firms should have discretion on internal procedures for disclosure of monetary and non-monetary benefits.

49. ESMA considers that ex-post disclosure of inducements is needed in the circumstances indicated in the draft technical advice (see paragraph 44 above) in order to provide information to clients about inducement which is accurate and comprehensive. The ex-post disclosure is justified in light of both Article 24 (4) of MiFID II (ex-post information on costs and charges) and Article 25 (6) of MiFID II (reporting to clients about the services provided).

Technical advice

Accept and not retain third party payments

1. Independent investment advisers and portfolio managers must return to clients any monetary third party payments received in relation to the services provided to that client as soon as possible after receipt by transferring the monies received to the client money account. The obligation to pass on the monetary benefits should comprise all sums the investment firm receives from third parties in relation to the provision of independent investment advice and portfolio management. The requirement to pass on such monies should not contain a specific timeframe, since third party payments can be received by the investment firm at various points in time and for several clients at once. It is the responsibility of the investment firm to ensure that any such payments received are passed on to the client as soon as reasonably possible. In this context, investment firms should be required to set up a policy to ensure that third party payments received are allocated and transferred to the each individual client as part of the organisational requirements under Article 16 of MiFID II.

2. Clients should be informed about the monetary amounts transferred to them though regular bank account statements for their money account. Additional reporting requirements by investment firms can be kept to a minimum. By requiring independent investment advisers and portfolio managers to inform a client about the total amount of third party payments received and passed on to the client as part of the regular periodic reporting statements provided to the client, the client will have a comprehensive overview of the relevant information in respect of the services provided to him.

3. Investment firms providing the service of independent investment advice and portfolio management are not allowed to receive non-monetary benefits that do not qualify as minor.

Minor non-monetary benefits

4. ESMA advises the Commission to introduce an exhaustive list of non-monetary benefits that

can be considered to be minor and are therefore acceptable. All such benefits should only qualify as minor when they are reasonable and proportionate and of such a scale that they are unlikely to influence the recipient's behaviour in any way that is detrimental to the interests of the relevant client.

5. This list should include the following benefits:

   i. information or documentation relating to a financial instrument or an investment service. This information could be generic in nature or personalised to reflect the circumstances of an individual client;

   ii. participation in conferences, seminars and other training events on the benefits and features of a specific financial instrument or an investment service; and

   iii. hospitality of a reasonable *de minimis* value, this could for example include food and drink during a business meeting or a conference, seminar or other training events mentioned under ii

   iv. other minor non-monetary benefits meeting the criteria indicated in paragraph 4 as identified in ESMA guidelines.

6. Minor non-monetary benefits as defined above should be clearly disclosed by investment firms before providing investment or ancillary services to clients.

Investment research

7. The provision of research by third parties (such as firms executing orders or independent research providers) to investment firms providing portfolio management (or other investment or ancillary services) to clients should not be regarded as an inducement if it is received in return for:

   i. direct payments by the investment firm out of its own resources (which they may choose to reflect in an increase to the firm's portfolio management or advice fees), or

   ii. payments from a separate research payment account controlled by the investment firm, provided the following conditions relating to the operation of this account are met:

      a) The research payment account shall only be funded by a specific research charge to the client. The specific research charge shall:

         - only be based on a research budget set by the investment firm for the purpose of establishing the need for third party research in respect of investment services rendered to its clients; and

         - not be linked to the volume and/or value of transactions executed on behalf of

the clients.

The total amount of research charges received in the research payment account may not exceed the research budget.

The investment firm must agree with each client the research charge as budgeted by the firm and the frequency with which the specific research charge will be deducted from the resources of the client over the year. The investment firm may only increase the research budget with the client's written agreement. If there is a surplus in the research payment account at the end of a period, the firm should have a process to rebate those funds to the client or to offset it against the research budget and charge calculated for the following period.

b) As part of establishing a research payment account and agreeing a reasonable charge with their client, the investment firm must set and regularly assess a research budget as an internal administrative measure. The research budget is managed solely by the investment firm and is based on a reasonable assessment of the need for third party research. The allocation of the research budget to purchase third party research should be subject to appropriate controls and senior management oversight to ensure it is managed and used in the best interests of the firm's clients. Such controls include a clear audit trail of payments made to research providers and how the amounts paid were determined with reference to the quality criteria referred to in paragraph 7(ii)(d). Investment firms may not use the research budget and research payment account to fund internal research.

c) The investment firm is responsible for operating the research payment account. The investment firm may delegate the administration of the research payment account to a third party, provided that the arrangement facilitates the purchase of third party research and payments to research providers in the name of the investment firm without any undue delay in accordance with the investment firm's instruction.

d) The investment firm should regularly assess the quality of the research purchased based on robust quality criteria and its ability to contribute to better investment decisions. Investment firms should be able to demonstrate these elements in a written policy and provide it to their clients. It should also address the extent to which research purchased through the research payment account may benefit clients' portfolios (including, where relevant, by taking into account investment strategies applicable to various types of portfolios) and the approach the firm will take to allocate such costs as fairly as practicable to the various clients' portfolios.

e) Where an investment firm makes use of the research payment account, it should provide the following disclosure to its clients:

- Ex-ante – In line with Article 24(4)(c) of MiFID II, clients should be informed

about the budgeted amount for research and the amount of the expected research charge for each of them. This information is further elaborated in the ESMA technical advice on information on costs and charges.

- Ex post – In line with Article 24(4)c of MiFID II clients should receive annual information on the total costs that each of them has incurred for third party research. The investment firm should also be required, upon request by their clients or by competent authorities, to provide a summary of the providers who were paid from this account, the total amount they were paid over a defined period, the goods and services received by the investment firm, and how the total amount spent from the account compares to the budget set by the firm for that period – noting any rebate or carry-over if residual funds remain in the account.

8. Firms providing execution services should identify separate charge for these services that only reflect the cost of executing the transaction (buying or selling a financial instrument). Any other goods or services rendered should be subject to a separately identifiable charge; the supply of these goods or services should not be influenced by (or be conditional on) levels of payment for execution services. Future ESMA guidelines may also be useful in this area.

9. The European Commission should also consider clarifying that an investment firm that provides execution and research services, and also carries out underwriting and placing activities, should ensure adequate controls are in place to manage any potential conflicts of interest between these activities and between their different clients receiving those services.

Article 24(9) of MiFID II - Quality enhancement

10. ESMA advises the Commission to make clear that the provisions included in Article 24(9) of MiFID II, which sets out conditions under which a fee, commission or non-monetary benefit may be provided or accepted, should apply cumulatively and firms should take appropriate measures to ensure that these provisions have been met on a case-by-case basis.

11. ESMA also advises the Commission to introduce a non-exhaustive list of circumstances and situations that NCAs should consider in determining when the quality enhancement test is not met. Where inducements are not fully passed on to clients, a fee, commission or non-monetary benefit may not generally be regarded as designed to enhance the quality of the relevant service to the client if any of the following conditions is applicable:

    i. it is not justified by the provision of an additional or higher level service to the relevant client, proportional to the level of inducements received, such as:

        a) the provision of non-independent advice on and access to a wide range of suitable financial instruments including an appropriate number of instruments from third par-

ty product providers having no close links with the investment firm; or

b) the provision of non-independent advice combined with either: an offer to the client, at least on an annual basis, to assess the continuing suitability of the financial instruments in which the client has invested; or with another on-going service that is likely to be of value to the client such as advice about the suggested optimal asset allocation of the client ; or

c) the provision of access, at a competitive price, to a wide range of financial instruments that are likely to meet the needs of the target market, including an appropriate number of instruments from third party product providers having no close links with the investment firm, together with either the provision of added-value tools, such as objective online information tools helping the relevant client to take investment decisions or enabling the relevant client to monitor, model and adjust the range of financial instruments in which they have invested, or providing periodic reports of the performance and costs and charges associated with the financial instruments;

ii. it directly benefits the recipient firm, its shareholders or employees without tangible benefit to the relevant client; or

iii. in relation to an on-going inducement, it is not justified by the provision of an on-going benefit to the relevant client.

12. In assessing whether or not the enhancement test can be met in accordance with these conditions, a fee, commission or non-monetary benefit may be considered acceptable only if all relevant services are provided to the clients without bias or distortion as a result of the fee, commission or non-monetary benefit being received.

13. In order to specify the circumstances listed in the above criteria, it could also be considered appropriate to develop further ESMA Guidelines and Recommendations at a later point of time.

14. Once investment firms have fulfilled the quality enhancement criterion, they should maintain the enhanced level of quality. It should be clarified however that this does not imply that firms must provide for a continuously increasing quality of services over time.

15. As part of the applicable organisational requirements, investment firms should be able to clearly demonstrate that any payments or non-monetary benefits paid or received by the firm are designed to enhance the quality of the service to the client, such as:

i. keeping an internal list of any and all commissions, fees and non-monetary benefits accepted by the investment firm from a third party in relation to the provision of investment or ancillary services;

ii. recording how the commissions, fees and non-monetary benefits used by the investment firm, or that it intends to use, enhance the quality of the services provided to the relevant clients and the steps taken in order not to impair the firm's duty to act honestly, fairly and professionally in accordance with the best interest of the client.

Permitted inducements: disclosure requirements

16. In relation to monetary payments and non-monetary benefits received from or paid to third parties, investment firms should disclose to the client the following information:

    i. prior to the provision of the relevant investment or ancillary service, the investment firm shall disclose to the client in a clear, comprehensive, accurate and understandable manner, the existence, nature and amount of the payment or non-monetary benefit concerned. Where the amount of payments cannot be ascertained, the method of calculating that amount must be clearly disclosed to the client. Minor non-monetary benefits should only be described in a generic way. Other non-monetary benefits received by the investment firm in connection with the investment service provided to a client shall be priced and disclosed separately;

    ii. where an investment firm was unable to ascertain on an ex-ante basis the amount of any payment or benefit it was to receive, and instead disclosed to the client the method of calculating that amount (in accordance with Article 24(9) of MiFID II), it should also provide its clients with information of the exact amount of the inducement received on an ex-post basis;

    iii. at least once a year, as long as (on-going) inducements are received by the investment firm in relation to the investment services provided to the relevant clients, the investment firm should inform its clients on an individual basis about the actual amount of payments or non-monetary benefits received. Minor non-monetary benefits should be excluded from this obligation.

17. In implementing these requirements, the investment firm should take into account the rules with regard to disclosure on costs and charges, as outlined in the 'Information to clients on costs and charges' chapter of this CP.

18. When a number of entities are involved in the distribution channel, each investment firm that is providing an investment or ancillary service must comply with its obligations to make disclosures to its clients.

2.16. Investment advice on independent basis

Background/Mandate

Extract from the Commission's request for advice (mandate)

ESMA is invited to provide technical advice on requirements to be complied with by investment firms providing investment advice on an independent basis. In particular, ESMA should advise on appropriate measures concerning the selection process to assess a sufficient range of financial instruments as well as the conditions under which investment firms may offer advice on an independent basis and on a non-independent basis.

1. Recital 73 of MiFID II states that:

   "In order to further establish the regulatory framework for the provision of investment advice, while at the same time leaving choice to investment firms and clients, it is appropriate to establish the conditions for the provisions of this service when firms inform clients that the service is provided on an independent basis. When advice is provided on an independent basis a sufficient range of different product providers' products should be assessed prior to making a personal recommendation. It is not necessary for the advisor to assess investment products available on the market by all product providers or issuers, but the range of financial instruments should not be limited to financial instruments issued or provided by entities with close links with the investment firm or with other legal or economic relationships, such as a contractual relationship, that are so close as to put at risk the independent basis of the advice provided".

2. Article 24(4) of MiFID II states that information to clients shall specify whether the advice is provided 1) on an independent basis or not and 2) *"whether the advice is based on a broad or more restricted analysis of different types of financial instruments and, in particular, whether the range is limited to financial instruments issued or provided by entities having close links with the investment firm or any other legal or economic relationships, such as contractual relationships, so close as to pose a risk of impairing the independent basis of the advice provided".*

3. Article 24(7) of MiFID II states that when the investment firm informs the client that investment advice is provided on an independent basis, the firm shall:

   "(a) assess a sufficient range of financial instruments available on the market, which should be sufficiently diverse with regard to their type and issuers or product providers to ensure that the client's investment objectives can be suitably met and should not be limited to financial instruments issued or provided by:

   (i) the investment firm itself or by entities having close links with the investment firm; or

(ii) other entities with which the investment firm has such close legal or economic relationships, such as contractual relationships, as to pose a risk of impairing the independent basis of the advice provided

(b) not accept and retain fees, commissions or any monetary or non-monetary benefits paid or provided by any third party or a person acting on behalf of a third party in relation to the provision of the service to clients. Minor non-monetary benefits that are capable of enhancing the quality of service provided to a client and are of a scale and nature such that they could not be judged to impair compliance with the investment firm's duty to act in the best interest of the client must be clearly disclosed and are excluded from this point".

4. Article 4(1)(35) of MiFID II states that: *"'Close links' means a situation in which two or more natural or legal persons are linked by: (a) 'participation in the form of ownership, direct or by way of control, of 20% or more of the voting rights or capital of an undertaking; (b) 'control' which means the relationship between a parent undertaking and a subsidiary, in all the cases referred to in Article 22(1) and (2) of 2013/34/EU, or a similar relationship between any natural or legal person and an undertaking, any subsidiary undertaking of a subsidiary undertaking also being considered to be a subsidiary of the parent undertaking which is at the head of those undertakings; (c) a situation in which they are permanently linked to one and the same person by a control relationship".*

5. Article 24(13) of MiFID II empowers the Commission to adopt delegated acts concerning measures to ensure that investment firms comply with these principles, including the criteria for the assessment of a range of financial instruments available on the market.

Analysis following feedback from stakeholders

<u>*Sufficient range of sufficiently diverse financial instruments available on the market*</u>

6. Respondents generally supported ESMA's draft technical advice in relation to the selection process to assess a sufficient range of financial instruments. Many of these respondents noted however that the requirement for firms to consider "*a substantial part of financial instruments available on the market*" (paragraph 1(iii) of the draft technical advice) could be disproportionate and should be redefined. ESMA reminds that the number and variety of financial instruments to be considered (other than the ones provided by the investment firm or entities close to the firm) should be proportionate to the scope of the advice (paragraph 1(ii) of the technical advice). ESMA is of the view that, irrespective of the scope of services offered, all assessments should be based on an adequate number of financial instruments available on the market. ESMA considers that this requirement, and the fact that it should be understood in light of the proportionality principle, can be better reflected through the use of "*adequately representative*" instead of "*substantial"*.

7. A significant number of these respondents also suggested that the final technical advice clarifies the intended meaning of the terms 'class' and 'type' of financial instruments in the draft technical advice. ESMA notes that the term 'types' of financial instruments is used in

MiFID II and the term class will be used in one of the ESMA draft technical standards on best execution. ESMA has therefore introduced, in paragraph 3 of the technical advice, the term ‘category’ used in a broad sense to better describe the concept of independent advisers specialising in certain financial instruments and to capture situations where a firm does not focus on types of financial instruments (such as shares, funds or bonds) but on other criteria that are not based on the technical structure of the instrument per se, such as ‘green’ or ’ethical’ investments.

8. Some respondents expressed the view that the final technical advice should be strengthened and should include a ban for firms to completely exclude certain types of financial instruments during their selection process (notably the ones with the lowest costs and the lowest degree of complexity). ESMA notes that the need to consider cost and complexity is explicitly mentioned in the draft technical advice on suitability and that the exclusion of certain instruments just because they are less costly or less complex would not be in line with the overarching principle to act honestly, fairly and professionally in accordance with the best interests of clients.

9. A majority of respondents disagreed with ESMA’s proposal whereby a firm should refer its client to another firm when it is unable to confirm that its business model matches the client's needs and objectives (paragraph 3 (iv) of the draft technical advice). Several respondents also noted that this requirement was unclear as to what is actually expected from firms. ESMA notes that in cases where the business model does not match the client’s needs and objectives it is of the utmost importance that the firm declines providing such a service to the client. However, ESMA acknowledges the practical and commercial difficulties associated with the requirement to refer a client to another firm in such cases. ESMA has therefore modified the technical advice on this point.

Investment firms providing both independent and non-independent advice

10. Several respondents disagreed with ESMA's proposal that a same individual could not perform both independent and non-independent advice. These respondents noted that such a proposal would *de facto* prevent the smallest firms from providing independent advice to their clients.

11. ESMA appreciates the potential difficulties triggered by this requirement but considers that enabling the same individual to provide both independent and non-independent advice would create confusion for the client.

12. Respondents which agreed with ESMA’s proposal suggested that firms wishing to provide both independent and non-independent advice put in place organisational requirements aiming at:

    i. mitigating potential conflicts of interest;

ii. separating the teams in charge of providing independent advice and non-independent advice within the firm; and

iii. distinguishing clearly the independent and non-independent advice offers.

13. ESMA considers that paragraph 4(iii) of the advice is in line with these suggestions.

Technical advice

Sufficient range of sufficiently diverse financial instruments available on the market

1. An investment firm informing a client that investment advice is provided on an independent basis shall define and implement a selection process to assess and compare a sufficient range of financial instruments available on the market. The selection process should include all of the following elements:

   i. a diversified selection of financial instruments by type, issuer, or product provider, which is not limited to financial instruments issued or provided by the investment firm itself or by entities having close links or other relevant close legal or economic relationship with the investment firm should be considered;

   ii. the number and variety of financial instruments considered should be proportionate to the scope of advice services offered by the independent investment adviser;

   iii. the number and variety of financial instruments considered is adequately representative of financial instruments available on the market;

   iv. the quantity of financial instruments issued by the investment firm itself or by entities closely linked to the investment firm itself is proportionate to the total amount of financial instruments considered; and

   v. the criteria for comparing the various financial instruments should include all relevant aspects such as risks, costs and complexity as well as the characteristics of the investment firm's clients, and should ensure that neither the selection of the instruments that may be recommended nor the recommendations that are made to client are biased.

2. If such a comparison would not be possible because of the business model or the specific scope of the service provided, the investment firm providing advice should not be allowed to claim itself as "independent".

3. An investment firm that provides investment advice on an independent basis and that focuses on certain categories or a specified range of financial instruments should comply with the following requirements:

i. the firm is able to market itself in a way that only attracts clients with a preference for certain categories or a range of financial instruments;

ii. (potential) clients should be able to easily identify a preference for the specified classes or range of financial instruments and be able to self-select with a high degree of accuracy;

iii. clients indicate that they are only interested in investing in the specified category or range of financial instruments; and

iv. the firm is able to easily confirm whether its service is appropriate for each new client, i.e. that its business model matches the client's needs and objectives, and the range of financial instruments that are suitable for the client. If this is not the case the firm must not provide such a service to the client.

Investment firms providing both independent and non-independent advice

4. An investment firm offering investment advice on both an independent basis and on a non-independent basis should comply with the following obligations:

i. in good time before the provision of its services, the investment firm should inform retail clients, in a durable medium, whether the advice will be independent or non-independent in accordance with Article 24(4)(a) of MiFID II and the relevant implementing measures (see the 'Information to clients about investment advice and financial instruments' chapter of this technical advice);

ii. the investment firm should not hold itself out as "independent" for its business as a whole. However a firm may hold itself out as acting independently in respect of the services for which it provides independent advice; and

iii. it should have adequate organisational requirements and controls in place to ensure that both types of advice services and advisers are clearly separated from each other. To this end the firm should not allow a relevant person to provide both independent and non-independent advice. These requirements and controls should also ensure that clients are not confused about the type of advice that they are receiving and are given the type of advice that is appropriate for them.

2.17. Suitability

Background/Mandate

Extract from the Commission's request for technical advice (mandate)

ESMA is invited to provide technical advice on the information to obtain when assessing the suitability or appropriateness of the services and financial instruments for their clients, criteria to assess non-complex financial instruments, the content and the format of records and agreements for the provision of services to clients and of periodic reports to clients on the services provided. In particular, the technical advice should consider any updates or improvements to the suitability assessment requirements as well as proposals for the content of suitability reports aiming to ensure a real added value for the client. Moreover, technical advice should further clarify and update the criteria to assess non-complex products set out in Article 38 of the Commission Directive 2006/73/EC.

The advice should take into account: (i) the nature of the services offered or provided to the client, taking into account the type, object, size and frequency of the transaction, (ii) the nature of the products being offered, including types of fin instrument and structured products and (iii) the retail and professional nature of the client, eligible counterparty.

1. The assessment of suitability is one of the most relevant obligations for investor protection. It applies to the provision of any type of investment advice (whether independent or not) and portfolio management. In accordance with this obligation, investment firms providing investment advice or portfolio management have to provide suitable personal recommendations to their clients or have to make suitable investment decisions on behalf of their clients. Suitability has to be assessed against clients' knowledge and experience, financial situation and investment objectives. To achieve this, investment firms have to obtain the necessary information from clients.

2. ESMA is required to advise the Commission on the general suitability provision in Article 25(2) and the contents of the suitability report in Article 25(6) of MiFID II.

3. Article 25(2) of MiFID II states:

   "When providing investment advice or portfolio management the investment firm shall obtain the necessary information regarding the client's or potential client's knowledge and experience in the investment field relevant to the specific type of product or service, that person's financial situation including his ability to bear losses, and his investment objectives including his risk tolerance so as to enable the investment firm to recommend to the client or potential client the investment services and financial instruments that are suitable for him and, in particular, are in accordance with his risk tolerance and ability to bear losses.

Member States shall ensure that where an investment firm provides investment advice recommending a package of services or products bundled pursuant to Article 24(11), the overall bundled package is suitable".

4. Article 25(6), subparagraph 2 states:

   "When providing investment advice, the investment firm shall, before the transaction is made, provide the client with a statement on suitability in a durable medium specifying the advice given and how that advice meets the preferences, objectives and other characteristics of the retail client".

5. In July 2012, ESMA published guidelines on certain aspects of the MiFID I suitability requirements.[36] This provided guidelines in relation to the suitability assessment provisions included in MiFID I and the MiFID Implementing Directive.

Analysis following feedback from stakeholders

Suitability assessment

6. In its CP, ESMA considered that provisions in Article 35 of the MiFID Implementing Directive are a good basis, to be expanded in a number of areas, for the development of the MiFID II implementing measures. ESMA also proposed that Article 35(1) should be updated to reflect that MiFID II now explicitly requires investment firms, when undertaking a suitability assessment, to assess both a client's ability to bear losses and a client's risk tolerance.

7. Generally, the majority of responses were not in favour of enhancing the existing suitability assessment. Strong recurring objections were observed to the proposed expansion of the suitability assessment especially to the proposals outlined under (iii) and (ix) and the proposal under (v) of the draft technical advice. However, there was solid support from consumer organisations for the proposals in the round although some called for further enhancements.

8. Those opposing any further assessment which requires examining whether an alternative less complex and less costly instrument would be more suitable (paragraph 1.ix and iii of the draft technical advice) argue that this requirement goes beyond the requirements in MiFID II, which stipulate that the client is recommended a suitable product, not the most suitable product. They further argue that they would then be obliged to survey the whole universe of products available and this would not be consistent with the non-independent business model. The majority of respondents also pointed to the 'legal risk/uncertainty' that would follow from such a requirement from clients complaining that a cheaper or less complex product was not advised/sold to them.

[36] http://www.esma.europa.eu/system/files/2012-387.pdf

9. The other main argument against this proposal is that it creates a false link between the complexity of a product and its risk. Many respondents objected to what they saw as an assumption that less complex and cheaper products would be deemed to be more suitable and argue that the draft technical advice would mean that even for clients for whom complex products are found to be suitable, non-complex products would always be preferable when this may not be the case for an individual client. They stress that other factors are just as relevant in the assessment of suitability. This kind of proposal could limit the access for clients to other products that better meets their profile and diversify/reduce the risks of their assets. Some respondents argued that this requirement is duplicative because these considerations are already implied when carrying out a suitability assessment.

10. The proposal (v) for firms to collect the necessary information to undertake an analysis of the costs and benefits of switching from an existing to a new investment was also unpopular amongst respondents. Key objections included that the requirement appears unclear and overly burdensome. It would also undermine the duties and function of portfolio managers: the portfolio manager has been given in writing by the client a full mandate to operate transactions and switches any time the portfolio manager finds it appropriate to do so.

11. Consumer organisations were supportive of the proposal for firms to assess the ability for clients to bear losses. Some also called for inter alia a suitability test to take account of not just qualitative criteria but also on quantitative measures which capture a clients' attitude to risk (e.g. the amount of money a client is willing to lose at maximum over a fixed time period); that the suitability report should be in format that can be easily comprehended by clients; and that any cost-benefit analysis around switching instruments/portfolios should be sufficiently tailored to the client's profile.

12. ESMA notes the arguments made above, however in respect of those in response to (ix) and (iii) of the TA ESMA's wishes to clarify that this requirement is not intended to be carried out consecutively or after an initial suitability assessment has been done as some respondents seemed to assume. Neither is it ESMA's intention to require detailed consideration of individual instruments from across all types or classes of instruments for each individual client. Indeed, this requirement merely gives more emphasis to some key factors that an advisor/portfolio manager should take into account when conducting a suitability assessment before making their final recommendation. Once a client's personal circumstances have been considered and the nature of the investments that they need have been assessed, this will include making choices between particular instruments. So, in practice, it will involve comparing individual instruments from within the firm's range that are broadly equivalent to each other (e.g. making a choice between two or more UCITS funds that invest in the same sector). Many firms may already be making this same assessment as part of their normal and existing suitability assessment and therefore there would be no additional burden on them as a result of complying with this requirement.

13. In respect of those points raised under (v) of the draft technical advice, ESMA does not consider that this would be an unduly burdensome requirement since firms should always act in the client's best interest and should be ensuring that every transaction benefits the

client. ESMA does not consider that this requirement undermines the ability or autonomy of the portfolio manager. The portfolio manager would continue to exercise their judgement and expertise as to which investment(s) are suitable for their clients and an inherent part of acting on their mandate would be to ensure that there is a benefit for the client.

14. The SMSG were generally supportive of the proposed clarifications to the suitability assessment. They note however that the term 'lower cost' is too general and recommends that clear guidance and definition of the term is given to ensure consistent application by Member States.

15. The SMSG also offered clarifying text to paragraphs (iii) and (ix) of the draft technical advice which together require firms to consider a less costly (and less complex) alternative. These proposed amendments are in line with the proposed clarification offered by ESMA as a result of the feedback received that the draft technical advice in its current form is contradicting the existing suitability assessment because (and as many respondents argued) the cost and complexity of the product range form part of the a suitability assessment and therefore are built-into their recommendations to the client. Specifically SMSG propose the following change to the draft technical advice:

iii. investment firms should have, and be able to demonstrate, adequate policies and procedures to ensure that they understand the nature, features, including costs and risks of instruments selected for their clients and that they assess, ***while taking into account complexity and costs,*** *whether alternative financial instruments~~**, less complex or with lower costs,**~~ could meet their client's profile.*

ix. when recommending a financial instrument to a client, investment firms should assess whether an alternative instrument, less complex and with lower costs, would ~~***better***~~ *meet the client's profile"*

16. The SMSG also called for greater clarity in the requirement in the draft technical advice viii (b) which specifies that firms have robust processes in place to assess a clients' risk appetite. They recommend clearer rule- making and in particular suggest the following drafting amendment to viii. (b) of the technical advice:

"b. Demonstrating **valid and reliable** assessments of ~~having robust processes for assessing~~ the risk clients are willing and able to take, including their ability to bear the investment

17. ESMA agrees that the SMSG's draft suggestions usefully clarify these requirements and address concerns expressed by other consultation respondents. These have therefore been taken on board when finalising the technical advice.

18. ESMA has also added a further point (xiii) to its technical advice recommending a clarification of the application of the suitability rules to automated and semi-automated advice and portfolio management services. This advice is consistent with ESMA's previously published Q&A on automatic execution of trade signals[37] (i.e. it is relevant to services normally referred to, by market participants, as 'copy trading','mirror trading', 'auto trading' or 'social trading') as well as to web-based advice and portfolio management services more generally.

Suitability reports

19. Opinion on the content of suitability reports came mainly from trade associations and consumer bodies. From the industry side, the common view is that already clients are overloaded with information mandated by regulation. There was a preference that anyway suitability reports should only be provided to retail clients. A number of respondents also argued that reference to 'disadvantages' (paragraph 2.iii of the draft technical advice) did not to be included in the suitability report since it would result in the restating of the risks captured in the overall suitability assessment.

20. Consumer bodies largely underscored their support for the ESMA's draft technical advice. Specific recommended included an explanation of the client's ability to bear losses and the client's risk tolerance.

21. In terms of the content of periodic suitability reports, firms broadly confirmed the draft technical advice to only cover changes in instruments/circumstances of the client in periodic reports. Some firms underlined that periodic reports should only be a requirement where an IF provides a monitoring service (under Article 24.4 (iii) of MiFID II) and that ordinary market fluctuations should not be a sufficient trigger to warrant the issuing of a periodic report. Industry respondents also noted that the ESMA approach is sensible to avoid consumers being over-loaded with information and unnecessary/frequent information provision would be more of a hindrance than a help. Consumer bodies also supported the view that periodic reports should not have to repeat all the details of the initial suitability report.

22. ESMA acknowledges the arguments made in relation to the proposal for firms to explain the disadvantages of the recommended course of action, and agrees that this requirement would be largely duplicative since this aspect is captured already in the overall suitability assessment and in the information provided to clients on risk. ESMA has therefore deleted this from the technical advice.

Technical advice

[37] MiFID Questions and Answers, June 2012 – Q9: Article 4(1)(9) of MiFID – Automatic execution of trade signals.

Suitability assessment

1. ESMA recommends that Article 35 of the MiFID Implementing Directive is expanded to clarify that:

   i. the responsibility to undertake the suitability assessment lies with the investment firm. When undertaking this, a firm shall inform clients, clearly and simply, that the reason for assessing suitability is to enable the firm to act in the client's best interest. At no stage should investment firms create any ambiguity or confusion about their own responsibilities in the process;

   ii. the suitability assessment is not limited to recommendations to buy a financial instrument. Every personal recommendation given to the client, or decision whether to trade, shall be suitable, which includes, for example, whether or not to buy, hold or sell an investment;

   iii. investment firms shall have, and be able to demonstrate, adequate policies and procedures to ensure that they understand the nature, features, including costs and risks of instruments selected for their clients and that they assess, while taking into account cost and complexity, whether equivalent financial instruments could meet their client's profile;

   iv. where an investment firm offers or has access to a limited range of instruments, or investment choices associated with instruments, they must not make a recommendation or decision to trade if none of the investments they offer are suitable for the client;

   v. when providing advice and, where appropriate, portfolio management services that involve switching investments (either by selling an instrument and buying another, or by exercising a right to make a change in regard to an existing instrument), a firm shall collect the necessary information on the client's existing investments and the recommended new investments to undertake an analysis of the costs and benefits of the switch, such that they are reasonably able to demonstrate that the benefits of switching are greater than the costs;

   vi. where the investment firm has an on-going relationship with the client, e.g. by providing an ongoing advice or portfolio management service, the firm shall have, and be able to demonstrate, appropriate procedures to maintain adequate and up-to-date information about the client to the extent necessary to fulfil the requirements at Article 35(1) of the MiFID Implementing Directive;

   vii. investment firms shall determine the extent of the information to be collected from clients in light of all the features of the investment advice or portfolio management services to be provided to those clients;

viii. investment firms shall take reasonable steps to ensure that the information collected about their clients is reliable. This includes, but is not limited to:

a. ensuring clients are aware of the importance of providing accurate and up-to-date information;

b. undertaking valid and reliable assessments of their client's knowledge and experience and risk they are willing and able to take, including their ability to bear the investment risk;

c. ensuring all tools employed in the suitability assessment process are appropriately designed for use with their clients and are fit-for-purpose, with any limitations identified and actively mitigated through the suitability assessment process. This includes, for example, any risk assessment profiling tools that may be used or tools to assess a client's knowledge and experience;

d. ensuring questions used in the process are likely to be understood by clients, capture an accurate reflection of the client's views and needs, and the information necessary to undertake the suitability assessment; and

e. taking steps, as appropriate, to ensure the consistency of client information. This includes, for example, considering whether there are obvious inaccuracies in the information provided by clients.

ix. as part of the process of identifying and recommending a financial instrument to a client, investment firms shall assess, while taking into account cost and complexity, whether an equivalent instrument would meet the client's profile;

x. where a client is a legal person or a group of two or more natural persons or where one or more natural persons are represented by another natural person, to identify who should be subject to the suitability assessment, the investment firm shall first rely on the applicable legal framework;

xi. if the legal framework does not provide sufficient indications in this regard, and in particular where no sole representative has been appointed (as may be the case for a married couple), the investment firm, based on a policy it has defined beforehand and that provides that the best interests of all the persons concerned and their need for protection are taken into consideration, should agree with the relevant persons (the representatives of the legal entity, the persons belonging to the group or the natural persons represented) as to who should be subject to the suitability assessment and how this assessment will be done in practice, including from whom information about knowledge and experience, financial situation and investment objectives, should be collected (in any case the agreement shall ensure that the person carrying out transactions on behalf of the entity has the necessary level of knowledge and experience). The investment

firm shall make a record of the agreement; and

xii. where a natural person is represented by another natural person and where a small entity is to be considered for the suitability assessment, the financial situation and investment objectives should be those of the underlying client (natural person who is represented or small entity). The knowledge and experience should be that of the representative of the natural person or the person authorised to carry out transactions on behalf of the entity.

xiii. where investment advice or portfolio management are provided in whole or in part through an automated or semi-automated system, the responsibility to undertake the suitability assessment lies with the investment firm providing the service and is in no way diminished owing to the use of an electronic system in making the personal recommendation or decision to trade. This includes services where an investment firm executes an order, or transmits it to another firm for execution, in response to pre-agreed signals (e.g. a particular person's decisions to buy or sell); either without further intervention from the client (amounting to a form of portfolio management) or with the client's agreement (amounting to a form of investment advice).

Suitability reports

2. In relation to suitability reports, investment firm shall be required, when providing investment advice, to provide a report to the retail client that must include:

   i. an outline of the advice given; and

   ii. how the recommendation provided is suitable for the retail client, including how it meets the client's objectives and personal circumstances with reference to the investment term required, client's knowledge and experience and client's attitude to risk and capacity for loss.

3. Where the recommended instruments are likely to require the retail client to seek a periodic review of their arrangements, this shall be brought to the client's attention and included in the report. This includes, for example, where a client is likely to need to seek advice to bring a portfolio of investments back in line with the original recommended allocation where there is a probability that the portfolio could deviate from the target asset allocation.

4. Where an investment firm provides a service that involves periodic suitability assessments and reports, the subsequent reports after the initial service is established would only need to cover any changes in the instrument(s) and/or the circumstances of the client. It would not be necessary for these reports to repeat all the detail of the first report. A periodic report could simply refer back the original report to a varying degree depending on any changes, and could be shorter in cases where the on-going assessment affirms the continued suitability of a previous recommendation or portfolio.

2.18. Appropriateness

Background/Mandate

Extract from the Commission's request for technical advice (mandate)

ESMA is invited to provide technical advice on the information to obtain when assessing the suitability or appropriateness of the services and financial instruments for their clients, criteria to assess non-complex financial instruments, the content and the format of records and agreements for the provision of services to clients and of periodic reports to clients on the services provided. In particular, the technical advice should consider any updates or improvements to the suitability assessment requirements as well as proposals for the content of suitability reports aiming to ensure a real added value for the client. Moreover, technical advice should further clarify and update the criteria to assess non-complex products set out in Article 38 of the Commission Directive 2006/73/EC.

The advice should take into account: (i) the nature of the services offered or provided to the client, taking into account the type, object, size and frequency of the transaction, (ii) the nature of the products being offered, including types of fin instrument and structured products and (iii) the retail and professional nature of the client, eligible counterparty.

1. When providing investment services other than investment advice and portfolio management, firms have to ask clients to provide information about their knowledge and experience in order to be able to assess the appropriateness of the service or product offered or demanded. Under specific identified circumstances this assessment is not required (so called execution-only services).

2. ESMA is required to advise the Commission on the appropriateness provision in Article 25(3) and (4) of MiFID II, which includes the definition of a non-complex instrument. This specifically includes providing advice in relation to the criteria to assess non-complex financial instruments for the purpose of paragraph 4(a)(vi) of Article 25 of MiFID II.

3. The main provisions in the MiFID Implementing Directive relating to appropriateness are set out in Articles 36, 37 and 38. To clarify the application of this, in 2009 CESR published a Q&A statement on MiFID complex and non-complex instruments.[38] In due course, ESMA intends to review this statement in light of the updated criteria included in MiFID II and market developments since 2009, to provide greater clarity around the distinction between the two types of investments.

[38] CESR/09-559.

4. MiFID II introduces the concept of a "*structure making it difficult for the client to understand the risk"* involved. Where a bond, other form of securitised debt or money market instrument incorporates such a structure, it should be considered complex. ESMA is required under Article 25(10) of MiFID II to develop and periodically update guidelines for the assessment of financial instruments that incorporate a structure that makes it difficult for the client to understand the risks involved. ESMA will take forward this work and publish the guidelines as required by MiFID II.

Analysis following feedback from stakeholders

5. Many industry respondents took issue with the expansion of Article 38 along the lines proposed by ESMA under point 2 of its draft technical advice (to make clear that those instruments explicitly excluded from the list of non-complex instruments under Article 25(4)(a) lit i) to v), cannot be further assessed against criteria established in the MiFID II implementing measures), especially in relation to shares in non-UCITS/AIFs. Other industry respondents offered mixed support for the amendments, typically agreeing to the additions to the criteria currently included in Article 38 of the MiFID Implementing Directive.

6. Many of the industry responses questioned ESMA's automatic exclusion of certain instruments from examination under Article 38 criteria. They argued that the purpose of Article 25(4)(a) is to identify certain instruments as being automatically 'non-complex' and those not named in Article 25 of MiFID II should then be judged against the (to be expanded) criteria in Article 38 of the MiFID Implementing Directive.

7. Those arguing particularly for AIFs to be subject to assessment against criteria in the MiFID II implementing measures highlighted that not doing so would run contrary to previous CESR position (2010).[39] Respondents noted that, in many cases, AIFs only differ from UCITS in terms of diversification limits and have high levels of transparency and incorporate measures to control risks and so claim that they would easily qualify as non-complex instruments under Article 38 of the MiFID Implementing Directive. Furthermore a classification as complex instruments would be inconsistent with AIFMD which allows individual Member States to enable sale of AIF to retail clients. Some respondents suggested therefore that, at least, ESMA does not include any explicit reference to AIF in its final advice to the Commission.

8. There was mixed support for the additional criteria listed in the draft technical advice. Whilst some respondents believe it will bring additional clarity to the definition of a non-complex product others took particular issue with the proposed criteria under paragraph 1(ii) of the

[39] In the Technical Advice, CESR stated that '*shares in a non-UCITS collective investment undertaking are first and foremost investments in a collective investment undertaking and that (for the purposes of the appropriateness requirements) this should prevail over the legal form they take (i.e. whether units or shares) in the interests of a consistent regulatory treatment of such investments for the purposes of the appropriateness requirements. CESR believes that shares in a non-UCITS undertaking should therefore be assessed against the Article 38 criteria* […].

draft technical advice. Many respondents contested the link between illiquidity - due to the application of an exit charge - and a product's complexity. The presence of an exit charge, they noted, should not automatically render the investment illiquid and therefore 'complex'.

9. Respondents also raised issues around the criterion under paragraph 1(i) arguing that the term "*fundamentally alters the nature or risk of the investment or pay out profile*" is drafted too vaguely and is open to wide interpretation by firms, and was therefore asked to be clarified. Some respondents argued this point through examples, including reverse convertibles or discount certificates, which feature some of the elements mentioned in the proposed criteria (clause, condition, or trigger) and therefore would be considered complex under the new regulations, even though they do not pose a significant risk for investors.

10. On the whole, firms did not think that additional changes to the ones proposed in the draft technical advice are necessary.

11. Few consumer bodies offered views, however those that did supported the amendments and particularly welcomed the narrowing of those instruments which could be considered non-complex and the inclusion of exit charges under paragraph 1 (ii) which they agreed could reduce liquidity.

12. In response to comments made about the exclusion of certain instruments from assessment under Article 38, ESMA would reiterate that MiFID II has clarified further which financial instruments it believes should be automatically considered as complex. In ESMA's view these instruments should not go on to be considered under Article 38. This approach is in line with the position already taken by CESR under MiFID I: "*If an instrument is explicitly excluded from the list of non-complex instruments in Art. 19(6), it should not be brought back in via Art. 38. Only those instruments not specifically mentioned in Art. 19(6) in the first place should be assessed against the criteria in Art. 38 as potentially "other non-complex financial instruments".* ESMA considers that, while MiFID II has changed the list of financial instruments mentioned in Article 25(4) (former Article 19(6) of MiFID I), the principle already accepted by CESR should be confirmed.

13. ESMA does wish to make clear, however, that instruments should only be considered as automatically complex under Article 25(4)(a) if they meet the criteria specified in the article. This means that units in structured UCITS and shares that embed a derivative should automatically be considered complex (as well as certain debt and money market instruments and structured deposits). For the avoidance of doubt, ESMA also understands that investments in non-UCITS collective investment undertakings should be considered complex, regardless of whether they take the legal form of shares or of units.

14. ESMA acknowledges the comments made to the additional criteria proposed under Article 38. In response to the point made about the link between illiquidity and complexity, ESMA's reiterates that where exit charges are unduly high (e.g. relatively to the purchase price) it is reasonable to suppose that they will act as an exit barrier and therefore the relevant instrument will be difficult to dispose of. ESMA further notes that the liquidity of an instrument as a

criterion for assessing an instrument's complexity is an existing and tested criterion under MiFID.

15. In its response to the draft technical advice covering underwriting and placing, the SMSG suggested that when investment firms undertake self-placement, they should, inter alia, be required to maintain records where an appropriateness assessment has found that the product is not appropriate or that appropriateness cannot be assessed due to a lack of data. ESMA agrees with this proposal and considers that it should be extended to any assessment of appropriateness. ESMA therefore considers that it would be appropriate for firms to maintain such records including:

    i. where an appropriateness assessment concluded an investment service or product was appropriate for a client;

    ii. where an appropriateness assessment concluded an investment service or product was not appropriate for a client;

    iii. where a client provided insufficient information to enable the investment firm to undertake an appropriateness assessment; and

    iv. whether the client proceeded with the investment service or product purchase irrespective of the result of the appropriateness assessment.

16. Reflecting that more instruments will be considered complex under MiFID II, ESMA may undertake future Level 3 work on this topic. In particular, ESMA may look at the warnings clients receive when an appropriateness assessment concludes a product or service may not be appropriate for that client.

Technical advice

1. ESMA recommends adding two additional criteria to Article 38 of the MiFID Implementing Directive, that an instrument not included explicitly in Article 25(4)(a) of MiFID II would need to meet to be considered non-complex:

    i. it does not incorporate a clause, condition or trigger that could fundamentally alter the nature or risk of the investment or pay out profile. This would include, for example, investments that incorporate a right to convert the instrument into a different investment; and

    ii. it does not include any explicit or implicit exit charges that have the effect of making the investment illiquid even though technically frequent opportunities to dispose or redeem it would be possible.

2. ESMA also recommends the clarification that the specific financial instruments that are excluded from the list of non-complex financial instruments described in Article 25(4)(a) of MiFID II cannot then be assessed against the criteria for the assessment of other non-

complex financial instruments in accordance with Article 25(4)(a)(vi) of MiFID II and they should be considered complex.

3. Investment firms shall maintain records of the appropriateness assessments they have undertaken. These records should include:

   i. the result of the appropriateness assessment;

   ii. any warning given to the client where the investment service or product purchase was assessed as potentially inappropriate for the client, whether the client asked to proceed with purchase despite the warning and, if applicable, whether the firm accepted the client's request to proceed with the purchase; and

   iii. any warning given to the client where the client did not provide sufficient information to enable the firm to undertake an appropriateness assessment, whether the client asked to proceed with purchase despite this warning and, if applicable, whether the firm accepted the client's request to proceed with the purchase.

2.19. Client agreement

Background/Mandate

Extract from the Commission's request for advice (mandate)

ESMA is invited to provide technical advice on the information to obtain when assessing the suitability or appropriateness of the services and financial instruments for their clients, criteria to assess non-complex financial instruments, the content and the format of records and agreements for the provision of services to clients and of periodic reports to clients on the services provided. In particular, the technical advice should consider any updates or improvements to the suitability assessment requirements as well as proposals for the content of suitability reports aiming to ensure a real added value for the client. Moreover, technical advice should further clarify and update the criteria to assess non-complex products set out in Article 38 of the Commission Directive 2006/73/EC.

The advice should take into account: (i) the nature of the services offered or provided to the client, taking into account the type, object, size and frequency of the transaction, (ii) the nature of the products being offered, including types of fin instrument and structured products and (iii) the retail and professional nature of the client, eligible counterparty.

1. Article 25(5) of MiFID II is identical to Article 19(7) of MiFID I:

   "The investment firm shall establish a record that includes the document or documents agreed between the firm and the client that set out the rights and obligations of the parties, and the other terms on which the firm will provide services to the client. The rights and duties of the parties to the contract may be incorporated by reference to other documents or legal texts".[40]

2. Article 25(8) of MiFID II empowers the Commission to adopt delegated acts to ensure that investment firms comply with the principles set out in Article 25, including:

   "the content and format of records and agreements for the provision of services to clients".

3. The MiFID Implementing Directive contains the following provisions:

   "*Member States shall require an investment firm that provides an investment service other than investment advice to a new retail client for the first time after the date of application of this Directive to enter into a written basic agreement, in paper or another durable medium, with the client setting out the essential rights and obligations of the firm and the client.*

[40] For the sake of completeness, it should be mentioned that MiFID II also requires a *"binding written agreement"* with the client where an investment firm provides direct electronic access to a trading venue (Article 17(5) of MiFID II), and where an investment firm acts as a general clearing member (Article 17(6) of MIFID II).

The rights and duties of the parties to the agreement may be incorporated by reference to other documents or legal texts" (Article 39 of the MiFID Implementing Directive, implementing Articles 19(1) and 19(7) of MiFID I, on Retail client agreement).

Analysis following feedback from stakeholders

Scope in relation to clients and services provided

4. In relation to ESMA's suggestion to require a written (or equivalent) agreement between firms and their professional clients, a large number of respondents highlighted that this is already a common practice on the market as it provides a higher level of legal certainty. Some of these respondents however noted that imposing a requirement where there are no market failures would be overly prescriptive (with few arguing that such a requirement would interfere with national civil law). More specifically, respondents suggested that the requirement could be limited to:

   i. the provision of portfolio management services because in this case the portfolio manager has discretion to take decisions on behalf of the client;

   ii. the provision of safekeeping of financial instruments because of the associated risks and the need for legal certainty in this matter; and

   iii. relationships with *"new"* professional clients in order not to impose on firms the need to review all existing relationships.

5. ESMA notes the comments received and confirms that the proposed requirement is limited to *"new"* professional clients and believes that the proposed requirement of a written (or equivalent) agreement is consistent with the content of Article 25(5) of MiFID II, the mandate received from the Commission and the existing MiFID I Implementing directive (which already regulates client agreements).

6. ESMA's proposal to require investment firms to enter into a written (or equivalent) agreement for the provision of investment advice to clients on a continuous basis received support from respondents, although support was stronger in reference to relationships with retail clients. Consumer associations noted that written agreements would strengthen legal certainty and would enable clients to better understand the nature of the service provided.

7. Several respondents however asked ESMA to clarify what is to be understood by "*continuing relationship*". ESMA has clarified its technical advice by aligning the scope of the proposed obligation with Article 24(4)(a)(iii) of MiFID II (investment firm providing a periodic assessment of the suitability of the financial instruments recommended in the course of the provision of financial advice).

8. Respondents almost unanimously agreed that investment firms should be required to enter into a written (or equivalent) agreement for the provision of custody services (safekeeping of financial instruments) to any client.

Scope in relation to the content of the agreement

9. The vast majority of respondents also agreed that investment firms should be required to describe in the client agreement any advice services, portfolio management services and custody services to be provided.

Technical advice

1. The content of Article 39 of the MiFID Implementing Directive should be modified in the areas below.

2. Investment firms providing any investment service or the ancillary service specified in Annex I, Section B(1) of MiFID II[41] to a new professional client after the date of application of MiFID II should enter into a written agreement, in paper or another durable medium, with the client setting out the essential right and obligations of the firm and the client. When investment advice is provided, this obligation should only apply where a periodic assessment of the suitability of the financial instruments recommended is provided to the professional client.

3. In addition to requirements established by Article 39 of the MiFID Implementing Directive, investment firms should enter into a written agreement with retail clients when providing (i) the service of investment advice (except when the investment firm does not provide a periodic assessment of the suitability of the financial instruments recommended to the client), and (ii) the ancillary service mentioned in Annex I, Section B(1) of MiFID II.

4. The written basic agreement should set out the "essential rights and obligations" of the parties including the following:

   i. the client agreement should describe the nature and extent of any investment advice services to be provided;

   ii. the client agreement should state the types of financial instruments that may be purchased and sold and the types of transactions that may be undertaken on behalf of the client, as well as any instruments or transactions prohibited, in the context of any portfolio management services to be provided; and

   iii. the client agreement should describe the main features of any custody services to be provided, including where applicable the role of the firm with respect to corporate actions relating to client securities and the terms on which securities financing transac-

[41] MiFID II Annex I Section B: "(1) *Safekeeping and administration of financial instruments for the account of clients, including custodianship and related services such as cash/collateral management and excluding maintaining securities accounts at the top tier level".*

tions involving client securities will generate a return for the client.

5. The proposals above are intended to achieve a common minimum regime in the European Union. ESMA considers that client agreements should remain a minimum harmonisation area under MiFID II.

2.20. Reporting to clients

Background/Mandate

Extract from the Commission's request for technical advice (mandate)

ESMA is invited to provide technical advice on the information to obtain when assessing the suitability or appropriateness of the services and financial instruments for their clients, criteria to assess non-complex financial instruments, the content and the format of records and agreements for the provision of services to clients and of periodic reports to clients on the services provided. In particular, the technical advice should consider any updates or improvements to the suitability assessment requirements as well as proposals for the content of suitability reports aiming to ensure a real added value for the client. Moreover, technical advice should further clarify and update the criteria to assess non-complex products set out in Article 38 of the Commission Directive 2006/73/EC.

The advice should take into account: (i) the nature of the services offered or provided to the client, taking into account the type, object, size and frequency of the transaction, (ii) the nature of the products being offered, including types of fin instrument and structured products and (iii) the retail and professional nature of the client, eligible counterparty.

1. The first subparagraph of Article 25(6) of MiFID II states: *"The investment firm shall provide the client with adequate reports on the service provided in a durable medium. These reports shall include periodic communications to clients, taking into account the type and the complexity of financial instruments involved and the nature of the service provided to the client and shall include, where applicable, the costs associated with the transactions and services undertaken on behalf of the client".*

2. There has not been any major change in MIFID II compared to MIFID I in relation to the provision of reports on services provided, apart from Article 30(1), which states that transactions with eligible counterparties are no longer exempt from applying Article 25(6). There is also one other amendment to clarify the requirement that reports should include *"periodic communications to clients, taking into account the type and the complexity of financial instruments involved and the nature of the service provided to the client*".

3. The MiFID Implementing Directive contains the following relevant provisions:

   i. reporting obligations in respect of execution of orders other than for portfolio management (Article 40);

   ii. reporting obligations in respect of portfolio management (Article 41);

   iii. additional reporting obligations for portfolio management or contingent liability transactions (Article 42); and

iv. statements of client financial instruments or client funds (Article 43).

Analysis following feedback from stakeholders

Reporting obligations – Application to different categories of clients

4. The majority of respondents disagreed with ESMA's proposal to extend the current reporting requirements for retail clients, on execution of orders and portfolio management, also to professional clients. These respondents stated that professional clients often require the reports to be tailored to their needs, which are different to those of retail clients, and that the requirement would increase costs for firms without providing professional clients with the information they need. Some of these respondents suggested amending the advice in order to simply require firms to enter into agreements with both professional clients and eligible counterparties on the content and timing of reporting.

5. More specifically on the topic of execution reports, some respondents asked ESMA to clarify whether it would be possible for a firm not to send execution reports to a professional client who explicitly asks not to receive them.

6. ESMA notes the comments made by respondents in relation to the information to be given to professional clients. However, aligning the content of reports for professional clients with those currently applicable to retail clients minimises the risk of mis-judged and sub-optimal investment decisions being taken and therefore of detriment not just to professional clients but to their clients also, when, in turn, they provide services to other clients. On the other hand, ESMA notes that existing reporting obligations in respect of portfolio management already provide for flexible options on the reports that the client may choose to receive.

7. Furthermore, in order to be fully consistent with the extension of Article 25(6) of MiFID II to the relationship with eligible counterparties, ESMA is clarifying that requirements apply to all categories of clients. At the same time, ESMA confirms the possibility for eligible counterparties to request different calibration of reporting requirements and to adapt content and timing of the reports to their needs.

Reporting obligations in respect of portfolio management

8. The vast majority of respondents objected to ESMA's proposed change to the frequency of reporting, and noted that quarterly reporting would imply greater costs and create risks of information overload for clients.

9. ESMA recognises that a number of portfolio managers have developed online systems to allow clients to access up-to-date valuations of their portfolios. For clients that access this information on-line, requiring firms to additionally send quarterly statements could be seen as duplicative.

10. ESMA continues to believe that it is essential for clients to have access to regular information about their portfolios and should receive this information at least quarterly. There-

fore, based on the feedback received, ESMA has refined the technical advice. If a portfolio manager offers clients access to up-to-date valuations using an online or equivalent system, which qualifies as a durable medium and where the firm has evidence that the client has accessed this valuation at least once during the quarter and the client can also easily access the information required by Article 43(2) of MiFID Implementing Directive through the same system, they do not need to provide the client with a quarterly report for that period. Firms can generally satisfy themselves that a client has accessed the valuation if they have a record that the consumer has logged onto the online system and accessed the relevant section of the system where this valuation is provided.

11. Where a firm offers an online valuation system, but does not have a record that the client has accessed a valuation at least once during the quarter, it should provide the client with a periodic statement at the end of the quarter.

Reporting obligations on losses in respect of portfolio management or contingent liability transactions

12. A large number of respondents suggested that it should be left to mutual agreement between clients and firms to determine the threshold for the reporting on leveraged financial instruments or other financial instruments. Furthermore, trade associations, investment firms and asset managers stated that a higher threshold would be more apt (for example 20%). On the other hand, the only consumer association responding on this topic suggested lowering the threshold to 5% (and multiples thereof) as retail investors need to be informed of losses which go beyond what they are prepared to incur.

13. ESMA was also asked to clarify whether the thresholds are to be determined by reference to the overall portfolio value or by reference to individual holdings.

14. ESMA notes the comments made in relation to the reporting threshold for reporting to clients on the losses of the initial investment value. It is ESMA's view that retail clients should be kept informed on the performance of their portfolio. It is not straightforward to set a quantitative threshold to trigger such a reporting obligation but when a loss of 10% of the initial value occurs this seems to ESMA to be an appropriate juncture to inform the client (and thereafter at multiples of 10%).

15. ESMA therefore has updated its technical advice to recommend the observance of a 10% loss of initial investment value (and thereafter at multiples of 10%) as an appropriate trigger for reporting to retail clients. In the case of portfolio management, this trigger would be set at the depreciation of 10% (and multiples of 10%) of the overall value of the overall portfolio at a certain date and not individual holdings. This threshold would not be triggered because of intentional revisions by the portfolio manager or client. Where investment firms hold a retail client account that includes positions in leveraged financial instruments or other contingent liability transactions, they shall report to the client (on an instrument-by-instrument basis, unless otherwise agreed with the client), where the initial value of each instrument depreciates by 10% and thereafter at multiples of 10.

Reporting obligations in respect of holding clients' financial instruments and funds

16. The consumer association providing input on the topic of provision of information to clients on the market or estimated value of the financial instruments stated that this information is important to clients and should be included in periodic reporting from firms. The consumer association noted that investment firms should be required to provide clients with the market value of financial instruments, where available, or with an estimated value based on reasonable underlying assumptions. In cases where the valuation is based on an estimated value, the method used should be in line with standard market practice and the methods used by the investment firm to evaluate its own assets. The client should also be informed/warned that the absence of a market price is likely to be indicative of a lack of liquidity.

17. The majority of trade association and investment firms instead suggested not to include a duty to state the estimated value of financial instruments in cases a market price is not available. It was noted that it may be very difficult to gather information for a reasonable estimate and the valuation as such can be intricate and costly. Furthermore, depending on the information quality and on the valuation assumptions, stating an estimated value may be misleading for the client.

18. Asset managers also pointed out that the lack of an indicative price is not necessary linked to a lack of liquidity and could be due to other factors such as suspensions from trading or corporate actions.

19. ESMA acknowledges the comments made in relation to providing clients with a valuation of their financial instruments. In view of the comments received however, ESMA has confirmed in its technical advice a requirement for firms to provide, where available, the market value of their financial instruments or an estimated value based on reasonable underlying assumptions. For many liquid instruments there will be readily available data to make these valuations. For more illiquid instruments, firms anyway would be limited to providing estimated values where no more precise information is available. Furthermore, ESMA has clarified in its advice that the evaluation shall be done by firms *"on a best effort basis"*. This seems to ESMA a proportionate approach. As long as firms make it clear that certain valuations are estimated values only and should be read accordingly, then this should fulfil a firm's obligations to take reasonable steps to inform clients.

20. ESMA also notes the issue raised by asset managers on the lack of an indicative price, but underlines that the technical advice does not prevent firms from informing clients of specific situations where the lack of a price is caused by events such as a suspension from trading or a corporate action.

21. A consumer association stated that it would be beneficial to clients to receive details of those financial instruments which are subject to TTCA (i.e. not subject to MiFID protections) when the statement is issued, as well as details of those financial instruments that were subject to TTCA during the reporting period.

22. On the other hand, trade associations and investment firms noted that the costs of system developments and productions costs related to this proposal would outweigh the benefits for clients, especially considering that investment firms are already obliged to (i) get the prior consent of the clients to use its financial instruments and in the case of retail clients, by getting its signature (ii) inform every client about the existence and the terms of any security interest or lien over the financial instruments held on their behalf and (iii) in the case of retail clients, to provide them in a durable medium, with clear information on the obligations and responsibilities of the investment firm with respect to the use of those financial instruments.

23. ESMA acknowledges the comments made by many respondents in relation to reporting to clients on TTCA. Therefore, in its technical advice, ESMA is proposing to require reporting to clients on financial instruments that are subject to TTCA at the date in which the statement is issued but not on financial instruments that were subject to TTCA during the reporting period.

Technical advice

1. The content of Articles 40 to 43 of the MiFID Implementing Directive should be modified in the following areas.

Reporting obligations – Application to different categories of clients

2. Investment firms should send execution reports to professional clients no later than the first business day following execution. The content of the reports for professional clients and eligible counterparties as well as the exceptions in terms of timing of the reports and exceptions applicable to certain financial instruments should be aligned with the requirements applicable to reports for retail clients, both for portfolio management and the carrying out of orders.

3. Investment firms should be allowed to enter into agreements with eligible counterparties to determine content and timing of reporting which are different from the ones applicable to retail and professional clients.

Reporting obligations in respect of portfolio management

4. Reporting obligations for portfolio management should include a fair and balanced review of the activities undertaken and of the performance of the portfolio during the relevant period, for both retail and professional clients.

5. The basic frequency for reports for portfolio management services should be quarterly instead of every six months. If a firm provides its clients with access to an online system, which qualifies as a durable medium, where up-to-date valuations of the client's portfolio can be accessed, the firm does not need to provide a periodic report for the quarter where :

   i. the client can easily access the information required by Article 43(2) of the current Mi-

FID implementing directive through the same system, and.

ii. It has evidence that the client has accessed a valuation of their portfolio at least once during the quarter.

Reporting obligations on losses in respect of portfolio management or contingent liability transactions

6. Investment firms that provide the service of portfolio management shall report to the client where the overall value of the portfolio at the beginning of each reporting period depreciates by 10% and thereafter at multiples of 10%.

7. Investment firms that hold a retail client account that includes positions in leveraged financial instruments or contingent liability transactions shall report to the client, where the initial value of each instrument depreciates by 10% and thereafter at multiples of 10%. Reporting under this paragraph should be on an instrument-by-instrument basis unless otherwise agreed with the client.

Reporting obligations in respect of statements to clients on their holdings of instruments and funds

8. Investment firms should provide statements to clients on their financial instruments and funds on a quarterly basis and should provide such statements more frequently on request at reasonable commercial cost.

9. Statements concerning reporting obligations concerning client assets should include:

   i. a clear indication of the assets or funds which are subject to MiFID protections and those that are not, such as those that are subject to TTCA;

   ii. a clear indication of which assets are affected by some peculiarities in their ownership status, for instance due to some security interest; and

   iii. the market or estimated value, when the market value is not available, of the financial instruments included in the statement with a clear indication of the fact that the absence of a market price is likely to be indicative of a lack of liquidity. The evaluation of the estimated value shall be done by the firm on a best effort basis.

10. Regarding reporting obligations in respect of cost and charges, ESMA refers to its technical advice in relation to Article 24(4) of MiFID II (considered in the 'Disclosure of costs and charges' section of this Final Report).

2.21. Best execution

Background/Mandate

Extract from the Commission's request for technical advice (mandate)

ESMA is invited to provide technical advice on criteria for determining the relative importance of the different factors the investment firm takes into account for determining the best possible result for their clients and factors that may be taken into account by an investment firm when reviewing its execution arrangements and the circumstances under which changes to such arrangements may be appropriate. With a view to increasing clients' understanding and scrutiny over the quality of the execution, technical advice should also be provided with respect to the nature and extend of the information to be provided to clients, including information on selection of different venues or entities retained, any third-party payments or other fees being paid to the firm where a firm charges for instance both participants in a transaction. The technical advice should take account of requirements set out in Articles 44 - 46 of the Commission Directive 2006/73/EC.

1. The following MiFID II provisions are relevant to the topic of best execution:

   Recital 97:

   "Information provided by investment firms to clients in relation to their execution policy often are generic and standard and do not allow clients to understand how an order will be executed and to verify firms' compliance with their obligation to execute orders on term most favourable to their clients. In order to enhance investor protection it is appropriate to specify the principles concerning the information given by investment firms to their clients on the execution policy and to require firms to make public, on an annual basis, for each class of financial instruments, the top five execution venues where they executed client orders in the preceding year and to take account of that information and information published by execution venues on execution quality in their policies on best execution".

   Article 27:

   "(1) Member States shall require that investment firms take all sufficient steps to obtain, when executing orders, the best possible result for their clients taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order. Nevertheless, where there is a specific instruction from the client the investment firm shall execute the order following the specific instruction.

   Where an investment firm executes an order on behalf of a retail client, the best possible result shall be determined in terms of the total consideration, representing the price of the financial instrument and the costs relating to execution, which shall include all expenses incurred by the client which are directly relating to the execution of the order, including execu-

tion venue fees, clearing and settlement fees and any other fees paid to third parties involved in the execution of the order.

For the purposes of delivering best possible result in accordance with the first subparagraph where there is more than one competing venue to execute an order for a financial instrument, in order to assess and compare the results for the client that would be achieved by executing the order on each of the execution venues listed in the investment firm's order execution policy that is capable of executing that order, the investment firm's own commissions and the costs for executing the order on each of the eligible execution venues shall be taken into account in that assessment.

(2) An investment firm shall not receive any remuneration, discount or non-monetary benefit for routing client orders to a particular trading venue or execution venue which would infringe the requirements on conflicts of interest or inducements set out in paragraph 1 of this Article and Article 16(3) and Articles 23 and 24.

(3) Member States shall require that for financial instruments subject to the trading obligation in Articles 23 and 28 Regulation (EU) No .../2014 each trading venue and systematic internaliser and for other financial instruments each execution venue makes available to the public, without any charges, data relating to the quality of execution of transactions on that venue on at least an annual basis and that following execution of a transaction on behalf of a client the investment firm shall inform the client where the order was executed. Periodic reports shall include details about price, costs, speed and likelihood of execution for individual financial instruments.*

(4) Member States shall require investment firms to establish and implement effective arrangements for complying with paragraph 1. In particular, Member States shall require investment firms to establish and implement an order execution policy to allow them to obtain, for their client orders, the best possible result in accordance with paragraph 1.

(5) The order execution policy shall include, in respect of each class of financial instruments, information on the different venues where the investment firm executes its client orders and the factors affecting the choice of execution venue. It shall at least include those venues that enable the investment firm to obtain on a consistent basis the best possible result for the execution of client orders.

Member States shall require that investment firms provide appropriate information to their clients on their order execution policy. That information shall explain clearly, in sufficient detail and in a way that can be easily understood by clients, how orders will be executed by the investment firm for the client. Member States shall require that investment firms obtain the prior consent of their clients to the order execution policy.

Member States shall require that, where the order execution policy provides for the possibility that client orders may be executed outside a trading venue, the investment firm shall, in particular, inform its clients about that possibility. Member States shall require that invest-

ment firms obtain the prior express consent of their clients before proceeding to execute their orders outside a trading venue. Investment firms may obtain such consent either in the form of a general agreement or in respect of individual transactions.

(6) Member States shall require investment firms who execute client orders to summarise and make public on an annual basis, for each class of financial instruments, the top five execution venues in terms of trading volumes where they executed client orders in the preceding year and information on the quality of execution obtained.

(7) Member States shall require investment firms who execute client orders to monitor the effectiveness of their order execution arrangements and execution policy in order to identify and, where appropriate, correct any deficiencies. In particular, they shall assess, on a regular basis, whether the execution venues included in the order execution policy provide for the best possible result for the client or whether they need to make changes to their execution arrangements, taking account of, inter alia, the information published under paragraphs 3 and 6. Member States shall require investment firms to notify clients with whom they have an on-going client relationship of any material changes to their order execution arrangements or execution policy.

[…]

(9) The Commission shall be empowered to adopt delegated acts in accordance with Article 89 concerning:

(a) the criteria for determining the relative importance of the different factors that, pursuant to paragraph 1, may be taken into account for determining the best possible result taking into account the size and type of order and the retail or professional nature of the client;

(b) factors that may be taken into account by an investment firm when reviewing its execution arrangements and the circumstances under which changes to such arrangements may be appropriate. In particular, the factors for determining which venues enable investment firms to obtain on a consistent basis the best possible result for executing the client orders".

Analysis following feedback from stakeholders

8. Many respondents stated that they were in favour of the advice proposed by ESMA. However, many respondents made specific reference to the additional costs in creating such granular policies. The comments below set out the specific issues raised in relation to various aspects of the proposals.

<u>Detail of execution and RTO/placing policies</u>

9. Some respondents argued that requiring the investment firm to establish the fairness of an OTC price would be very difficult to gather. One respondent stated that the information on

the fairness of an OTC price should be gathered under the product governance obligations. ESMA has amended the technical advice to provide greater clarity on the detail required to assess *"fairness*".

10. Many respondents, mainly asset managers, stated that as they execute client orders with a very large number of brokers it is disproportionate to require them to list every single execution venue or entity they use for each category of financial instrument. A number of respondents specifically supported the proposal. A number of other respondents raised issues with the difficulty of updating this list. Other respondents argued instead that it should be sufficient to summarise on the investment firm's website information on the execution or RTO/placing policy of the execution venue or entity used.. A number of other respondents argued that there needed to be greater clarity on when investment firms are executing transactions and when they are transmitting and placing orders with other entities for execution.

11. ESMA agrees with some of the comments above and considers that in order to allow clients to assess where their orders will be executed it is important that such information is up-to-date and easily accessible. In this context, ESMA has clarified the advice to require investment firms to provide the list of execution venues and entities used for each class of financial instrument. Classes of financial instrument should be consistent with the ones set by Article 27(6) of MiFID II and the subsequent RTS to be developed under Article 27(10)(b) of MiFID II. ESMA also considers that, as already provided for in Article 46 of the MiFID implementing directive, such information could be provided by means of a website (where that does not constitute a durable medium) provided that the conditions specified in Article 3(2) of the implementing directive are satisfied. ESMA has also amended the advice to clarify that the information to be provided to clients on the execution or RTO/placing policy should state that entities other than trading venues can be used for execution and the consequences of counterparty risk. Those investment firms that transmit or place orders for execution that may occur outside such a trading venue should provide information on the entities used when requested by the client. Such information could be provided by means of a web link to the executing entity.

12. ESMA also considers that the information to be provided to clients on the execution or RTO/placing policy should include information on their best execution strategy, addressing the execution factors of price, costs, speed, likelihood of execution and any other relevant factors considered as part of all sufficient steps taken to obtain the best possible results for their clients. In this context, ESMA considers that investment firms should describe in summary those sufficient steps undertaken to achieve best execution making reference to elements such as execution venues selection, specific execution strategies employed, processes in place to analyse the execution quality obtained and to verify that the best possible results were obtained for clients.

Content of disclosure

13. Many respondents raised concerns about the new requirement to have, in certain instances, a summary of the execution or RTO/placing policy available for clients. Other respondents stated that requirements to set out in the execution or RTO/placing policy or the summary of these policies information on total known costs would be very difficult to comply with.

14. ESMA considers that the execution or RTO/placing policy summary which focusses on costs should be maintained as it is important that clients are aware of what costs they potentially face when submitting an order.

Third party payments

15. Many respondents sought clarity on what information should be included in the policy regarding third party payments. Some respondents sought clarity on whether fees paid by the client for order routing were still acceptable. Some respondents stated that third party payments for execution should still be permitted as long as they were disclosed to the client.

16. ESMA considers that Article 27(2) of MiFID II is clear that investment firms shall not receive any remuneration, discount or non-monetary benefit for routing client orders to a particular execution venue or entity which would infringe the relevant requirements on conflicts of interest or inducements. In addition, ESMA has amended the advice to clarify that any third party payment must comply with Article 24(9) of MiFID II.

Transparency of execution venue selection

17. Many respondents strongly agreed with the content of this proposal. Many respondents also stated that it was unclear whether ESMA expects investment firms to present execution fees for different execution venues or entity in other documents without listing all the advantages/disadvantages for each execution venue or entity. ESMA considers that it is up to the investment firm to determine how it should disclose this information to clients. ESMA wishes to recall that investment firms should not induce a client to instruct it to execute an order in a particular way, by expressly indicating or implicitly suggesting the content of the instruction to the client, when the investment firm ought reasonably to know that an instruction to that effect is likely to prevent it from obtaining the best possible result for that client. (This advice is now provided under the section *Content of disclosure)*.

Other issues

18. The mandate given by the Commission to ESMA clearly highlights the necessity to provide clients with a similar level of protection and information, regardless of whether their orders are executed by the investment firm with which they have a contractual relationship or by another entity selected by their investment firm. ESMA considers that in order to act in accordance with the best interests of their client and to be able to provide client with appropriate information on where placed or transmitted orders are executed, investment firms should be required to publish relevant data on order flow and execution quality. For this reason, ESMA has amended the technical advice to ensure that investment firms that transmit

or place client orders are required to report on the top five entities used for the transmission/placing of client orders for each class of financial instrument and provide information on the quality of execution obtained by those entities who executed the orders.

19. ESMA also wishes to clarify that in complying with the best execution obligations, investment firms will have to execute client orders in shares in accordance with Article 23 of MIFIR.

Technical advice

1. The requirements set out in Articles 44 - 46 of the Commission Directive 2006/73/EC shall be maintained and the following amendments made in order to take into account the increased levels of disclosure of matters relating to execution of client orders and consideration of the new data publication requirements set out in Article 27(6) of MiFID II, for investments firms who transmit and place client orders. The definition of execution venue shall be amended to take account of the addition of OTFs in the definition of a trading venue in MiFID II.

Detail of information on execution policies

Article 45(5) and 46(2) to be amended

2. Both the information on the execution policies and the policies of investment firms transmitting or placing orders with other entities for execution shall be customised depending on the class of financial instrument and type of service provided. Investment firms shall set out in the information to be provided to clients on their execution or RTO/placing policy the list of factors used to select an execution venue or other entity for execution (including qualitative factors like clearing schemes, circuit breakers, scheduled auctions, or any other relevant consideration), and the relative importance of each factor. Investment firms shall also provide information addressing how the execution factors of price costs, speed, likelihood of execution and any other relevant factors are considered as part of all sufficient steps to obtain the best possible results for their clients. Such information shall also summarise: how venue selection occurs, specific execution strategies employed, the procedures and processes used to analyse the quality of execution obtained and, how the firm monitors and verifies that the best possible results were obtained for their clients.

Article 45(5) and 46(2)(b) to be amended

3. The list of execution venues or entities used by an investment firm for execution/transmission/placing of client orders must be listed in the information to be provided to clients on the execution or RTO/placing policy. The list shall specify which execution venues or entities are used for each class of financial instruments.

Article 44 and 45 be amended

4. The information about the factors used to select an execution venue for execution and the entities used by the investment firm for the transmission or placing of client orders shall be consistent with the controls used by the investment firm to demonstrate to clients that best execution has been achieved on a consistent basis and when reviewing the adequacy of its policy and arrangements.

Article 44 and 45 to be amended

5. In the case of execution of orders and decision to deal in OTC products including bespoke products, the investment firm shall be able to check the fairness of the price proposed to the client, by gathering market data used in the estimation of the price of such product and when possible by comparing with similar or comparable products.

Disclosure and consent

Article 45(5) and 46(2) to be amended

6. Investment firms shall answer clearly and within a reasonable time when their clients make reasonable and proportionate requests for information about their policies or arrangements and how they are reviewed.

Article 45(5) and 46(2) to be amended

7. When an investment firm executes orders or transmits or places orders with an entity that may execute these orders outside a trading venue, this must be clearly indicated in the information to be provided to clients on the investment firm's execution policy or RTO/placing policy to allow the client to take this information into consideration and to request any additional information about the consequences of this means of execution. This information shall also set out the consequences of counterparty risk to the client from this means of execution.

Article 45 to be amended

8. While prior express consent is not required for investment firms transmitting or placing orders that may be executed outside a trading venue, investment firms shall provide their clients with appropriate information about these entities where their orders are executed following a reasonable request from a client.

Content of disclosure

Article 45 and 46 to be amended

9. When the fees applied to a client by the investment firm are different depending on the execution venue or entity retained, the information to be provided to clients on the execution or RTO/placing policy shall provide sufficient information in order to allow the client to understand both the advantages and the disadvantages of the choice of one execution venue

or entity over another made by the firm. Where the firm invites the client to choose the execution venue or entity this information shall be fair, clear, not misleading, and sufficient to prevent the client choosing one execution venue or entity rather than another on the sole basis of the price policy applied by the firm.

10. When the execution policy or RTO/placing policy concerns retail clients, these clients shall be provided with a summary of the relevant policy, focused on the total costs they face in order to give understandable information to the retail client. Although the summary cannot include price data (which is not known in advance), it shall provide a link to the most recent execution quality data published in accordance with Article 27(10)(a) of MiFID II.

Third party payments

Article 44(1) and 45 to be amended

11. Investment firms shall only receive third party payments that comply with Article 24(9) of MiFID II, in receiving such payments the information to be provided to clients on the execution or RTO policy has to include clear information about the inducements that may be received by the investment firm from the execution venues, or other entities to which the orders may be transmitted. This information shall specify the fees charged by the investment firm to all counterparties involved in the transaction, and if the fees vary depending on the client, the policy must indicate the maximum fees or range of the fees that may be payable.

Article 44(1) to be amended

12. Where an investment firm is able, within the scope of Article 24(9) of MiFID II, to charge more than one participant in a transaction, the client shall be aware of the value of any monetary or non-monetary benefits received by the firm.

Factors that may constitute a 'material change'

Article 45(6) and 46(2) to be amended

13. Investment firms are required to review their execution or RTO/placing policy and arrangements at least annually and whenever there is a material change that affects their ability to obtain the best possible results for the execution of their client orders.

14. A material change shall be understood as a significant event of internal or external nature that could impact parameters of best execution (cost, price, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order). An investment firm shall assess whether a material change has occurred which requires it to consider making changes to the relative importance of the best execution factors or to the execution venues or entities on which it places significant reliance in meeting the overarching best execution requirement.

Use of a single execution venue or entity for execution

Article 44 and 45 to be amended

15. An investment firm that executes orders or transmits or places orders with other entities for execution can include a single execution venue or entity in its policy if it is able to show that this allows it to satisfy the overarching best execution requirement.

16. The investment firm shall reasonably expect that the execution venue or entity it selects will enable it to obtain results for its clients that are at least as good as the results that it reasonably could expect from using alternative execution venues or entities. This reasonable expectation must be supported by relevant data or information published under Article 27 of MiFID II or by other internal analysis conducted by the investment firm.

Information to clients

Article 45 to be amended

17. In order to ensure that investment firms, that transmit or place client orders with other entities for execution, comply with Article 24(1) of MiFID II to act in accordance with the best interests of their clients and Article 24(4) of MiFID II for appropriate information to be provided to clients in relation to the investment firm and its services, investment firms shall provide clients with appropriate information on the entities chosen. Specifically when investments firms do not execute client orders but select other investment firms to provide the execution service, they shall summarise and make public, on an annual basis, for each class of financial instruments, the top five investment firms in terms of trading volumes where they transmitted or placed client orders in the preceding year and information on the quality of execution obtained. The specific content of such information shall be consistent with the information to be published by investment firms as set out in the RTS required under Article 27(10)(b) of MiFID II.

2.22. Client order-handling

Background/Mandate

Extract from the Commission's request for advice (mandate)

ESMA is invited to provide technical advice on adaptations and further improvements to the procedures and arrangements which result in the prompt, fair and expeditious execution of client orders and the situations in which or types of transaction for which investment firms may reasonably deviate from prompt execution so as to obtain more favorable terms for clients as well as to the different methods through which an investment firm can be deemed to have met its obligation to disclose not immediately executable client limit orders to the market.

1. The following MiFID II provisions on client order-handling are relevant with respect to the mandate above:

   Article 28:

   "(1) Member States shall require that investment firms authorised to execute orders on behalf of clients implement procedures and arrangements which provide for the prompt, fair and expeditious execution of client orders, relative to other client orders or the trading interests of the investment firm.

   Those procedures or arrangements shall allow for the execution of otherwise comparable client orders in accordance with the time of their reception by the investment firm.

   (2) Member States shall require that, in the case of a client limit order in respect of shares admitted to trading on a regulated market or traded on a trading venue which are not immediately executed under prevailing market conditions, investment firms are, unless the client expressly instructs otherwise, to take measures to facilitate the earliest possible execution of that order by making public immediately that client limit order in a manner which is easily accessible to other market participants. Member States may decide that investment firms comply with that obligation by transmitting the client limit order to a trading venue. Member States shall provide that the competent authorities may waive the obligation to make public a limit order that is large in scale compared with normal market size as determined under Article 4 of Regulation (EU) No …/2014".*

Analysis following feedback from stakeholders

2. During the public consultation, ESMA received a very limited number of comments on the topic. The majority of respondents stated that it agreed with ESMA that the existing provisions the MiFID Implementing Directive on client order-handling should be confirmed. However, some respondents noted that:

   i. ESMA should explicitly specify that aggregation of client orders should not be used for the purpose of artificially creating a total order size that results in an order which falls

above the large in scale (LIS) thresholds and therefore can be executed without full transparency;

ii. under the current regime there still are issues of lack of transparency of order execution that should be addressed, as it is not always clear to retail investors whether brokers use smart routing systems.

3. ESMA considers that practices or issues that fall under i are captured under MAD requirements, where such practices are manipulative. In relation to point ii, ESMA considers that information to be provided in the best execution policy, such as information on the factors used to select entities or venues for execution should identify whether a firm uses a smart routing system. ESMA therefore does not propose any changes to the technical advice.

Technical advice

1. The existing provisions the MiFID Implementing Directive on client order-handling should be confirmed.

2.23. Transactions executed with eligible counterparties

Background/Mandate

Extract from the Commission's request for advice (mandate)

ESMA is invited to provide technical advice on the procedures for eligible counterparties, referred to under Article 30(2) first subparagraph, to request, either on a general form or on a trade-by-trade basis, treatment as clients whose business with investment firms is subject to Articles 24, 25, 27 and 28 and the pre-determined proportionate requirements, including quantitative thresholds that would allow an undertaking to be an eligible counterparty under Article 30(3), as well as the procedures for obtaining the express confirmation from the prospective counterparty that it agrees to be treated as an eligible counterparty. Any further improvements to the current implementing framework should be considered.

1. The following main provisions of MiFID II are relevant with respect to transactions executed with eligible counterparties:

   Article 30(2):

   "Member States shall recognise as eligible counterparties for the purposes of this Article investment firms, credit institutions, insurance companies, UCITS and their management companies, pension funds and their management companies, other financial institutions authorised or regulated under Union law or under the national law of a Member State, national governments and their corresponding offices including public bodies that deal with public debt at national level, central banks and supranational organisations.

   Classification as an eligible counterparty under the first subparagraph shall be without prejudice to the right of such entities to request, either on a general form or on a trade-by-trade basis, treatment as clients whose business with the investment firm is subject to Articles 24, 25, 27 and 28."

   Article 30(3):

   "Member States may also recognise as eligible counterparties other undertakings meeting pre-determined proportionate requirements, including quantitative thresholds. In the event of a transaction where the prospective counterparties are located in different jurisdictions, the investment firm shall defer to the status of the other undertaking as determined by the law or measures of the Member State in which that undertaking is established.

   Member States shall ensure that the investment firm, when it enters into transactions in accordance with paragraph 1 with such undertakings, obtains the express confirmation from the prospective counterparty that it agrees to be treated as an eligible counterparty. Member States shall allow the investment firm to obtain that confirmation either in the form of a general agreement or in respect of each individual transaction."

2. Article 30(2) subparagraph 1 of MiFID II lists the entities that should be recognised as eligible counterparties when certain services, mentioned in paragraph 1 of the same Article, are provided to them; the list mainly includes entities active in the financial sector. Investment firms providing services to eligible counterparties are not obliged to comply with a number of rules aimed at protecting investors (a number of conduct of business rules, best execution and client order-handling requirements).

3. Article 30(2) subparagraph 2 gives eligible counterparties the right to request, either on a general form or on a trade-by-trade basis, treatment as professional or retail clients, whose business with the investment firm benefits from the application of investor protection requirements.

4. Article 30(3) of MiFID II enables Member States to recognise as eligible counterparties undertakings, other than the entities mentioned in Article 30(2) subparagraph 1 of MiFID II, provided that they meet pre-determined proportionate requirements, including quantitative thresholds. Investment firms should obtain the express confirmation from the prospective counterparty that it agrees to be treated as an eligible counterparty.

5. According to Article 30(5) of MiFID II, the Commission shall be empowered to adopt delegated acts to specify, inter alia,

   i. the procedures for requesting treatment as clients under Article 30(2) of MiFID II;

   ii. the procedures for obtaining the express confirmation from prospective counterparties under Article 30(3) of MiFID II; and

   iii. the pre-determined proportionate requirements, including quantitative thresholds that would allow an undertaking to be considered to be an eligible counterparty under Article 30(3) of MiFID II.

6. The Commission empowerment is unchanged in comparison with Article 24(5) of MiFID I. Article 24 (5) of MiFID I has been implemented with Article 50 of the MiFID Implementing Directive.

7. In its request for advice, the Commission recognises that Article 50 of the MiFID Implementing Directive might still constitute an adequate and satisfactory framework but requires ESMA to consider the need for specific improvements of that provision.

Analysis following feedback from stakeholders

8. Respondents were split in their comments to the ESMA proposal to confirm the provisions of Article 50 of the MiFID Implementing Directive with the exception of Article 50(1) subparagraph 2, which should not be maintained. On one hand, approximately half the respondents agreed with ESMA's suggestion, on the other hand the other half of the respondents disa-

greed and stated that the current client categorisation scheme has worked well so far and should not be amended and that the amendment might limit client choice.

9. No respondent was able to provide information on how many clients they have classified as eligible counterparties using the following approaches under Article 50(1) of the MiFID Implementing Directive.

10. ESMA notes the comments received but confirms the view that the possibility to recognise undertakings that are not large undertakings as eligible counterparties is not in line with the objectives of the MiFID review and should not be confirmed under the MiFID II implementing measures.

11. ESMA also notes that Article 50 of the MiFID Implementing Directive does not regulate the procedures to request eligible counterparty treatment (when permitted). ESMA proposes to introduce a specific procedure to this effect which should include a clear express confirmation, in writing, about the request and the acknowledgement of the protection that can be lost as a result of the classification as an eligible counterparty.

12. Concerning the possibility for eligible counterparties to request treatment as a professional client, ESMA proposes to clarify in the MiFID implementing measures that such request such be done in writing and should indicate whether it is general or whether it refers to one or more particular services or transactions or type of transaction or product. ESMA believes that no change to the current implementing measures is needed with regards to the procedure - regulated by Article 50(2), subparagraph 2 - to be followed by eligible counterparties requesting treatment as a retail client.

Technical advice

1. The provisions of Article 50 of the MiFID Implementing Directive shall be confirmed with the exception of:

   i. Article 50(1) subparagraph 2, which should not be maintained.

   ii. Article 50(2), subparagraph 1, which should be amended in order to require that any request from an eligible counterparty to be treated as a professional client should be done in writing. The request should indicate whether it is general or whether it refers to one or more particular services or transactions or type of transaction or product.

2. Clients may request to be treated as an eligible counterparty, in accordance with Article 30(3) of MiFID II, when the following procedure is followed:

   i. The investment firm should provide these prospective counterparties with a clear written warning of the protections they may lose; and

   ii. The clients must confirm in writing that they wish to be treated as an eligible counter-

party either generally or in respect of a particular investment service or transaction or type of transaction or product and that they are aware of the consequences of the protections they may lose.

2.24. Product intervention

Background/Mandate

Extract from the Commission's request for advice (mandate)

ESMA is invited to provide technical advice on measures specifying the criteria and factors to be taken into account by competent authorities in determining when there is a significant investor protection concern or a threat to the orderly functioning and integrity of financial markets or commodity markets or to the stability of the whole or part of the financial system of the Union or of the financial system within at least one Member State. As the Regulation establishes an identical framework for EBA intervention powers in respect of structured deposits and as factors and criteria to be taken into account for the exercise of product intervention powers for structured deposits should be similar to (if not identical to) those set for ESMA with respect to financial instruments, ESMA is invited to closely liaise with and consult EBA when providing its technical advice to the Commission and proposing factors and criteria for intervention powers in accordance with Articles 40, 41 and 42 of the Regulation.

1. Under Articles 40(8), 41(8) and 42(7) of MiFIR, the Commission is required to adopt delegated acts specifying criteria and factors to be taken into account by ESMA, EBA and NCAs in determining when there is a significant investor protection concern, or a threat to the orderly functioning and integrity of financial markets (or commodity markets, in relation to ESMA and NCAs) and to the stability (of the whole or part) of the financial system (of the Union or within at least one Member State, respectively) arise. These criteria and factors shall include:

   i. the degree of complexity of a financial instrument or structured deposit and the relation to the type of client to whom it is marketed and sold;

   ii. the size or the notional value of an issuance of financial instruments or structured deposits (Article 42 (7) of MiFIR, concerning the intervention powers of NCA has given special emphasis to this criterion in relation to the orderly functioning and integrity of financial markets or commodity markets);

   iii. the degree of innovation of a financial instrument or structured deposit, an activity or a practice; and

   iv. the leverage a financial instrument or structured deposit or practice provides.

2. As the three empowerments in Articles 40, 41 and 42 of MiFIR broadly share the same wording, the criteria and factors to be specified should generally be the same for all three provisions.

3. In light of the EBA's intervention powers in respect of structured deposits (Article 41 of MiFIR), EBA has received a separate mandate by the Commission and has held a separate

consultation on its product intervention powers on structured deposits in accordance with Article 41 of MiFIR. EBA and ESMA have cooperated closely in relation to the respective consultations.

Analysis following feedback from stakeholders

4. Several respondents agreed with ESMA's draft technical advice. Many of them noted however that the fact that criteria listed under paragraphs 3 of the draft technical advice should not apply cumulatively was not proportionate and would give ESMA (and NCAs) too much discretion when determining whether/when they exercise product intervention powers.

5. A minority of respondents, including some investors associations, expressed the view that the draft technical advice does not provide sufficient guidance as to the situations where 'investor protection concerns' arise, and that the notions of 'complexity', 'innovation', 'leverage' or 'risks' should be further clarified or specified. The SMSG also supported this opinion and suggested that the sub-criterion "*probability, scale and nature of any detriment, including the amount of loss potentially suffered"* (Paragraph 3(ii)(d) of the draft technical advice) be given more prominence in the final technical advice.

6. ESMA would like to stress that the list of factors and criteria presented in the ESMA technical advice has the objective, in accordance with the empowerment of the Commission for the adoption of delegated acts, to identify situations "*to be taken into account*" by ESMA or NCA in determining when, in accordance with Articles 40 and 42, there is a significant investor protection concern or a threat to the orderly functioning and integrity of financial markets or commodity markets or to the stability of the financial system (Article 40(8) and 42(7) of MiFIR).[42] Considering the potential variety of situations that ESMA and NCAs may face and considering that a first list of criteria is already provided in MiFIR, the draft technical advice has proposed an approach which lists in a detailed way those factors and criteria. In some cases one of these criteria will be sufficient to identify, for example, a significant investor protection concern while in other cases the combined effect of more factors may justify an intervention; this assessment however depends on the concrete circumstances of each case. Furthermore, ESMA would like to note that these factors and criteria are only one of the conditions for intervention and that several other conditions are listed in the respective Articles of MiFIR in order to limit the discretion of national and European authorities (see for instance Article 40(2) of MiFIR concerning ESMA intervention powers). ESMA notes that the adoption of delegated acts is not required in relation to all the other conditions identified under MiFIR.

42 It should be noted that, in accordance with Article 42(2)(a)(ii) of MiFIR, NCAs should consider whether "*a derivative has a detrimental effect on the price formation mechanism in the underlying market*". No delegated act is however required in this area. On the other hand, as specified in paragraph 3 (xvii) of the technical advice, ESMA considers that the possibility that a financial instrument leads to a significant and artificial disparity between prices of a derivative and those in the underlying market is a criterion that can be relevant in considering the threat to the orderly functioning and integrity of the financial market or commodity market and to the stability of the financial system or the significant concerns in the perspective of investor protection.

7. A few respondents, referred to a hierarchy between criteria provided in the technical advice and requested that, in certain instances, the order of the criteria should be changed. The SMSG also mentioned the issue of the ranking of the criteria. ESMA would like to clarify that the order in which criteria are provided in the draft technical advice is in no way intended to suggest a hierarchy or a ranking between them.

8. Several respondents requested that the final technical advice clarifies that the use of ESMA's/NCA's intervention powers remains a means of last resort and consequently that the assessment of the criteria should be very rigorous. The majority of the SMSG also considers that NCA's intervention powers should not be seen as complementary but as subsidiary tools. ESMA notes that one of the requirements to exercise product intervention powers is that the regulatory requirements under Union law that are applicable to the relevant financial instrument or activity do not address the threat posed by the relevant product or activity. Furthermore, these product intervention powers supplement, rather than replace, powers already established under Union law and do not alter firms' responsibilities, such as those established by the product governance requirements in MiFID II.

9. A few respondents suggested the deletion of the some of the sub-criteria suggested under the 'complexity' criteria in paragraph 3(i) of the technical advice. ESMA considers that it is key for NCAs, and to an even larger extent for ESMA[43], that the list of criteria suggested to the Commission should be as complete as possible in order to enable NCAs and ESMA to intervene to any type of event willing to constitute a significant investor protection concern or a threat to the orderly functioning and integrity of financial markets or commodity markets or to the stability of the financial system. ESMA consequently believes that all of the sub-criteria listed in paragraph 3(i) of the technical advice should be maintained as it considers that all of them may have relevance, depending on the circumstances of each case, for the assigned purpose.

10. A few respondents noted that the sub-criteria listed in paragraph 3(ii) of the draft technical advice in relation to the 'size of the potential problem or detriment' criteria are not appropriate. Some noted that these sub-criteria were not good indicators of a significant investor protection concern or of a threat to the orderly functioning of the markets. Others expressed the view that these sub-criteria are not suited to meet the specificities of certain type of investment (e.g. derivatives).

11. The majority of respondents did not suggest criteria in addition to the ones in the draft technical advice. Some respondents, notably from the fund management industry, suggested an additional criterion for intervention that is the availability of alternative means of supervisory intervention (such as a product approval or notification process prior to the commencement of distribution). ESMA notes in this respect that MiFIR does not introduce or suggest a distinction between financial instruments based on whether they are subject to a product ap-

[43] Please refer to paragraph 14 below.

proval or notification procedure or not. Furthermore, ESMA notes that the assessment of existing regulatory requirements or supervisory intervention are already identified as separate conditions under MiFIR (Article 40(2)(b) and 40(2)(c) and Article 42(2)(b) of MiFIR).

12. The SMSG suggested that complexity should refer to the sense of complexity for the investor to be able to understand the investment product. Reference is also made to the toxicity (defined as the high probability that an investment product does not achieve the stated/advertised goals and/or lead to destroy the real value of savings) and to the 'magnitude of total charges and commissions' borne by investors. The SMSG has also recommended to replace the term "consumer" with client or investor, in line with MiFID II. ESMA has added a reference to the type of client to whom the product is marketed in the context of "complexity". ESMA also notes that the list provided in the draft technical advice include reference to the probability of a detriment arising from a certain product or the degree of disparity between expected return or benefit for investors and risk of loss in relation to the financial instrument. Costs and charges are also mentioned in different areas of the draft technical advice. ESMA has referred to "investor" instead of "consumer" in its final technical advice.

13. ESMA notes that, in some of the detailed examples proposed in the technical advice, each of the supporting elements for consideration can sometimes apply to more than one criterion.[44] Possible repetitions in the technical advice are therefore intentional and intended to better illustrate how different elements can impact each criterion.

14. Considering a recent judgment of the European Court of Justice (ECJ)[45], ESMA deems appropriate to advise the Commission to assess the need to set the list of criteria suggested in the technical advice as an exhaustive list for ESMA. However, as clearly indicated in the technical advice, ESMA is of the view that such list should not be exhaustive with respect to NCAs.

Technical advice

1. The below listed range of factors and criteria are relevant when assessing whether there is a "*significant investor protection concern or a threat to the orderly functioning and integrity of financial markets or commodity markets and to the stability of the whole or part of the financial system of the Union".*

2. ESMA notes that the existence of a "threat" is the intervention pre-requisite in the perspective of the orderly functioning and integrity of financial/commodity markets or stability of the

[44] For example, "costs and charges" may lead to a higher degree of complexity of an instrument as well as to its non-transparency or should generally be considered regarding pricing matters as well.
[45] Judgment of the ECJ (Grand Chamber) of 22 January 2014, United Kingdom of Great Britain and Northern Ireland v European Parliament and Council of the European Union, Case C-270/12, which discussed, *inter alia*, the interpretation of the powers of intervention conferred on ESMA in exceptional circumstances by Regulation (EU) No 236/2012.

financial system. In comparison to the investor protection prerequisite, where there would need to be a “significant concern”, this requires the existence of a more intense detriment before the intervention power was used. This does not prevent the power being used where only a single factor, as set out below, is present.

3. The factors and criteria listed in this advice are elements which are relevant when assessing whether there is a significant investor protection concern, a threat to the orderly functioning and integrity of financial markets or commodity markets or to the stability of the whole or part of the financial system which would justify that ESMA or a NCA exercise its product intervention power. These factors and criteria are not intended to represent an exhaustive list for NCAs. ESMA considers that the following factors and criteria are relevant:

   i. The degree of complexity of the financial instrument or type of financial activity or practice and the relation to the type of clients to whom it is marketed and sold. Under this factor, more detailed elements to be considered could include, for example:

      a. the type and transparency of the underlying;

      b. non-transparent costs and charges arising, for example, from multiple layers of such costs and charges ;

      c. the performance calculation complexity. Under this criterion, more detailed elements to be considered could include, for example whether:

         - the return is dependent on the performance of one or more underlying which might in turn be affected by other factors;

         - when applicable, the return depends not only on the values of the underlying at the initial and maturity dates, but also on the values during the lifetime of the product.

      d. the nature and scale of any risks;

      e. whether the instrument or service is bundled with other products or services; and

      f. the complexity of any terms and conditions.

   ii. The size of the potential problem or detriment. Under this factor, more detailed elements to be considered could include, for example:

      a. the notional value of the financial instrument;

      b. number of clients, investors or market participants involved;

      c. relative share the product has in investors’ portfolios;

d. probability, scale and nature of any detriment, including the amount of loss potentially suffered;

e. anticipated persistency of the problem or detriment;

f. volume of the issuance;

g. number of intermediaries involved;

h. growth of the market or sales; and

i. the average amount invested by each client in the financial instrument.

iii. The type of clients involved in an activity or practice or to whom a financial instrument is marketed or sold. Under this factor, more detailed elements to be considered could include, for example:

a. whether the client is a retail client, professional client or eligible counterparty under MiFID;

b. features characterising clients' skills and abilities, e.g. level of education, experience with similar financial instruments or selling practices;

c. features characterising clients' economic situation, e.g. income, wealth;

d. clients' core financial objectives, e.g. pension saving, home ownership financing; and

e. whether the instrument or service is being sold to clients outside the intended target market or where the target market has not been adequately identified.

iv. The degree of transparency of the financial instrument or type of financial activity or practice. Under this factor, more detailed elements to be considered could include, for example:

a. the type and transparency of the underlying;

b. any hidden costs and charges;

c. the use of features that draw clients' attention but that do not necessarily reflect the suitability or overall quality of the instrument or service;

d. visibility of risks; and

e. the use of product names or of terminology or other information that imply greater

levels of safety and/or return than are actually possible or likely.

v. The particular features or underlying components of the financial instrument or transaction including any leverage a product or practice provides. Under this factor, more detailed elements to be considered could include, for example:

   a. the leverage inherent in the product;

   b. the leverage due to financing;

   c. the features of securities financing transactions; and

   d. as applicable, the fact that the value of the underlying(s) is (are) no longer available or reliable

vi. The degree of disparity between expected return or benefit for investors and risk of loss in relation to the financial instrument, activity or practice. Under this factor, more detailed elements to be considered could include, for example:

   a. the structuring and other costs;

   b. the disparity in relation to issuer's risk (where retained by issuer); and

   c. the risk/return profile.

vii. The ease and cost for investors to switch or sell an instrument. Under this factor, more detailed elements to be considered could include, for example:

   a. the bid/ask spread;

   b. the frequency of trading availability;

   c. the issuance size and size of the secondary market;

   d. the presence or absence of liquidity providers or secondary market makers;

   e. the features of the trading system; and

   f. any other barriers to exit.

viii. The pricing and associated costs. Under this factor, more detailed elements to be considered could include, for example:

   a. the use of hidden or secondary charges; and

   b. charges that do not reflect the level of service provided.

ix. The degree of innovation of a financial instrument, an activity or practice. Under this factor, more detailed elements to be considered could include, for example:

a. the degree of innovation related to the structure of the financial instrument, activity or practice, e.g. embedding, triggering;

b. the degree of innovation relating to the distribution model/length of intermediation chain, e.g. “originate-to-distribute”;

c. the extent of innovation diffusion, i.e. whether the financial instrument, activity or practice is innovative for particular categories of clients;

d. innovation involving leverage;

e. the opacity of underlying; and

f. the experience of the market with similar financial instruments or selling practices.

x. The selling practices associated with the financial instrument. Under this factor, more detailed elements to be considered could include, for example:

a. the communication and distribution channels used;

b. the information, marketing or other promotional material associated with the investment;

c. the assumed investment purposes; and

d. whether the decision to buy is secondary or tertiary following another purchase.

xi. The situation of the issuer of a financial instrument. Under this factor, more detailed elements to be considered could include, for example:

a. the financial situation of the issuer or any guarantor; and

b. the transparency of the situation of the issuer or guarantor.

xii. Whether there was insufficient, or insufficiently reliable, information about a financial instrument, provided either by the manufacturer or the distributors, to enable market participants to which it was targeted to form their judgment, taking into account the nature and type of instrument;

xiii. Whether the financial instruments or activities pose a high risk to performance of transactions entered into by participants or investors in the market or product in question;

xiv. Whether the activities or practices would significantly compromise the integrity of the

price formation process in the market concerned so that: a) the price or value of the financial instrument in question was no longer determined according to legitimate market forces of supply and demand; and/or b) market participants were no longer able to rely on the prices formed in the market or volumes of trading as a basis for their investment decisions;

xv. Whether the characteristics of financial instruments make them particularly susceptible to being used for the purposes of financial crime. Under this factor, more detailed elements to be considered could include, for example whether the characteristics could favour the use of the financial instruments for:

a. any fraud or dishonesty;

b. misconduct in, or misuse of information, relating to a financial market;

c. handling the proceeds of crime;

d. the financing of terrorism; or

e. facilitating money laundering;

xvi. Whether activities or practices pose a particularly high risk to the resilience or smooth operation of markets and their infrastructure;

xvii. Whether a financial instrument or activity or practice would lead to a significant and artificial disparity between prices of a derivative and those in the underlying market;

xviii. Whether the financial instrument or practice or activity poses a high risk of disruption to financial institutions deemed to be important to the financial system of the EU or, in relation to NCAs' powers only, to the national financial system of the Member State of the NCA;

xix. The relevance of the distribution of the financial instrument as a funding source for the issuer;

xx. Whether a product or practice or activity poses particular risks to the market or payment systems infrastructure, including clearing and settlement and trading systems); and

xxi. Whether a financial instrument or practice would threaten the investors' confidence in the financial system.

4. When considering factors and criteria in relation to a potential threat to the orderly functioning and integrity of financial markets or commodity markets and to the stability of the whole or part of the financial system, criteria listed in items (xii) to (xxi) of paragraph 3 are particu-

larly relevant.

5. The factors and criteria should not apply cumulatively – that is, not all factors and criteria would need to be present when ESMA or NCAs are determining whether to intervene. Depending on the severity of the issue, it may be that an intervention is justifiable where only one of these factors or criteria is present.

6. In accordance with the overall conditions for intervention specified under Articles 40and 42 of MiFIR, ESMA and NCAs should be able to intervene in new instruments or services or activities that may not meet these factors or criteria or, conversely, not necessarily intervene if given criteria are met but overall detriment is not foreseen or detected or the relevant proportionality test is not satisfied.

3. Transparency

3.1. Liquid market for equity and equity-like instruments

Background/Mandate

Extract from the Commission's request for technical advice (mandate)

ESMA is invited to provide technical advice on how to further specify the criteria under which an equity or a class of equity instrument should be considered to be liquid to ensure a uniform application of this Regulation. ESMA should take account of the criteria set out in Article 22 of Commission Regulation (EC) No 1287/2006, taking into account the need to extend these criteria to equity instruments other than shares and any need to develop these standards in light of market and technological developments.

1. ESMA was requested to advise the Commission on how to further specify the criteria under which an equity or a class of equity instrument should be considered liquid in order to ensure a uniform application of MiFIR. In particular, ESMA should advise on whether the criteria existing under Article 22 of Commission Regulation (EC) No 1287/2006 for shares are still adequate and whether these criteria could be extended to equity instruments other than shares.

2. Article 22(1) of Commission Regulation 1287/2006 specifies that a share is considered to have a liquid market if *"the share is traded daily with a free float not less than €500m, and one of the following conditions is satisfied:*

   i. *The average daily number of transactions in the share is not less than 500; or*

   ii. *The average daily turnover for the share is not less than €2m."*

3. Under MiFID II, Article 2(1)(17)(b) defines *"liquid market"* for the purposes of applying transparency measures to equity and equity-like instruments:

   "*for the purposes of Articles 4, 5 and 14, a market for a financial instrument that is traded daily where the market is assessed according to the following criteria:*

   i. *the free float*

   ii. *the average daily number of transactions in those financial instruments;*

   iii. *the average daily turnover for those financial instruments".*

4. The criteria under Article 2(1)(17)(b) of MiFIR although not setting specific thresholds, replicate the four factors (free float, average daily number of transactions, average daily turnover

and daily traded) which must be used to determine whether there is a liquid market set under MiFID I. However, the role of liquidity is expanded significantly under MiFIR in two ways: firstly the concept of a liquid market applies to both equity and equity-like instruments including ETFs, certificates and depositary receipts and secondly, it will also drive certain transparency obligations for trading venues as well as the quoting obligations for systematic internalisers.

5. The definition of "*liquid market"* has implications for the transparency regime applicable to shares, depositary receipts, ETFs, certificates and other similar financial instruments.

6. Negotiated transactions: Articles 4 and 5 of MiFIR relate to the waivers for equity and equity-like instruments. Article 4 imposes different restrictions regarding the price at which a negotiated transaction can be executed under the rules of a trading venue, depending on whether there is a liquid market in the relevant instrument. Article 5 sets quantitative limits (the double volume cap mechanism) on the total volume of trading which can be carried out under the reference price waiver and to certain types of negotiated trades. Where there is a liquid market for an instrument, waivers to pre-trade transparency may apply to negotiated trades up to limits set under the double volume cap mechanism. However, the double volume cap mechanism does not apply to negotiated trades in shares, depositary receipts, ETFs, certificates or other similar financial instruments for which there is no liquid market (or to transactions subject to conditions other than the current market regardless of the liquidity of the financial instrument). Therefore, NCAs may grant a waiver from pre-trade transparency for negotiated transactions in illiquid instruments outside the quantitative limits established by the double volume cap mechanism.

7. Quoting obligations for systematic internalisers: Article 14 of MiFIR sets the quoting obligations for systematic internalisers, which are driven by whether there is a liquid market for the instrument or not. The main requirement is to make public firm quotes on a regular and continuous basis for in-struments for which there is a liquid market whereas for illiquid instruments, the obligations are less onerous and systematic internalisers need only disclose quotes to their clients upon request.

8. In addition, Article 22(2) of the Commission Regulation permits a Member State to override the criteria defined in the paragraph 1 where the total number of liquid shares in its jurisdiction is less than five. In such circumstances, the Member State may specify additional shares as being liquid, even if they do not fulfil the above criteria under Article 22(1), providing that the total number of shares deemed to be liquid through this route is not more than five.

Analysis following feedback from stakeholders

Shares

9. As ESMA noted in the CP, the concept of liquid shares is important today under MiFID I and also under the Short Selling Regulation 236/2012/EC and in considering what should be the

liquidity thresholds for equities, ESMA has looked at the existing levels under MiFID I. Whilst noting that the four liquidity criteria under MiFID I are replicated under MiFIR, under MiFID I only one of the two criteria - the average daily number of transactions or the average daily turnover criterion – must be met in addition to the free float and daily traded criteria. Also, under MiFID I Member States can, in respect of shares for which they are the most relevant market, decide that both conditions apply. In order to simplify and harmonise the regulatory regime, ESMA noted its view in the CP that all four of the criteria should be met for a share or depositary receipt to be deemed liquid. For that reason, and in order to ensure that a sufficient number of instruments remain subject to the transparency requirements ESMA stated that it was also considering lowering the existing thresholds (e.g. average daily number of transactions in the share will be set at a level below 500) to ensure that the policy objective of greater transparency is met.

10. ESMA sought views in the CP on the option to retain or not the discretion permitted to Member States under Article 22(2) of the Commission Regulation n.1287/2006 to specify additional shares as being liquid, even if they do not fulfill the criteria, providing that the number of shares deemed to be liquid through this route is not more than five.

11. Responses received were equally split among those being in favour of retaining the discretion permitted to Member States under Article 22(2) and those considering that such option should be removed. Respondents in favour of maintaining the discretion emphasises, on one side, the positive effects on the overall level of transparency in the EU and, on the other, the fact that such discretion gives in fact a little bit of lee-way and flexibility in a situation where liquidity still differs significantly among Member States, thus reducing any potential negative side effect coming from a “one size fits all” model. On the same grounds, some respondents suggest that the discretion should be applied also to equity-like financial instruments, underlying that such flexibility is especially required for ETF markets.

12. Those responses suggesting not to retain the discretion permitted in Article 22(2) of Commission Regulation base their view on the grounds of a consistent and objective application of the regime, based on quantitative measures, for the purpose of harmonization.

13. Some respondents suggest that when an instrument/class of instruments is notified as liquid by a Member State, the instrument/class of instrument should be considered liquid across all member States, to avoid un-level playing field issues.

14. In light of the responses received, ESMA notes that there are still reasons for allowing Member States to specify additional financial instruments (equity and equity-like) as being liquid, even if they do not fulfil the criteria. Therefore, where a Member State would be the most relevant market in terms of liquidity as defined in Article 26 for fewer than five liquid financial instruments (equity and equity-like), the member State shall retain the flexibility, for shares, DRs, ETF and certificates, to specify the number of liquid financial instruments for that member State providing that the total is no greater than five (i.e. five instruments for each type of equity and equity-like instruments). In line with existing MiFID, when an instru-

ment is notified as liquid by a Member State pursuant to such provision, the instrument should be considered liquid in all Member States.

15. In setting the thresholds for equities, ESMA noted the importance of remaining also mindful of the trading obligation for shares which requires, under Article 23 of MiFIR, that all shares admitted to trading on a RM or traded on a trading venue, must be traded on a RM, an MTF, a third country trading venues deemed equivalent or a systematic internaliser unless the transactions are (1) non-systematic, ad-hoc, irregular and infrequent, or (2) carried out between eligible and/or professional counterparties and do not contribute to the price discovery process.

16. Given that systematic internalisers are permitted platforms under the trading obligation for shares and that their quoting obligations depend on whether the instrument is liquid, it is of further importance that the liquidity thresholds are set at an appropriate level to ensure the objective of enhanced transparency is met regardless of whether the instrument is traded on a RM or MTF or in a systematic internaliser. Equally, it is necessary to ensure a level playing field exists between trading venues and systematic internalisers to the extent possible.

17. However, expanding the definition of what is liquid is likely to bring into the transparency regime a greater number of instruments which may be less liquid than those shares subject to the regime under MiFID I. This may pose challenges, for example, for less liquid shares, such as those of SMEs, if investment firms dealing in shares that do not trade continuously decide to abstain from trading in those instruments on their own account because they are unable to, or do not wish to, comply with the continuous quoting obligation under the systematic internaliser regime. This risks leading to a further reduction in liquidity for less liquid shares.

18. ESMA is also mindful of the fact that, as highlighted by responses to the consultation, the definition of liquidity in MiFID II is not only important for systematic internalisers but also has implication both on other sections of MiFID II (e.g. pre-trade transparency waivers, double volume cap mechanisms, etc.) and on other pieces of EU legislation.

19. For instance, Article 7(14)(d)[46] of the CSD Regulation (CSDR) establishes a link between the definition of liquidity under MiFID II and the buy-in regime under CSDR in case of settlements fails. In this respect, ESMA appreciates that, in case of settlement fails, illiquid instruments might be granted a prolonged period of time to obtain the securities and cover the initial failed settlement. However, ESMA also notes that the exact circumstances under which the buy-in periods will be prolonged will only be defined in the final RTS on CSDR.

[46] Article 7(14)(d) of CSDR: "ESMA shall, in close cooperation with the members of the ESCB, develop draft regulatory technical standards to specify […] the circumstances under which the extension period could be prolonged according to asset type and liquidity of the financial instruments, in accordance with the conditions referred to in point (a) of paragraph 4 taking into account the criteria for assessing liquidity under Articles 2(1)(7a) of MiFIR [MIFIR determination of 'liquid market']".

20. As a basis for setting the liquidity thresholds for shares, ESMA conducted a data analysis exercise, collecting post-trade data from EU RMs only, on 3,669 shares, with data for the same shares traded on more than one RM aggregated at ISIN level, from 11 EU countries. The reference period was 1 January 2013 to 31 December 2013.

21. On this basis, ESMA proposed six scenarios using the liquidity criteria set out in the definition under Article 2(1)(17)(b) MiFIR but varying the liquidity criteria of size of free float, average daily number of transactions and average daily turnover (set out under line #1, #2 and #4 of the below table respectively-changes highlighted in red).

22. In the baseline scenario, ESMA applied the liquidity criteria currently set for shares under MiFID I and according to Article 22 of the MiFID Implementing Regulation, i.e. a share is considered to have a liquid market if it is traded daily, the free float is not less than € 500m, and either the average daily number of transactions in the share is not less than 500 or the average daily turnover (ADT). For other scenarios, ESMA applied the liquidity criteria on a cumulative basis.

		BASELINE SCENARIO	SCENARIO#1	SCENARIO#2	SCENARIO#3	SCENARIO#4	SCENARIO#5	SCENARIO#6
(#1) Free float (€)	(>=)	500,000,000	500,000,000	500,000,000	500,000,000	100,000,000	100,000,000	100,000,000
(#2) Average # of trades per day	(>=)	500	500	250	500	500	250	100
(#3) Num of days traded during the 1-year period	(>=)	250	250	250	250	250	250	250
(#4) Average daily turnover (€)	(>=)	2,000,000	2,000,000	2,000,000	500,000	2,000,000	1,000,000	2,000,000
# of shares meeting all the above requirements		654	587	601	619	605	747	641
representing X% of the total # of shares		17.83%	16.00%	16.38%	16.87%	16.49%	20.36%	17.47%
Total turnover over 1 Year for this category		4,457,579,499,981	4,422,734,098,787	4,432,429,055,320	4,436,172,018,670	4,438,402,443,983	4,494,305,711,534	4,460,415,872,016
representing X% of the total 1Y-turnover for all shares		94.96%	94.22%	94.42%	94.50%	94.55%	95.74%	95.02%
Total trades over 1 Year for this category		480,225,235	473,202,451	474,614,964	477,846,269	477,913,226	493,905,183	480,432,640
representing X% of the total trades for all shares		89.80%	88.49%	88.76%	89.36%	89.37%	92.36%	89.84%

Table 1: Scenarios using the liquidity criteria[47]

23. ESMA's proposal in the CP was to set the liquidity thresholds for equities at the levels proposed under scenario #5:

	Free Float	Average daily number of transactions	Average daily turnover
Equities	€ 100,000,000	250	€ 1,000,000

Table 2: Liquidity thresholds for equities

24. ESMA sought views in the CP on the above proposed liquidity thresholds for equities. Responses received were split reasonably evenly between agreeing with ESMA's proposed

[47] It should be noted that data used for this analysis only included transactions executed on order book on Regulated Markets and MTFs and, hence, do not include negotiated trades and OTC transactions.

thresholds and concerns that lowering the thresholds, and in particular the free float criterion, would harm medium and small caps. Consequently, a number of respondents recommended lowering the free float threshold to EUR 200m in line with the SME definition under Art 4(1)(13) MiFID II. A couple of respondents proposed lowering the free float threshold to EUR 250m, reducing it by 50% from its current level.

25. ESMA appreciates the concerns raised about the potential harmful impact a lower free float threshold might have on SME markets. However, it is important to bear in mind that the proposed thresholds will be applied cumulatively and, hence, shares with a free float above EUR 100,000,000 will not necessarily be captured. Hence, after careful consideration, ESMA believes that the proposed thresholds are appropriate for all markets and should be maintained.

26. Some responses to the consultation also invite ESMA to provide further clarifications with respect to the definition of free float. In this regard, ESMA proposes to maintain the definition of Article 22(4) of MiFID I Implementing Regulation (Commission Regulation (EC) No 1287/2006) and to define free float as the outstanding capital (number of issued shares times the share price) less the shareholdings exceeding 5% of the total voting rights of the issuer, unless such interests are held by collective investment undertaking or pension funds. Voting rights shall be calculated on the basis of all the shares to which voting rights are attached, even if the exercise of such a right is suspended.

27. For shares that are traded only on MTFs and for which a prospectus is not necessarily available and, more importantly, to which the major shareholdings regime of the Transparency Directive does not apply, ESMA has to face the problem that the calculations described above for shares admitted to trading on a regulated market cannot easily be performed. ESMA therefore recommends using the market capitalisation as a proxy for the free float. Taking into account the fact that market capitalisation is usually higher than the actual free float, ESMA proposes using for those instruments a higher threshold for such “MTF only” shares. Therefore, in ESMA’s view, those instruments should be deemed to be liquid if the market capitalisation amounted to at least EUR 200,000,000.

28. For newly issued instruments, it is proposed to follow the same approach as stipulated under Article 22(5) and Article 33(3) of MiFID I Implementing Regulation. According to the existing Regulation, “*before the first admission of a share to trading on a regulated market, the relevant competent authority for that share shall ensure that estimates are provided, in respect of that share, of the average daily turnover, the market capitalisation as it will stand at the start of the first day of trading*”.

29. Building upon this existing framework, ESMA proposes that, until six weeks after its first admission to trading:

    i. A share shall not be considered to have a liquid market if the estimate of the total market capitalisation for that share at the start of the first day's trading after that admission is less than EUR 200,000,000.

ii. Where the estimate of the market capitalisation for that share is EUR 200 million or more the relevant competent authority shall provide the average daily number of transactions and, for those shares which satisfy the conditions laid down in the table above, the free float. The liquidity of the share will then be assessed against these estimates.

iii. For shares that are estimated to be liquid shares, the relevant competent authority shall also provide an estimate of the average value of the orders to be executed so as to determine the standard market size for that share.

30. The estimates shall relate to the six-week period following admission to trading, or the end of that period, as applicable, and shall take account of any previous trading history of the share, as well as that of shares that are considered to have similar characteristics. After this period, liquidity will be calculated using actual data related to the first four weeks of trading and on the basis of the methodology described above. For those shares admitted to trading less than four weeks before the end of the year, calculation should be provided as soon as practicable and in any case before the end of the six-week period using actual data related to the first four weeks of trading and on the basis of the methodology described above.

Depositary Receipts

31. Under Article 4(1)(45) of MiFID II depositary receipts are defined as:

"those securities which are negotiable on the capital and which represent ownership of the securities of a non-domiciled issuer while being able to be admitted to trading on a regulated market and traded independently of the securities of the non-domiciled issuer".

32. In its CP, ESMA noted that today depositary receipts are traded on trading venues and OTC and are used by firms located in other jurisdictions to facilitate cross-border trading. For investors, depositary receipts make securities issued in other countries more accessible and usually at a lower cost than if the investor were to buy directly the issued shares in the home country. A depositary receipt represents an ownership interest in the underlying security and is issued for a specified number of securities and, in the CP, ESMA stated its opinion that, generally, depositary receipts are as liquid as the underlying securities. New depositary receipts can be created or cancelled depending on investor interest with new ones created where there is greater demand in the international market and cancelled when there is greater demand in the home market.

33. Given the direct link between shares and depositary receipts, as each depositary receipt is backed by a specific number of shares or a fraction of such, ESMA was proposing to use for DRs the same liquidity thresholds as for shares. ESMA notes that a large majority of responses to the consultation agreed with this proposal which will hence be maintained.

34. Naturally, whether respondents agreed with the liquidity thresholds ESMA proposed for depositary receipts depended on their view of whether the thresholds proposed were appropriate for equities and so, respondents – as for equities - were fairly evenly split regarding

whether they agreed with ESMA's proposed thresholds for DRs or not. However, since ESMA has decided to maintain the same thresholds for shares, the same approach should be followed for depositary receipts and ESMA advises thus the Commission to use the below thresholds:

	Free Float	Average daily number of transactions	Average daily turnover
Depositary Receipts	€ 100,000,000	250	€ 1,000,000

Table 3: Liquidity thresholds depositary receipts

35. With respect to DRs' free float, ESMA was suggesting that it could be determined by the number of shares issued in the issuer's home market. Some respondents agreed with this preliminary proposal, whereas some others recommended using an assessment independent of the underlying equity. ESMA notes that although the former approach would present some advantages, it might turn difficult to implement in practise. For instance, some respondents noted that certain jurisdictions limit foreign ownership which may impact the creation of new depositary receipts and that the amount of depositary receipts admitted to EU markets may represent less than 100% of issuer capital in the home market. ESMA believes that a simpler solution should be favoured and, hence, proposes to use the market capitalisation (i.e. number of outstanding units times the price of the DR) of the DRs as an alternative solution.

36. It is worth noting that DR's might use different conversion ratio (e.g. one DR being equivalent to 10 shares) which needs to be taken into account when assessing the liquid of those instruments. The free float and the average daily turnover already embeds the conversion ratio in the price of the DR (by no arbitrage the price of the DR will be equal to the share price times the shares represented by each DR) but not the average daily number of transactions that might be affected by the conversion ratio when different from 1. However, since the relationship between the number of transactions and the conversion ratio is not be linear ESMA retains at 250 the average daily number of transactions with no adjustment for the conversion ratio.

37. For newly issued instruments, the relevant competent authority for that DR shall ensure that estimates are provided of the average daily turnover and market capitalisation as it will stand at the start of the first day of trading.

38. On this basis, a DR shall not be considered to have a liquid market until six weeks after its first admission to trading if the estimated market capitalisation for that DR at the start of the first day's trading after that admission is less than EUR 100,000,000.

39. Where the estimate of the market capitalisation for that DR is EUR 100 million or more the relevant competent authority shall provide the average daily number of transactions. The liquidity of the DR will then be assessed against all the estimates provided.

40. For DRs that are estimated to have a liquid market, the relevant competent authority shall also provide an estimate of the average value of the orders to be executed so as to determine the standard market size for those DRs.

41. As for shares, the estimates shall relate to the six-week period following admission to trading, or the end of that period, as applicable, and shall take account of any previous trading history of the DR, as well as that of DRs that are considered to have similar characteristics. After this period, liquidity will be calculated using actual data related to the first four weeks of trading and on the basis of the methodology described above. For those DRs admitted to trading less than four weeks before the end of the year, calculation should be provided as soon as practicable and in any case before the end of the six-week period using actual data related to the first four weeks of trading and on the basis of the methodology described above.

Exchange Traded Funds

42. Under Article 4(1)(46) of MiFID II exchange traded funds are defined as:

    "a fund of which at least one unit or share class is traded throughout the day on at least one trading venue and with at least one market maker which takes action to ensure that the price of its units or shares on the trading venue does not vary significantly from its net asset value and, where applicable, from its indicative net asset value".

43. Today ETFs are not subject to post-trade transparency under MiFID I and therefore obtaining an accurate indication of the volume of ETFs traded in the Union is difficult to gauge. Equally, ESMA noted in the CP that currently a significant percentage of activity in ETFs is executed OTC.

44. As a basis for setting the liquidity thresholds for ETFs, ESMA presented in its CP a data analysis exercise, collecting post-trade data from EU RMs on 1,646 ETFs, with data for the same ETF traded on more than one RM aggregated at ISIN level, from 11 EU countries. The reference period was 1 January 2013 to 31 December 2013. Most of the ETFs, approximately 70% included in the exercise, are listed on more than one EU RM.

45. On this basis, ESMA proposed six scenarios using the liquidity criteria set out in the definition under Article 2(1)(17)(b) of MiFIR but varying the thresholds (see the table below). However, with regard to the first criterion (i.e. the free float), ESMA stressed that this concept is not suitable for ETFs as it is for shares given the redemption/creation process that is typical of the ETF market and therefore, ESMA was suggesting to use a de minimis number of units issued for trading as a proxy for free float for ETFs. The liquidity criteria of average daily number of transactions and average daily turnover (set out under line #2 and line #4 of the below table respectively) were therefore the only two parameters varying (changes highlighted in red) given the free float criterion was remaining a constant de minimis number of units.

46. All respondents agreed that the criterion of free float was not meaningful in the context of ETFs. The majority of respondents agreed with ESMA's proposal of setting a de minimus of 100 units as a means of satisfying this criterion on a simple basis. Those who disagreed with the proposal argued that as free float was not meaningful, it should not be used and/or that other measures, such as market capitalisation of units issued or assets under management should be used instead. After due consideration, ESMA believes that its original proposal of setting a de minimis threshold for the ETF free float criteria (i.e. setting the number of unit at 100) is still appropriate and, hence, that it should be maintained

		SCENARIO#1	SCENARIO#2	SCENARIO#3	SCENARIO#4	SCENARIO#5	SCENARIO#6
(#1) Num of units issued for trading (free float)	(>=)	100	100	100	100	100	100
(#2) Average # of trades per day	(>=)	500	500	250	100	50	20
(#3) Num of days traded during the 1-year period	(>=)	250	250	250	250	250	250
(#4) Average daily turnover (€)	(>=)	2,000,000	100,000	2,000,000	1,000,000	500,000	500,000
# of ETFs meeting all the above requirements		11	11	29	71	157	297
representing X% of the total # of ETFs		0.67%	0.67%	1.76%	4.31%	9.54%	18.04%
Total turnover over 1 Year for this category		85,824,546,029	85,824,546,029	154,617,845,394	224,397,972,545	279,229,413,072	337,162,320,305
representing X% of the total 1Y-turnover for all ETFs		20.84%	20.84%	37.55%	54.49%	67.81%	81.88%
Total num of trades for this category		2,728,596	2,728,596	4,266,558	5,855,459	7,331,746	8,473,073
representing X% of the total number of trades for all ETFs		26.72%	26.72%	41.78%	57.34%	71.80%	82.98%

Table 4: Scenarios using the liquidity criteria

47. In summary, the key points from the results of the above scenarios were:

i. For scenario #1, ESMA applied the liquidity criteria currently set for shares under MiFID I on a cumulative basis (shares traded daily with an average daily number of transactions not less than 500 and an average daily turnover (ADT) not less than €2m). On the basis of these thresholds less than 1% of the ETFs, representing roughly 20% of the turnover, qualify as liquid.

ii. Trading patterns for ETFs are characterised by few large-in-value trades as evidenced by com-paring scenario #1 to scenario #2 above, where reducing the ADT threshold from €2m to €100,000 does not impact the results.

iii. Halving the average number of trades per day from 500 to 250 (under scenario #3, everything else being equal to the parameters in scenario #1), results in the percentage of ETFs qualifying as liquid increasing slightly to 1.8%, representing roughly 40% of turnover.

iv. In scenarios #4, #5 and #6 different combinations of thresholds for ADT and average number of trades per day were applied. The percentage of liquid ETFs doubles from 4% in scenario #4 to 10% in scenario #5 and to 18% in scenario #6. The percentage of turnover corresponding to the ETFs qualifying as liquid increases from 55% in scenario #4 to 68% in scenario #5 and to 82% in scenario #6.

48. Based on the above analysis, ESMA proposed to set the liquidity thresholds for ETFs at the following levels:

ETFs	Free Float (Number of units issued for trading)	Average daily number of transactions	Average daily turnover
	100	20	500,000

Table 5: Liquidity thresholds for ETFs

49. The majority of respondents were sceptical that the preliminary results of ESMA's ETF data analysis presented in the CP were sufficiently representative of trading patterns in this market. Most of these responses concentrated on the scope of the data used (post-trade data from EU RMs only excluding negotiated trades and OTC transactions), noting that the OTC trading in ETFs was substantial and therefore the data sample used represented a too small proportion of ETF transactions and, hence, was unrepresentative. To provide some context, a couple of respondents estimated that OTC trading for ETFs was between 70 to 80% with only a small portion of this volume reported.

50. Therefore, several respondents considered that the proposed thresholds would classify a too small number of ETFs as liquid. In the same vein, some pointed out that the liquidity of ETFs was dependent on the liquidity of its underlying and that as many as or even all ETFs should be considered as liquid. In their view, this objective could be reached by using a de minimis number for the average daily number of transactions and/or the average daily turnover.

51. ESMA believes that it would not be appropriate to use de minimis thresholds for all the three criteria but proposes to lower the average daily number of transactions to 10 trades so as to capture additional instruments and reflect to some extent the concerns raised during the consultation. Therefore, ESMA advises the Commission to adopt the following thresholds for ETFs:

ETFs	Free Float (Number of units issued for trading)	Average daily number of transactions	Average daily turnover
	100	10	500,000

Table 6: Revised liquidity thresholds for ETFs

52. For newly issued instruments, the relevant competent authority for that ETF shall ensure that the estimated average daily turnover is provided as it will stand at the start of the first day of trading.

53. Where the estimate of the average daily turnover for that ETF is EUR 500,000 or more the relevant competent authority shall provide the average daily number of transactions. The ETF shall be deemed to have a liquid market until six weeks after its first admission to trading when this last estimate is at or above 10 transactions.

54. For ETFs that are estimated to have a liquid market, the relevant competent authority shall also provide an estimate of the average value of the orders to be executed so as to determine the standard market size for those ETFs.

55. As for shares, the estimates shall relate to the six-week period following admission to trading, or the end of that period, as applicable, and shall take account of any previous trading history of the ETF, as well as that of ETFs that are considered to have similar characteristics. After this period, liquidity will be calculated using actual data related to the first four weeks of trading and on the basis of the methodology described above. For those ETFs admitted to trading less than four weeks before the end of the year, calculation should be provided as soon as practicable and in any case before the end of the six-week period using actual data related to the first four weeks of trading and on the basis of the methodology described above.

Certificates

56. Certificates are defined under Article 2(1)(27) of MiFIR as:

    "those securities which are negotiable on the capital market and which in the case of a repayment of investment by the issuer are ranked above shares but below unsecured bond instruments and other similar instruments".

57. ESMA conducted an analysis, similar to that presented above for shares and ETFs, as a basis for setting the liquidity thresholds for certificates. Having consulted 11 EU Member States, ESMA identified in the CP only two types of instruments falling within the category of certificates: Spanish Participaciones Preferentes and German Genussrechte/-scheine. Post-trade data from RMs was collected for 84 certificates over the period from 1 January 2013 to 31 December 2013.

58. However, responses to the consultation suggested to include additional instruments into this category and in particular Rabobank-certificates. ESMA believes that they should be indeed also included into the certificate category.

59. Based on the this analysis of the certificate market, ESMA proposed four scenarios using the liquidity criteria set out in the definition under Article 2(1)(17)(b) of MiFIR but varying the thresholds (see table below).

		SCENARIO#1	SCENARIO#2	SCENARIO#3	SCENARIO#4
(#1) Free float (issuance size)	(>=)	1,000,000	1,000,000	1,000,000	1,000,000
(#2) Average # of trades per day	(>=)	500	20	20	50
(#3) Num of days traded during the 1-year period	(>=)	250	250	250	250
(#4) Average daily turnover (€)	(>=)	2,000,000	500,000	100,000	500,000
# of certificates meeting all the above requirements		-	1	1	-
representing X% of the total # of certificates		0.00%	1.19%	1.19%	0.00%
Total volume over 1 Year for this category		-	134,755,679	134,755,679	-
representing X% of the total 1Y-volume for all certificates		0.00%	23.48%	23.48%	0.00%

Table 7: Scenarios using the liquidity criteria

60. As for ETFs, ESMA noted that the concept of free float did not apply to certificates as it did to shares and therefore, ESMA was suggesting to use a de minimis issuance size for certificates as a proxy for the free float.

61. In summary the key points from the results of the above scenarios were:

    i. For scenario #1, ESMA applied the liquidity criteria currently set for shares under MiFID I on a cumulative basis (certificates are traded daily, the average daily number of transactions is not less than 500, the Average Daily Turnover (ADT) is not less than €2m). On the basis of these thresholds, no certificates qualify as liquid.

    ii. In the other three scenarios, the liquidity thresholds were adjusted; however, lowering the average number of trades per day to either 20 or 50 and the ADT to either €100,000 or €500,000 does not change the initial result.

    iii. On the basis of the above evidence, trading activity for certificates seems to be limited.

62. Responses to the consultation agreed with the ESMA conclusion emphasising that although classified as equity-like products under MiFID II level 1 framework, these instruments trade more like fixed income products.

63. Therefore, ESMA has decided to maintain it original proposal to the Commission and recommends to set the liquidity thresholds for certificates at the following levels:

Certificates	**Free Float (issuance size in euro)**	**Average daily number of transactions**	**Average daily turnover**
	1,000,000	20	500,000

Table 8: Liquidity thresholds for certificates

64. For newly issued instruments, the relevant competent authority for that certificate shall ensure that estimates are provided of the average daily turnover and the issue size as it will stand at the start of the first day of trading.

65. On this basis, a certificate shall not be considered to have a liquid market until six weeks after its first admission to trading if the estimates of the total issuance size for that certificate at the start of the first day's trading after that admission is less than EUR 1,000,000.

66. Where the estimate of the issuance size for that certificate is EUR 1,000,000 or more the relevant competent authority shall provide the average daily number of transactions. The liquidity of the certificate will then be assessed against all the estimates provided.

67. For certificates that are estimated to have a liquid market, the relevant competent authority shall also provide an estimate of the average value of the orders to be executed so as to determine the standard market size for those certificates.

68. As for shares, the estimates shall relate to the six-week period following admission to trading, or the end of that period, as applicable, and shall take account of any previous trading history of the certificate, as well as that of certificates that are considered to have similar characteristics. After this period, liquidity will be calculated using actual data related to the first four weeks of trading and on the basis of the methodology described above. For those certificates admitted to trading less than four weeks before the end of the year, calculation should be provided as soon as practicable and in any case before the end of the six-week period using actual data related to the first four weeks of trading and on the basis of the methodology described above.

Technical advice

1. An instrument must meet all of the four criteria listed under Article 2(1)(17)(b) of MiFIR (free float, average daily number of transactions, average daily turnover and daily traded) in order to be deemed to have a 'liquid market'. The four criteria shall apply cumulatively to establish a uniform and simplified regime.

2. As an exception to the above, where a Member State would be the most relevant market for fewer than five liquid instruments per asset class (i.e. for shares, ETFs, DRs and certificates), the Member State may designate, for each asset class, one or more additional liquid instruments provided that the total number of instruments which are considered in consequence to be liquid is no greater than five per asset class. The specification shall be made public.

Shares

3. A share will be deemed to have a liquid market if it meets the following criteria:

    i. it is traded daily;

    ii. the free-float is:

        a. not less than EUR 100 million for shares admitted to trading on a regulated market;

or

b. not less than EUR 200 million for shares that are only traded on MTFs.

iii. the average daily number of transactions in the shares is not less than 250; and

iv. the average daily turnover for the shares is not less than EUR 1 million.

4. The size of the free float for shares should be defined as the outstanding capital (number of outstanding shares times the price) less the shareholdings exceeding 5% of the total voting rights of the issuer, unless such interests are held by collective investment undertaking or pension funds. Voting rights shall be calculated on the basis of all the shares to which voting rights are attached, even if the exercise of such a right is suspended.

5. For shares that are traded only on MTFs and for which no prospectus is available, the market capitalisation should be used as a proxy for the free float.

6. For newly issued instruments, ESMA recommends using the following procedure:

i. The relevant competent authority for a share shall ensure that, before the first admission of that share to trading, estimates are provided, in respect of that share, of the average daily turnover and market capitalisation as it will stand at the start of the first day of trading.

ii. On this basis, a share shall not be considered to have a liquid market, until six weeks after its first admission to trading, if the estimates of the total market capitalisation for that share at the start of the first day's trading after that admission is less than EUR 200,000,000.

iii. Where the estimate of the average daily turnover and market capitalization for that share are respectively at or above EUR 1,000,000 and EUR 200 million, the relevant competent authority shall provide the average daily number of transactions and, for those shares which satisfy the conditions above, the free float. The liquidity of the share will then be assessed against all these estimates.

iv. For shares that are estimated to be liquid shares, the relevant competent authority shall also provide the average value of the orders executed in order to determine the standard market size for that share.

v. The estimates shall relate to the six-week period following admission to trading, or the end of that period, as applicable, and shall take account of any previous trading history of the share, as well as that of shares that are considered to have similar characteristics. After this period, liquidity will be calculated using actual data related to the first four weeks of trading and on the basis of the methodology described above. For those shares admitted to trading less than four weeks before the end of the year, calculation

should be provided as soon as practicable and in any case before the end of the six-week period using actual data related to the first four weeks of trading and on the basis of the methodology described above.

Depositary Receipts

7. A depositary receipt will be deemed to have a liquid market if it meets the following criteria:

   i. it is traded daily;

   ii. the free float is not less than EUR 100 million;

   iii. the average daily number of transactions in the depositary receipts is not less than 250; and

   iv. the average daily turnover for the depositary receipts is not less than EUR 1 million.

8. The size of the free float for a depositary receipt should be determined by the market capitalisation (i.e. number of outstanding units times the price of the DR) of this depositary receipt which corresponds to the quantity of units outstanding times the price.

9. For newly issued instruments, ESMA recommends using the following procedure:

   i. The relevant competent authority shall ensure that, for that DR, estimates are provided of the average daily turnover and market capitalisation as it will stand at the start of the first day of trading.

   ii. On this basis, a DR shall not be considered to have a liquid market until six weeks after its first admission to trading if the estimated market capitalisation for that DR at the start of the first day's trading after that admission is less than EUR 100,000,000.

   iii. Where the estimate of the market capitalisation for that DR is EUR 100 million or more the relevant competent authority shall provide the average daily number of transactions. The liquidity of the DR will then be assessed against all the estimates provided.

   iv. For DRs that are estimated to have a liquid market, the relevant competent authority shall also provide an estimate of the average value of the orders to be executed so as to determine the standard market size for those DRs.

   v. The estimates shall relate to the six-week period following admission to trading, or the end of that period, as applicable, and shall take account of any previous trading history of the DR, as well as that of DRs that are considered to have similar characteristics. After this period, liquidity will be calculated using actual data related to the first four weeks of trading and on the basis of the methodology described above. For those DRs admitted to trading less than four weeks before the end of the year, calculation should be provided as soon as practicable and in any case before the end of the six-week period

using actual data related to the first four weeks of trading and on the basis of the methodology described above.

Exchange Traded Funds

10. An ETF will be deemed to have a liquid market if it meets the following criteria:

    i. it is traded daily;

    ii. the free float for an ETF shall be set as a de minimis number of 100 units issued for trading;

    iii. the average daily number of transactions in the ETF is not less than 10; and

    iv. the average daily turnover for the ETFs is not less than EUR 500,000.

11. For newly issued instruments, ESMA recommends using the following procedure:

    i. The relevant competent authority for that ETF shall ensure that the estimated average daily turnover is provided as it will stand at the start of the first day of trading.

    ii. Where the estimate of the average daily turnover for that ETF is EUR 500,000 or more the relevant competent authority shall provide the average daily number of transactions. The ETF shall be deemed to have a liquid market until six weeks after its first admission to trading when this last estimate is at or above 10 transactions.

    iii. For ETFs that are estimated to have a liquid market, the relevant competent authority shall also provide an estimate of the average value of the orders to be executed so as to determine the standard market size for those ETFs.

    iv. The estimates shall relate to the six-week period following admission to trading, or the end of that period, as applicable, and shall take account of any previous trading history of the ETF, as well as that of ETFs that are considered to have similar characteristics. After this period, liquidity will be calculated using actual data related to the first four weeks of trading and on the basis of the methodology described above. For those ETFs admitted to trading less than four weeks before the end of the year, calculation should be provided as soon as practicable and in any case before the end of the six-week period using actual data related to the first four weeks of trading and on the basis of the methodology described above.

Certificates

12. A certificate will be deemed to have a liquid market if it meets the following criteria:

    i. it is traded daily;

ii. the free float is not less than EUR 1 million;

iii. the average daily number of transactions in the certificates is not less than 20; and

iv. the average daily turnover for the certificates is not less than EUR 500,000.

13. For newly issued instruments, ESMA recommends using the following procedure:

i. The relevant competent authority for that certificate shall ensure that estimates are provided of the average daily turnover and the issuance size as it will stand at the start of the first day of trading.

ii. On this basis, a certificate shall not be considered to have a liquid market until six weeks after its first admission to trading if the estimates of its issuance size at the start of the first day's trading after that admission is less than EUR 1,000,000.

iii. Where the estimate of the issuance size for that certificate is EUR 1,000,000 or more the relevant competent authority shall provide the average daily number of transactions. The liquidity of the certificate will then be assessed against all the estimates provided.

iv. For certificates that are estimated to have a liquid market, the relevant competent authority shall also provide an estimate of the average value of the orders to be executed so as to determine the standard market size for those certificates.

v. The estimates shall relate to the six-week period following admission to trading, or the end of that period, as applicable, and shall take account of any previous trading history of the certificate, as well as that of certificates that are considered to have similar characteristics. After this period, liquidity will be calculated using actual data related to the first four weeks of trading and on the basis of the methodology described above. For those certificates admitted to trading less than four weeks before the end of the year, calculation should be provided as soon as practicable and in any case before the end of the six-week period using actual data related to the first four weeks of trading and on the basis of the methodology described above.

3.2. Delineation between bonds, structured finance products and money market instruments

Background/Mandate

Extract from the Commission's request for technical advice (mandate)

ESMA is invited to provide technical advice to further specify the definition of money market instruments in order to set a clear delineation between bonds and structured finance products and money market instruments.

Analysis following feedback from stakeholders

1. MiFID and MiFIR contain the following three definitions for bonds, structured finance products and money-market instruments:

Article 4(1), MiFID II

[…]

(17) 'money-market instruments' means those classes of instruments which are normally dealt in on the money market, such as treasury bills, certificates of deposit and commercial papers and excluding instruments of payment;

(44) 'transferable securities' means those classes of securities which are negotiable on the capital market, with the exception of instruments of payment, such as:

[…]

(b) bonds or other forms of securitised debt, including depositary receipts in respect of such securities;

Article 2(1) MiFIR

[…]

(28) 'structured finance products' means those securities created to securitise and transfer credit risk associated with a pool of financial assets entitling the security holder to receive regular payments that depend on the cash flow from the underlying assets;

2. The European Commission can further specify some technical elements in respect of these definitions via their general empowerments in Article 4(2) MiFID II and Article 2(2) MiFIR. Specifying these definitions further is important due to the scope of the MiFIR non-equity

transparency framework which explicitly includes bonds and structured finance products as financial instruments to which pre-trade and post-trade transparency requirements apply. Money-market instruments however are excluded from the scope as they are a separate category of financial instrument under Annex I Section C2 of MiFID while not being mentioned as a category to which transparency obligations under Articles 8 and 10 MiFIR apply.

3. The purpose of this further specification would be a clear delineation between instruments within and outside the MiFID II scope so it is clear to all stakeholders whether trading in an instrument is subject to transparency obligations.

4. ESMA already pointed out in the Consultation Paper that apart from being defined in MiFID II, money-market instruments are also mentioned in Recital 36 of the UCITS Directive 2009/65/EC and being characterised as "*transferable instruments which are normally dealt in on the money market rather than on the regulated markets, for example treasury and local authority bills, certificates of deposit, commercial papers, medium-term notes and bankers' acceptances'* and are defined in Article 2(1)(o) of the same directive as meaning '*instruments normally dealt in on the money market which are liquid and have a value which can be accurately determined at any time"*.

5. The Eligible Assets Directive 2007/16/EC (Articles 3[48] and 4) specifies further what characteristics money market instruments normally have. In particular, it is specified in this Directive that they have a maximum maturity of 397 days at issuance or residually.

6. In addition, the Regulation of the European Central Bank (EU) No 883/2011 amending Regulation (EC) No 25/2009 in its Article 1 (Section 2g) defines money market instruments as instruments normally traded on the money market which are liquid and have a value which can be accurately determined at any time.

7. ESMA considered in the Consultation Paper that the regulatory purpose of the Eligible Assets Directive in the context of regulating UCITS is different. While ESMA considers the maximum maturity of 397 days as a useful guideline, for the purposes of MiFIR those 397 days should always be counted from issuance.

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[48] *Article 3 Instruments normally dealt in on the money market […]*
2. The reference in Article 1(9) of Directive 85/611/EEC to money market instruments as instruments normally dealt in on the money market shall be understood as a reference to financial instruments which fulfil one of the following criteria:
(a) they have a maturity at issuance of up to and including 397 days;
(b) they have a residual maturity of up to and including 397 days;
(c) they undergo regular yield adjustments in line with money market conditions at least every 397 days;
(d) their risk profile, including credit and interest rate risks, corresponds to that of financial instruments which have a maturity as referred to in points (a) or (b), or are subject to a yield adjustment as referred to in point (c).

8. ESMA also considered that money market instruments for MiFIR purposes should be strictly limited to such instruments expressly stated to be treasury bills, certificates of deposit, commercial paper and other instruments with equivalent features.

9. ESMA proposed that regarding financial instruments that are traded on a trading venue and have a maturity of 397 days or less, the only instruments that can only be considered as money-market instruments and therefore are not subject to non-equity transparency are those for which the value can be determined at any time on either an amortised cost basis or in reference to the short term yield curve for the currency of the instrument.[49] In contrast debt securities bearing a Classification of Financial Instruments (CFI) identifier 'DY' for money market instruments should be treated as falling within the scope of non-equity transparency if the maturity at issuance of the instrument is greater than 397 days or if the market value cannot be determined in an objective and unbiased fashion.

10. Respondents to the Consultation had mixed views with a sizable proportion agreeing with the ESMA proposals and another sizable proportion disagreeing based on their view that the definition of money market instruments should be aligned across pieces of European legislation, notably the future Money Market Funds Regulation and the Eligible Assets Directive.

11. Other major points in the responses to the consultation were that the definition should apply to instruments with a maturity at issuance of 2 years or less and with a residual maturity of 2 years or less citing again the on-going negotiations for the Money Market Funds Regulation. The definition proposed should also not refer to instruments "expressly" stated to be of a certain kind as this was inconsistent with market practice and to refer to instruments having "substantially equivalent" features rather than just equivalent as no instruments were deemed to pass a 100% equivalence test.

12. ESMA appreciates that consistency of definitions across legislation is always desirable but has to point out to respondents that the European Commission has asked for ESMA's advice on further specifying the MiFID definition of money market instruments and ESMA has to answer to that mandate.

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[49] *Article 4 Liquid instruments with a value which can be accurately determined at any time […]*
2. The reference in Article 1(9) of Directive 85/611/EEC to money market instruments as instruments which have a value which can be accurately determined at any time shall be understood as a reference to financial instruments for which accurate and reliable valuations systems, which fulfil the following criteria, are available:
(a) they enable the UCITS to calculate a net asset value in accordance with the value at which the financial instrument held in the portfolio could be exchanged between knowledgeable willing parties in an arm's length transaction;
(b) they are based either on market data or on valuation models including systems based on amortised costs.
3. The criteria referred to in paragraphs 1 and 2 shall be presumed to be fulfilled in the case of financial instruments
which are normally dealt in on the money market for the purposes of Article 1(9) of Directive 85/611/EEC and which are admitted to, or dealt in on, a regulated market in accordance with points (a), (b) or (c) of Article 19(1) thereof, unless there is information available to the UCITS that would lead to different determination.

13. ESMA also does not agree with extending the scope caught by the definition of money market instruments to two years from issuance and recommends keeping it at 397 days from issuance exactly to maintain a degree of consistency across European legislation (in this case the Eligible Assets Directive). ESMA is of the view that certificates of deposits, treasury bills, commercial papers and other similar instruments with maturities exceeding 397 days shall be treated as transferable securities.

14. However ESMA does not consider it appropriate to link the definition in MiFID II to residual maturity as in the Eligible Assets Directive. Given that the money markets instruments definition (among other things) is important for determining the exact application of the transparency requirements, referring to residual maturity would insert an element of uncertainty to that application which would make an already complex transparency regime even more difficult to implement and operate in practice. In addition, making the classification dependent on residual maturity may result in certain instruments to be reclassified under the execution-only test as they mature which would introduce another element of uncertainty and complexity to no apparent benefit.

15. ESMA agrees with the points some respondents made in relation to expressly stating whether instruments are of a certain kind and equivalence and has amended the advice accordingly.

16. ESMA has also introduced additional elements to the further specification of money market instruments which it considers helpful for the purposes of delineation. These elements specify that money market instruments are liquid and their value can be determined at any time and that they do not have derivative elements.

17. In the Consultation Paper, ESMA considered asset backed commercial paper as a special case which can be classified as a structured finance product as well as a money market instrument. Pointing at the legal precedent in Article 5(4)(e) of Commission Delegated Regulation (EU) No 448/2012, ESMA proposed classifying asset backed commercial paper as a structured finance product for the purposes of MiFIR.

18. Many respondents to the consultation disagreed with this proposal with some stating purely a preference for categorising asset backed commercial paper as a money market instruments while others cited an inconsistency with the treatment of commercial paper.

19. ESMA took those comments into account and decided to amend its advice accordingly.

Technical advice

1. Money-market instruments shall be further specified as treasury bills, certificates of deposits, commercial papers and other instruments with substantially equivalent features that have the following characteristics:

i. they have a value that can be determined at any time;

ii. they are not derivatives; and

iii. they have a maturity at issuance of 397 days or less.

3.3. The definition of systematic internaliser

Background/Mandate

Extract from the Commission's request for technical advice (mandate)

ESMA is invited to provide technical advice to further specify the quantitative elements of the definition of systematic internaliser by providing advice on the numerical thresholds to be used to assess the frequent, systematic and substantial basis.

Article 4(1)(20), MiFID II

Systematic internaliser means an investment firm which, on an organised, frequent, systematic and substantial basis, deals on own account by executing client orders outside a regulated market, an MTF or an OTF without operating a multilateral system.

The frequent and systematic basis shall be measured by the number of OTC trades in the financial instrument carried out by the investment firm on own account when executing client orders. The substantial basis shall be measured either by the size of the OTC trading carried out by the investment firm in relation to the total trading of the investment firm in a specific financial instrument or by the size of the OTC trading carried out by the investment firm in relation to the total trading in the Union in a specific financial instrument. The definition of systematic internaliser shall only apply where the pre-set limits for a frequent and systematic basis and for a substantial basis are both crossed or where an investment firm which chooses to opt-in under the systematic internaliser regime.

1. ESMA was requested to advise the Commission on how to further specify the quantitative elements of the definition of systematic internaliser by providing advice on the numerical thresholds to be used to assess the frequent, systematic and substantial basis.

2. The notion of systematic internaliser is defined under Article 4(1)(20) of MiFID II. Whereas MiFID I is only providing qualitative criteria for determining whether an investment firm is acting as a systematic internaliser, MiFID II introduces a new definition of systematic internaliser which is based on quantitative criteria for assessing when the activity of dealing on own account by executing client orders is sufficiently:

   i. Frequent and systematic; and

   ii. Substantial.

3. Separately from the new definition, MiFID II extends the systematic internaliser regime so that from applying solely to shares, as is the case under MiFID I, it will apply to a much broader range of asset classes: equity-like instruments (depositary receipts, ETFs, certifi-

cates and other similar financial instruments) and non-equity instruments (derivatives, bonds, structured finance products and emission allowances).

Analysis following feedback from stakeholders

4. This chapter (like other sections) should be read together with the CP published by ESMA in May 2014. The rationale of those items covered already in the CP for which no relevant changes have been introduced, is not developed again in this Final Report.

General approach

5. As already mentioned in its CP, it is ESMA's intention to calibrate the thresholds for the frequent, systematic and substantial basis criteria with the aim of preserving and, when possible, enhancing the current level of transparency while having regard to the different trading patterns of instruments within the scope of the regime.

6. ESMA appreciates that Article 4(1)(20) of MiFID II provides a definition of systematic internaliser which does not distinguish between liquid and illiquid instruments. Therefore, it is ESMA's understanding that the new systematic internaliser regime will apply regardless of the liquidity profile of these instruments.

7. However, ESMA notes that the new systematic internaliser regime should only have a limited impact on the transparency of illiquid instruments traded OTC. Under Articles 4(1) and 9(1) of MiFIR, NCAs have the ability to waive the pre-trade transparency obligations for illiquid instruments. Articles 14(1) and 18(1) of MiFIR, which set the obligation for SIs to make public firm quotes, only apply when there is a liquid market.

8. Similarly, Recital 18 of MiFIR refers only to instruments for which there is a liquid market:

   "In order to ensure that trading carried out OTC does not jeopardise efficient price discovery or a transparent level playing field between means of trading, appropriate pre-trade transparency requirements should apply to investment firms dealing on own account in financial instruments OTC insofar as it is carried out in their capacity as systematic internalisers in relation to shares, depositary receipts, ETFs, certificates or other similar financial instruments for which there is a liquid market and bonds, structured finance products, emission allowances and derivatives which are traded on a trading venue and for which there is a liquid market."

9. Therefore, in ESMA's view, investment firms that would qualify as systematic internalisers for an illiquid instrument would be subject to limited requirements. Thus, when calibrating the thresholds for determining frequent, systematic and substantial basis, ESMA has taken liquid instruments into greater consideration.

Frequency of calculation and time to comply with the systematic internaliser regime

10. In the CP, ESMA proposed a quarterly assessment by investment firms in respect of their systematic internaliser activity. Respondents to the consultation disagreed with the proposed timeframe which is, in their view, too short and, thus, would not allow to adequately capture the seasonality of instruments (especially for non-equity instruments). According to them, this would make the SI regime too reactive to episodic internalisation resulting from life-cycles of the products and, hence, would not ensure sufficient stability and would not give enough legal certainty to stakeholders.

11. Moreover, responses emphasised that for an investment firm qualifying as SI for the first time, the one-month period proposed by ESMA to establish all the arrangements necessary for complying with the regime is not sufficient. In their view, SI obligations require putting in place systems and procedures and this cannot be achieved within the timeframe proposed by ESMA.

12. ESMA has taken some of the proposals received in the consultation on board and amended its initial proposal. In ESMA's view, investment firms should assess their systematic internaliser activity on a quarterly basis. However, in order to make the calculation less sensitive to episodic internalisation, ESMA proposes to calculate the thresholds based on data from a longer rolling period, i.e. 6 months. Assessments by investment firms should be performed at fixed and pre-defined dates (i.e. on the first working day of the months January, April, July and October).

13. In addition, ESMA also recommends granting a longer delay for investment firms to comply with all the SI regime obligations. ESMA believes that two months should provide sufficient time in this respect. For the sake of simplicity, ESMA has decided not to differentiate between firms that would qualify as an SI for the first time and the others although, in practice, ESMA expects the latter to comply with all SI obligations with no or a very limited delay.

14. For newly issued instruments, ESMA proposes:

    i. For equity and equity-like financial instruments to consider them when historical data covers a period at least equal to three months; and

    ii. For non-equity financial instruments to consider them when historical data covers a period at least equal to six weeks in order to take into account that trading in non-equity instruments is often most active shortly after issuance.

Access to EU wide data

15. Several respondents to the consultation stressed that a lot of uncertainty remains with respect to the way calculations will have to be undertaken. They noted that those calculations imply to have information about the total volume of trading or total number of transactions in the same financial instrument in the Union and that this information is currently not available.

16. ESMA appreciates this operational issue, which could potentially hamper the calculation. However, it is worth noting that the Level 1 itself refers, under Article 4(1)(20) of MiFIR, to "*the total trading in the Union in a specific financial instrument*" so that this is an inherent feature of the SI regime. ESMA did not receive any empowerment to publish trading figures and at this point in time cannot guarantee that there will be a Consolidated Tape Provider that could provide those figures for the whole of the Union, but hopes that solutions in this respect could arise from market initiatives or other operational solutions that can be put in place during the MiFID II / MiFIR implementation period.

17. It should also be noted that, for frequent and systematic thresholds further described below, ESMA has added together with the percentage threshold a minimum absolute threshold under which the firm would be considered as not performing frequent and systematic trading without the necessity to undertake any further calculation. Preliminary analysis showed that this floor should in practice avoid to make such calculations at least for financial instruments for which EU wide data is the most difficult to get hold of.

<u>*Equities*</u>

Frequent and systematic

18. The majority of respondents supported the proposal of calibrating the threshold for the frequent and systematic criterion on the liquidity of the financial instrument as measured by the average number of transactions executed.

19. In the CP published in May 2014, ESMA proposed, for liquid instruments, to set a threshold between 0.25% and 0.5% of the total number of trades in Europe. Following on from the feedback received and considering the current level of internalisation by existing systematic internalisers in shares, ESMA believes that the threshold should be set at 0.4%.

20. Therefore, in ESMA's view, an investment firm should be considered as trading on a frequent and systematic basis when the number of OTC transactions executed by this firm on own account in liquid instrument is, during the relevant period of time, equal or larger than 0.4% of the total number of transactions in the relevant financial instrument in the European Union during the same period.

21. For illiquid instruments, the frequent and systematic criteria will be deemed to be met when the investment firms has dealt on own account OTC in this financial instrument on average on a daily basis during the relevant period of time.

Substantial basis

22. Question 125 of the CP was asking views on whether the threshold here should be based on the turnover (quantity multiplied by price) as opposed to the volume (quantity) of shares traded. It appeared that the vast majority of respondents support a threshold based on turnover and, thus, ESMA has maintained its initial proposal in this regard.

23. With respect to the substantial criteria, respondents generally agreed with ranges proposed by ESMA in its CP although some responses suggested the use of lower thresholds. Taking all these comments into consideration, ESMA advises to consider client internalisation for a specific financial instrument as substantial when its accounts either:

    iii. for 15% or more of the firm's total trading activity for this instrument (the total trading activity shall include all transactions executed by the investment firm in any capacity and executed on any trading venue or OTC); or

    iv. for 0.4% of the total trading activity for this financial instrument in the Union (the total activity in the Union shall include trading carried out OTC and on any EU trading venue for that financial instrument).

Link with the trading obligation for shares

24. One of the main changes to market structure for shares in MiFIR is that under Article 23, investment firms must undertake all trades (i.e. on own account and on behalf of clients) on a regulated market, MTF, a third country venue recognised by MiFID or, different from the derivatives trading obligation, via a systematic internaliser, unless there is a legitimate reason for them to be concluded outside of such platforms.

25. The exemption to this obligation only applies where the trades are (i) non-systematic, ad-hoc, irregular and infrequent or (ii) are carried out between eligible and/or professional counterparties and do not contribute to the price discovery process, the latter exemption being subject to further specification by ESMA at Level 2.

26. ESMA notes, as pointed out by some of the respondents to the consultation, that the terms used to define the first range of criteria ("*non-systematic, ad-hoc, irregular and infrequent*") is similar (in opposite terms) to the wording used under Article 4(1)(20) of MiFID II to characterise systematic internalisers. In this context, ESMA believes that it would be useful for the European Commission to clarify the potential interlinkages that might exist between the two regimes (i.e. trading obligation for shares and systematic internaliser regime).

27. In addition, ESMA is aware of concerns also expressed in the consultation that the systematic internaliser regime could be used to circumvent the trading obligation for shares, unless the boundaries of the systematic internalisation activity are further specified. ESMA agrees that this is a concern that warrants further attention in the rule-making process while being aware that it is outside of the mandate from the Commission for defining systematic internalisers.

Equity-like instruments

28. In its CP, ESMA was of the opinion that the criteria and thresholds proposed for shares were also adequate for equity-like instruments – i.e. certificates, depositary receipts, ETFs and other similar financial instruments.

29. Respondents to the ESMA consultation generally agreed that the criteria and thresholds used for shares are also relevant for certificates and depositary receipts. However, views were more diverse concerning ETFs. A small majority of respondents believe that ESMA should here as well apply the same thresholds whereas others stressed that these instruments usually trade amongst a more limited number of market participants and, hence, should be subject to higher thresholds.

30. ESMA, after careful consideration of all the arguments presented, has decided to maintain its initial proposal and advises to apply the same thresholds to all equity-like instruments (including ETFs) as for shares.

31. However, ESMA notes that some inconsistencies might arise between the thresholds proposed for the definition of SIs and the liquidity thresholds recommended by ESMA in this final report. For instance, ESMA recommends considering an ETF as liquid when, amongst other criteria, the average daily number of transactions is at least equal to 10 and, thus, an investment firm could pass the frequent and systematic test with 0.04 trades per day on average. Therefore, it is proposed to use, together with the percentage threshold described above, a minimum absolute threshold under which the firm would be considered as not performing frequent and systematic trading without the necessity to undertake any further calculation. This threshold should be equal to the threshold proposed for illiquid instrument (i.e. on average on a daily basis).

Non-equity instruments

Level of granularity at which the calculations should be performed

32. With respect to the level of granularity at which the calculation should be conducted, ESMA pointed out in its consultation paper that, according to Article 4(1)(20) of MiFID II, the thresholds have to be computed for each “specific financial instrument”. ESMA noted that if the concept of “financial instruments” is relatively clear for bonds and structured finance products where the ISIN code can be used as a proxy, the concept appears to be less practical when it comes to derivatives.

33. For bonds and SFPs, respondents to the consultation agreed to a large extent with ESMA’s proposal to apply the SI thresholds at an ISIN code level and, hence, the proposal is maintained.

34. For derivatives, a majority of respondents agreed that a certain level of aggregation was necessary. In this respect, they generally support the approach presented under Annex 3.6.1 of the discussion paper although with some technical adjustments.

35. In this respect, ESMA believes that the aggregation required in the context of the systematic internaliser regime should build upon the categories to be defined by ESMA for transparency purposes.

36. However, and although the liquid classes are not yet finalised at the time of writing, ESMA appreciates that these categories to be defined for liquidity purposes might have a different scope with some classes focusing on a very limited number of specific instruments whereas others having a much broader scope and capturing diverse instruments.

37. Operationally, ESMA considers that the final classes to be used for the purposes of the systematic internaliser definition could be determined by using the following criteria:

    i. Level 1: liquidity of the instrument under COFIA (Classes of Financial Instruments Approach, as defined in the Transparency section of the Discussion Paper);

    ii. Level 2: asset class (interest rate derivatives, foreign exchange derivatives, equity derivatives, commodity derivatives, credit derivatives, other derivatives, contract for difference);

    iii. Level 3: product type (e.g. futures, options, swaps, FRAs, etc.); and

    iv. Level 4: underlying (i.e. the specific stock, index, interest rate, bond, etc.).

38. For securitised derivatives, as suggested by some respondents the thresholds can be applied at the ISIN level.

39. As far as emission allowances are concerned, ESMA proposes to calculate the *frequent and systematic* and *substantial basis* thresholds on the basis of the emission allowance types identified for liquidity calculation purposes - i.e. European Union Allowances (EUA), Certified Emission Reductions (CER), European Union Aviation Allowance (EUAA) and Emission Reduction Units (ERU). It is worth noting in this respect that preliminary results indicate that EUAs concentrate 99.9% of the emission allowance trading in the EU.

Level of granularity at which the thresholds should be set

40. With regard to the level of granularity at which the thresholds should be set, a majority of responses indicate that they should be defined at asset class level as initially proposed by ESMA (i.e. one threshold for “bonds”, one threshold for “Structured Finance Products”, etc.). ESMA notes that some respondents advocated for setting different thresholds according to the issue size. However, for the sake of simplicity, ESMA recommends to maintain only one threshold per asset class and not to differentiate issuance sizes in this respect.

41. For derivatives, most of the respondents were of the opinion that it would be inappropriate to apply one single threshold across the board. They stressed that some classes of derivatives (e.g. FX derivatives) are very liquid instruments and that for those classes the SI regime should be calibrated so as to capture a wider range of market participants. ESMA agrees that the liquidity of derivative instruments is very heterogeneous and that it might be challenging to apply identical thresholds for all of these instruments. However, ESMA also appreciates that the differences in terms of liquidity between those instruments should already

be captured through the thresholds to be proposed by ESMA for liquidity purposes and according to criteria listed under Article 2(1)(17) of MiFIR. Moreover, liquidity can also vary between instruments within the same class of derivatives. Hence, in order to be as precise as possible, the thresholds would need to be set at a level which would be too granular in this context. Therefore, after due consideration, ESMA suggests to rather adopt a harmonised approach and to use the same thresholds for all derivatives.

42. Lastly, ESMA in the consultation paper was asking whether it was necessary to set a threshold for liquid derivatives since many of them may be caught by the trading obligation for derivatives in MiFIR and, thus, would not be affected by the systematic internaliser regime which applies to OTC trading only. Responses to the consultation showed a clear support for ESMA's proposal to set thresholds for these instruments.

Frequent and systematic

43. ESMA's initial proposal with regard to the frequent and systematic thresholds for non-equity instruments was to adopt the same approach as for the equity and equity-like instruments regime and to set the thresholds as percentages for liquid instruments and as absolute thresholds for illiquid instruments.

44. Under Q135 of its Consultation Paper, ESMA was looking for views from stakeholders on the respective benefits of setting thresholds as absolute numbers rather than percentages. Responses pointed out that although absolute thresholds are easier to implement, they would not allow to appropriately take into account the diversity of non-equity instruments and to adapt to market changes. Percentages are deemed more complex but provide further flexibility and are applicable to a wider range of instruments.

45. In addition, a large group of respondents emphasised that there were some inconsistencies between the proposed thresholds for the definition of SIs and the initial liquidity thresholds presented by ESMA in its Discussion Paper (Chapter 3.6, Liquid market definition for non-equity financial instruments, p.127 of ESMA DP). In a nutshell, in the scenarios presented in the DP, ESMA was considering setting a liquidity threshold in terms of number of trades during the 1-year period between 240 and 480. At the same time, ESMA was proposing to set, for liquid bonds, the "frequent and systematic" threshold between 2 and 3% of the total number of trades in the EU. This would have meant that an investment firm could have passed the frequent and systematic test with 4.8 trades in a year (i.e. a threshold lower than the one proposed for illiquid instruments set at "on average at least once a week").

46. ESMA agrees with the points summarised above and, therefore, has adapted its initial proposal to take those remarks into account. As a consequence, ESMA proposes to use, together with a percentage threshold, a minimum absolute threshold under which the firm would be considered as performing non-frequent trading without the necessity to undertake any further calculation. ESMA recommends setting this absolute threshold in line with the thresholds used for illiquid instruments (i.e. on average once a week).

47. ESMA received only limited input during the consultation with respect to the concrete levels at which the thresholds should be set. Some respondents provided ESMA with alternative proposals but did not provide adequate data to support their views.

48. For fixed income products, ESMA has undertaken an additional data gathering and a further analysis which indicates that the thresholds proposed in the discussion paper were roughly in line with the patterns that can be observed in the market and as a result ESMA is of view that the thresholds should be maintained. Moreover, as mentioned above, ESMA believes that when calibrating thresholds, special consideration should be given to liquid instruments. In this regard, it is worth noting that the framework governing the determination of liquidity for non-equity financial instruments has not been finalised yet and ESMA also has to emphasise that it is difficult to collect the right data at this point in time. Thus, ESMA has decided to suggest to the Commission ranges for the thresholds to be set rather than a concrete one in order to leave adequate flexibility.

49. For derivatives, it is also proposed to maintain similar thresholds as those presented in the Consultation Paper. However, in order to provide more clarity to the European Commission ranges have been reduced and aligned with the thresholds to be used for bonds.

50. For emission allowances, in ESMA's view an investment firm should be considered as trading on a frequent and systematic basis when the number of OTC transactions executed by this firm on own account in liquid emission allowances represents, during the relevant period of time, more than 3% to 5% of the total number of transactions in the European Union during the same period. At a minimum the investment firm shall deal on own account in such instrument on average once a week which is also the threshold set for illiquid emission allowance classes.

Substantial basis

51. With respect to the substantial basis thresholds, respondents also suggested to use absolute numbers. In particular, some respondents pointed out that for some fixed income instruments only one investment firm is active and might concentrate 100% of total nominal amount traded in the Union. This might concern small regional banks which do not necessarily have the resources to comply with the obligations of the SI regime.

52. ESMA appreciates those concerns, however, notes that the calculation is limited by the Level 1 text which requires the use of relative thresholds. Article 4(1)(20) of MFID stipulates that "*the substantial basis shall be measured either by the size of the OTC trading carried out by the investment firm in relation to the total trading of the investment firm in a specific financial instrument or by the size of the OTC trading carried out by the investment firm in relation to the total trading in the Union in a specific financial instrument*".

53. ESMA is also of the view that those cases would concern mainly fixed income instruments for which there is not a liquid market. As mentioned above, investment firms that will qualify

as a systematic internaliser for an illiquid instrument will be subject to only a limited set of requirements which should mitigate the impact of the new SI regime.

54. Therefore, ESMA maintains its initial proposal and recommends assessing the “substantial basis” criterion via two thresholds (if any of the two thresholds is exceeded the substantial basis criterion would be met):

    i. the size of the internalisation activity compared to the firm's total trading in a particular financial instrument executed either on-venue or OTC; or

    ii. the size of the internalisation activity compared to the total trading in the Union for that instrument executed either on-venue or OTC.

55. With regard to the substantial criterion, responses suggest to use thresholds based on notional volume rather than turnover. Respondents emphasised that the market value would otherwise introduce volatility into the calculation. They also stressed that market valuation is currently based on methodologies which are not standardised and, thus, difficult to compute. ESMA agrees with those comments and recommends using the nominal amount for bonds and SFPs and the notional amount for derivatives.

56. For the substantial basis thresholds, in line with what is proposed for the frequent and systematic criteria for non-equity financial instruments, ESMA suggests:

    i. Maintaining the thresholds set for bonds and structured finance products in the CP;

    ii. Applying, for derivatives, the same thresholds as for bonds; and,

    iii. Setting, for emission allowances, the thresholds as follows:

        a. 30% of the total nominal amount traded in that financial instrument executed by the investment firm on own account or on behalf of clients and carried out on any trading venue or OTC; or

        b. 1.5 to 3% of the total nominal amount traded in that financial instrument executed in the Union and carried out on any EU trading venue or OTC.

Table 9: Thresholds for non-equity financial instruments

		Bonds	SFP	Derivatives	Emission allowances
Frequent and systematic basis threshold (liquid instruments)	Number of transactions executed by the investment firm on own account OTC / total number of transaction in the same financial instrument in the EU	2 to 3% and at least once a week	3 to 5% and at least once a week	2 to 3% and at least once a week	3 to 5% and at least once a week
Frequent and systematic basis threshold (illiquid instruments)	Minimum trading frequency	at least once a week	at least once a week	at least once a week	at least once a week
Substantial basis threshold Criteria 1	Size of OTC trading by investment firm in a financial instrument on own account / total volume in the same financial instrument executed by the investment firm	25%	30%	25%	30%
Substantial basis threshold Criteria 2	Size of OTC trading by investment firm in a financial instrument on own account / total volume in the same financial instrument in the European Union	0.5 to 1.5%	1.5 to 3%	0.5 to 1.5%	1.5 to 3%

Technical advice

Shares, depositary receipts, ETFs, certificates and other similar financial instruments

1. An investment firm shall be treated as a systematic internaliser in respect of each share, depositary receipt, ETF, certificate and other similar financial instrument if it meets the following criteria:

Frequent and Systematic

i. The investment firm internalises on a frequent and systematic basis if the number of OTC transactions executed by the investment firm on own account when executing client orders in liquid instruments is, during the last six months equal or larger than 0.4% of the total number of transactions in the relevant financial instrument in the Union executed on any trading venue or OTC during the same period. At a minimum the investment firm shall deal on own account in such instrument on average on a daily basis to be considered as meeting the frequent and systematic basis criteria.

For shares, depositary receipts, ETFs, certificates and other similar financial instruments for which there is not a liquid market as determined in accordance with Article 2(1)(17)(b) of MiFIR the condition is deemed to be met when the investment firm deals on own account OTC in the same financial instrument on average on a daily basis during the last six months.

Substantial Basis

ii. The investment firm internalises on a substantial basis if the size of OTC trading carried out by the investment firm on own account when executing client orders is, during the last six months, equal or larger than either:

a. 15% of the total turnover in that financial instrument executed by the investment firm

on own account or on behalf of clients and carried out on any trading venue or OTC; or

b. 0.4% of the total turnover in that financial instrument executed in the European Union and carried out on any EU trading venue or OTC.

2. The investment firm shall assess whether it meets the conditions (i) and (ii) above on a quarterly basis based on data from the last six months. These assessments shall be performed on the first working day of the months of January, April, July and October. Newly issued instruments shall only be considered when historical data covers a period of at least three months.

3. When the conditions (i) and (ii) above are both met, the investment firm shall comply within two months with all requirements set in Articles 13, 14, 15 and 16 of MiFIR.

4. When setting the numerical thresholds to be used to assess the frequent, systematic and substantial basis, ESMA advises the European Commission to clarify and, where appropriate, take into consideration the interlinks that might exist between the systematic internaliser regime and the trading obligation for shares as defined under Article 23 of MiFIR.

<u>*Bonds*</u>

5. An investment firm shall be treated as a systematic internaliser if it meets the following criteria:

Frequent and Systematic

i. The investment firm internalises on a frequent and systematic basis if the number of transactions executed by the investment firm on own account OTC in liquid instruments is, during the last six months, equal or larger than 2 to 3% of the total number of transactions in the relevant financial instrument in the European Union executed on any trading venue or OTC during the same period. At a minimum the investment firm shall deal on own account in such instrument on average once a week to be considered as meeting the frequent and systematic basis criteria.

For instruments for which there is not a liquid market the condition is deemed to be met when the investment firm dealt on own account OTC in the same financial instrument on average once a week during the last six months.

Substantial Basis

ii. The investment firm internalises on a substantial basis if the size of OTC trading carried out by the investment firm on own account, during the last six months, is equal or larger than either:

a. 25% of the total nominal amount traded in that financial instrument executed by the

investment firm on own account or on behalf of clients and carried out on any trading venue or OTC; or

b. 0.5 to 1.5% of the total nominal amount traded in that financial instrument executed in the Union and carried out on any EU trading venue or OTC.

6. The investment firm shall assess whether it meets the conditions (i) and (ii) above on a quarterly basis based on data from the last six months. These assessments shall be performed on the first working day of the months of January, April, July and October). Newly issued instruments shall only be considered when historical data covers a period of at least six weeks.

7. When the conditions (i) and (ii) above are both met, the investment firm shall comply within two months with all requirements related to systematic internalisation and in particular Article 18 of MiFIR.

Structured Finance Products

8. An investment firm shall be treated as a systematic internaliser if it meets the following criteria:

Frequent and Systematic

i. The investment firm internalises on a frequent and systematic basis if the number of transactions executed by the investment firm on own account OTC in liquid instruments, during the last six months, is equal or larger than 3 to 5% of the total number of transactions in the relevant financial instrument in the European Union executed on any trading venue or OTC during the same period. At a minimum the investment firm shall deal on own account in such instrument on average once a week to be considered as meeting the frequent and systematic basis criteria.

For instruments for which there is not a liquid market the condition is deemed to be met when the investment firm dealt on own account OTC in the same financial instrument on average once a week during the last six months.

Substantial Basis

ii. The investment firm internalises on a substantial basis if the size of OTC trading carried out by the investment firm on own account, during the last six months, is equal or larger than either:

a. 30% of the total nominal amount traded in that financial instrument executed by the investment firm on own account or on behalf of clients and carried out on any trading venue or OTC; or

b. 1.5 to 3% of the total nominal amount traded in that financial instrument executed in

the Union and carried out on any EU trading venue or OTC.

9. The investment firm shall assess whether it meets the conditions (i) and (ii) above on a quarterly basis based on data from the last six months. These assessments shall be performed on the first working day of the months of January, April, July and October). Newly issued instruments shall only be considered when historical data covers a period of at least six weeks.

10. When the conditions (i) and (ii) above are both met, the investment firm shall comply within two months with all requirements related to systematic internalisation and in particular Article 18 of MiFIR.

Derivatives

11. An investment firm shall be treated as a systematic internaliser if it meets the following criteria for the:

Frequent and Systematic

i. The investment firm internalises on a frequent and systematic basis if the number of transactions executed by the investment firm on own account OTC in a specific class of derivatives, during the last six months, is equal or larger than 2 to 3% of the total number of transactions in the relevant class of derivatives in the European Union executed on any trading venue or OTC during the same period. At a minimum the investment firm shall deal on own account in such class of derivatives on average once a week to be considered as meeting the frequent and systematic basis criteria.

   For classes of derivatives for which there is not a liquid market the condition is deemed to be met when the investment firm dealt on own account OTC in the same class of derivatives on average once a week during the last six months.

Substantial Basis

ii. The investment firm internalises on a substantial basis if the size of OTC trading carried out by the investment firm on own account is, during the last six months, equal or larger than either:

   a. 25% of the total notional amount traded in that financial instrument executed by the investment firm on own account or on behalf of clients and carried out on any trading venue or OTC; or

   b. 0.5 to 1.5% of the total notional amount traded in that financial instrument executed in the Union and carried out on any EU trading venue or OTC.

12. The investment firm shall assess whether it meets the conditions (i) and (ii) above on a quarterly basis based on data from the last six months. These assessments shall be per-

formed on the first working day of the months of January, April, July and October). Newly issued instruments shall only be considered when historical data covers a period of at least six weeks.

13. When the conditions (i) and (ii) above are both met, the investment firm shall comply within two months with all requirements related to systematic internalisation and in particular Article 18 of MiFIR.

Emission allowances

14. An investment firm shall be treated as a systematic internaliser if it meets the following criteria:

Frequent and Systematic

i. The investment firm internalises on a frequent and systematic basis if the number of transactions executed by the investment firm on own account OTC in liquid emission allowances, during the last six months, is equal or larger than 3 to 5% of the total number of transactions in the relevant type of emission allowances in the Union executed on any trading venue or OTC during the same period. At a minimum the investment firm shall deal on own account in this type of emission allowances on average once a week to be considered as meeting the frequent and systematic basis criteria.

   For instruments for which there is not a liquid market the condition is deemed to be met when the investment firm dealt on own account OTC in the same type of emission allowances on average once a week during the last six months.

Substantial Basis

ii. The investment firm internalises on a substantial basis if the size of OTC trading carried out by the investment firm on own account, during the last six months, is equal or larger than either:

   a. 30% of the total nominal amount traded in that type of emission allowances executed by the investment firm on own account or on behalf of clients and carried out on any trading venue or OTC; or

   b. 1.5 to 3% of the total nominal amount traded in that type of emission allowances executed in the Union and carried out on any EU trading venue or OTC.

15. The investment firm shall assess whether it meets the conditions (i) and (ii) above on a quarterly basis based on data from the last six months. These assessments shall be performed on the first working day of the months of January, April, July and October).

16. When the conditions (i) and (ii) above are both met, the investment firm shall comply within two months with all requirements related to systematic internalisation and in particular Arti-

cle 18 of MiFIR.

Annex 3.3.1.: Data analysis on systematic internalisation

This data analysis is based on a data gathering conducted by the consortium working for ESMA in the context of the MiFID II, Level 2 cost-benefit-analysis. Anonymised data was received from a sample of European firms to illustrate the current internalisation activity during the calendar year from 1 July 2013 to 30 June 2014 for bonds and during the quarter April to June 2014 for equities. The relevant findings are produced on an aggregated level in the tables below: Generally speaking, the levels of internalisation are at a higher level in the tables compared to the thresholds proposed by ESMA. The reason for this is that the firms in the sample, being mostly large ones, are expected to have a higher level of internalisation compared to the European average.

Table 1: Shares

									Frequent & Systematic Threshold		*Substantial Firm Threshold*	*Substantial Market Threshold*
	Num of shares	How many shares have at least 1 SI (*)?	On average for how many shares one firm internalises?	Num of combination of shares and firms (**)	How many SI (***)?	How many firms internalise on average for each share (****)?	The minimum and maximum number of firms that do internalise (*****)	Maximum number of firms that qualify as SI for the same share (*****)	Average of [trades own account/ trades at EU level] ratio	Average of daily trading frequency ratio (number of trades /252)	Average of the [turnover own account/ turnover at firm level] ratio	Average of the [turnover own account/ turnover at EU level] ratio
THRESHOLDS =>									0.4% for liquid but not applicable for illiquid	on average once a day	15%	0.40%
Liquid	150	124	51	1,800	280	5	min - max 10	max 4	1.15%	31.21	23.63%	0.9257%
Illiquid	150	-	56	1,800	-	6	min - max 9	max -	0.15%	0.11	8.15%	0.0001%

(*) Explanatory example: for the class of liquid shares 124 shares out of 150 have at least 1 SI

(**) This is the number of shares multiplied by the number of firms that provided the data (i.e. 12)

(***) Explanatory example: for the class of liquid shares the value 280 represents the number of SI out of those 1800 combinations (1800 is given by the number of liquid shares, i.e. 150 multiplied by the number of firms that provided data for those ISINs (i.e. 12)). In other words these 280 SI can be, among other combinations, the result of (example#1) one firm qualifying as SI in all the different 150 liquid shares and another firm qualifying as SI for 130 out of 150 liquid shares or, (example#2) 12 firms qualifying as SI in 23 or 24 different shares each

(****) This number represents the average number of SI for liquid or illiquid shares

(******) Explanatory example: liquid shares have a maximum of 10 firms that internalise the same share. However, for each share having firms that internalise a maximum of 4 firms qualify as SI. Example#1: in the case of a share having 3 firms internalising, either 0 or 1 or 2 or 3 firms qualify as SI. Example#2: in the case of a share having 7 firms internalising, either 0 or 1 or 2 or 3 or 4 firms qualify as SI

Table 2: Corporate and Sovereign bonds

	Trading frequency of the bond	Num of bonds	How many bonds have at least 1 SI (*)?	Num of combination of bonds and firms (**)	How many SI (***)?	How many firms internalise on average for each bond (****)?	The minimum and maximum number of firms that do internalise (*****)				Maximum number of firms that qualify as SI for the same bond (*****)		Frequent & Systematic Threshold		Substantial Firm's Business Threshold	Substantial Market Threshold	
													Average of [trades own account/ trades at EU level] ratio	Average of weekly trading frequency ratio (number of trades /52)	Average of the [turnover own account/ turnover at firm level] ratio	Average of the [turnover own account/ turnover at EU level] ratio	
THRESHOLDS =>													2-3%	on average once a week	25%	0.5-1.5%	
Sovereign	less than once a week	50	-	500	-	3	min	-	max	5	max	-	9.5%	0.14	71%	11.7%	illiquid bonds
Sovereign	once a week	50	12	500	13	5	min	1	max	9	max	2	3.6%	0.26	62%	6.1%	
Sovereign	once a day	50	16	500	19	5	min	1	max	9	max	2	3.4%	0.48	61%	6.2%	
Sovereign	between 2 and 4 times a day	100	64	1,000	105	7	min	2	max	9	max	4	2.7%	0.83	55%	5.2%	liquid bonds
Sovereign	more than 5 times a day	100	62	1,000	88	8	min	6	max	9	max	3	1.1%	4.34	49%	2.6%	
Corporate	less than once a week	50	4	500	4	3	min	-	max	6	max	1	10.6%	0.16	78%	11.4%	illiquid bonds
Corporate	once a week	50	8	500	10	4	min	-	max	8	max	2	4.0%	0.30	61%	6.8%	
Corporate	once a day	50	14	500	18	6	min	-	max	8	max	2	2.0%	0.29	53%	4.3%	
Corporate	between 2 and 4 times a day	100	70	1,000	133	6	min	1	max	9	max	6	1.8%	0.62	51%	3.7%	liquid bonds
Corporate	more than 5 times a day	100	77	1,000	161	7	min	2	max	9	max	5	1.4%	1.21	47%	3.7%	

(*) Explanatory example: for the class of sovereign bonds trading once a week, 12 bonds out of 50 have at least 1 SI

(**) The number of bonds multiplied by the number of firms that provided the data (i.e.10)

(***) Explanatory example: for the class of sovereign bonds trading once a week the value 13 represents the number of SI out of those 500 combinations. In other words these 13 SI can be, among other combinations, the result of the same firm that qualifies as SI in 10 different bonds and 3 different firms qualifying as SI in 3 different bonds or also 1 firm that qualifies as SI in 13 different bonds

(****) This number represents the average number of SI for the bonds in a particular class

(*****) Explanatory example: for the class of sovereign bonds trading once a week, each bond belonging to this class has at least 1 firm and a maximum of 9 firms that internalise. However, for each bond having firms that internalise a maximum of 2 firms qualify as SI. Example#1 for a bond 1 firm internalises, but either 0 or 1 firm qualify as SI. Example#2 for a bond 2 firms internalise, but either 0 or 1 or 2 firms qualify as SI. Example#3 for a bond 5 firms internalise, but either 0 or 1 or 2 firms qualify as SI. Example#4 for a bond 9 firms internalise, but either 0 or 1 or 2 firms qualify as SI

3.4. Transactions in several securities and orders subject to conditions other than the current market price

Background/Mandate

Extract from the Commission's request for technical advice (mandate)

ESMA is invited to provide technical advice to develop the criteria specifying those transactions where execution in several securities is part of one transaction or those orders that are subject to conditions other than current market price as referred to in Article 15(3) of MiFIR. ESMA should take account of the criteria set out in Article 25(1) of the Commission Regulation (EC) No 1287/2006, taking into account the need to extend these criteria to equity instruments other than shares and any need to develop these standards in light of market and technological developments.

Analysis following feedback from stakeholders

1. Article 15(2) of MiFIR requires a systematic internaliser to execute transactions in relation to shares, depositary receipts, exchange-traded-funds, certificates and other similar financial instruments, at the quoted prices at the time of the reception of the order. The requirement seeks to ensure that those prices provide meaningful information to clients and to the wider market by being firm up to the attached size.

2. However Article 15(3) of MiFIR allows systematic internalisers to execute orders they receive from their professional clients at prices different to the quoted ones without having to comply with the requirements established in Article 15(2) of MiFIR in respect of:

   i. transactions where execution in several securities is part of one transaction; or

   ii. orders that are subject to conditions other than the current market price.

3. The rationale of the provision is to allow certain transactions to be carried out on the systems provided by the systematic internaliser without having to comply with price restrictions, which would be impractical or unfeasible given the nature of those transactions.

4. With regard to when execution in several securities can be considered part of one transaction, ESMA notes that under MiFID I the implementing regulation 1287/2006 defines a portfolio trade for the purposes of the systematic internaliser regime as a trans-

action in 10 or more securities where those securities are traded as a single lot against a specific reference price.[50]

5. With regard to orders subject to conditions other than the current market price, ESMA notes that Regulation 1287/2006 considers any order which is neither an order for the execution of a transaction in shares at the prevailing market price, nor a limit order as an order subject to conditions other than current market price.[51]

6. In addition, it is relevant to note that under Articles 3(1) and 3(2) of the implementing regulation, portfolio trades and volume weighted average price transactions are considered, for the purpose of the negotiated trade waiver, transactions subject to conditions other than the current market price.

7. The definition of portfolio trade and of orders subject to conditions other than the current market price proposed by ESMA in the consultation paper were broadly based on the current MiFID I summarised above which are only relevant for shares admitted to trading on a regulated markets.

8. The majority of the responses to the consultation paper were generally in favour of the definitions proposed by ESMA. However many respondents in favour of the proposed definitions suggested that those definitions should be sufficiently flexible to accommodate the evolution of new types of orders and that the list of orders subject to conditions other than the current market price should be updated on an ongoing basis to ensure it remains in line with market developments.

9. ESMA appreciates the importance of establishing a regulatory framework that remains appropriate as markets evolve. However, by being exemptions to the general requirement that systematic internalisers execute transactions with clients at the quoted price, ESMA is of the view that definitions should be sufficiently precise to provide legal clarity to market participants and seek to ensure that quoted prices are informative to clients and the wider public. In ESMA's view, the definitions proposed in this technical advice strike the proper balance between legal clarity and flexibility.

10. Some respondents noted that the definition of portfolio trade proposed in the consultation paper could potentially allow systematic internalisers to improperly aggregate orders that could be executed separately only for the purpose of circumventing the transparency requirement. Separately, other respondents noted that the requirement to execute a transaction in at least 10 financial instruments is too restrictive.

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[50] See Article 2(6) and Article 25(1) of Regulation 1287/2006.
[51] See Article 25(1) of Regulation 1287/2006.

11. ESMA sees merits in further clarifying that the aggregation of trades in a portfolio trade can only occur if the order for execution in several financial instruments is received from the systematic internaliser at the same time and from the same client. However ESMA is of the view that no other conditions should be imposed on portfolio trades (such as that the components of the trade should not be capable to independent execution because, for example, they are part of a trading strategy). In ESMA's view the exemption from pre-trade transparency requirements for portfolio trades is meant to incentivise systematic internaliser to provide liquidity to clients by allowing them to trade at prices different from the quoted ones. An excessively narrow definition of portfolio trade may result in the unintended consequence of systematic internalisers avoiding altogether execution with clients at the quoted prices as permitted under the circumstances of Article 17(2) of MiFIR. As regard to the number of financial instruments, ESMA is of the view that 10 should remain the minimum number to qualify for a portfolio trade.

12. With respect to orders subject to conditions other than the current market price a number of respondents questioned the inclusion of securities financing transaction in the list on the basis that those transactions should not be within the transparency regime altogether. ESMA agrees that transactions where a transfer of ownership between two counterparties occurs in the context of a repo transaction or the borrowing/lending of a financial instrument shall not be considered as transactions providing information as to level of trading interest in a financial instrument. For that reason and in line with MiFID I, ESMA understands that securities financing transactions will continue to be excluded from the scope of the transparency requirements.

13. Some respondents questioned whether orders for execution at the Time-Weighted Average Price (TWAP) and Volume-Weighted Average Price (VWAP) are in fact orders subject to conditions other than the current market price given that the price at which those transactions are executed is derived from a pre-defined combination of current market prices. ESMA notes that the existence of a market price is not relevant in order to determine whether a specific order is subject to other conditions. In the specific circumstance of TWAP and VWAP, the execution price is almost always different from the prevailing price at the time of execution.

14. Finally, ESMA sees merits in revising the wording under limb (iii) as drafted in the consultation paper which, according to a couple of respondents, may not be sufficiently clear and precise to prevent circumvention of the general obligation to execute transaction at the quoted price. The revised technical advice clarifies that an order is subject to conditions other than the current market price when it is neither a market nor a limit order but it is contingent to technical conditions that are unrelated to the current market valuation of that financial instrument. Finally ESMA added item (iii) to the list to clarify the stock contingent transactions, where an order for execution in a security is contingent on the execution of a related derivative contract shall be considered as subject to conditions other than the current market price.

Technical advice

1. Execution in several securities shall be regarded as part of one transaction if that one transaction is a portfolio trade that involves an order for execution of 10 or more financial instruments from the same client and at the same time and the single components of the trade are meant to be executed only as a single lot. An order for the execution of several securities in a portfolio trade shall also be considered as subject to conditions other than the current market price.

2. An order shall be considered subject to conditions other than the current market price when:

   i. the price is calculated over multiple time instances according to a given benchmark, including volume-weighted and time-weighted average prices;

   ii. it is contingent on the execution of a related derivative contract with the same client; or

   iii. it is neither a market order nor a limit order but it is contingent on technical characteristics of the transaction which are unrelated to the current market valuation of that financial instrument.

3.5. Exceptional market circumstances and conditions for updating quotes

Background/Mandate

Extract from the Commission's request for technical advice (mandate)

ESMA is invited to provide technical advice to develop the criteria specifying what can be considered as exceptional market conditions that allow for the withdrawal of quotes as well as the conditions for updating quotes as referred to in Article 15(1).

Analysis following feedback from stakeholders

1. Article 15(1) of MiFIR allows systematic internalisers to temporarily withdraw their quotes under exceptional market conditions. ESMA understands that the rationale of the provision is to protect systematic internalisers from being exposed to excessive risk as a result of the obligation to make available to clients firm quotes on a continuous basis. Requiring systematic internalisers to comply with the above obligation during disorderly market conditions would jeopardise the prudential stability of the investment firm and likely result in uninformative quotes.

2. ESMA consulted on a non-exhaustive list of circumstances which could be considered exceptional. The purpose of having a non-exhaustive list of exceptional market circumstances is to balance the need of legal certainty (and facilitate investment firms' compliance) with the need to establish a regulatory framework capable of coping with unforeseen events.

3. With regard to the conditions for updating the quotes, ESMA's proposal clarified that systematic internalisers should be allowed to update their quotes at any time provided that their quoting behaviour reflects genuine trading intensions and is not discriminatory against clients. The proposal further clarified that systematic internalisers should be allowed to update their quotes as market-wide or instrument-specific circumstances change or following any transaction executed with a client.

4. Respondents to the consultation paper raised some relevant issues with the proposed advice. With respect to the criteria specifying exceptional market conditions many respondents argued in favour of including in the list circumstances when a financial instrument is in the auction phase in the relevant market. ESMA appreciates that during call auctions systematic internalisers may face greater uncertainty or risk. However ESMA believes that call auctions should not be considered as exceptional market conditions given the regularity and predictability of those events. Besides ESMA notes that MiFIR provides some mitigating factors to the risks of making available to clients firm quotes during a call auction. During a call auction it is reasonable to expect that the quotes provided by systematic internalisers would reflect (in line with the requirement

that systematic internalisers' quote shall reflect prevailing market conditions) the circumstance that the relevant financial instrument is not traded on a continuous basis and that two way prices are unlikely to be available on other trading venues. Besides ESMA notes that the quoting obligation for systematic internalisers only applies during normal trading hours and therefore investment firms may want to restrict the trading activity in their capacity as systematic internalisers only to periods when the financial instrument is traded on a continuous basis.

5. ESMA notes that Article 32 of MiFID II provides that where a financial instrument is suspended or removed from trading by a trading venue or a competent authority, the competent authority in whose jurisdiction the suspension or removal originated, or any other notified competent authority shall also apply the suspension or removal to regulated markets, MTFs and systematic internaliser which fall under their jurisdiction and trade the same financial instrument or related derivatives. ESMA has considered that, since those cases where already covered by Level 1 text, they should not be further developed again within the list of exceptional market circumstances so as to avoid duplication and regulatory overlapping.

6. ESMA has deleted from the list those circumstances where the total number and/or volume of orders exceeds the norm because, in ESMA's view Article 17(2) of MiFIR already provides sufficient protection to systematic internalisers when managing their risk.

7. In regard of the technical advice on the conditions for updating their quotes, some respondents to the consultation paper argued that ESMA's proposal improperly restricted the flexibility granted to systematic internalisers by MiFIR to update their quotes at any time. The ESMA original proposal stressed that systematic internalisers have indeed a great deal of flexibility. The proposal also clarified that any market-wide or instrument-specific event or any change in the firm's exposure following a transaction with a client would allow systematic internalisers to update their quotes. The revised technical advice deletes any reference to specific circumstances in order to avoid any interpretation which may not be consistent with MiFIR. However the advice maintains the principles that the quoting behaviour should be consistent with genuine trading intentions and non-discriminatory treatment of clients.

Technical advice

Technical advice on specifying what can be considered as exceptional market conditions

1. A systematic internaliser should be allowed to withdraw its quotes under exceptional market conditions, which are circumstances where the obligation to provide firm prices to clients would be contrary to the prudent management of the risks the investment firm is exposed to in its capacity as systematic internaliser. Exceptional market circumstances can include when:

i. the trading venue where the financial instrument was first admitted to trading or the most relevant market in terms of liquidity halts trading for that financial instrument in accordance with Article 48 of Directive 2014/65/EU;

ii. the trading venue where the financial instrument was first admitted to trading or the most relevant market in terms of liquidity allows market making obligations to be suspended;

iii. in the case of an exchange traded fund, a reliable market price is not available for a significant number of instruments underlying the ETF or the index; or

iv. a competent authority prohibits short sales in that financial instrument according to Article 20 of the Short Selling Regulation (236/2012);

Technical advice on specifying the conditions for updating quotes

2. A systematic internaliser shall be able to update its quotes at any time provided that the quoted behaviour is consistent with genuine trading intentions and with non-discriminatory treatment of its clients.

3.6. Orders considerably exceeding the norm

Background/Mandate

Extract from the Commission's request for technical advice (mandate)

ESMA is invited to provide technical advice to develop the criteria specifying when the number and/or volume of orders sought by clients considerably exceed the norm as referred to in article 17(2). ESMA should take account of the criteria set out in Article 25(2) and (3) of Commission Regulation (EC) No 1287/2006, taking into account the need to extend these criteria to equity instruments other than shares and any need to develop these standards in light of market and technological developments.

Analysis following feedback from stakeholders

1. By making bid and offer prices available for execution to clients, a systematic internaliser exposes itself to a number of risks, including market, counterparty and settlement risk. ESMA notes that the risk management policy of an investment firm depends on a variety of aspects, including the nature, scale and complexity of the activities undertaken and on the risk appetite of the investment firm itself.

2. For that reason ESMA believes that it is not advisable to rigidly prescribe for all investment firms acting as systematic internalisers the number and/or volume of transactions exceeding the norm. Rather, each investment firm should determine in advance, in an objective and non-discriminatory way and consistently with its risk management policy when the number or volume of orders shall be regarded as considerably exceeding the norm and expose the firm to undue risk.

3. Responses to the consultation paper were in large majority in support of the proposed approach and ESMA is maintaining the original technical advice.

Technical advice

1. The number or volume of orders shall be regarded as considerably exceeding the norm if a systematic internaliser cannot execute those orders without exposing itself to undue risk.

2. All investment firms acting as systematic internalisers shall determine in advance, in an objective way and consistently with its risk management policy when the number or volume of orders shall be regarded as considerably exceeding the norm and expose the firm to undue risk.

3. In order to identify the number and volume of orders that it can execute without expos-

ing itself to undue risk, a systematic internaliser shall maintain and implement as part of its risk management policy a non-discriminatory policy which takes into account the volume of the transactions, the capital that the firm has available to cover the risk for that type of trade, and the prevailing conditions in the market in which the firm is operating.

4. Where an investment firm limits the number or volume of orders it undertakes to execute, it shall set out in writing, and make available to clients and potential clients, the arrangements designed to ensure that such a limitation does not result in a discriminatory treatment of clients.

3.7. Prices falling within a public range close to market conditions

Background/Mandate

Extract from the Commission's request for technical advice (mandate)

ESMA is invited to provide its technical advice the criteria specifying when prices fall within a public range close to market conditions as referred to in Article 15(2) of [MiFIR].

Analysis following feedback from stakeholders

1. Under Article 14(1) of MiFIR, investment firms are required to make public firm quotes for equity and equity-like instrments traded on a trading venue for which they are systematic internaliser and for which there is a liquid market.

2. Article 15(2) of MiFIR requires a systematic internaliser to execute transactions at the quoted prices at the time of the reception of the order. The requirement seeks to ensure that by being firm up to the attached sizes, the quoted prices provide meaningful information to clients and to the wider market with regard to the level of trading interest in a specific financial instrument. However, in justified cases a systematic internaliser can execute a client order at a better price (i.e. buy at a higher price or sell at a lower price than the quoted prices) provided that the price falls within a public range close to market conditions.

3. ESMA notes that Article 14(3) of MiFIR requires that any bid and offer made public by a systematic internaliser in respect of shares, depositary receipts, ETFs, certificates and other similar financial instruments, shall reflect prevailing market conditions, which in ESMA's view means that they are close in price to comparable quotes for the same instrument in other trading venue.

4. In the consultation paper ESMA proposed that any price falling within the bid and ask spread quoted by the systematic internaliser would fall within a public range close to market conditions for that financial instrument and be consistent with meaningful quoting behaviour.

5. While the majority of respondents agreed with the ESMA's proposal, a significant number of market participants were in disagreement with the proposed advice on several grounds. Some argued that the flexibility offered to systematic internalisers to improve prices at their only discretion would not be compatible with the general requirement to provide firm quotes to clients when dealing below standard market size in liquid instruments. Others further stressed that the flexibility afforded to systematic internalisers would not be fair and possibly discriminatory towards clients and to trading venues which, under MiFIR, are subject to certain constrains, such as price conditions and vol-

ume caps, when executing comparable orders under a pre-trade transparency waiver. Those market participants propose, as a way to mitigate the risk of creating an uneven playing field, to require systematic internalisers to trade only at the mid-price of their own quotes.

6. ESMA agrees that the possibility of trading away from the quoted prices is a challenge to the intent of seeking to ensure that systematic internalisers contribute to price formation. ESMA also shares the objective of treating clients fairly and of establishing a level playing field between equivalent execution venues.

7. However ESMA notes that the ability to improve upon the published quotes is granted by MiFIR subject to the "justified cases" requirement, for which there is no empowerment for implementing measures. With respect to the discriminatory treatment of clients ESMA notes that under Article 17(1) of MiFIR systematic internalisers are indeed allowed to decide the clients to whom they give access to their quotes but this flexibility can only be exercised according to clear, objective and non-discriminatory standards. Besides, systematic internalisers are subject, when executing client orders, to best execution obligations and client order handling rules.

8. With regard to the issue of ensuring a level playing field between multilateral venues and systematic internalisers and constraining the price improvement to mid-price, ESMA remains of the view that the wording within a public range close to market conditions includes, but is not restricted to the mid-price between the prices quoted by the systematic internaliser. ESMA is also of the view that restricting the price improvement to mid-price only may prevent systematic internalisers to price transaction according to characteristics of the client such as the counterparty risk and prevent clients from receiving best execution.

Technical advice

1. With respect to the execution of a transaction at a better price than the quoted one, a price falls within a public range close to market conditions when the price is within the bid and offer quotes of the systematic internaliser provided that those quotes reflect prevailing market conditions for that financial instrument.

3.8. Pre-trade transparency for systematic internalisers in non-equity instruments

Background/Mandate

Extract from the Commission's request for technical advice (mandate)

ESMA is invited to provide technical advice on the sizes referred to in Article 18(6) at which a firm shall enter into transactions with any other client to whom the quote is made available. The size specific to the financial instrument shall be determined in accordance with the criteria set in Article 9(5)(d) for financial instruments traded on request-for-quote and voice trading systems. For financial instruments not traded on request-for-quote and voice trading systems ESMA is invited to provide technical advice on whether the same criteria should be used or whether alternative criteria should be developed.

Article 19(2), MiFIR

The Commission shall adopt delegated acts in accordance with Article 50, specifying the sizes referred to in Article 18(6) at which a firm shall enter into transactions with any other client to whom the quote is made available. The size specific to the financial instrument shall be determined in accordance with the criteria set in Article 9(5)(d).

1. The current MiFID I regime for systematic internalisers with regard to pre-trade transparency is restricted to equities only. MiFIR now introduces new pre-trade rules that systematic internalisers trading in bonds, structured finance products, emission allowances and derivatives have to comply with.

2. Article 18 of MiFIR establishes the general rule that systematic internalisers shall make public firm quotes and shall make these quotes available to other clients of theirs if they are prompted for a quote by a client and if they agree to provide such quotes.

3. At the same time MiFIR establishes a number of exemptions or modifications to this general rule affecting the obligation to publish quotes as well as the obligation to make them available to other clients.

4. A systematic internaliser does not have to publish firm quotes under the following circumstances:

    i. if there is no liquid market in an instrument. In this case the quote shall only be disclosed to its clients upon their request in accordance with Article 18(2) of MiFIR; or

    ii. if the internaliser deals in sizes above the size specific to an instrument determined in accordance with Articles 9(5)(d) and 18(10) of MiFIR.

5. A systematic internaliser does not have to make quotes available to and does not have to enter into transactions with other clients if the following conditions are fulfilled:

   i. the number of transactions to be executed in respect of a specific quote exceeds the number established in accordance with Article 18(7) of MiFIR; or

   ii. the quoted size exceeds the size specific to the instrument established in accordance with Article 19(2) of MiFIR.

6. Conversely, Article 18(6), subparagraph 1 means that systematic internalisers have to make quotes available to other clients if the quoted size is at or below a size specific to a financial instrument unless the financial instrument in question drops below the level of liquidity established in accordance with Article 9(4) (temporary suspension of pre-trade transparency obligations).

Analysis following feedback from stakeholders

7. In the consultation paper, ESMA stated that it was considering that the size specific referred to in Article 18(6) needs to be calibrated for all asset classes encompassed by the quoting obligation. In ESMA's view, the end result to ensure legal certainty and practicability therefore needs to be a matrix where each financial instrument is automatically assigned a specific size based on certain parameters and characteristics.

8. Article 19(2) of MiFIR makes reference to the criteria used to determine the size specific to an instrument in Article 9(5)(d) of MiFIR where for certain trading systems (request for quote systems, voice trading systems) pre-trade transparency can be waived if it would expose liquidity providers to undue risk while taking into account whether relevant investors on the market are from the retail or wholesale sector.

9. ESMA noted in the CP that the situation of liquidity providers trading on request for quote and voice trading systems may be similar, although not identical, to that of systematic internalisers. The liquidity provider puts up its own capital in a way broadly comparable to a systematic internaliser. Establishing different sizes for liquidity providers, on the one hand, and systematic internalisers, on the other, would hence put one or both at a competitive disadvantage. Therefore ESMA proposed that the size specific thresholds established for liquidity providers under Article 9(5)(d) shall also apply to systematic internalisers.

10. ESMA explained that, in its view, this would mean in practical terms that the results the Commission comes to when drafting its delegated act for Article 19(2) and the results ESMA comes to when preparing the technical standard in respect of Article 9(5)(d) should not just be determined in accordance with the same criteria, as Article 19(2) requires, but also closely aligned if not identical.

11. In the consultation paper, ESMA sought views from respondents on the similarities ESMA had identified between the risk borne by liquidity providers using actionable indications of interest in request-for-quote and voice trading systems (as referred to in Article 9(1)(b) of MiFIR,) and the risk borne by systematic internalisers when dealing in sizes above the size specific to the instrument. A large majority of respondents agreed with ESMA's views. For those who did not agree, responses were split reasonably evenly between respondents considering that an SI faces less risk than liquidity providers and those having diametrically opposed views (i.e. SIs face more risk than liquidity providers). The former stressed that an SI had information advantage (about identity of their client and their positions) compared to liquidity providers. The latter pointed out that liquidity providers have decided in advance to operate a liquidity provision business and, thus, have organized their business accordingly whereas the systematic internaliser regime is usually not part a strategic decision and does not necessarily imply that the investment firm that would qualify for the first time is operationally ready to comply with all SI requirements and in particular the quoting obligation.

12. With respect to the ESMA proposal to align size specific thresholds established for liquidity providers under Article 9(5)(d) with size specific thresholds for systematic internalisers under Article 18(6), respondents to the consultation expressed broad support and welcomed in particular the simplicity and consistency of the approach. Hence, given the responses received, ESMA has decided to maintain its original proposal and advises the Commission to align, as much as possible, the size specific to the instrument for the purpose of Article 19(2) with the size specific to the instrument of Article 9(5)(b)

13. To this end, ESMA refers to its regulatory technical standard in respect of Article 9(5)(d) and undertakes to cooperate closely with the Commission in particular on this issue to ensure that despite the different legal procedures of delegated act and RTS the outcome should be closely aligned in order not to create an unlevel playing field.

14. This approach should cover all financial instruments caught by Article 9(5)(d) which are those traded on request for quotes and voice trading systems. The future Commission delegated act could simply incorporate the thresholds set through the ESMA technical standard in respect of Article 9(5)(d) MiFIR by reference. Therefore, the Commission delegated act would only have to establish new sizes specific in case the technical standard in respect of Article 9(5)(d) would not cover certain instruments due to them never being traded on the respective systems.

Technical advice

1. ESMA recommends the European Commission to establish the size specific to the instrument for the purposes of Article 19(2) of MiFIR in close cooperation and closely aligned with ESMA establishing the size specific to the instrument for the purposes of Article 9(5)(d) of MiFIR.

2. For instruments traded on request for quote or voice trading systems, ESMA advises the Commission to establish, in its Delegated Act, the size specific to the instrument by reference to the ESMA technical standard establishing the size specific to the instrument for the purposes of Article 9(5)(d) of MiFIR.

3. For instruments not traded on request for quote or voice trading systems for which no size specific is established under the ESMA technical standard in respect of Article 9(5)(d) of MiFIR, ESMA advises the Commission to establish sizes specific by using the same methodology as applied in the ESMA technical standard in respect of Article 9(5)(d) of MiFIR.

4. Data publication

4.1. Access to systematic internalisers' quotes

Background/Mandate

Extract from the Commission's request for advice (mandate)

ESMA is invited to provide technical advice to develop […] the criteria specifying when a quote is published on a regular and continuous basis and is easily accessible as referred to in Article 15(1), as well as the means by which investment firms may comply with their obligation to make public their quotes, which shall include the following possibilities:

i. through the facilities of any regulated market which has admitted the financial instrument in question to trading;

ii. through an APA;

iii. through proprietary arrangements.

1. MiFIR establishes pre-trade transparency requirements for trading venues and for systematic internalisers (SIs), which may differ depending on the type of instrument (acting as SI for equity and equity-like does not subject investment firms to the same requirements as for non-equity instruments).

2. Article 14 of MiFIR obliges SIs to make public quotes for equity and equity-like instruments traded on a trading venue for which there is a liquid market. Where there is not a liquid market, SIs shall disclose quotes to their clients upon request. It is important to note that MiFIR differentiates here between concepts: making information public and disclosing information to clients.

3. ESMA has to determine "*the criteria specifying when a quote is published on a regular and continuous basis and is easily accessible as referred to in Article 15(1) as well as the means by which investment firms may comply with their obligation to make public their quotes*".

4. Article 27(3) of MiFID I establishes that SIs should make public their quotes on a regular and continuous basis during normal trading hours. So as to ensure that this obligation was accomplished, Article 27(4) imposed on NCAs the obligation to check that investment firms regularly updated bid and/or offer prices published and maintained prices reflecting prevailing market conditions.

5. The pre-trade transparency obligations for SIs were further clarified in Articles 21 to 24 of the MiFID I Implementing Regulation and "*normal trading hours*" were defined in Article 2(5) of the same regulation.

6. ESMA is developing RTS under Article 14(7) of MiFIR specifying the arrangements for the publication of a firm quote, as well as other matters and notes the need to ensure consistency between those implementing measures and the ones adopted under Article 17 of MiFIR (Access to quotes).

Analysis following feedback from stakeholders

7. ESMA has not been informed of any problems in relation to the Articles of the MiFID I framework mentioned above. Therefore, it proposed in the CP to maintain the existing regulatory approach in this regard.

Publication on a regular basis

8. With respect to the definition of "regular and continuous" so that quotes are available at all times during normal trading hours, the vast majority of respondents supported the proposed definition. The main objections received to the proposal were:

   i. ESMA should align the quoting obligations for SIs with market making obligations where the presence time does not reach 100 % of the time and may withdraw from the market when "exceptional circumstances" arise.

   ii. One of the respondents disagreed with the approach proposed by ESMA, on the grounds that the interpretation of "regular and continuous" would be incompatible with making the quotes available at all times.

9. ESMA notes that the obligation to be present on a regular and continuous basis, i.e. at all times, during "normal trading hours" unless "exceptional circumstances arise" comes from Article 15 MiFIR. Furthermore, the obligations in Article 15 MiFIR apply to shares, depositary receipts, ETFs, certificates and other similar financial instruments.

10. On the basis of the responses received, ESMA is keeping the advice presented in the CP.

Normal trading hours

11. Approximately half of the responses (mostly buy-side) supported aligning the concept of "normal trading hours" with that of the main regulated market for that instrument in the relevant Member State. The rest of the responses supported the SIs being free to determine their "normal trading hours". In particular, one respondent agreed with awarding firms trading OTC the freedom to determine their own "normal trading hours", pointing out however that SIs using external publication arrangements, cannot force an extension of the operating hours of their respective providers.

12. The determination of "normal trading hours" is heavily dependent on the means to publish SIs' quotes. An alignment of the "normal trading hours" of SIs with any other institu-

tion (such as trading venues or data reporting services) would only be justified in those cases where the publication of the quotes should be made through those other institutions.

Technical advice

1. ESMA recommends considering the publication of a quote as "*regular and continuous*" if it is available at all times during normal trading hours unless "*exceptional market conditions*" (MiFIR Article 15(1)) arise.

2. "*Normal trading hours*" for a systematic internaliser should be considered as those hours which the systematic internaliser establishes in advance and makes public as its trading hours.

Means to publish SIs' quotes

13. The obligation of SIs to make public their quotes on a regular and continuous basis during normal trading hours (Article 15 of MiFIR) is further developed by Article 17 of MiFIR with a two-fold purpose: ensuring the efficient valuation of shares, depositary receipts, ETFs, certificates and other similar financial instruments and maximising the possibility of investment firms to obtain the best deal for their clients.

14. Disclosure of firm (i.e. executable) quotes has to ensure that trading carried out OTC does not jeopardise efficient price discovery or a transparent level-playing field between means of trading (Recital 18 of MiFIR). As a consequence, it is critical to ensure that quotes published by investment firms are consistent across all the publication arrangements, i.e. that market participants do not receive different information depending on the means used to publish the quote.

15. On this basis and in line with Article 17(3)(a) of MiFIR, ESMA presented a proposal based on the publication by SIs of their quotes either on their own website, through the arrangements of the trading venue where the instrument was effectively traded or through a data reporting services provider (DRSP) located in the EU.

16. Buy side and banks agreed with the proposal. Trading venues and data vendors were opposed to allowing SIs to publish their quotes only through proprietary arrangements for a number of reasons. From those reasons, ESMA notes in particular, the difficulties in pulling out and consolidating the data, which could lead to the same lack of consolidation that happened under MiFID I.

17. A few respondents noted that the obligation for an SI to publish its quotes through the trading venue's arrangements where it acts as market maker would not be justified, disagreed with limiting the concept of "proprietary arrangements" to the firm's website and considered it necessary to time stamp the quotes.

18. It should be kept in mind that MiFID II requires consolidation only in relation to post-trade transparency under Articles 65 and 66 of MiFID II. However, having the broader policy objective of MiFID II to foster transparency in mind, publication through centralised arrangements should be encouraged so as to facilitate the widest possible view of the liquidity available in the market.

19. ESMA maintains its original advice in this respect. MiFIR allows for different means for publishing quotes without giving any indication that various publication means have to be used at the same time. ESMA therefore considers that it is not possible to impose the use of more than one publication means.

20. Regarding the question on whether an SI should identify itself when publishing its quotes through a trading venue or DRSP, most respondents agreed with the proposed advice of mandating such identification.

21. A minority of respondents (from the sell side) objected to this obligation or considered that it should not be mandatory.

22. On that basis, ESMA considers that the publication of the identity of the SI is necessary where the SI has decided to publish its quotes through external publication arrangements. Otherwise, the publication of such quotes may create confusion in the market, as it would be necessary to monitor all of the SIs' websites to identify which one is offering those quotes.

23. With respect to whether there is any other means of communication that should be considered by ESMA, the vast majority of responses agreed with the means originally identified. One trading venue suggested that there should be a public centralised point to identify the arrangements used by SIs to publish their quotes. A data vendor suggested preserving the current market practice of investment firms publishing quotes through data vendors whilst another respondent proposed to add publication by phone.

24. ESMA maintains the original advice in this respect.

25. Regarding the question on the consistency of quotes published across publication arrangements, there was unanimous support for ESMA's proposal in the responses received. However, several respondents noted the different latency inherent in the publication through proprietary and non-proprietary arrangements (for instance, one respondent noted that there would be a microsecond difference between the publication on its own website and through DRSPs).

26. ESMA maintains its original advice, noting that the responsibility of the SI is to deliver the data at the same time to all the publication arrangements it uses.

27. The compulsory use of data standards, formats and technical arrangements, was unanimously supported by the received answers.

28. Regarding implementation issues, many respondents requested that those standards should be comprehensibly adopted, consistently applied and cost effectively administered. One trading venue promoted, in this respect, the MMT initiative.[52] A data vendor requested that market participants should be able to use the standards currently used.

29. On the basis of the responses received, ESMA maintains its original advice. ESMA notes as well that this advice has to be read in conjunction with its technical advice under Article 16 of MiFID II (in particular paragraph 6 on record keeping obligations) and the draft regulatory technical standards under Articles 64(6) and 65(6) of MiFID II (machine readability) as well as Article 14(7) of MiFIR (publication of firm quotes).

Easily accessible quotes

30. Article 14(1) (first subparagraph) and Article 15(1) of MiFIR prevent SIs on equity and equity-like instruments for which there is a liquid market from limiting the disclosure of their quotes to their clients and require SIs to make such quotes public in an easily accessible way.

31. ESMA considered in its CP that excessive fragmentation of pre-trade transparency may make finding liquidity difficult. On that basis, the sole publication through the investment firm's proprietary arrangements should be subject to more stringent requirements. To that end, ESMA considered that the quote should be published in a machine-readable manner (meeting the same standards and requirements as developed in the draft RTS under Article 64(6) and 65(6) of MiFID II) and also in a way which is easily understandable for humans.

32. The vast majority of respondents were supportive of imposing that the publication is both in a "machine-readable" and a "human-readable" format if investment firms are publishing their quotes only through their own websites.

33. The objections received were based on the time and resource consumption to translate the quotes into a human readable format (in a context where ESMA is requesting time stamping in nanoseconds), the lack of clarity about what "human readable" means and the lack of a justification for that. Other respondents objected to the possibility of SIs publishing quotes through their own websites.

34. On the basis of the responses received, ESMA maintains its original advice with the exception that proprietary arrangements should not be limited to the investment firm's website. However, ESMA suggests that "human readability" would best be achieved via publication on the investment firm's website. ESMA proposes that in those cases where

[52] The Market Model Typology (MMT) Initiative is an industry initiative (exchanges, data vendors and reporting venues) setting standards on trade equity data.

the firm publishes the quote also through a DRSP or a trading venue, publication only in a machine-readable way would suffice.

35. Regarding the identification of when the publication of quotes is easily accessible, most respondents agreed with the proposal, noting that access to the data is not only dependent on the technical arrangements, but also on what should be considered a "reasonable commercial basis" in this context.

36. Some trading venues disagreed with permitting publication only through proprietary arrangements. One of these venues requested that SIs publishing data only through proprietary arrangements should make available upon request and in the same format full historical quote and trade data. Another trading venue agreed with the proposal, but noted that if SIs were permitted to undertake riskless principal trading, the requirements for SIs should be aligned to those imposed on market makers on multilateral trading venues.

37. On the basis of the responses received, ESMA maintains its original proposal. ESMA also notes that "reasonable commercial basis" is addressed separately in this technical advice.[53]

Technical advice

1. ESMA considers a systematic internaliser on shares, depositary receipts, ETFs, certificates and other similar financial instruments has complied with the obligation to make public its quotes when the investment firm has proceeded in any of the following ways:

    i. The quote is published through the facilities of a regulated market or a multilateral trading facility (MTF) as defined by Article 4(1)(21) and (22) of MiFID II where the instrument was effectively traded before the date of submission.

    ii. The quote is made public through a data reporting services provider located in one Member State of the European Union.

    iii. The quote is published through the investment firm's own proprietary arrangements.

2. The systematic internaliser should specify the arrangements through which it publishes its quotes. This information should be disclosed on its website and be kept up to date.

3. ESMA considers that in the cases where the quotes of a systematic internaliser are published through the facilities of a trading venue or through a data reporting services

[53] Please refer to section 4.3 of this TA for the advice on "reasonable commercial basis".

provider, these quotes should include the identity of the systematic internaliser, so that market participants are able to direct their orders to it.

4. Systematic internalisers are responsible for distributing their quotes simultaneously through all the means they utilise so as to ensure that the quotes published through the firm's own proprietary arrangements and those published through a data reporting services provider or a trading venue are consistent and no quotes are out-of-date. Systematic internalisers' quotes (and more generally, pre-trade transparency data) should be published according to harmonised standards and formats, so as to facilitate as much as possible the provision of consolidated information about trading opportunities.[54]

5. The publication of quotes through an investment firm's own proprietary arrangements is 'easily accessible' when it meets the following requirements:

   i. all market participants wishing to access those quotes may access them;

   ii. the quote shall be published in a 'human readable way' (i.e. suitable for average human readers) and also in a 'machine-readable way'.[55]

6. A quote is published in a machine-readable way if it meets the following criteria:

   i. It is in an electronic format designed to be directly and automatically read by a computer and known in advance by the party wishing to access the data;

   ii. It is in a location known in advance by the party wishing to access the data and stored in an IT architecture that enables automatic access;

   iii. It is robust enough to ensure continuity and regularity in the performance of the services provided and ensures adequate access in terms of speed; and

   iv. It can be accessed, read, used and copied by freely and publicly available computer software, the source code of which is openly shared.

7. A quote is published in a human-readable way if it meets the following criteria:

   i. The quote is published in a format understandable to the average human reader; and

   ii. The quote is displayed on a section of the firm's website which can be found follow-

[54] See the technical advice on Article 16 MiFID II.
[55] The definition of "machine-readable" should be aligned with the definition ESMA is currently developing for the RTS under Articles 64(6) and 65(6) MiFID II to ensure overall consistency.

ing clear indications from the homepage.

8. In those cases where the investment firm is publishing simultaneously the quote through a data reporting services provider or a trading venue, publication in a machine-readable way will suffice.

4.2. Publication of unexecuted client limit orders on shares traded on a venue

Background/Mandate

Extract from the Commission's request for advice (mandate)

ESMA is invited to provide technical advice on adaptations and further improvements to the procedures and arrangements which result in the prompt, fair and expeditious execution of client orders and the situations in which or types of transaction for which investment firms may reasonably deviate from prompt execution so as to obtain more favourable terms for clients as well as to the different methods through which an investment firm can be deemed to have met its obligation to disclose not immediately executable client limit orders to the market.

1. In the context of the general obligation for investment firms authorised to execute orders on behalf of clients to "*implement procedures and arrangements which provide for the prompt, fair and expeditious execution of client orders*", Article 28(2) of MiFID II sets out the obligation that "*in the case of a client limit order in respect of shares admitted to trading on a regulated market or traded on a trading venue which are not immediately executed under prevailing market conditions, investment firms are, unless the client expressly instructs otherwise, to take measures to facilitate the earliest possible execution of that order by making public immediately that client limit order in a manner which is easily accessible to other market participants. Member States may decide that investment firms comply with this obligation by transmitting the client limit order to a trading venue*. *Member States shall provide that the competent authorities may waive the obligation to make public a limit order that is large in scale compared with normal market size as determined under Article 4 of MiFIR*". ESMA should define the different methods through which an investment firm can be deemed to have met its obligation to disclose not immediately executable client limit orders to the market.

2. This Article follows the same approach as Article 22(2) of MiFID I, implemented and further developed by Article 31 of the MiFID I Implementing Regulation, which sets out two methods an investment firm can use: "*An investment firm shall be considered to disclose client limit orders that are not immediately executable if it* ***transmits the order to a regulated market or MTF*** *that operates an order book trading system, or* ***ensures that the order is made public and can be easily executed*** *as soon as market conditions allow*".

Analysis following feedback from stakeholders

3. This section does not deal with the first part of the mandate quoted above – which may be found in the section of this paper dedicated to client order-handling rules – but focuses on the second part of the mandate, i.e., "the different methods through which an investment firm can be deemed to have met its obligation to disclose not immediately executable client limit orders to the market."

4. ESMA considers that the submission of clients' limit orders to regulated markets and MTFs has adequately fulfilled the existing requirement.

5. ESMA lacks evidence regarding other means to make public this type of pre-trade transparency information under MiFID.

6. ESMA remains sceptical about the other two possible ways that can be envisaged for the facilitation of unexecuted orders under the MiFID II framework: publication through a data reporting services provider (DRSP) and publication through the investment firm's own proprietary arrangements. Proprietary arrangements may not be appropriate given the potential conflicts of interest emerging from the different roles that investment firms play at the same time (e.g. the prioritisation of the investment firm's own venue against more liquid markets) and may therefore not lead to the quickest possible execution of the client's order. DRSPs on the other hand may have the technical ability to publish unexecuted client limit orders in an easily accessible way, but it is not their main business model.

7. However, after a careful reading of the option granted to Member States in Article 28(2)[56] of MiFID II, ESMA considers that this drafting implies that more than one publication method should be possible. ESMA therefore recommends allowing publication also via DRSPs provided that the order can be easily executed as soon as market conditions allow.

8. Regarding whether the publication of unexecuted orders through a data reporting service or through an investment firm's website would effectively facilitate the execution of unexecuted client's limit orders most respondents considered that the only way to ensure execution was the submission of the order to a trading venue. However, a small number of responses considered that publication through the firm's website or a DRSP would effectively facilitate execution.

9. Some respondents noted, in particular, that publication of unexecuted orders without submission to a venue might have a negative impact on the client and one of them considered the approach inconsistent with Level 1. Another respondent proposed leaving this to the discretion of the firm. Finally, one contributor suggested that unexecuted orders should not be published in any case, even if the order has been submitted to a trading venue for execution.

10. Some comments noted that the original ESMA proposal contained a reference to OTFs, which in the final version of MiFID (Article 4(1)(23)) trade only bonds, structured finance products, emission allowances or derivatives. ESMA agrees that the scope of Article

[56] "Member States may decide that investment firms comply with that obligation by transmitting the client limit order to a trading venue".

28(2) of MiFID II is shares admitted to trading on a regulated market or traded on a trading venue. As a consequence, the references to OTFs have been eliminated.

11. This topic elicits the following considerations:

12. Firstly, the transmission of an unexecuted order to a regulated market or MTF means that the order becomes subject to regular pre-trade transparency.

13. Secondly, even though ESMA agrees with the point made by some respondents that publication of unexecuted orders by other means may not be as effective as sending the orders to a trading venue for the purposes of facilitating the earliest possible execution, the text of Article 28(2) of MiFID II suggests that there should be several means of publication, as it leaves Member States the discretion to decide whether investment firms have complied with this requirement only by submitting the order to a trading venue.

14. Finally, the experience accrued under the MiFID I Implementing Regulation and the fact that the main aim of this provision is to achieve the quickest possible execution of the clients' order leads ESMA to the conclusion that the best possible way to achieve the execution of the client limit orders is to ensure their interaction in a multilateral environment, in the terms described in our original advice.

15. As a consequence, ESMA considers that it should be considered that an investment firm has met its obligation under Article 28(2) of MiFID II when the order has been submitted to a regulated market or a multilateral trading facility (MTF) *for execution*. In addition, publication via a DRSP may be considered as meeting the requirements under Article 28(2) of MiFID II, if the order can be easily executed as soon as market conditions allow, for the reasons mentioned above.

16. ESMA also remains of the view that submission of an unexecuted order to a trading venue should be reflected in the investment firm's best execution policy.

17. Investment firms may play different roles at the same time that may give rise to potential conflicts of interest. In the case of execution of a client's orders, the main problem that regulators may envisage is the prioritisation of the investment firm's own venue or a venue which is part of the investment firm's group (RM or MTF) against more liquid markets. In these cases, investment firms should remember that they are subject to the obligation to identify and manage potential conflicts of interests as an investment firm (Article 23 of MiFID II).

18. ESMA notes that according to Article 28(2) of MiFID II, where the NCA has waived the pre-trade transparency of orders whose size exceeds the applicable large in scale threshold, the investment firm is not under the requirement to disclose the order.

Technical advice

1. ESMA considers that client limit orders in respect of shares admitted to trading on a regulated market or traded on a trading venue which have not been immediately executed under prevailing market conditions shall be considered as being available to the public when the investment firm has submitted the order *for execution* to a regulated market or a multilateral trading facility (MTF) as defined in Article 4(1)(21) and 4(1)(22) of MiFID II or the order has been published by a data reporting services provider located in one Member State of the European Union and can be easily executed as soon as market conditions allow.

2. Regulated markets and MTFs should be prioritised according to the firm's best execution policy, to ensure execution as soon as market conditions allow.

4.3. Reasonable commercial basis (RCB)

Background/Mandate

1. MiFID II and MiFIR contain a number of references to "*reasonable commercial basis*", and there are five separate powers for the European Commission to clarify what the phrase means through Delegated Acts.[57]

2. The European Commission's 2010 MiFID Review consultation[58] asked for views on "*reasonable commercial basis*", arguing that prices for trading data were higher in the EU than, for example, in the US. Industry responses ranged from banks and buy side firms calling for prices to be fixed at marginal cost plus a reasonable profit margin, to exchanges arguing that their existing charging schemes were both reasonable and commercial, and disputing the evidence of relatively high prices in Europe.

Extract from the Commission's request for advice (mandate) [59]

ESMA is invited to provide technical advice on what constitutes reasonable commercial in relation to the provision of data in accordance with Articles 64(1) and 65(1) of MiFID II and 13(1), 15(1) and 18(8) of MiFIR. In providing technical advice, ESMA shall ensure apply the same analytical framework set out in mandate [3.21/3.19].

In its technical advice ESMA should explore at least the following options and make a recommendation in terms of their net benefits. First, it should explore a "principle based approach" which is that of defining principles against which data providers and their customers could appreciate the reasonableness of data prices. Second, it should explore approaches for restricting charges by reference to appropriate benchmarks such as overall revenues or costs in order to ensure that the prices charged by data providers do not allow them to earn more than reasonable profit/return. Third, it should explore a combination of these two options.

The technical advice should further develop criteria to ensuring that charges are non-discriminatory. In providing technical advice ESMA should take into account the link to unbundling of data as per its regulatory technical advice in accordance with Article 12(2).

In providing technical advice, ESMA should have regard to the specificities of approved reporting arrangements and consolidated tape providers and provide an assessment of the

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[57] Listed in the "Range of Markets" section below
[58] *Public consultation: Review of the Markets in Financial Instruments Directive (MiFID)* – European Commission – 8 December 2010, ec.europa.eu/internal_market/consultations/2010/mifid_en.htm
[59] The extract aggregates two points of the European Commission's mandate, at 3.19 and 3.22, which cover the MiFID II and MiFIR provisions respectively in similar terms.

implications of these specificities in terms of setting out the criteria for the application of the reasonable commercial basis test.

3. In sections 3.19 and 3.22 of the above mandate, the European Commission said that data charges in the EU were too high, and ESMA was required to give technical advice on the best way in which the Commission could use its power to adopt Delegated Acts to bring prices down to a reasonable level. ESMA has considered and consulted on methods to do this, not on whether current price levels are, or are not, too high.

4. ESMA's Secondary Markets Standing Committee discussed this issue with the Consultative Working Group on 6 September 2013. Reactions were mostly polarised into those who thought that price caps would be the only effective method of regulation, and those who believed that the definition should be limited to broad principles.

5. Copenhagen Economics, commissioned by the Danish and Swedish Securities Dealers Association, sent ESMA a paper they published on 5 October 2012[60]. They recommended bottom-up price regulation based on expert knowledge/independent evaluation. Addressing the issue of setting appropriate prices for the wide range of bundles sold by trading venues, they recommended prescribing a price limit only for a complete supply of all raw data. Copenhagen Economics published a further paper on 11 July 2014.[61]

6. Oxera, commissioned by Deutsche Börse, Nasdaq OMX, NYSE Euronext and SIX Swiss Exchange, sent ESMA a paper[62] dated January 2014, and a subsequent note criticising the Copenhagen Economics paper. Oxera's conclusion was that there was no justification for regulating venues' data prices; that regulating would be impracticable and would risk distorting the market; but that there might be benefits from more transparency about how venues recover their costs. Oxera published a further note on 4 September 2014.[63]

7. ESMA's Securities Markets Stakeholder's Group (SMSG), in its September 2014 meeting, encouraged ESMA to develop the transparency option (in particular enhancing public transparency of pricing and of forthcoming changes to pricing and related policies). Furthermore, the SMSG advised ESMA against pursuing either revenue share capping

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[60] Copenhagen Economics, *Regulating access to and pricing of equity market data*, 5 October 2012, revised 12 September 2013, www.copenhageneconomics.com/Website/Publications/Public-Finance---Financial-Markets.aspx?M=News&PID=2035&NewsID=538. Executive summary attached at Annex 4.3.2.

[61] Copenhagen Economics, *How to ensure reasonable prices of financial market data*, 11 July 2014, www.copenhageneconomics.com/Website/Publications/Public-Finance---Financial-Markets.aspx?M=News&PID=2035&NewsID=971

[62] Oxera, *Pricing of market data services*, January 2014, http://www.oxera.com/Latest-Thinking/Publications/Reports/2014/Pricing-of-market-data-services-an-economic-analys.aspx. Executive summary attached at Annex 4.3.3.

[63] Oxera, *Reasonable commercial terms for market data services*, 4 September 2014, www.oxera.com/Latest-Thinking/Publications/Reports/2014/Reasonable-commercial-terms-for-market-data-servic.aspx

or LRIC+, and specifically drew ESMA's attention to the need to regulate data vendors as these intermediaries are, as such, not within the MiFID scope.

Analysis following feedback from stakeholders

8. As required by the European Commission's mandate, ESMA explored three options (A – transparency and general principles, B – revenue share limitation, and C – Long Run Incremental Cost Plus (LRIC+)) and consulted on them in its May Consultation Paper (CP). The following sections summarise the results of ESMA's explorations into the net benefits, including what has been learned from the responses to the CP.

9. Many respondents commented that charges by trading venues (incl. regulated markets) were just one part of the costs of data for users. A considerable number of data users obtain data through data vendors. In this case, costs related to data will encompass not only charges by trading venues, but also by connectivity providers and data vendors.

10. With that in mind, there is a risk that a cost reduction at trading venue level, may not be entirely passed on to the end users. ESMA notes that data vendors and connectivity providers are not within the scope of MiFID/MiFIR.

Option A: Transparency and general principles

11. Under the principles based approach, data prices, and the other terms on which data is supplied, should be fair, reasonable and non-discriminatory. Sellers of data should provide comprehensive transparency about their pricing, by publishing, with easy access for the public as well as regulators, their data charges and certain other information.

12. The large majority of responses to the consultation were in favour of this option. Some (mainly exchanges) thought it should be a standalone measure, but about half of respondents said that it would not be enough on its own.

13. In terms of costs and benefits, this option was generally agreed not to be costly and to be useful, but there were questions about its effectiveness. Some (mainly exchanges) thought its value would be to demonstrate to customers that exchange charges are reasonable and are only a small part of the overall cost of data to them. Others believed it would put some downward pressure on charges, or at least do something to inhibit price rises. Almost half of respondents who expressed a view said that either Option A was enough in terms of desired regulatory intervention, or that it was unnecessary. The others said that more would be needed.

14. A number of respondents said that the charging schedules of exchanges were so varied and so complex that it would not be possible to make comparisons, unless exchanges were forced to standardise their approach to pricing. And one said that transparency would be of little value because the data from different exchanges was not a substitute for one another and so, according to this view, there could be no competition.

15. On coverage, some exchanges wanted to limit the scope of the transparency requirement, either only to equities, as data prices for derivatives were no higher than in the US, or to post-trade plus single best bid and offer prices with volumes at those prices.

16. There were also calls to increase or reduce the items that had to be disclosed. No-one disagreed that complete price lists, changes in prices, and historic prices should be included in any transparency requirement. But a number of exchanges wanted to stop there and not include the other items listed in the CP (e.g. number and turnover of instruments traded) which they saw as proxies for costs. Several respondents suggested including revenue from data sales as a percentage of total venue revenue (proposed in connection with Option B). And a handful of respondents proposed the following elements:

    i. “Unit of count” policy (with an expressed preference for the unit of count to be mandated as "natural user")

    ii. Support and Development policy (with an expressed preference for support development users to be free of charge)

    iii. Volume discount policy

    iv. Any other discount policy

    v. Fixed access fees prices

    vi. Fixed Non Display fees price

    vii. Cost of market data normalised for trading venue turnover

    viii. Netting policy for multiple products e.g. top of the market netted again depth of market

    ix. Standard products codes

    x. Entitlements codes for all major vendors”

Option B: Revenue share limitation

17. Under this option, as explained in more detail in the CP, a venue would have to set its data charges so as to be limited by a revenue share. For example, market data services as a proportion of revenues should not exceed a certain percentage. If a venue wanted to exceed this limit, then, for example, it would have to consult its customers and explain the reasoning behind this change.

18. The majority of the respondents did not favour this option as a stand-alone option. Some respondents suggested that data revenue's share of total exchange revenue could be a useful measure to require venues to publish.

19. Some respondents said that this option could be considered if option A does not succeed.[64]

20. The respondents not wanting option B on a stand-alone basis presented the following main arguments:

    i. Many respondents were of the opinion that option B will be far too difficult to implement and will distort competitive factors and will lead to increases in overall fees.

    ii. Some respondents argued that limits on market data revenue as a percentage of total revenues is not practical as exchange revenues can be derived from many different products and may vary over time.

    iii. There would be uncertainties on how to calculate the revenue shares as trading venues all have different products, product combinations and different markets.

    iv. It is considered that this is not the appropriate option. However, the share of revenue that market data services represents is a useful indicator, when compared across venues.

    v. The setting of a limit on the share of revenue will be too difficult to monitor and enforce.

    vi. A cap on revenues would harm the fundamentals of exchanges with regard to price information.

21. Certain respondents proposed a range for a revenue limit, offering different ranges for ESMA to consider. Some respondents advocated that the limit should be set on the high end, so as to take into consideration the differences across exchanges.

Option C: Long-Run Incremental Cost plus (LRIC+)

22. Under this option, as explained in more detail in the CP, a venue would have to set its data charges so as to recover only the Long Run Incremental Cost of providing a data service plus an appropriate share of common costs (LRIC+).

[64]Note that ESMA asked in the Consultation Paper only about the preferred option and the majority of the respondents prefer option A. ESMA did not ask about the second preferred option. It can only be assumed that the majority would have favoured option B or option C if option A would not have been a choice

23. One respondent (buy-side) preferred Average Variable Cost to LRIC+, but otherwise, those who expressed a view agreed with the ESMA proposal that LRIC+ would be the best basis if there was to be cost-based price regulation.[65] The LRIC+ proposal elicited opposing views from respondents, consistent, to a considerable extent, with their respective roles in the financial market.

24. The majority of the respondents mostly but not only those representing exchanges, and more than half of those who answered the specific question on LRIC+ opposed the introduction of the LRIC+ (or were strongly against LRIC+ and cost-based regulation in general). Their main arguments were:

    i. Both regulated entities and regulators would need to make enormous efforts to implement a LRIC+ model. Regulated entities will need additional resources to deal with a LRIC+ model which would be challenging especially for smaller exchanges with lower economies of scale.

    ii. There was no economic justification for a LRIC+ approach because regulation of market data prices will have no significant impact on end customers (banks, funds) or on end investors and therefore potentially would have no positive effect on economic welfare. In fact, the additional administrative and monitoring costs would lead to increasing prices for pre- and post-trade data at the exchange level and would in turn increase the costs of market data to users.

    iii. A LRIC+ model would be impractical to administer and enforce. Monitoring and regulation of the currently 243 trading venues within the EU would be potentially complex and costly for regulators. LRIC+ would create a severe risk of regulatory errors or unintended consequences because there was no experience with this type of regulation in the financial services sector.

    iv. The LRIC+ approach faced several methodological disadvantages and price regulation was detrimental to the market in almost all circumstances. MiFID was based on the principle of competition between trading venues but LRIC+ would interfere with the trading venues´ freedom of competition. Limiting charges by reference to costs would offer no incentive to reduce cost bases and improve efficiency.

    v. The LRIC+ concept was not used in the US financial markets nor was it an accepted accounting standard for any other industry.

    vi. LRIC+ would be an extreme measure which was not in line with the principle of proportionality – especially because they saw no market failure warranting such a regulatory intervention.

[65] Option B cannot be considered a basis for cost-based price regulation as it is based on revenues rather than costs.

vii. A simple comparison of EU and US market data fees was misleading because the price differential was caused by structural differences between these two markets.

25. About a third of the respondents who expressed a view on the specific LRIC+ question[66] - mostly representatives of banks – considered LRIC+ as an appropriate mechanism for preventing overcharging and misuse of market dominance, i.e. correcting the market failure identified by the European Commission. They said that trade data were monopoly products which needed to be recognised as such and there was a need to limit the monopolistic behaviours of data providers and trading venues. Further they argued that such price regulation is indeed feasible, which has been demonstrated in several other industries. They acknowledged that some administration and compliance costs would be associated with such a model, primarily in the initial process of constructing the LRIC model, however elucidated that these costs are much less significant than in other regulated industries such as telecommunications and energy distribution where markets and cost structures are much more complex and difficult to disentangle. In addition, these costs should be compared with the current amount of costs incurred by the market data consumers who are currently spending a vast amount of resources ensuring that a myriad of complex terms of conditions attached are met. They also said that the current EU exchange fees for the construction of a pan-European view of the market were significantly higher than in the US and regulators should align these fees accordingly to the same level as currently established in the US.

Combinations of options

26. A significant majority of respondents to the question on the possibility of combining options[67], including representatives of trading venues as well as representatives of banks, favoured option A on its own.[68] A number of respondents favoured a combination of A + B + C. A small minority of responses favoured a combination of A + C. One favoured A+B or A+C or A+B+C. One respondent favoured option A + the FISD exchange matrix[69] and a prohibition on above inflation increases in data prices. The remaining responses did not favour any regulatory intervention in data prices.

27. Amongst those who favoured A + B + C, most of those clarified that Option B should not be an enforceable limit, but rather that venues should be required to publish the metrics.

Proposal

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[66] Pls. note that this universe is smaller (45) than the universe of respondents to the question on the sufficiency of the disclosure requirements (71).
[67] Question 162, which was: "Within the options A, B and C, do you favour one of them, a combination of A+B or A+C or A+B+C? Please explain your reasons."
[68] ESMA notes that the answers to this question have to be read side by side with the responses to the question on the sufficiency of transparency option.
[69] Proposals put forward by a working group of exchanges set up by the Financial Information Services Division of the Software & Information Industry Association (FISD).

28. In the light of the responses, ESMA does not recommend a revenue cap (option B) as it is neither practicable nor likely to be effective. Neither does ESMA recommend the option of limiting data charges by reference to costs, defined as LRIC+ (option C). ESMA advises that this option contains interesting ideas but is not a workable solution as it would impose too burdensome a cost on venues and others, including their supervisors, and would present significant challenges to implement. This leaves option A (principles and transparency) as the only remaining proposal. However, this proposal has its own shortcomings, which were identified in the CP as well as in the table at the end of this advice.

29. ESMA has sought to develop further Option A as set out in the CP, and recommends the following measures setting out criteria to enable customers to judge if data was being supplied on a reasonable commercial basis and enhance transparency of license terms and data feeds so as to make it easier to apply the criteria (enhanced Option A+).

30. ESMA proposes the following requirements:

    i. Trading venues to submit current and new price list information to a website as a single point of reference for any market data user. Contractual terms and conditions should be made public as well.

    ii. Adaptions of price lists should be made public prior (e.g. at least 90 days) to their entering into effect in advance on the central website.

    iii. Transparency has to be provided in a form which allows for comparison also with regard to the role of data vendors (e.g. reference of previous as well as new licence terms, classification as per use of licences). A standardised template further specifying the information set out in the table contained in the advice box could achieve this. This should also allow for historical comparison of data licence fee adaptions in order to judge how often and in which size a licence fee adaption has been conducted.

    iv. Additional information like number of instruments covered could be provided.

31. The following tools and instruments would ensure that market data fees across all user groups would come down:

    i. Unbundling/disaggregation, as per Articles 12 and 13;[70]

[70] MiFIR: Art 12 (Obligation to make pre-trade and post-trade data available separately) states: Market operators and investment firms operating a trading venue shall make the information published in accordance with Articles 3, 4 and 6 to 11 available to the public by offering pre-trade and post-trade transparency data separately. ESMA shall develop draft regulatory technical standards to specify the offering of pre-trade and post-trade transparency data, including the level of disaggregation of the data

ii. Trading venues should be obliged to offer price per user (PPU) licences, as set out in paragraphs 40 to 47, below.

32. ESMA believes that the abovementioned tools would assist in reducing prices. However, if the European Commission preferred to take additional measures, ESMA proposes the following criteria:

    i. The level of prices charged for data should be based on the costs for producing and disseminating data, including an appropriate share of joint costs

    ii. Any increases in prices should reflect changes in costs attributable to data sales, including both the direct costs of data production/dissemination and the appropriate share of joint costs

    iii. The differentials in prices charged to different categories of customers should be proportionate to the value of the data to those customers, taking into account:

        a. the scope and scale of the data (e.g. number of instruments, volume of trading)

        b. the field of use of the data (e.g. is it for the customer's own trading, for on-selling, or for creating value added data products?)

33. ESMA has considered whether venues should be required to publish cost information. There are challenges in framing such a requirement: there are no agreed standards for separating out the costs of data provision from the overall cost of operating an exchange, and many costs are joint. It is therefore possible that venues would calculate costs on different bases, preventing valid comparisons of cost figures between venues. Specifying in regulation exactly how costs should be apportioned and calculated would be difficult, given the different business and accounting structures in different venues, and would increase compliance costs.

34. Despite these difficulties, ESMA recognises that there are arguments for requiring some cost information, as from the customers' point of view it will be difficult to assess prices against the criteria set out above without some cost data to compare with the prices being charged.

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to be made available to the public as referred to in paragraph 1. Article 13 (Obligation to make pre-trade and post-trade data available on a reasonable commercial basis) states: Market operators and investment firms operating a trading venue shall make the information published in accordance with Articles 3, 4 and 6 to 11 available to the public on a reasonable commercial basis and ensure non- discriminatory access to the information. Such information shall be made available free of charge 15 minutes after publication.

35. A further possible issue with requiring the publication of cost information is that releasing this commercially sensitive information might put the venues at a competitive disadvantage. It would be possible to avoid this risk by requiring venues to provide cost information to their NCAs, or simply by NCAs using their existing supervisory powers to obtain such data, rather than requiring publication of the cost data. In this case, customers would be less able to pursue their rights to obtain data on a reasonable commercial basis in court, and the onus would be on competent authorities to supervise prices.

36. ESMA considers that the adoption of detailed principles on pricing will enable customers and supervisors to form a clear view of whether a particular venue is charging on a reasonable commercial basis. Moreover, mandating transparency will further empower data customers to challenge pricing schedules as it will enable comparison across different structures.

37. In the event that a venue is selling data on a non-reasonable commercial basis, ESMA expects that the measures proposed here will make it easier for a customer or a group of customers to take effective action whether by engaging directly with the venue, complaining to the venue's competent authority, or by challenging the pricing in a court of law.

38. The proposed approach relies on comparability. ESMA is aware that as well as standardisation of information prices and costs, standardisation of information on contract terms (including restrictions on the use of license data) could also be beneficial to this end.

39. Overall, taking into account the responses received, ESMA believes that an enhanced Option A+ would be the best way to move on as this would not involve significant costs, and would make it easier to monitor the evolution of charges. An enhanced option A+ will enable data users to compare the exchange fees for market data with the costs they actually have for receiving the data. The tools and instruments described in the paragraphs above would contribute to reducing market data fees. After a certain period of time (2019) it could be reviewed if there is any change in the current level of data charges or whether additional action appears necessary.

Per-user pricing model of market data

40. ESMA has become aware of another aspect that plays a significant role in the cost of data in Europe and suggested in the CP a measure that would apply regardless of the three options discussed above.

41. Market data is not always supplied directly from exchanges to end-users, but are very often purchased through data vendors or independent software vendors. In most cases, end-users are charged based on the number of devices receiving data. As a consequence, an end-user receiving the data from an exchange through different channels

(data vendors or Application Programming Interfaces - API[71]) may turn out to pay for the same data several times.

42. In order to address this issue, some exchanges now offer their clients a new user-based unit–of-count model allowing them basically to net part of the market data costs from a single source across data vendors and across devices on a natural user level ('per-user' model), subject to certain eligibility conditions.

43. In the CP, ESMA has proposed to require exchanges to offer such a per-user model alongside their existing model applicable to non-eligible clients (please see questions Q165 and Q166).

44. Responses to the consultation on this topic were basically split and polarised[72], depending on the size of the respondents.

45. Big organisations were usually supportive, regardless of the type of business (broker/dealers, asset managers, exchanges, major data vendors). The largest consumers of market data, buy or sell side, deem the proposal as an effective step to reduce the costs of market data. Some respondents base their judgment explicitly on their experience. The proposal is also one of the recommendations put forward by a working group of exchanges set up by the Financial Information Services Division of the Software & Information Industry Association (FISD).

46. On the other hand, small or medium organisations spoke against the proposal. The opponents, who included mostly exchanges and asset managers, were of the opinion that costs would outweigh the benefits. Indeed, while the exchanges currently rely to a large extent on a few data vendors to bill and collect the fees of their end clients, the new model would force exchanges to establish and maintain a direct relationship with each end client willing to benefit from the model, increasing administrative costs of exchanges. In particular, some consumers of market data also feared that part of the extra costs incurred by exchanges might actually be supported by / passed onto all clients anyway, including those who did not want to, or cannot benefit from the 'per-user' model because of their size.

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[71] An Application Programming Interface or API is the specification *of a software component in terms of its operations, their inputs and outputs and underlying types. Its main purpose is to define a set of functionalities that are independent of their respective implementation, allowing both definition and implementation to vary without compromising each other*. in Wikipedia, http://en.wikipedia.org/wiki/Application_programming_interface .

[72] The results of the consultation broke down into 40 rejections and 22 supports, counting equally each identical response of the members of associations in addition to the response of these associations. By excluding the identical responses from association members and keeping only the original ones, i.e. those of their associations, results were more balanced with 22 pros and 19 cons

47. As a consequence, ESMA believes that the offering of the per-user model should be required unless an exchange can demonstrate that there would be insufficient demand for such a unit-of-count. In particular, this would accommodate the situation of small exchanges, on which a one size fits all solution would impose an excessive burden.

Other RCB issues

Range of markets

48. As noted above, there are five separate provisions in MiFID II and MiFIR that empower the European Commission to clarify what "*reasonable commercial basis*" means through Delegated Acts. ESMA has considered mainly the power in Article 13(2) of MiFIR which relates to the publication of pre- and post-trade data by trading venues. This was the focus of the MiFID Review's consideration of "*reasonable commercial basis*" and it is one where it follows from the European Commission's mandate to ESMA that there is a concern that the prices charged by some venues are too high.

49. In relation to trading venues' data sales, the definition of "*reasonable commercial basis*" will constrain the data which is mandated to be published by Articles 3 to 11 of MiFIR. This includes all post-trade data, and pre-trade data to the extent prescribed by Technical Standards under Articles 4(6) and 9(5). The sale of more detailed data, or of data-based value-added products, will not be constrained by MiFIR.

50. The remaining four powers also relate to the terms on which trading data is made available, according to whether it is published by:

    i. Systematic Internalisers (SIs) in relation to equities (Article 15(5) of MiFIR);

    ii. SSIs in relation to non-equities (Article 19(3) of MiFIR);

    iii. Approved Publication Arrangements (APAs) (Article 64(7) of MiFID II); or

    iv. Consolidated Tape Providers (CTPs) (Article 65(7) of MiFID II).

51. ESMA is not aware of any significant market power in relation to SIs, or of any reason to think there would be such significant market power held by APAs or CTPs when these exist. The respondents to the public consultation broadly agreed with this. They also broadly supported applying the transparency requirements, mutatis mutandis, to SIs, APAs and CTPs. Even those who supported applying options B or C to trading venues did not in general think it appropriate to apply them to these organisations. ESMA's view is that the European Commission should use the future transparency information to assess whether there is any evidence of abuse of market power, and if so to consider what form of clarification of "reasonable commercial basis" might be appropriate to the circumstances of each type of organisation. ESMA is of the view that the requirements

proposed in its Technical Advice should apply equally to all types of entity required to make data available on a reasonable commercial basis.

Unbundled services

52. Separately from the prices charged for data, there is also the question of unbundling. In addition to the disaggregation of data by the trading venue under Article 12 of MiFIR and the related RTS, it is important that members, users and participants face sufficiently granular tariffs that enable them to access and pay for only those services they need. In particular, it should be possible to acquire and pay for trade data services without having to acquire other services that may not be wanted.

Non-discrimination

53. "Reasonable commercial basis" should include a measure of non-discrimination. Suppliers should offer the same prices, and other terms and conditions, to all customers who are in the same position according to published, objective criteria. These criteria should allow suppliers to differentiate between different types of customers where it is reasonable to do so. For example, an exchange might charge one set of prices for its trading data to data vendors or other entities that are going to sell it on or re-use it, another price to sell it direct to buy-side firms, and another lower price for individual retail investors.

Third-party suppliers

54. If a trading venue makes its data feed available only in such a way that customers need to use the services of a third-party supplier (e.g. an external IT provider for decryption), then it should be the responsibility of the trading venue to ensure that the overall data service is available to customers on a reasonable commercial basis, including on a non-discriminatory basis.

Technical advice

(Technical Advice on what constitutes a reasonable commercial basis in relation to the provision of data in accordance with Articles 64(1) and 65(1) of MiFID II and Articles 13(1), 15(1) and 18(8) of MiFIR)

1. ESMA has reviewed the options for clarifying "reasonable commercial basis" as required by the mandate, including conducting a public consultation on them.

2. On the option of limiting data charges by imposing a limit on the share that data revenues can have of total venue revenues (Option B in the consultation), ESMA does not recommend this option as it is neither practical nor likely to be effective.

3. Neither does ESMA recommend the option of limiting data charges by reference to costs, defined as Long-Run Incremental Costs plus (Option C). ESMA advises that this option contains interesting ideas but is not a workable solution as it would impose too burdensome a cost on venues and others, including their supervisors, and would present significant challenges to implement.

4. On the option of a principles and transparency based approach ("Option A"), ESMA recommends that the European Commission should introduce it, enhanced as Option A+ so as to make it more effective than the model consulted on, including criteria to enable venues, customers and competent authorities to assess whether data sales are on a reasonable commercial basis, as set out in paragraphs 5-9, and transparency requirements to be made public as set out in the table below (points i-ix and xiv).

Criteria indicating whether data has been sold on a reasonable commercial basis

5. The level of prices charged for data should be based on the costs for producing and disseminating data, including an appropriate share of joint costs

6. Any increases in prices should reflect changes in costs attributable to data sales, including both the direct costs of data production/dissemination and changes to the appropriate share of joint costs

7. The differentials in prices charged to different categories of customers should be proportionate to the value of the data to those customers, taking into account:

   i. the scope and scale of the data (e.g. number of instruments, volume of trading)

   ii. the field of use of the data (e.g. is it for the customer's own trading, for on-selling, or for creating value added data products?)

Cost information

8. The Commission should assess whether the information on costs should be published or provided to competent authorities only. On the one hand releasing this commercially sensitive information might put the venues at a competitive disadvantage and might therefore call for requiring venues to provide cost information to their national competent authorities, rather than publishing it. On the other hand, disclosure to national competent authorities only, would make it more difficult for customers to pursue their rights to obtain data on a reasonable commercial basis in court and the onus would be on competent authorities to supervise prices.

9. If the Commission decides to require transparency on costs, ESMA recommends that this should consist of:

i. Costs for collating and disseminating data

ii. Reasonable apportionment of joint costs

iii. Brief explanation of method used to calculate cost figures

Data from providers other than venues

10. The principles based approach including enhanced transparency should apply to all the instances of "reasonable commercial basis" the European Commission has power to define, i.e. to APAs, CTPs and SIs as well as to trading venues.

Unbundling

11. Data should be available for sale on its own, without being bundled with other services.

Non-discrimination

12. Sellers should offer the same prices, and other terms and conditions, to all customers who are in the same position according to published, objective criteria.

13. Trading venues should have scalable capacities so as to ensure that their members can always access their data feed on an equal footing as the other clients buying the same type of feed and through the same channel.

Third party suppliers

14. If a trading venue makes its data feed available only in such a way that customers need to use the services of a third-party supplier (e.g. an external IT provider for decryption), then it should be the responsibility of the trading venue to ensure that the overall data service is available to customers on a reasonable commercial basis, including on a non-discriminatory basis.

Per-user pricing

15. In order to address the issue of charging several times for the same information to a single user, ESMA recommends that trading venues should offer their clients a "per-user" based model in addition to the existing model applicable to non-eligible clients. In elaborating the scope of this obligation, the Commission should have due regard to the need for the benefit to outweigh the cost, taking into account the scale and the scope of the venues affected.

Review

16. ESMA recommends that the European Commission should use the information pursuant to this empowerment in its review under Article 90(1)(g) of MiFID II to assess the development in prices for pre and post trade information and consider whether additional action is necessary.

Transparency recommendation
Pricing information
i. Full transparency of current price lists, including a. Fees per display user b. Non-display fees c. Discount policies (volume and any other) d. Contractual terms and conditions e. Fees associated with different licence conditions f. Fees for pre-trade and for post-trade g. Fees for other subsets of information, including those required by the RTS under MiFIR Article 12(2) ii. Advance (e.g. at least 90 days before) full disclosure of future price changes iii. Availability of historic information on prices
Information about content of data
i. Number of instruments covered ii. Total turnover of instruments covered iii. Pre-trade / post-trade data ratio iv. Information about value added information enclosed v. Date of last licence fee adaption for each data product.
Revenue information
i. Revenue for data sales as a percentage of total venue revenue
Cost information
i. Costs for collating and disseminating data ii. Reasonable apportionment of joint costs iii. Brief explanation of method used to calculate cost figures

Publication of information	
i.	Easy access to information for the public as well as regulators through publication on a central web-site as a single point of reference for any market data user

Annex 4.3.1.: summary table of comparative advantages and disadvantages of options

	A: Principles and Transparency	B: Revenue share limit	C: LRIC+	A: Option A+
Advantages	• Simplest and cheapest to implement for venues and regulators • Transparency well-established regulatory approach • Will make it easier to compare prices between venues • May put downward pressure on prices	• Simpler and cheaper for venues • Simpler and cheaper for regulators • Limits prices	• Limits prices to what would be charged in a competitive market • Allows suppliers to recover incremental cost and a share of common costs	• Simple and cheap to implement for venues and regulators • Will lead to transparency • Will make it easier to compare prices between venues • More likely to drive prices downwards than Option A.
Disadvantages	• Complexity and variety of pricing schedules will make it difficult for customers to compare between venues • Lack of substitutability of data from different venues will limit effect of better informed competition • Unlikely to lead to dramatic/ significant reduction in data prices	• No precedent for regulatory use • Discretionary choice of percentage limit • Applying same percentage limit to all suppliers will not take account of specific circumstances (e.g. corporate structure of supplier) • If enforcement not carried out consistently a risk of regulatory arbitrage • Risk of gaming	• No precedent for regulatory use in financial services sector • Complex modelling required • Discretionary choice of the mark-up to allow recovery of an appropriate share of common costs • Judgements involved (e.g. shares of joint and common costs, cost of capital) may lead to inconsistent application • Supervision will require more resources • If enforcement not carried out consistently a risk of regulatory arbitrage	• Complexity and variety of pricing schedules will make it difficult for customers to compare between venues • Lack of substitutability of data from different venues will limit effect of better informed competition

Note: For all options, when an end-client receives data through a data vendor, there is a risk that any reduction in the cost of data at the trading venue level will not be passed on to the end-client.

Annex 4.3.2.: Executive summary, Copenhagen Economics, *Regulating access to and pricing of equity market data*, 5 October 2012, revised 12 September 2013

A key objective of the original MiFID has been to increase competition in the market for equity trading by encouraging competition between trading venues. It is safe to say that this has been a success. Competition amongst trading venues with respect to trade executions is now fierce, due to the increased amount of alternative trading venues challenging the position of traditional stock exchanges. Ultimately the most important result being that direct costs of trading have fallen to the benefit of investors.

However, this success is not without downsides. In fact we identify seven problems where the current and proposed legislation is not adequate. The first and most prominent problem is that the very success of MiFID in having more trading venues involved in the trading of the same equities has intensified an already existing problem. As more venues acquire significant market shares, traders and investors face the problem of buying market data from an increasing amount of sellers. As several indications suggest that each trading venue holds a de facto monopoly position with respect to the market data generated as a result of trading at the venue itself, there is strong reason to believe that the total cost of market data for investors is unreasonably high (Problem 1).

The original MiFID reform was based on the premise that exchanges would sell market data on the basis of reasonable costs assessment. However, there are clear indications of trading venues taking advantage of holding a monopoly position with respect to its own trade data, giving it the possibility to charge "unreasonable" price. We identify at least four such indications:

- It can be observed that equivalent packages of market data are priced significantly higher in EU than for comparable markets in the US. The US takes a more active stance in controlling prices which may be the reason for this.

- While the direct costs of trading have gone down, unit costs of data has increased despite continued improvements in technology (Problem 2 and 4).

- At a more micro level, exchanges have tended to bundle together data in packages and increased the complexity and limitation of use of products, while market participants have expressed interests for simpler and unbundled products. This is an indication of a market not responding to customer requirements and preferences (Problem 3 and 7).

- The lack of access to raw price data in comparable technical standards

from exchanges have prevented the creation of consolidated and comparable data sets covering trade in the same products across the relevant trading venues. This fragmentation of data makes it more costly to implement strategies which seek out the best prices for clients (Problem 5 and 6).

The current review of MiFID - the so-called MiFID 2.0 - has recognised that MiFID 1.0 had limitations with respect to market data. At least two options are being suggested: First, it is proposed that the EU Commission gets the right to clarify what "reasonable commercial basis" means in practice, thus availing itself the right to intervene more directly in the market for market data. *Second,* it is proposed that post- trade data should be available free of charge 15 minutes after the execution of a trade. While we acknowledge that these suggestions are a step in the right direction, we do not believe that they fully address the challenges with respect to the pricing of market data.

In the work following the MiFID 2.0 proposal, this study therefore highlights three priorities with respect to the regulation of market data:

Firstly, that prices for both pre and post trade data should be regulated due to the un- competitive nature of trading venues in the market for market data. Such regulation should focus on the (close to) raw data.[73] It is easier to estimate the costs of transmitting raw (or nearly raw) market data to participants than to estimate the costs of producing and then transmitting bundled products. By creating technical standards for raw data this would also facilitate the creation of new actors that can develop consolidated tapes both for pre and post trade data. The step by the Commission to define "reasonable commercial basis" is crucial in this respect, and should be a priority going forward.

This is consistent with the EU Commission's own focus: it underlines that market participants should have access to unbundled products and promotes the role that consolidated tape providers can provide in creating an efficient market in equity trading. However, the focus from the Commission on post-trade is not sufficient, as the (at least) equally important pre trade data is not addressed.

Secondly, that the ownership to trade data is clarified. There is a good case for letting market participants get co-ownership to the data associated with the trades they are part of (both order book postings and trades executed). Such data can subsequently be pooled within and between trading firms and investors, most likely with the assistance of specialised data providers as referred to above. This can create an alternative source of consolidated pre trade data to that offered by the exchanges. This could by itself help improve price formation by lowering costs of data purchases for traders while also providing regulators with a good benchmark against which to regulate prices of raw data. However, the current disputes on own-

[73] The pure information derived from order book posting and trade executions without bundling or containing any value added services.

ership of data and limitations of the traders' use of their "own" market data limit this source of competition in the creation of trade data.

Thirdly, that an extensive examination of the pricing behaviour of trading venues is conducted. Currently, the pricing strategy of trading venues is highly complicated, as e.g. products continually are bundled together and new products are created complemented by limitation of use on other products. Such pricing strategies increases the total cost of the same data, however in a non-transparent way. To complement an analysis of what constitutes "reasonable commercial basis", it is necessary to have a clear description of trading venues' price increases over time.

Annex 4.3.3.: Executive summary, Oxera, *Pricing of market data services*, January 2014

Context

Over the past ten years, there have been some considerable changes in terms of market structure and trading techniques in European capital markets.

Where once only one, or possibly two, exchanges offered trading in a particular equity, for most European equities multiple trading venues now compete for liquidity due to the full implementation of the Markets in Financial Instruments Directive (MiFID) in 2007. One effect of introducing competition has been the fragmentation of trading data on particular stocks across a number of venues. This, together with the creation of new trading strategies (such as algorithmic and high-frequency trading), has generated demand for market data and faster access to the full order books for a wider coverage of markets.

In response to the growing variety of market data needs, exchanges and multilateral trading facilities (MTFs) have introduced new types of data licences, such as non-display licences that cover the whole institution's use of market data for algorithmic trading, post-trade data separated from pre-trade data in order to support the planned EU post-trade consolidated tape, and a harmonised delay period of 15 minutes for data free of licence fees.

Data vendors, independent software vendors, MTFs and exchanges provide products to meet the demand for market data from different types of market participants. While trading venues make their data available, as wholesalers, it is typically offered to market participants by market data vendors, acting here as the retailers. Brokers sometimes also offer data services themselves—for example, when they provide the relevant trading venue's data to retail customers via their web-based offerings.

Market data vendors such as Bloomberg and Thomson Reuters offer market data from more than 500 trading venues across Europe, the USA and Asia via one desktop terminal in a single format. Data sources can be chosen separately or, where relevant, in a consolidated form. The data is usually presented in additional applications (analytics and news services etc.).

After the introduction of MiFID I, the industry (under the lead of the Federation of European Stock Exchanges (FESE)) decided to standardise market data across multiple markets within the EU through projects like the Market Model Typology. The aim of this project is to ensure a more efficient consolidation of data from different trading venues.

The current European Commission proposals to amend MiFID include a number of provisions in relation to trading venues' market data.[74] Trading venues will be

[74] Proposal for a Regulation of the European Parliament and of the Council, Title II, Articles 3, 5, 7, 9, 11, 12 and 18.

required to unbundle pre- and post-trade data, provide post-trade data (published with a 15-minute delay) free of data licence fees, and provide pre-trade and post-trade data on a reasonable commercial basis.

Although most of these requirements have already been implemented by most of the trading venues ahead of the adoption of MiFID II, there has been some debate over whether a definition of 'reasonable commercial basis' would be required, and the way in which it should be interpreted, with some stakeholders advocating the need for detailed rules and others promoting a principles-based approach with greater reliance on market forces—and some questioning the necessity of a definition.

The market structure and value chain in which market data is produced and consumed is complex, making it challenging to assess the role of regulation. This report aims to provide an economic framework within which the pricing of market data services can be evaluated. To contribute to the regulatory debate, the report provides economic analysis of the following:

- the role of market data in the value chain for trading in European equities;
- the key economic characteristics of trade execution and market data services;
- the current pricing and costs to users of market data services in Europe, drawing comparisons with the prices and costs to users in the USA;
- the potential impact of different pricing schedules and cost recovery mechanisms on market outcomes for end-investors.

The report is written specifically in the context of European equity trading, and thus all statements refer to European equities unless otherwise specified.

The role of market data in the trading of European equities

The production and consumption of market data is part of a larger value chain that includes the trading of financial instruments and the trading of European equities. The latter is the focus of this report.

The objective of the trading system is to provide an efficient mechanism to transfer the ownership of equities from one party to another. In order for this to take place, market participants require access to the market data that is produced by the trading services provided by the trading venues.

The production and consumption of market data across the trading value chain is complex. Figure 2.2 of the report, repeated below, sets out the main data flows in terms of the contribution of trading data by brokers (red arrows and shading); the consumption of that processed data by investors, brokers and other market participants (purple arrows and shading); the production of market data by trading venues (through the provision of trade execution services); and the further processing of market data by data vendors (brown shading), including value-added services offered by data vendors, software applications, and IT infrastructure providers.

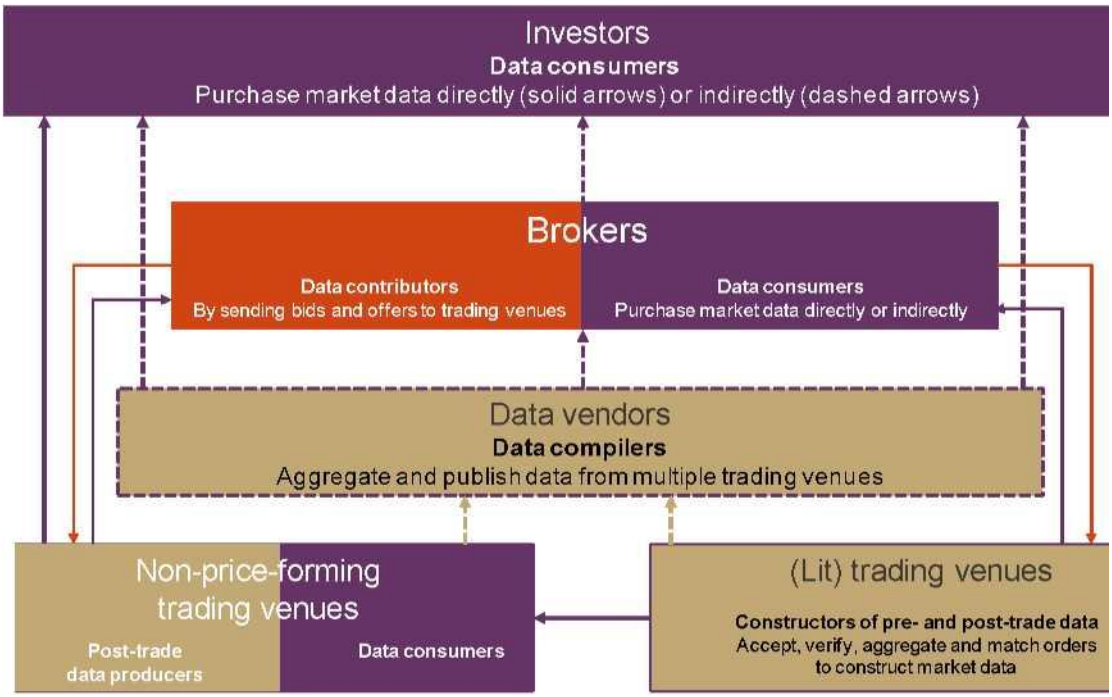
The market data offered by trading venues is only one element in the value chain for market data. Other services include the value-added services offered by data

vendors, software applications, IT infrastructure and in-house market data expertise. According to research in 2010,[75] exchange market data licence fees were estimated to account for 8% to 15% of customer market data expenditure; IT infrastructure was estimated to account for 10% to 16%; and data vendor services were estimated to account for the remaining 65% to 80%.

Market data is often complemented by other sources of information and data to which market participants may have different levels of access, and which they may interpret in different ways. For example, investment decisions typically draw on a broad mix of information sources in addition to market data such as annual reports, financial statements and more general news services.

[75]Atradia (2010), 'The cost of access to real time pre & post-trade order book data in Europe', August, p. 21.

Information flows in the trading of European equities



Source: Oxera.

There is significant variation in the use of market data by market participants, which is analysed in more detail in the report. Users can choose between several types of data products, and whether they purchase the data directly from trading venues (usually reducing latency) or indirectly via data vendors or brokers (which may also provide analysis software, and combine market data from multiple trading venues). Market data products vary according to depth (i.e., how much information about the demand and supply of a particular stock is included in the data product); the speed at which data is received by the market data recipient; and coverage of the types of stocks or asset classes captured in the data product.

In addition to anonymised market data sets for publication, trading venues generate non- anonymised data for surveillance purposes. This data is used only by the trading venues' market surveillance, and by regulators. The confidential nature of the information included in such data, such as trader IDs or Algo Trading IDs, means that it is not suitable for public dissemination.

An economic framework to assess the pricing of market data services in Europe

Market data and trade execution are linked not only at the level of consumption (i.e., market data is required in order for traders to take decisions on trading), but also at the level of production.

Market data is a by-product of the overall operation of the trading system. Given the general structure of electronic order books and electronic order matching, it is not possible to provide transaction services without generating market data, and it is not possible to generate trade transaction or market depth—data without also supplying a trade execution service. In economic terms, trade execution and mar-

ket data are joint products.

The joint product nature of trade execution and market data has two important implications.

- With joint products, the production costs of the outputs cannot be separated i.e., they are joint costs. This has been well established in the economic literature and regulatory practice. Joint costs are incurred when production facilities simultaneously produce two or more products in fixed proportions, such that an increase in the output of one product will necessarily mean a corresponding increase in the output of the other product.

  This means that the recovery of costs by a trading venue cannot be assessed effectively by the independent analysis of either trade execution services or market data services. The appropriate frame of reference for the economically efficient recovery of the costs of the secondary market activities of trading venues is at the level of combined transaction revenues and data revenues.

- This, in turn, means that the economic characteristics of the production of the trade execution service are also relevant. Trading venues are characterised by high fixed costs and low marginal costs, and significant economies of scale. In industries with these characteristics, the pure competitive outcome where prices are set at forward- looking marginal costs may not be economically efficient. Marginal cost pricing would not be sufficient to recover the total cost of production, and therefore trading venues would exit the market. Furthermore, charging the same price to all customers would not account for the different valuations that different types of customers may have. Different market participants often have very different valuations of what is essentially the same information. This suggests that a single price for all users may not be efficient.

With this framework in mind, this report analyses the way in which trading venues in Europe currently recover their costs through fees for both trade execution and market data services, and assesses the implications of the current (and potentially different) cost recovery mechanisms for the functioning of the equity markets, and their impact on end-investors.

Analysis of the current pattern of cost recovery by trading venues

The current pattern of cost recovery has been analysed on the basis of a number of specific metrics using data from the participating exchanges and that available in the public domain (in annual reports and pricing schedules). These metrics are as follows.

- **The revenues from market data services as a proportion of combined revenues from market data and trade execution services, including membership fees**

  - This analysis shows that, within both Europe and the USA, there is a certain amount of variation in the relative importance of market data

revenues. In 2012, market data revenues accounted for about 19-35% of market data and trade execution revenues combined for the European markets of the participating exchanges. For the US markets (of the participating exchanges) the range was fairly similar, at about 14% to 29%.

- Over the past four to seven years, the proportion of revenue accounted for by market data services by each exchange appears to have been relatively stable. Analysis of historical data licence pricing schedules from European exchanges suggests that this is because licence fees have not generally increased. While faster or more detailed market data products have been introduced, for which higher fees are charged, licence fees have not been frequently increased. There are some exceptions to this general trend, and some trading venues have increased their fees for market data services at a time when revenues from trade execution services have been falling (due to lower trading volumes).

- **The fees incurred by brokerage firms (hereafter referred to as brokers) to purchase market data services, compared with the fees incurred for trade execution services**

  - This analysis was undertaken by designing user profiles and applying these to the pricing schedules for trade execution and market data services. The analysis shows that the relative importance of data licence fees can vary significantly between brokers according to their business model.

  - Large brokers generally pay exchanges between 0.05bp and 0.15bp of their value of trading in market data licence fees, compared to around 0.08bp and 0.55bp in trade execution fees and less than 0.01bp in membership fees i.e., as a proportion of total fees for trade execution and market data services paid to exchanges, market data fees are usually in the range of 10% to 30%. The breadth of this range reflects the observed differences in the use of market data products by different brokers transacting similar volumes. Large brokers are here defined as executing around 50,000 trades a day, or around €100 billion a year (assuming an average trade size of €8,000), at a particular trading venue.

  - In terms of a 'mid-active broker' at a trading venue, market data fees cover a broader range as market data needs can vary more widely, but they are typically in the range of 15% to 40% of total fees paid to exchanges. A mid-active broker is here defined as a brokerage firm that executes around 1,000 trades a day, or around €2 billion a year (assuming the same average trade size of €8,000).

  - There is some variation in pricing schedules for market data services across trading venues. For example, most but not all trading venues in Europe offer market data for free to registered traders for trading on that venue.

- **The cost of consolidated tapes in Europe and the USA**
  - When expressed in absolute amounts, European trading venues are typically more expensive for both data and transaction services than those in the USA. However, a more detailed analysis shows that this is driven by large differences in economies of scale, and a number of other factors such as the complexity of the European markets, and the specifics of the regulatory requirements around Reg NMS. It is well known that trading fees in the USA are lower than in Europe and that this is driven partly by differences in economies of scale—similarly, data fees are lower in the USA, and this is also driven partly by the same differences in economies of scale.
- **Market data costs as a proportion of the total costs (in relation to trading and holding securities) incurred by end-investors**
  - The relative importance of market data fees compared to other costs incurred by end-investors (i.e., the cost of trading and post-trading and the costs of fund management) can be estimated in two ways.
  - The 'top-down' approach compares market data revenues of an exchange (as a proxy for the market data fees incurred indirectly and directly by end-investors) against the domestic market capitalisation of stocks traded on the exchange (as a proxy for the value of investments held by the end-investors in the local market). This suggests that annual market data costs represent less than 0.01% of the value of an investor's assets under management.
  - The 'bottom-up' approach considers all the services provided to an end-investor, from fund management, brokerage and trading, to clearing and custody); estimates the expenditure by each intermediary on market data; and compares this to the total costs of these services charged to the end-investor. This approach estimates that annual market data costs represent less than 0.02% of the value of an investor's assets under management.

The precise relationship between market data fees and the total costs incurred in making a transaction will vary depending on the investment style (and other factors) adopted by the end-investor or fund manager. However, taking both a top-down and a bottom-up approach, the annual market data fees received by trading venues are likely to account for less than 2% of the total annual costs associated with trading and holding securities incurred by institutional investors.[76] This is typically equivalent to less than 0.02% of assets under management.[77] (The significance of market data fees charged by trading venues for retail investors in Europe is even smaller, as many European trading venues offer market data to retail in-

[76] The services considered are: fund management services; trade execution services provided by brokerage firms and trading platforms; market impact costs experienced by funds; clearing services provided by clearing firms and CCPs; and custody services provided by custodians and CSDs.

[77] This cost is based on a fund with a turnover ratio of 50%—ie, a fund in which 50% of the assets held are changed each year, such that the value of assets under management is the same as the value of trading each year.

vestors for licence fees of €1 a month or for free.)

This shows that the market data costs (in relation to the market data provided by stock exchanges) are relatively small compared with the total costs that investors incur in relation to trading and post-trading.

Competition in the markets for fund management, market making and brokerage services keeps the fees charged by intermediaries for such services close to the costs incurred in providing them. This means that any change in the cost of providing such services—for example, an increase in market data licence fees would be expected to be passed on to end-users in the form of higher fees charged by intermediaries for them.

Changes in fees for market data and trading services may affect the demand for them. However, given the relatively small proportion of the total costs represented by market data fees, it would seem unlikely that, at a general level, changes in the licence fees for market data would significantly affect the overall level of activity of trading.

This is not to say that a different balance between market data service fees and the fees for trade execution services provided by trading venues would have no impact on either end users or other intermediaries. The next section looks at what would happen were trading venues to implement different pricing structures.

- **Potential impact of different pricing structures on market outcomes**

Changing the pricing schedules for trade execution and market data services may have a number of potential effects on market participants and market outcomes for end-investors, which are analysed in detail in the report. These effects can be summarised as follows.

Distributional effects—changing the balance of cost recovery may create winners and losers among market participants. Shifting costs from market data services to trading services, for example, would improve the competitive position of those brokerage firms with the highest data needs given their trading activity.

However, the number of customers purchasing data services tends to be higher than the number purchasing transaction services it is likely that anyone who purchases trading services will also purchase market data services, while there are a number of customer groups who will purchase market data services but not directly purchase trading services or other related services for which an exchange charges a fee (for example, fund managers).

This means that the general pattern would be that those purchasing both transaction services and market data services would be worse off, while those purchasing only market data would be better off. It should be noted that market data is free for some brokers so such brokers will not benefit from lower data fees, and experience only the higher trading fees.

From an end-investor perspective, this may not matter so much. If trading fees were increased and market data fees reduced, the fund management fee would reduce

but commissions paid to brokers (often directly by the funds) would increase.

Impact on market efficiency—although there is some assessment in the economic literature of the impact of charging or not charging for market data services on market efficiency, there is not sufficient evidence from these models to draw a conclusion on the relationship between the efficiency of markets and the pricing of market data. In theory, charging for market data services could reduce the demand for data and therefore potentially have a negative effect on the price discovery process. However, if there are multiple trading platforms, individual platforms have incentives to ensure that they are attractive both in terms of fees (for trade execution and market data services) and non-fee elements (such as price discovery and liquidity).

Impact of different pricing schedules on volume of trading—trading platforms can recover their costs in a number of ways and design different types of pricing schedules.

In the report, two extreme scenarios are analysed: a scenario where all costs were recovered through market data fees (and trade execution fees were set at zero), and a scenario where all costs were recovered through trading fees (and market data fees were set at zero).

The analysis shows that the effect is not clear-cut. In the first scenario, the volume of trading may go up (since transaction fees are set at zero), but the volume of trading may go down as a result of the increase in market data costs leading to a reduction in the consumption of market data by fund managers, and this in turn could lead to a reduction in the demand for trading services (ie, decisions are made not to trade when, with access to the data, the decision would be to trade). The overall net effect is an empirical question in the first scenario, the net effect is likely to be more marginal transactions, and in the second scenario it is likely to be fewer marginal transactions.

Furthermore, the first scenario is likely to encourage consolidation among brokerage firms, as the largest brokers are likely to find it easier to increase the average value/volume of trading per data user. Niche brokers that trade smaller amounts per trader would be disadvantaged. However, this increase in concentration is unlikely to result in a significant reduction in the degree of competition, and is therefore unlikely to affect the end-investors.

In sum, the analysis shows that, even in extreme scenarios of recovering all costs through trade execution fees or market data services fees, there is no evidence that the impact on market outcomes in terms of efficiency and volume of trading would be detrimental to endinvestors.

Conclusions

As explained, market data and trade execution services are joint products. Therefore, from an economic perspective, an assessment of the pricing of market data services requires an analysis of the revenues from both trade execution and market data services. Furthermore, both services are intermediate products, which means that the analysis needs to focus on the market outcomes in terms of the efficiency of the market, the volume of trading, and the total costs of trading for the end-users, ie,

investors.

The analysis in this report shows that the current cost of market data as a percentage of total costs to end-investors is low, at less than 2% of the total annual costs associated with trading and holding securities incurred by institutional investors. This is typically equivalent to less than 0.02% of assets under management. This indicates that a change in market data fees is unlikely to have a significant effect on behaviour in terms of, for example, the volume of trading.

The conceptual analysis also shows that, even if the pricing of market data services were changed significantly, there would be unlikely to be a significant detrimental effect on market outcomes for end-investors.

This suggests that there is no justification for regulating the pricing of market data services. Although this report has not analysed potential options for the regulation of the pricing of market data services, it is clear that it would be very challenging to design a framework that is practicable and there would be a risk that it would actually distort the functioning of the market defining the relevant services and regulating the prices would be far from straightforward.

Annex 4.3.4.: Reasonable Commercial Basis – Accompanying assessment and data gathering exercise

1. Introduction

This paper presents a preliminary assessment of the market for financial data with a focus on trading venues. It includes the results of a targeted consultation which gathered quantitative and qualitative data to assess the different options presented in ESMA's consultation paper (CP) on the draft technical advice on "reasonable commercial basis" (RCB)[78]. This assessment fed into the evaluation of the different options and supports the technical advice given by ESMA.

The data gathering exercise was run on behalf of ESMA by the Centre for European Policy Studies (CEPS) and consisted of two questionnaires: one addressed to trading venues ("Trading Venues" questionnaire), and one addressed to a broader range of market participants ("Others" questionnaire). The questionnaires were distributed to key stakeholders across the industry (i.e. buyers of market data, trading venues and data providers) and collected quantitative and qualitative data on the nature of financial market data products, production costs and revenues, as well as market practices and the possible impact of ESMA's proposals. A total of 50 market participants replied (9 trading venues[79] , 1 data provider, 1 index provider, and 39 buyers of market data) from 11 European countries[80]. For more details on the data gathering exercise please see Annex 1.

The paper starts with a short description of the market for financial market data, including product characteristics, market participants and potential market failures. Section 3 and 4 assess the different options suggested by ESMA in the CP, i.e. the transparency approach vs. the price based proposals revenue cap and LRIC+. Section 5 compares the different options and concludes.

2. The market for financial market data

Financial market data are information about transactions in financial instruments or about values of financial products resulting from trading activity or desk calculations (e.g. an order book quote or an index value). These data play an important role in the financial system by improving information flow for investment decisions and thereby contributing to the price discovery mechanism. The following sections illustrate the characteristics of this market, including pricing, market participants, raw market data, [81] i.e. pre and post-trade information provided by trading venues according to Article 13 of MiFIR, and potential market failures.

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[78] ESMA Consultation Paper, MiFID II/MiFIR, ESMA/2014/549, 22 May 2014.
[79] Six out of nine were major EU trading venues in equities, fixed income and listed derivatives products.
[80] Denmark, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Spain, Sweden and the United Kingdom
[81] "Raw" data mean market data that is not processed by the platform in a way that adds value for the user, i.e. pre-trade data received by the user via the standard data feed of the trading venue.

2.1 Variables determining market data offerings

Supply-driven characteristics of market data offerings typically mirror the complexity of the trading systems (e.g. order book vs. request for quote) and the business of the trading venue selling them (e.g. product coverage, market coverage). Demand factors reflect clients' needs and types of use/users which determine the additional variables suppliers (trading venues and data vendors) consider when offering and pricing market data. Given this complexity, numerous product combinations with different pricing and bundling arrangements are currently offered. Table 1 presents the key variables determining market data offers.

Table 1. Key variables of market data offers

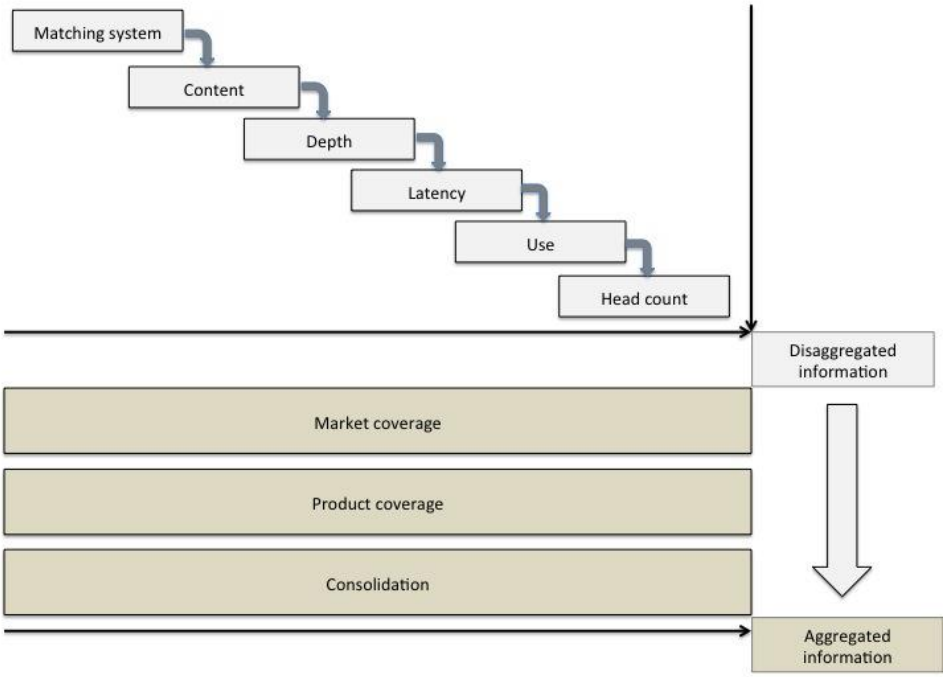
Supply-driven	
Content	• Pre-trade information (including the estimated value of an instrument [like an index]) • Post-trade information • Surveillance data (e.g. audit trails)
Depth	• Full order book (level 2+) • Partial order book (level 2)[82] • Best bid-offer (BBO or level 1) • Last price • Full transaction details (post-trade)
Latency	• Regular latency (standard data feed) • Delayed (including historical series in different formats) • Closest to real-time (co-location latency)
Matching system	• Order book/matching engine (continuous, auction, RFQ, etc.) • Off order book (on or outside local matching engine [reported])
Product coverage	• By instrument (e.g. per share) • Single asset class (e.g. all shares or fixed income products on the trading venue) • Multiple asset classes (shares and fixed income on the trading venue)
Market coverage	• Sectorial (e.g. an index family for a specific sector) • Market specific (e.g. all shares of FTSE 100 or another sub-index of "blue chips" or a European listing index)

[82] Trading venues can offer different level 2 depth levels. Borsa Italiana and MTS, for instance, offer 4 levels of depth up to all quotes and orders displayed on the order book.

Consolidation	• None • Multiple venues (within the same legal entity, i.e. the Group) • Multiple venues (e.g. consolidated data on an instrument traded on multiple venues)
Demand-driven	
Use restrictions	• Display • Non-display • Re-distribution (internal or external) • Derived data production (including financial product creation) • Single user (retail investor or academics)
Head count (based on use and user type)	• Per message/quote/ticker (volume-based) • Per user ID • Per device or terminal • Per application • Per business activity (same user; e.g. trading versus research use)

Excluding latency (a value added service) and head count (based on licensed uses), and assuming that pre and post-trade data are fully unbundled (as required by MiFID II), there are potentially 100 different combinations of disaggregated raw market data products that could fall under the RCB clause. Those combinations could go up to thousands if the venue aggregates information across different sets of instruments, asset classes, sectors, venues or geographical locations. This lack of standardisation may make it difficult for market data users to evaluate and compare offerings from different providers, and for regulators to closely supervise market practices. Figure 1 illustrates the decision flow that a raw market data seller may follow when producing a market data product offering.

Figure 1. Market data products decision flow



2.2 Product characteristics

Production process

Market data are the output of a joint production process which includes the production of trade execution and in some cases, listing services (when an instrument is listed in the particular venue selling the market data). Products in a joint production process can be either produced simultaneously, i.e. joint products, or incidentally, i.e. by-products. *Joint products* are two or more products of equal importance that are produced simultaneously from the same process, each having significant economic value. A *by-product* is a secondary or subsidiary product that emanates as a result from manufacturing the main products. In the case of market data, the question to assess is whether they are jointly produced with the provision of trading execution and/or listing services or are just incidental to the production of these services.

The identification of the type of production process market data belong to is highly subjective (e.g. which criteria to use, how to weight the different criteria) and might not be stable over time. This is also reflected in the academic literature, e.g. two reports produced respectively by Oxera and Copenhagen Economics on market data products have come to opposite conclusions on the nature of the product and in consequence on the policy measures to pursue.[83] The production process adds a

[83] Oxera claims that market data products are joint products, and that price regulation, which requires the allocation of joint costs, be inefficient. CE, instead, claims that raw market data are by-products and hence could be made subject to price regulation without difficulties. See Oxera, 2014 "Pricing of market data services: an economic analysis", available at http://www.oxera.com/Latest-Thinking/Publications/Reports/2014/Pricing-of-market-data-services-an-economic-analys.aspx; Copenhagen Economics, *Regulating access to and pricing of equity market data*, 5 October 2012, revised 12 September 2013, www.copenhageneconomics.com/Website/Publications/Public-Finance---Financial-Markets.aspx?M=News&PID=2035&NewsID=538.

further dimension of complexity when considering the introduction of price-regulation (see section 4).

Economic value of market data

We used data on revenues, collected through the data gathering exercise, as a proxy to assess the economic value of market data, compared with trade execution and listing services.

Table 2 shows the relative importance of the contribution of revenues from raw market data and market data revenues to the trading related and total revenues of trading venues.

Table 2. Market data revenues

1. Market data revenues / Trading related revenues				
Low	*High*	*Average*	*Weighted average*	*Median*
6%	32%	20%	26%	22%
2. Market data revenues / Total revenues				
Low	*High*	*Average*	*Weighted average*	*Median*
5%	20%	13%	14%	11%
3. Raw market data revenues / Market data revenues				
Low	*High*	*Average*	*Weighted average*	*Median*
52%	100%	79%	81%	81%

Note: The weights used for the weighted average are total revenues of individual firms. Data received from eight trading venues were used. The sample for computation 3 only includes data from four trading venues because of fewer responses to more disaggregated revenue information.
Raw market data revenues =Revenues from unprocessed pre- and post-trade data
Market data revenues =raw market data revenues + revenues from processed data.
Trading related revenues= market data revenues + execution revenues + listing revenues
Total revenues= Trading related revenues + revenues from other market infrastructure services (e.g. clearing and settlement services) and any other services offered by the trading venue.

The first and second computations suggest that market data revenues are an important component of trading related revenues (market data + execution + listing revenues) and total revenues (e.g. trading related revenues +revenues from other market infrastructure services). According to our sample, market data products have a relatively high economic value. They represent on average 20% of trading related revenues. However, if prices were distorted (through market power or product cross subsidization), revenues may overestimate the importance of market data.

Our sample also suggests that the value of market data may increase with the size of the trading activity in a given instrument on that specific venue. For those trading venues with a sizeable pan-European presence, market data represents 22% to 32% of trading related revenues, while for smaller venues it is as low as 6%. Therefore, for calculations 1 and 2 above, the weighted average (using revenues as weights) is higher than the simple average for all the trading venues in the sample.
The third computation shows that raw market data represent the vast majority of the total market data revenues, particularly for smaller venues. Raw market data constitute on average 79% of total market data revenues.[84]

Production costs

The responses to the data gathering exercise provided only a few tentative estimates of fixed and variable costs. Some firms do not allocate costs for market data provision at all, and most trading venues or data/index providers do not allocate production costs to each business area (i.e. market data products, trade execution services or other business areas). The responses received suggest the following:

- Fixed costs (excluding sunk costs) are the main joint production cost;
- Fixed costs are mainly costs for personnel and technology, i.e. devices and systems contributing to listing and running of market surveillance and monitoring of execution and listing rules;
- About one third of fixed costs are allocated to the production of market data. Two respondents indicated a range of 25 and 50% of the total infrastructure cost, while other two suggested it was equal or above 50%. However, the size and diversification of the business of a trading platform affects these numbers.

Table 3 puts in perspective the cost of the common infrastructure vs. the revenues generated by various business areas to give a grasp of the importance of market data revenues for the recoupment of total production costs. On basis of these data[85], revenues from market data and listing services cannot individually cover a proxy cost of the common infrastructure, while trade execution services alone produce more than enough revenues to cover the cost of the common infrastructure.

Table 3. Common infrastructure cost over…

	Low	High	Average	Median
…market data revenues (%)	101%	537%	264%	209%
…trading-related revenues (%)	16%	54%	31%	28%
…total revenues (%)	8%	49%	24%	20%

[84] When interpreting these results it has to be kept in mind that the sample size used for calculations is very small compared to the total number of trading venues in the EU. This holds particularly true for calculation 3 which includes only data from four trading venues.
[85] Only 4 trading venues provided data. The calculations should therefore be only seen as a rough indicator.

Note: one response underestimates the cost of the common infrastructure because it only includes IT costs. Only two responses could be used for the calculation of listing revenues. Sample size of 4 trading venues.

Pre- and post-trade data

Pre and post-trade data display prices and quantities available for execution (pre-trade) or recently executed (post-trade). *Pre-trade data* provide information about bids and offers for a particular financial instrument in a particular market. Pre-trade market information is an indispensable piece of information for any buyer or seller willing to trade on that market and submit the limit order to the venue. *Post-trade data* provide information about the price and quantity of a transaction and are in particular used to meet regulatory requirements or for valuation purposes.[86]

Table 4 provides a rough estimate on the importance of pre-trade market data revenues compared to total raw market data revenues[87]. On average, revenues of pre trade and post trade data are 85% and 15% of raw market data fees, respectively, . For three out of four respondents that are covered in this table, including a trading venue with sizeable pan-European trading activity, pre-trade data revenues are 100% of raw market data revenues.

Table 4. The importance of pre-trade market data

1. Pre-trade market data revenues / Raw market data revenues				
Low	*High*	*Average*	*Weighted average*	*Median*
43%	100%	85%	87%	92%

Note: The weights used for the average are total revenues of the individual firm. Four respondents to the survey provided data on revenues from pre and post-trade market data. Sample size of 4 trading venues.

Trading venues used to often bundle the offer of pre- and post-trade data together to extract a higher consumer surplus. Increased competition in secondary trading activities and the anticipation of the new requirements in MiFID II already led to changes in market practice with many trading venues offering pre- and post-trade data separately. In our sample only a few trading venues were still bundling the two sets of data.

2.3 Market participants

The demand side for market data products represents a broad variety of financial market participants, ranging from very small (e.g. small specialised investment firms or investment funds and individuals) to very big players (e.g. globally active banks, data vendors buying raw data) with very different business models and data needs (e.g. academics are interested in data for research purposes, investment firms are interested in post-trade data for regulatory purposes, proprietary trading desks are

[86] In the absence of pre-trade data, post-trade provides also valuable insight in trading opportunities.
[87] Please note that calculations are based on data from only four trading venues.

interested in pre-trade data for trading purposes). Buyers, given their size and diversity also have very different market power when negotiating conditions with providers of market data.

Suppliers for market data products are trading platforms and data vendors. The latter are neither regulated nor covered in the Commission's mandate for technical advice, and they are present both in the demand side for trading venues market data as well as in the supply side for buyers of market data. *Trading platforms* are the producers of raw pre-trade and post-trade data, which can be sold directly to investors or to data vendors. Furthermore, many trading venues also process and sell their own data or data from other trading revenues. *Data vendors* sell either directly the data received from trading venues, possibly bundled with information on other financial instruments or financial news, or process the raw data before selling it (e.g. to provide a consolidated picture across multiple markets or simply create an index), or they sell data consolidated together from multiple trading venues.

This market structure affects the total costs of market data. Overall, raw market data fees, i.e. data directly received from and sold by trading venues, are only a small component of the total market data expenditure of a typical professional/institutional investor, which Atradia estimated between 8% to 15% in 2010[88]. According to this study, data vendors' share of market data expenditure for those investors could reach up to 80% and mark-ups only on level 1 data fees (essentially raw market data) could go up to almost 60% in some cases.

As a consequence, the mark-up of data vendors on raw market data, their value added or consolidated services together with the cost of consolidating this information across trading venues, are an important contribution to the high market data cost in Europe.

2.4 Potential market failures

The comparatively high prices for (raw) market data in the EU in comparison to the US,[89] create barriers to the provision and usage of market data, impair information flow and the price discovery process and may ultimately effect market stability.[90] If these barriers are driven by voluntary actions, i.e. reflecting market power and hence the ability of a firm to raise prices over a competitive level, this could indicate a market failure and call for stronger policy action to ensure that market data is provided on a RCB.

As shown in section 2.2, the value of market data increases with the volume of trades executed on the trading venue. Consequently, market power in listing or execution services, measured in terms of market share[91], can be transferred to the adjacent market for market data. While many financial instruments traded across Europe

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[88] See Atradia (2010), "The cost of access to real time pre & post trade order book data in Europe. A review of content fees within the wider context of data product, delivery and infrastructure costs", August.

[89] See Oxera and Copenhagen Economics reports in footnote 83 for a more detailed illustration.

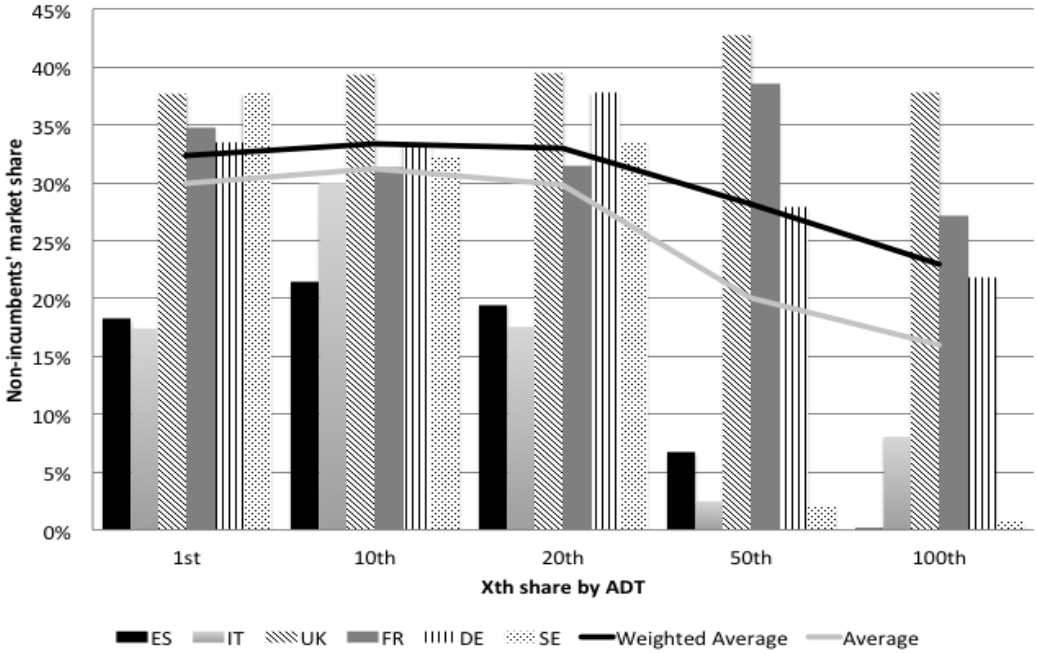
[90] Among others, Easley, D., O'Hara, M., & Yang, L. (2013), "Differential access to price information in financial markets", Working paper, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1787029##, Cespa, G., & Foucault, T. (2013), "Sale of price information by exchanges: does it promote price discovery?", *Management Science*, *60*(1), pp. 148-165.

[91] The best measure of market power is the ability to charge prices over the marginal cost. Since marginal cost cannot be estimated, the second best proxy to measure market power is usually the market share.

on more than 250 venues[92], currently only very few venues have a consolidated pan-European dimension and offer services covering the same range of financial instruments across the EU. Those existing pan-European venues may use both high "horizontal" and "vertical" leverage when setting prices for market data. *Horizontal leverage* refers to the possibility of specialised venues (e.g. equities or fixed income) to exercise market power resulting from only very limited competition in their area of specialisation. *Vertical leverage* refers to the spill over of market power from execution and listing services to market data products. Since, secondary market trading in a given instrument remains on average highly concentrated, horizontal and vertical leverage remain high.

Figure **2** shows the market share of alternative trading platforms ("non-incumbents") in the six EEA markets from November 2013 to October 2014. While the market share of non-incumbent venues has increased to about 40% for the most liquid shares, i.e. shares with a high average daily turnover (ADT), significant dispersion across Member States can be observed and trading in less liquid shares remains more concentrated. In addition, non-incumbent trading activities are mostly wholesale with no listing services, which limits the price discovery power of their data.[93]

Figure 2. Alternative venues' market share in liquid equities



Source: ESMA MiFID Database and Fidessa Fragulator. Lit total turnover over the period 1 November 2013 – 31 October 2014. Liquid shares are selected and ranked according to their average daily turnover (ADT) on 2nd February 2014. Countries

[92] The ESMA MiFID Database lists about 106 regulated markets and 151 multilateral trading facilities.
[93] Hasbrouck (1995) suggests that, even if trading can take place in alternative venues, price discovery tends to be concentrated in the place where the instrument was originally issued (primary market), see Hasbrouck, J. (1995), One Security, Many Markets: Determining the Contributions to Price Discovery. *Journal Of Finance*, *50*(4), 1175-1199.

include Spain, Italy, United Kingdom, France, Germany, Sweden. The average is weighted by the size of the turnover of trading activity in shares during 2013.[94]

In other asset classes, such as fixed income and derivatives products, the concentration of market share of incumbents is much higher. Since barriers to market entry and exit remain high, it is unlikely that the situation will change in the near future. Hence, the concentrated trading activity can affect overall pricing of market data.

The lack of concentration on the demand side, in particular of smaller market participants, further increases the pricing power of trading venues. On the other hand, trading venues which offer several other related services to buyers of market data (e.g. execution, post-trading) have less incentives to charge high fees or rely on opaque market practices and are more likely to take customer feedback into account.

Market power and the lack of concentration of the demand side can also create incentives for unfair market practices. Box 1 provides an overview of the practices identified in our survey as unfair.

Box 1. An overview of market practices

Buyers of market data, responding to ESMA's CP and to the data gathering exercise, listed some frequent practices of sellers of raw market data (trading venues) and data vendors, which in their view are "unfair". Issues arise in particular with the transparency of some pricing and licensing practices:

- **Disclosure of terms of use.** Limited disclosure of the terms of use for data products may allow for discretionary decisions about discounts or different terms of use that are not based on objective criteria.
- **Sudden changes to terms of use.** Some trading venues may change the terms of use with no advance notice, justification and without any consultation, in case of major changes or when new licences are introduced.
- **Bundling**. Combination of data in different bundles of products or uses may result in users charged multiple times for the same information under non-display licenses.[95]
- **Multiple charging for same information.** The same data may be sold to the same user multiple times, in case the trading venue does not apply a "per-user pay" model. Venues may charge different licenses per area of use for the same buyer (e.g. Research, Risk, Trading, Portfolio Valuation).
- **Restrictions to production of new data**. Licensing terms for the production of new derived data (like indices) may not allow free of charge, even internal, distribution of newly created information.
- **Unnecessary charges.** Additional fees charged that are not strictly linked

[94] The shares representing the 1st, 10th, 20th, 50th and 100th most liquid share by ADT for the following countries are: UK (Vodafone, Lloyds Banking Group, Anglo American, Aberdeen Asset Management, Babcock International Group), Italy (Unicredit, SNAM, UBI Banca, Cerved Information Solutions, Sogefi), France (Sanofi, France Telecom, Carrefour, Natixis, Bourbon), Spain (Banco Santander, Gas Natural, ACS Actividades de Construccion y Servicios, Almirall, Tecnocom), Germany (Siemens, Muenchener Rueck, Fresenius Medical Care, Celesio, SGL Carbon), Sweden (Ericsson, SEB, Tele2, Bufab Holding AB, Bilia A).

[95] In the case of re-distribution licenses, it is common to charge for the number of devices that access this information. For non-display licenses this may result in multiple charges for the same information if there are overlapping data bundles.

to market data (e.g. Network Service Provider fees).

Respondents confirmed that, in the case they still charge per device, those additional charges could be avoided via a direct feed with the venue. According to the responses received on this topic, a per user payment model would stop or limit these potentially excessive charges.

3. The transparency approach

3.1 High level assessment of policy trade-offs

Transparency requirements can contribute to ensure that market practices follow the guiding principles of fairness, reasonableness and non-discrimination. The application of those principles could provide for more transparent and comparable data fees and terms of use and potentially drive market data costs down.

More transparency on the pricing of fees, content of data and costs of producing and disseminating data would enable supervisors, buyers and other stakeholders to effectively compare offerings, spot best practices, monitor compliance with the non-discrimination requirement and allow for better informed investment decisions, as investors may internalise the cost of accessing data. However, given the multitude of market data offerings, it may be difficult to monitor market practices if more transparency is not accompanied by more harmonisation on the formats and content of information to be provided.

Lastly, an approach based on principles would not be costly in terms of implementation, as confirmed by the majority of respondents to the data gathering exercise, including trading venues.

Table 5. Policy trade-offs

Advantages	Disadvantages
Greater comparability of data fees and terms of use allow for better informed investment decisions	Limited impact on pricing power of trading venues and on costs for market data for end users
Pricing based on transparent and objective criteria measurable ex ante (low uncertainty)	
More effective market monitoring and lower barriers to access information	
Limited impact on business models (incl. low compliance costs)	

Greater transparency of market data offers, however, would be insufficient by itself to reduce pricing as market power of incumbents, which is then translated to their data offerings would not be affected (one still needs to buy data from the relevant markets in terms of liquidity or the reference markets). The ability “to shop around” is thus limited, and buyers would still have to buy the data from a particular venue that concentrates most of the liquidity in an instrument, if they intend to trade in that instru-

ment. Furthermore, trading venues may have incentives to control dissemination of market data to preserve some level of differentiation between informed and uninformed traders[96]

The following sections further develop the conditions for ensuring that increased transparency can deliver its benefits by defining the key elements of information to be disclosed and enhancing comparability (harmonization) of the information to be provided.

3.2 Content to be disclosed

In the CP ESMA proposed a list of items to be published on a website, including disclosure of changes to prices:

1. Price lists (including updates and changes);
2. Historical information;
3. Number of instruments covered;
4. Total turnover of instruments covered;
5. Pre-trade/post-trade ratio;
6. Value added information;
7. Last licence fee adaption for the respective product.

Respondents to the consultation (including trading venues and users) were sceptical about this list, stressing that it does not necessarily reflect the granularity of the information required for greater transparency and comparability of market data products. Respondents believed that some of the items were unnecessary for users to assess market data offers, while some others not included were deemed relevant. Terms of use were considered as important as levels of price, since adjusting the terms can change the value of the data without changing the price and unbundling per financial instrument and, in some cases, per different markets appears to be not commonly available.

More granular information on prices and terms of use and information on costs would enable users to assess whether data was provided on an RCB. In light of the feedback received, the following categories are considered indispensable for delivering a high standard of transparency, and we have modified our recommendation accordingly:

1. Transparency of market data products prices and terms of use;
2. Transparency of the process through which prices and terms of use are set and applied to users (incl. disclosure to customers of changes of prices and terms of use in advance and a justification for a price increase or decrease);
3. Transparency on costs and revenues

[96] See Grossman, S. J., & Stiglitz, J. E. (1980), “On the impossibility of informationally efficient markets”, *The American economic review*, 393-408.

3.3 Enhancing comparability

Thousands of potential bundling combinations can make pricing of market data products very complex, and could make an approach based on cost assessment very difficult to put in place and to supervise. The information about the data offer should be fully comparable and allow end users to evaluate whether the data offer is in line with the overarching principles of fairness, reasonableness and non-discrimination.
To ensure disclosure in a user friendly way allowing for comparability and enhancing access to market data, the use of a template (a so-called Key Market Data Document) for each data product offered by a trading platform within the scope of the RCB, could be considered. The information would be disclosed, for example on the website of the trading venue, in a concise format, accompanied by a more detailed description of each component, where necessary. An individual "data product" could be defined on the basis of market data with a specific content (e.g. pre or post-trade), depth (e.g. level 1 or level 2), latency (e.g. normal latency or closest to real-time) and terms of use. A price should be available for each combination of these four factors. At least the following information should be included in the template:

1. Definition of the "data product"
    a. Content (e.g. pre-trade data);
    b. Depth (e.g. level 1);
    c. Latency (e.g. real-time or delayed);
    d. Type of license available with its terms (e.g. derived data);
2. Pricing information
    a. Fees for all the available licences;
    b. Advance disclosure of changes to the terms of use and fees (including the last change to the fee, with relative amount increase/decrease);
    c. Discount policies;
    d. Unit of count (e.g. device, user, etc.).
3. Content information
    a. Number and nature of the instrument or instruments covered;
    b. Value added service with the additional fee component (e.g. a customised data feed for algorithmic traders);
    c. Last licence fee adaption.

4. The price-based proposals: the revenue cap and the LRIC+

An alternative approach to ensure that market data products are sold on an RCB is based on the definition of a viable methodology to calculate the "reasonable" price, via tools commonly used in price regulation. The rationale for such interventions is the limitation of a principles based approach (described above) to remedy the market power of trading venues to set prices above the level one would expect in competitive markets.
As mentioned in section 2.2 the characteristics of the production process for market data may add additional complexity since price regulation for joint products is more challenging than for by-products. Whereas for by-products no joint costs would have to be allocated due to their incidental nature and costs would be limited to variable and fixed costs for collecting and distributing the data, joint costs and their allocation

play an important role for joint products. Furthermore, some cross-subsidisation with execution and listing services, where market power ultimately resides, is possible. Hence lower prices for market data might potentially result in higher fees for trading related services.

ESMA has identified two main tools through which limits on prices could be imposed on trading venues selling raw market data:

1. A cap based on a monetary indicator (total revenues); and
2. Price fixation via a long run incremental cost calculation, plus a mark-up (LRIC+).

4.1 The "total revenues" cap

Under a cap on total revenues a venue would have to limit the revenues from data charges to a proportion of total revenues. A cap on revenues has the advantage that is readily available and is regularly updated by individual firms. This tool also leaves some flexibility to the producer on how to reallocate revenues (and so the prices) among the products offered to the market (see

Table 6).

Table 6. Policy trade-offs

Advantages	Disadvantages
Easily identifiable indicator	Inaccurate and static measure that may impact investments in innovation and relies on arbitrary criteria
Flexibility for the producers to adjust prices and quantities across products under the same threshold	Implementation risks (never implemented before in financial services)
	Monitoring costs (risk of circumvention)
	Impact on business models and on costs of trading

However, this proposal has important shortcomings. Firstly, revenues are an alternative way to look at prices. If prices are distorted, an indicator based only on revenues will not solve the underlying problem that prices are distorted in the first place. Therefore, setting a threshold in the absence of a cost estimation is arbitrary and risks to be inaccurate, with the risk of curbing investment in innovation (if too low) or having a limited impact on prices (if too high). It would also need to be constantly monitored and periodically reviewed to avoid a significant impact on the incentives of the market infrastructure to invest in innovation. If incorrectly designed, a revenues cap can also lead to regulatory arbitrage via for instance the use of different accounting standards or a different consolidation of revenues at group level to inflate or deflate values as needed.

Secondly, it would not adapt to the business model of the firm or provide incentives for the firm to invest in a more efficient infrastructure. It is also unknown territory since such an approach has to date never been implemented in the area of financial

services. While one-off costs appear to be low on first glance, ongoing costs could potentially be high, both for firms, which would have to regularly calculate revenues per product or per business area, and supervisors, which would have to oversee the offer of data products encompassing thousands of potential combinations.
Finally, a cap on revenues might miss its main policy objective, i.e. to improve access to market data on a RCB. Since venues would not be able to increase revenues from selling data, it is unlikely that access to data would be improved. It could also be that trading services become more expensive to compensate for lower market data fees.
Given the significant disadvantages and risks ESMA has ruled out the use of a cap on a cost indicator.

4.2 A long-run incremental cost model with a mark-up (LRIC+)

The LRIC+ model has two key components: the LRIC and a mark-up (the plus, "+"). The LRIC component estimates the change in the total cost of running the incremental service (a discrete variation), in this case the provision of the entire publication service. LRIC is often used in the case of natural monopolies, where only one supplier can efficiently provide a production level at the lowest marginal cost. Supervisors fix the sale price to avoid that the existing supplier can abuse its position but can recover costs at the same time. By definition, long-run incremental costs do not include fixed costs, i.e. investments in the common market infrastructure (including sunk costs). These are recovered by the mark up (the "+").
Besides allowing trading venues to recover joint production costs allocated to market data, this option has the advantage of effectively restraining the supplier's market power and is expected to lead to less spill-over effects on investments in innovation than the revenues cap model since it adapts to different business models.

Table 7. Policy trade-offs

Advantages	Disadvantages
Recovery of joint production costs	Inaccuracy risk (cost modelling) and impact on price discovery
Restraining suppliers' market power with limited impact on investment in innovation	Implementation risks, as never implemented before in financial services regulation and it needs a common methodology
Flexibility towards diversity of business models	Implementation and compliance costs for for trading venues and supervisors
	Impact on business models of trading venues

On the other hand, LRIC+ has significant drawbacks. Firstly, there is the risk of inaccuracy, i.e. wrongly estimating the LRIC and the mark-up. The model would estimate a "variable" long-term component, essentially a measure estimating the cost of distribution of market data and also a "fixed" long-term component, the "plus", which can be defined as an indicator to allocate the total cost of the common infrastructure

producing the joint products. ESMA suggested that the increment should be the venue's entire data publication service. The risk of inaccuracy in setting the parameters and negatively affect the price discovery mechanism[97] call for a rigorous testing of the two components of the cost model.

Secondly, it would go along with high one-off and on-going implementation costs for supervisors and trading venues. Supervisors would need to implement a common methodology applied across the market. If firms themselves calculate the LRIC+ with no detailed guidance, very different models might be used, impeding effective supervision. In addition, supervisors would have to face the complexity of market data offerings and their pricing in several combinations and bundles. Respondents to the targeted data gathering confirmed that implementing LRIC+ by firms would imply high compliance costs. They expressed concerns on how costs would be defined and estimated with the bottom-up approach, since this would entail the definition of a theoretical model for the estimation of the LRIC component. Data users also showed preoccupation around the supervisory and compliance costs to run this model, which in their view would be passed onto clients. If not constantly monitored and periodically reviewed, these practicalities can make the approach costly and inefficient for supervisors, industry and final users.

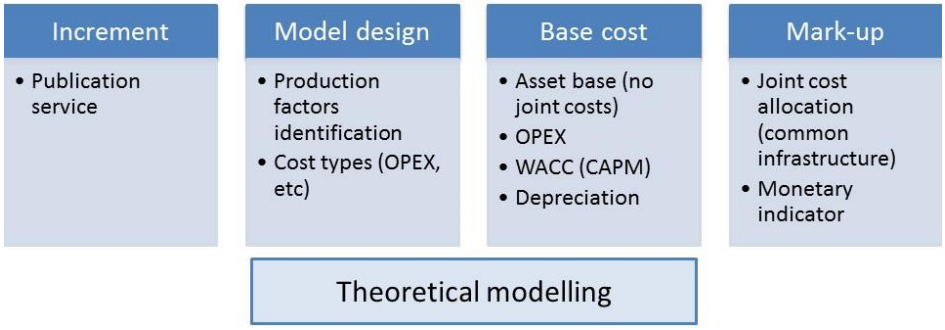
Thirdly, to date LRIC(+) has never been applied in the area of financial services. While it has been successfully applied in the telecommunication sector and other utilities, the financial services sector has different characteristics than these utilities which might raise additional challenges. Lastly, LRIC+ is a very intrusive approach with possibly far reaching impacts on the business models of trading venues, as has been stressed by respondents to the data gathering exercise.

4.2.1 Calculation Methodology

The LRIC+ can be modelled in four phases (Figure 3). The first phase defines the incremental service that serves as the reference to establish how total cost varies with its introduction. When designing the cost model, i.e. identifying which production factors contribute to the production and distribution of raw market data, the modelling should map the costs of the production factors (e.g. salaries, software, etc.). The third and fourth phase would estimate the base cost (LRIC) and a mark-up ("+"). Estimating the mark-up requires identifying and allocating joint costs. The mark-up should also include the share of joint-costs before split-off not captured in the LRIC. Revenues could be a good starting point to assess the share of joint costs to be allocated to the data publication service.

[97] As Cespa & Foucault (2013, p. 21) write: *"One drawback [of capping fees] however is that as price information becomes more widely available, speculators might have less incentive to acquire information from other sources. A decrease in the fee for price information could then negatively affect price discovery, instead of strengthening it."*

Figure 3. LRIC+ Modelling



If a LRIC+ approach where considered it should be based on the following methodology:

1. Define the key business areas that use the common infrastructure (most likely, listing, trading execution, raw market data, non-raw market data);
2. Establish the total cost to run the infrastructure for those services (mainly IT, property costs and personnel, but also an estimate of sunk costs);
3. Collect data on revenues generated by the individual key business areas; and
4. Use the raw market data revenues estimate (a percentage of total listing, execution and data revenues) as the indicator to establish the share of total (fixed) costs for common infrastructure that is attributable to the provision of raw market data services.[98]

5. Conclusions: benchmarking the three options

The regulation of market data is a complex exercise in a relatively new field of economic theory. Taking into account the nature of the product and the market structure, ESMA had proposed three options in its CP:

1. Transparency requirements;
2. A cap on total revenues;
3. A price fix based on a LRIC+ model.

Table 8 provides a high-level summary table of the policy trade-off of these different options. According to users of market data responding to the targeted data gathering exercise, a reduction of market data costs would significantly reduce overall trading costs. Moreover, lower costs would improve the overall efficiency of financial markets in terms of quality and quantity of information flows by reducing barriers to market data access for the market as a whole. LRIC+ appears to be the most effective option in terms of reducing prices, but it is also the most intrusive approach and goes along with high costs, both for venues and supervisors, and implementation difficulties.

On the other hand, improving transparency would be far less intrusive, albeit with the drawback of a more limited impact on the level of prices. The further developed transparency approach recommended by ESMA (the A+ option) overcomes some

[98] The estimate could also include sunk costs, if they can be estimated.

shortcomings of the initial transparency approach by requiring the disclosure of more granular data in a harmonized format and also information on costs and revenues. This approach should help in isolating unfair practices due to reputational losses. It will also contribute to improve market monitoring through a more effective and consistent communication and consultative process with market participants (including competitors). Even though the proposal may not immediately lead to significantly lower market data charges, it may create incentives for the development of best practices, mainly based on reputational mechanisms. Furthermore, it will increase transparency on the mark-ups charged by data vendors, which may increase market pressure to limit additional charges from them and may thereby contribute to lower charges for market data for end-users.

Table 8. Summary table of policy trade-offs

	Advantages	**Disadvantages**
Transparency requirements	• Greater comparability of fees and terms of use allow for better informed investment decisions • Pricing based on transparent and objective criteria measurable ex ante (low uncertainty) • More effective market monitoring and lower barriers to access information • Limited impact on business models (incl. low implementation costs	• Limited impact on market power and costs for market data end users
Total revenues cap	• Easy identifiable indicator • Flexibility for producers to adjust prices and quantities across products under the same threshold	• Inaccurate and static measure that may impact investments in innovation and relying on arbitrary data • Implementation risk • Monitoring costs (risk of circumvention) • Impact on business models of trading venues and costs of trading
LRIC+	• Recovery of joint production costs • Restraining suppliers' market power with limited impact on investment in innovation • Flexibility towards diversity of business models	• Inaccuracy risk (complex modelling) and impact on price discovery • Implementation risk • Implementation and compliance costs for trading venues and supervisors

		• Impact on business models of trading venues

A policy intervention in two steps can be an effective roadmap to clamp down high data fees and opaque market practices. In a first step option A+ should be pursued. The development in prices for market data should be assessed when reviewing MiFID II, including considering whether additional action is necessary. The role of data vendors could also be assessed at this stage.
While the RCB mandate does not cover issues in the underlying markets price discovery, it should be highlighted that an important contribution to higher prices for raw market data stems from the lack of competition at pan-European level.

The data gathering exercise

The data gathering exercise was run on behalf of ESMA by the Centre for European Policy Studies (CEPS) and consisted of two questionnaires: one addressed to trading venues, and one addressed to a broader range of market participants. These questionnaires were distributed to key stakeholders across the industry (i.e. buyers of market data, trading venues and data providers) asking for quantitative and qualitative data on the nature of financial market data products, their cost of production and generated revenues, as well as about market practices and the possible impact of ESMA's proposals.

The full database of firms that were contacted on this topic takes into account size, geographical location and nature of business activities. For that purpose, first, a database specifically for this data gathering was created with contacts from multiple sources including those received from national competent authorities and national or European associations. Customised questionnaires were sent to those that, according to the nature of their business activity, had an interest in providing data and information on the topic.

Two questionnaires were distributed to two distinct groups of market participants. The first questionnaire was sent to trading venues (TVs), i.e. producers of raw pre-trade and post-trade market data because they are the platform where trading takes place and raw market data are originally produced ("Trading Venues" questionnaire). The second questionnaire went out to a broader set of market participants, which included licensing and licensed data vendors and buyers of market data, mainly MiFID investment firms and investment funds (.Others" questionnaire). A total of 50 market participants answered to these questionnaires, 9 trading venues[99], 1 data provider, 1 index provider, and 39 buyers of market data).

Table 1. Questionnaire responses

	Total	TVs	Data/index providers	Others (buyers)
"Trading Venues" Questionnaire	10	9	1	-
"Others" Questionnaire	40	0	1	39
Total	**50**	**9**	**2**	**39**

The sample received represents the characteristics of different financial market data markets within the EU, as it includes data from 11 European countries: Denmark, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Spain, Sweden and the United Kingdom.

Key areas of the questionnaires

[99] Six out of nine were major EU trading venues in equities, fixed income and listed derivatives products.

The data gathering aimed at collecting as much information as possible on the key characteristics of market data products, their production process (including costs and revenues), market practice and the implications of ESMA's proposals on the offering of market data products and services.
The "Trading venues" questionnaire covered the following areas:

- Revenues;
- Data services/products provided;
- Bundling and pricing;
- Licenses and restrictions to use;
- Economic value of market data activity;
- Costs (fixed and variable) of the common infrastructure[100];
- Cost allocation;
- Costs (fixed and variable) of market data;
- Types of variables and fixed costs;
- Possible estimation of a long-run incremental cost (LRIC);
- Compliance costs (in selected areas); and
- Perceived impact (with explanation) of the ESMA options.

The "Others" questionnaire covered the following areas

1. Buyers of market data from primary source (including licensed/licensing data providers)
    - Unfair market practices
    - Best practices
2. Licensing/licensed data providers
    - Limitations in the use of data
    - Revenues
    - Services
    - List of licenses
    - Cost (fixed and variable) of the infrastructure
    - Cost allocation
    - Costs of market data (variable and fixed)
    - LRIC estimation
    - Compliance costs (selected areas
3. Buyers of market data as final users (including buyers from data vendors)
    - Transparency
    - Unfair terms
    - Multiple licenses
4. Overall impact of ESMA's proposal

[100] "Common infrastructure" is the platform through which trade execution and market data production take place.

- General impact of the 3 options presented in the CP
- Impact of ESMA's proposals on business models

5. Micro-structural issues

5.1. Algorithmic and high frequency trading (HFT)

Background/Mandate

Extract from the Commission's request for technical advice (mandate)

ESMA is invited to provide technical advice to further specify on the definition of what should be considered algorithmic trading as opposed to high frequency algorithmic trading technique to ensure a uniform application of the authorization requirement for persons that engage in high frequency algorithmic trading technique taking into account the need to capture all genuine high frequency traders.

1. The concepts of "algorithmic trading" and "high frequency algorithmic trading technique", as they appear in the Commission's mandate, are defined under Articles 4(1)(39) and (40) of MiFID II:

    i. Article 4(1)(39) of MiFID II defines algorithmic trading as "trading in financial instruments where a computer algorithm automatically determines individual parameters of orders such as whether to initiate the order, the timing, price or quantity of the order or how to manage the order after its submission, with limited or no human intervention, and does not include any system that is only used for the purpose of routing orders to one or more trading venues or for the processing of orders involving no determination of any trading parameters or for the confirmation of orders or the post-trade processing of executed transactions";

    ii. Similarly, Article 4(1)(40) of MiFID II defines high frequency algorithmic trading technique as "an algorithmic trading technique characterised by: (a) infrastructure intended to minimise network and other types of latencies, including at least one of the following facilities for algorithmic order entry: co-location, proximity hosting or high-speed direct electronic access; (b) system-determination of order initiation, generation, routing or execution without human intervention for individual trades or orders; and (c) high message intraday rates which constitute orders, quotes or cancellations".

2. Recital 61 states that high frequency trading (HFT) is a specific subset of algorithmic trading. Pursuant to Article 2(1)(d)(iii) of MiFID II any person that applies a high frequency algorithmic trading technique is required to be authorised as an investment firm. Therefore it is necessary to distinguish between these two concepts to ensure the uniform application of the authorisation requirement. Recital 63 further explains that it is desirable to ensure that all high frequency algorithmic trading firms be authorised to ensure they are subject to organisational requirements under the Directive and are properly supervised. Therefore any

further specification of the definition of “high frequency algorithmic trading technique” should be sufficiently broad to ensure that all genuine high frequency (HF) traders will be caught and dynamic enough to cope with market and technological developments.

3. Apart from what is described in the Commission’s mandate, it is relevant to note that using HFT techniques also entails other type of regulatory consequences under MiFID II. The last paragraph of Article 17(2) of MiFID II requires an investment firm that engages in a HFT technique to store, in an approved form, accurate and time sequenced records of all its placed orders, including cancellations of orders, executed orders and quotations on trading venues and to make them available to the NCA upon request.

Analysis following feedback from stakeholders

Original proposal by ESMA in the Consultation Paper

4. ESMA proposed two different approaches as regards the clarification of the HFT definition described below.

5. Under Option 1, a firm is deemed to be a HF trader if the following infrastructures designed to minimise latency and the capacity to transfer data to the venue are evidenced:

   i. the use of infrastructure designed to reduce latency such that the order messages are initiated, generated, routed, executed, amended or cancelled in proximity of the trading venue's matching engine; or

   ii. the use of infrastructure enabling a high volume of data to be transferred to the matching engine. Most markets offer higher bandwidths for latency-sensitive traders, because such enable them to achieve faster messaging or executions. On the basis of the information currently available, a bandwidth in the range of 10 Gigabit/second would be considered among the fastest provided. However, ESMA is conscious of the fact that the definition of “high bandwidth” is subject to technological change; and

   iii. the use of infrastructure resulting in a trading frequency of 2 messages per second on average should be considered as being generated by a machine/algorithm. The message volume should be monitor on a daily rolling basis based on the previous 12-month period.

   On that basis, in order to determine this threshold in absolute term (total number of messages per trading day), it would be necessary to multiply the amount of seconds available per trading day (which may vary from market to market) by 2.

   For each member, the sum of messages would then be calculated for each trading day and the moving average thereof calculated on a daily basis using the last 250 trading days. Days where a particular member/trader did not send messages at all would be

considered as having zero messages if the respective venue had been open for trading on that particular day.

6. ESMA proposed that the references to 'messages' above should be interpreted strictly, i.e. considering as one message each content that needs independent processing. On that basis, the messages to be counted for these purposes are each new order or quote, each successful change to an order or quote and each successful deletion of an order or quote. In cases of bulk transactions, every single message should be counted separately.

7. Under Option 2, each trading venue should periodically calculate the median daily lifetime of orders which have been modified or cancelled by all members/participants and the median daily lifetime of orders modified or cancelled by each individual member or participant. In cases where the median daily lifetime of the orders modified or cancelled by a members or participants falls below the median daily lifetime of orders modified or cancelled for the entire market, this member or participant would be considered as a HF trader. For this purpose 'Daily lifetime of orders' means that orders with a lifetime longer than one day should not be considered in the calculations.

8. ESMA's preliminary view was that the determination of the median daily lifetime of the orders submitted to the trading venue by all members/participants should only be made for liquid instruments, in which HFT is more frequent. Therefore, it was originally proposed that only orders regarding instruments considered as liquid following Article 2(1)(17) MiFIR should be considered for these purposes.

9. In order to calculate the median daily lifetime of the orders submitted by each member/participant it would be possible to consider either only those orders submitted for liquid instruments or all orders submitted to the trading venue (i.e. liquid and illiquid instruments, which might simplify the calculations because it would not be necessary to disentangle the activity of a member/participant relating to liquid instruments).

10. ESMA's preliminary view was that once a firm is deemed as a HF trader in one market, it should be considered as such for all trading venues in the EU.

11. Under Option 2, it would also be necessary to meet the MiFID II provisions, i.e. there has to be infrastructure to minimise latency (co-location, proximity hosting or high speed DEA) and system determination of order initiation, generation, routing or execution. Therefore, under this proposal, a trading venue that does not meet the Level 1 conditions would not be covered by either of the two options.

Feedback received from stakeholders

12. The majority of respondents supported Option 1 as they considered this proposal was:

    i. more straightforward;

ii. similar to the rule implemented and proven feasible in Germany; and

iii. based on the activity of investment firms rather than being dependent on the activity of other market participants.

13. Nevertheless, many of these respondents also considered that the threshold proposed (2 messages per second) was too low and that many large firms that were non-HFT would be captured by this threshold. A significant number of respondents considered that the calculation should be made on a per instrument/symbol/contract basis rather than on a per venue basis, due to the wide range of products traded on a single venue and the risk of large non-HFT firms being caught by trading simultaneously on multiple products. This would be particularly significant for firms trading derivatives, given the characteristics of these products.

14. Criticisms of Option 1 were based on the following arguments:

    i. It included a qualitative criterion (directly proximate), which is open to arbitrary interpretation;

    ii. Its quantitative thresholds could become obsolete due to technological changes, and as a consequence, they would need to be revised frequently;

    iii. The number of daily transactions could easily be circumvented;

    iv. The reference to a high bandwidth should be substituted by a reference to the speed of the connection available as, according to these respondents, the key for HF traders is speed and not capacity.

15. The main arguments cited by the respondents supporting Option 2 were the following:

    i. Focus on relative metrics (“median order duration”) which remain applicable as technology evolves;

    ii. Could not be circumvented easily;

    iii. Could be calculated by the trading venues without an input from the investment firms.

16. The criticisms of Option 2 brought forward by other respondents focused on:

    i. The need for a “floor”, otherwise under Option 2 every trading venue would have HFT participants. This would lead to a situation where non-algorithmic participants with the lowest median daily lifetime of orders in non-algorithmic trading venues would be considered as HF traders;

    ii. As it is based on a relative criterion, the calculation is strongly impacted by the speed and behaviour of other market participants trading on the same trading venue. It also

makes this criterion difficult to implement, maintain and administer because its parameters cannot be easily predicted;

iii. It would require firms to constantly assess their HFT status and result in a number of participants falling in and out of the HFT definition – this makes HFT obligations (e.g. maintenance of raw audit trail) very difficult to implement and makes it hard for firms to maintain awareness of their status during periods of growth and change;

iv. It would be easy to game by entering orders that stay longer in the book with the objective of increasing the median;

v. A consistent implementation in all trading venues might be complex and might require a harmonised technical implementation.

17. A significant number of respondents expressed strong reservations on both options in isolation. Some of these proposed combining the two options where both tests for high intraday message rates within Option 2 and Option 1 should be met.

18. Moreover, there were other technical comments with regards to the practical implementation of the above mentioned calculations:

    i. Some respondents noted that the calculation should be made on a per member/trading ID basis. However, other respondents also stress that ESMA should consider how the client is dealt with in the calculation (DEA or other client) and suggest to use the client ID and not the member/trader ID to perform the calculations. In particular, it was suggested considering separately the DEA flow of the member or participant of the trading venue.

    ii. Regarding the messages used for the calculations, it was indicated that:

        a. Only messages generated by the member or participant, not by the trading venue (internal system messages) should be taken into account. A particular case raised in this respect related to immediate or cancel (IOC), fill or kill (FOK) and book or cancel (BOC) orders where the cancellation message is generated by the trading venue, not the trading member. Respondents also suggested double counting of quotes on the other side and mass quotes.

        b. Only firm (directly executable) quotes should be considered for the calculations.

Algorithmic trading: further specification of the definition

19. When revising its proposals for the identification of HFT, a number of additional trading parameters were proposed by market participants:

i. Some respondents distinguished two types of processes that should be considered separately for the concept of “algorithmic trading” and HFT: automated trading decisions and optimisation of order-execution processes. These respondents noted that high frequency trading differs from algorithmic trading in that both processes are fully automated and synchronous;

ii. Adding a high order-to-trade ratio;

iii. Majority of aggressive orders;

iv. Turning inventory over frequently every day without holding a significant inventory at the end of the day;

v. Using advance technologies to manage latency such as GPUs and FPGAs or advanced coding techniques to avoid non-usable information in Java or C+.

20. ESMA agrees that there are two types of processes that should be considered separately for the clarification of “algorithmic trading” and HFT: automated trading decisions and optimisation of order-execution processes. In this respect, ESMA notes that:

    i. Algorithmic trading refers not only to the generation of orders but also to the optimisation of order-execution processes by automated means once the buy-and-sell decisions have been made by automated means or not. Therefore, algorithmic trading may still take place when the trading decision has been made by a person. This is consistent with the wording of Article 4(1)(39) of MiFID II whereby a computer algorithm automatically determines “individual parameters of orders”, i.e. also once the investment decision has been made;

    ii. There is limited or no human intervention (and therefore algorithmic trading) when the system at least makes independent decisions at any stage of order-execution processes, either on initiating, routing or executing orders. It is noted that the reference to “orders” encompasses “quotes” as well.

    iii. In particular in the case of HFT, both processes (trading decisions and optimisation of order-execution) are fully automated and synchronous, as highlighted by some respondents to the consultation. This is consistent with the wording of Article 4(1)(40) of MiFID II where it indicates that HFT encompasses “system-determination of order initiation, generation, routing or execution without human intervention for individual trades or orders”;

21. The use of algorithms which only serve to draw the trader’s attention to a particular situation is not considered as algorithmic trading. Thus, for example, the use of chart software which is programmed to chime or deliver a pop-up message whenever the price of a certain trad-

ing instrument intersects with the rolling average, without then automatically making a decision on issuing, amending or cancelling orders, is not seen as algorithmic trading.

22. Reference was made to the use of smart order routers in the responses to the consultation. In this respect, ESMA considers necessary to clarify the different scope of the concepts of Automated Order Routing and Smart Order Routing and specify whether they should be considered within the concept of "algorithmic trading".

23. Automated Order Routers (AOR) encompass those functionalities that determine the trading venue/s where the order should be submitted without changing any other trading parameter of the order. These functionalities often use algorithms and could thus be considered as algorithmic trading. However, Article 4(1)(39) of MiFID II explicitly excludes them from the definition of algorithmic trading if they only decide about the venue to which the orders should be routed. AORs defined as such are out of the scope of "algorithmic trading".

24. Smart Order Routers (SORs) are algorithms used for optimisation of order execution processes that may also determine additional parameters of the order other than determining the venue/s where the order should be submitted. In particular, SORs are able to slice the original order into "child orders" or determine the time of submission of the order or the "child orders". Examples of SORs would be trigger-contingent or delayed start time for an order; a trailing stop-loss order; orders contingent upon entry based on other instrument data and iceberg functionalities. SORs fall within the definition of "algorithmic trading" and the relevant MiFID II articles should apply to them.

High Frequency Algorithmic Trading Technique: revision of the original proposals and testing of the different approaches

25. While acknowledging the value that the alternative proposals put forward by market participants may have, ESMA does not advise including these parameters as a proxy for the identification of high intra-day rates because they may represent challenges in terms of detection by trading venues (for instance, a trading venue cannot know whether the trading decision and the optimisation of order-execution are synchronous) or in terms of harmonisation (there is no harmonised order-to-trade ratio that could be used as a common reference across Europe) and they would not capture all HFT strategies.

26. ESMA also acknowledges that the Commission's mandate indicates that "any further specification of the definition of "high frequency algorithmic trading technique" should be sufficiently broad to ensure that all genuine HF traders will be caught and dynamic enough to cope with market and technological developments".

27. At the same time, ESMA has considered the technical arguments put forward by respondents. In particular, ESMA acknowledges:

i. The comments received from a number of respondents indicating that both approaches might lead to “false positive” (non-HFT firms considered as such) and “false negatives” (HFT firms not considered as such); and

ii. The comments received by opponents to both approaches in relation to the possibility of “gaming” any of them.

28. So as to address the concerns reflected in the responses to the consultation, ESMA has used the database collected for the identification of HFT[101] to test the validity of the approaches described above. It took into account ESMA’s research carried out with this database: A sample of 100 stocks traded in BE, DE, ES, FR, IE, IT, NL, PT and UK during May 2013. The high heterogeneity of stocks in the sample can be used to analyse to what extent HFT activity is correlated with market value, value traded and fragmentation. The data collected cover 12 trading venues.

29. It is noted that the dataset is not complete in terms of instruments covered and venues. Therefore, the final results may diverge in case of using a complete dataset.

30. In line with what is described in this research, ESMA notes that there is no generally agreed proxy of HFT that can be used operationally. As a consequence, several different approaches have been identified, that could be classified into three categories:

    i. Direct approach, which relies on the identification of market participants based on their primary business (determined using the information available on the firms’ websites, business newspapers articles and industry events) or the use of co-location. The main drawback of this approach is that the dataset is not fully accurate: it does not include investment banks with HFT desks and in some cases the information about co-location is incomplete or inexistent (some trading venues did not have co-location facilities or these were outsourced to third parties and the data was not collected);

    ii. Indirect approach, uses patterns in trading and quoting as a proxy for HFT; and

    iii. Identification of strategies uses orders and trades to classify algorithms (market making, statistical arbitrage, momentum ignition, etc.)

31. On the basis of the responses received to the consultation ESMA has reworked the original proposals and tested them where possible against the identification of HFT using the direct approach.

[101] For further information about the data sample, see ESMA Economic Report “High frequency trading activity on EU equity markets”, December 2014, available in http://www.esma.europa.eu/page/CEMA-Documents.

32. This document explains the results of ESMA's analysis, without making a specific recommendation for one option or the other. Detailed results of this work will be also available in the ESMA Economic Report on High Frequency Trading activity on EU equity markets to be published by ESMA.

33. Taking the sample of data used for the ESMA survey, each market participant was flagged as "HFT", "investment bank" or "others" using a Direct Approach as described above. This means that for each of the stocks of the sample it was possible to identify the activity of different members/participants belonging to the categories referred above. Comparing HFT identification under Option 1 and Option 2 against the Direct Approach is useful, as the Direct Approach is likely to provide a lower bound for HFT activity[102].

Testing a modified version of Option 1 in the Consultation Paper [Absolute threshold per instrument]

34. ESMA has considered responses to the consultation which noted that making the calculations on a "per venue" basis would penalise big brokerage houses and firms trading multiple products on a venue while not capturing an investment firm effectively using a HFT strategy with a faster message rate per product if that firm's strategy is focused on a single product only.

35. Another issue worth mentioning is that setting a unique message threshold on a per venue basis will lead to more activity captured as HFT on large trading venues than on small trading venues, as it is easier to pass the message threshold on a large trading venue where a larger number of shares is traded than on a small trading venue.

36. Therefore, ESMA has considered a modified version of Option 1 [Absolute threshold per instrument] which considers that there is a "high message intra-day rate" where the market participant submits at least 2 messages per second with respect to any single instrument traded on a venue.

37. ESMA undertook the following analysis:

    i. Firstly, ESMA identified 1,211 members in different European trading venues[103] that were labelled as HF trader/Investment Bank/Other under the direct approach and were active at least once during the observation period (May 2013).

[102] The direct approach based on the identification of HFT firms according to their primary business provides a lower bound for HFT activity, as it does not capture HFT activity by investment banks.
[103] By construction, each member is different in each trading venue, including those venues that belong to the same holding.

Over the entire population of HFT, Investment Banks and Others, ESMA applied monthly the approach originally proposed in the Consultation (i.e. 2 messages per second in the ISINs covered by the sample), however on a stock-by-stock basis.

As being qualified as HFT affects the members' overall activity, and not only their activity in one particular instrument, ESMA determined which members fulfilled at least in one stock the abovementioned criterion. Those members meeting the proposed HFT identification criterion will be considered as HFT for their activity in all stocks (regardless of this member fulfilling the criterion in that particular stock).

Table 1 below show the results after applying the initial proposal of 2 messages per available second to an original population of 1,211 members in different venues (181 of them qualified as HFT under the direct approach) that met the criterion at least once for the stocks in the sample.

It was found that only 21 of those members had sent a number of orders that is at least higher than 2 times the available seconds in a particular stock. Of these 21 firms, 16 were classified in the Direct Approach as HFT firms, and 5 of them as Investments Banks.

ESMA tested again the threshold with less stringent time multipliers (1.5 per second, 1 per second and so forth) obtaining results that get closer to the number of combinations using the direct approach.

Table 1: Number of members[104] that fulfil the filter in at least one stock for different time multipliers

Message traffic approach. Number of firms classified as HFT under different thresholds								C.1
Direct approach	Total Population	Threshold value						
		2	1.5	1	0.75	0.5	0.25	0.1
HFT	181	16	24	30	37	40	57	75
IB	319	5	7	16	20	30	59	96
Other	711	0	1	1	1	2	7	12
All	1211	21	32	47	58	72	123	183

Note: Total population column contains the number of firms in each of the available categories according to the Direct approach. Columns under "Threshold value" indicate the number of firms that are classified as HFT according to the message traffic approach.

Source: ESMA.

ii. Secondly, ESMA has identified the percentage of trading that corresponds to those firms considered as HFT after applying the 2-messages per second threshold (and subsequently, less demanding thresholds thereof). From that perspective, the identified 21 firms categorised as HFT account for 13% of trading volumes in the stocks of the sample during the analysed period (May 2013).

[104] By construction, each member is different in each venue. Thus, a company that was member in two venues would be considered twice in this table.

Table 2: Percentage of total value traded by members that have been classified as HFT using different time multipliers

Message traffic approach. Activity classified as HFT under different thresholds. Upgrade rule								C.1
		Threshold value						
Direct approach	Total Value Traded	2	1.5	1	0.75	0.5	0.25	0.1
HFT	24	9	11	13	16	16	18	20
IB	61	4	6	12	13	17	28	42
Other	15	0	0	0	0	0	1	2
All	100	13	18	25	30	33	47	63

Note: % of value traded to total value traded. Total value traded considers all the activity by members using only their classification by the Direct approach. Columns under "Threshold value" indicate the % of value traded to total value traded in the sample that is classified as HFT according to the message traffic approach after using the upgrade rule, i.e. considering as HFT any activity of a firm that was considered as such in at least a stock.

Source: ESMA.

iii. It is noted that a significant number of respondents supported a combination of Options 1 and 2 setting more demanding thresholds under Option 1. On the basis of the analysis undertaken, it is highlighted that:

a. Any combination of those approaches will necessarily lead to a further reduction of the HFT identified increasing the difference between the number of HFT identified using the direct approach and the number of HFT identified using Option 1 and Option 2 cumulatively;

b. Setting a more demanding threshold under Option 1 (e.g. 4 messages per second) will also decrease the population of HFT captured significantly.

38. As already mentioned, setting a unique message threshold on a per venue basis will lead to more activity captured as HFT on large trading venues than on small trading venues. Thus, if the Commission considers proceeding with a threshold of messages per venue, these thresholds may need to vary in accordance with the number of liquid instruments traded on various venues.

Alternative proposal based on Option 1 of the Consultation Paper [Absolute threshold per trading venue and per instrument]

39. One of the weaknesses of option 1 modified described above is that a firm may exhibit a high intra-day message rate, but just below the single instrument threshold, across a range of products and hence not be classified as HFT. Therefore, ESMA has also considered an alternative proposal based on Option 1, the absolute threshold per trading venue and per instrument, which considers that there is a "high message intra-day rate" where the market participant submits at least 4 messages per second with respect to all instruments across a venue or, where the market participant submits at least 2 messages per second with respect to any single instrument traded on a venue.

40. This approach looks to ensure that a greater proportion of firms exhibiting a "high message intra-day rate" are identified as such. The single instrument messaging calculation looks to identify firms that are extremely active in a single product. A number of respondents noted that they felt this was an important hallmark of HF traders. To address this concern, ESMA proposes a lower messaging threshold to be applied to messaging activity on a single instrument basis only. If, however, this approach is not combined with a higher threshold for messaging activity, aggregated at a trade venue level, the definition may be more easily circumvented. Following a single instrument approach leaves the potential scenario where a firm is extremely active, but just below the thresholds outlined, on all instruments across a venue, and is not identified as exhibiting a "high message intra-day rate". To mitigate this scenario ESMA has outlined a separate, and higher, messaging threshold for messaging activity to be aggregated at a trading venue level.

41. Investment firms would be defined as HFT firms on a rolling basis under this approach and the determination would be made using the preceding 12 months' trading data. Testing this approach has not been possible as it would require the trading data of all participants, across all venues, to identify firms as HFT. It is likely, however, to result in a higher proportion of firms being identified as HFT under option 1 as there is an additional threshold with which to capture HFT activity.

Testing Option 2 of the Consultation Paper [Relative threshold]

42. ESMA undertook the following analysis:

    i. Over the entire population of 1,211 members in different European trading venues that were labelled as HFT/Investment bank/Other under the direct approach and were active at least once during the observation period (May 2013), ESMA applied the criterion originally proposed in the Consultation Paper: the median daily lifetime of the orders submitted by one member fell below the median daily lifetime of all orders submitted. Again, it has to be noted that more inclusive filters increase as well the risk of having "false positives" (firms wrongly classified as HFTs) and less inclusive filters increase the risk of having "false negatives" (HFTs not captured as such).

As being qualified as HFT affects the members' overall activity, and not only its activity in one particular instrument, ESMA determined which members fulfilled at least in one stock the abovementioned criterion. Those members are considered as fulfilling the proposed HFT filter, and all their activity in different stocks (regardless of this member fulfilling the filter in that particular stock) will be considered as executed by a member with HFT capacities.

Table 3 below shows that from an original population of 1,211 members (181 of them qualified as HFT under the direct approach) that had traded at least once in one of the stocks in the sample, the population reduces to 565 if one considers those whose median lifetime of orders falls immediately below the median daily lifetime of the entire orders [<50 percentile] submitted to that particular stock (represented in the table as 50 percentile):

a. 153 correspond to firms identified as HFT using the Direct Approach;

b. 221 correspond to firms identified as Investment Bank using the Direct Approach; and

c. 191 correspond to firms identified as Others using the Direct Approach.

To calibrate this filter, alternative thresholds have been used and their results reported. Instead of using the median daily lifetime of orders in this particular stock, lower percentiles have been used (10th, 20th, 30th and 40th). These are stricter identification criteria, thus the number of identified HFT decreases.

Table 3: Number of members that fulfil the filter in at least one stock for different percentiles of lifetime (by stock)

Lifetime of orders relative approach. Number of firms classified as HFT under different thresholds						C.1
		Threshold value				
Direct approch	Total Population	10th Percen-tile	20th Percen-tile	30th Percen-tile	40th Percen-tile	50th Percen-tile
HFT	181	61	84	118	145	153
IB	319	40	75	123	162	221
Other	711	21	57	92	131	191
All	1211	122	216	333	438	565

Note: Total population column contains the number of firms in each of the available categories according to the Direct approach. Columns under "Threshold value" indicate the number of firms that are classified as HFT according to the relative lifetime approach.

Source: ESMA.

ii. Following on from this, ESMA has identified the percentage of trading that corresponds to those firms considered as HFT after applying the Option 2 approach (and subsequently, more demanding thresholds thereof). From that perspective, the identified 565 firms categorised as HFT account for 78% of value traded in the stocks of the sample during the analysed period (May 2013).

Table 4: Percentage of total value traded by members that has been classified as HFT using different percentiles of lifetime (by stock)

Lifetime of orders - relative approach. Activity classified as HFT under different thresholds. Upgrade rule						C.1
		Threshold value				
Direct approch	Total value traded	10th Percen-tile	20th Percen-tile	30th Percen-tile	40th Percen-tile	50th Percen-tile
HFT	24	9	13	18	21	22
IB	61	7	16	26	34	47
Other	15	0	2	3	4	8
All	100	16	31	47	59	78

Note: % of value traded to total value traded. Total value traded considers all the activity by members using only their classification by the Direct approach. Columns under "Threshold value" indicate the % of value traded to total value traded in the sample that is classified as HFT according to the relative lifetime approach after using the upgrade rule, i.e. considering as HFT any activity of a firm that was considered as such in at least a stock.

Source: ESMA.

43. On that basis, and provided that the Commission decides to follow this approach, it is recommended considering a member or participant in a trading venue having a "high message intraday rate" where the median daily lifetime of its modified or cancelled orders falls under a certain threshold to be set between the 40th and the 20th percentiles of the daily lifetime of modified or cancelled orders from all members or participants on that trading venue.

Other considerations

44. The mandate received by ESMA only refers to the provision of "technical advice to further specify on the definition of what should be considered algorithmic trading as opposed to high frequency algorithmic trading technique to ensure a uniform application of the authorisation requirement for persons that engage in high frequency algorithmic trading technique taking into account the need to capture all genuine high frequency traders".

45. However, from the responses received arises a number of issues worth considering in isolation: the limitation of the scope; timing of calculations; order flow to be considered for identifying HFT; whether a firm caught by the HFT definition for one instrument in one venue should be considered as such for other instruments or venues and how should firms cap-

tured under the concept of “market making strategy” under Article 17 of MiFID II be considered for these purposes.

Limitation of the scope

46. MiFID II does not contain any limitation in terms of scope for the determination of high frequency trading and the effects thereof. However, while acknowledging that high frequency trading strategies can be implemented in illiquid instruments, empirical evidence indicates that there is more HFT activity in very liquid stocks with high market values (“blue chips”)[105].

47. When asked in the context of Option 2 about a limitation of the scope to liquid instruments, many respondents only took the opportunity of this question to reiterate their support for option 1. In their views, option 2 would:

    i. Allow participants to circumvent the rules (by ceasing to trade for a few days or slowing down trading when the median rises too high);

    ii. Enable big market participants to influence on the status of other trading participants; and,

    iii. Restrain the development of new (or existing low-volume) products for which they are only a few firms trading increasing the risk to qualify as an HFT for those products.

48. For those who effectively answered the question, 4 respondents agreed with taking into account only orders sent for liquid instruments while 4 others favoured the inclusion of all instruments which would, in their views, greatly simplify monitoring and compliance.

49. Lastly, it should be noted that for many respondents, should option 2 be preferred, the median should be calculated at market or even at instrument level.

50. Nevertheless and in case any of the options described above is preferred by the Commission, ESMA still recommends that at least in a first phase (considering as such until the assessment of the report foreseen in Article 90(1)(c) of MiFID II) the identification of HFT should be focused on liquid instruments. In this way, it is possible to address the concerns of those respondents that pointed out the need for a “floor”, to avoid a situation where in non-algorithmic trading venues those non-algorithmic participants with the lowest median daily lifetime of orders would be considered as HFTs.

Timing of calculations to determine whether one firm should be considered as HFT

[105] See ESMA Economic Report indicated above.

51. Option 1 proposed a determination of the threshold on a rolling basis per trading day based on the previous 12-month period, whereas Option 2 did not propose a specific periodicity for the analysis of the median daily lifetime of the order.

52. One of the points raised by the responses received against Option 2 was the uncertainty that the calculation may raise to market participants, as they should keep control of their status as registered HFT in particular in a context where that registration would depend on the performance of the rest of the market. So as to address these concerns, it is recommended that in case option 2 is followed, the calculations should be made on an annual basis by the trading venues jointly with the annual transparency calculations.

Order flow to be considered for identifying HFT

53. A number of respondents were concerned that aggregating messaging activity at trading venue level would incorrectly identify firms acting on behalf of a large number of clients as high frequency traders.

54. Firms trading algorithmically must, under Article 25 of MiFIR, retain relevant data relating to all orders and all transactions in financial instruments which they have carried out, whether on own account or on behalf of a client.

55. In that context, and regardless of the approach followed by the Commission to identify high frequency trading, it is proposed that if an investment firm is classified as HFT, the firm may challenge this classification if it believes this is a direct result of its non-proprietary messaging flow.

56. Investment firms shall analyse the records above to determine the level of messaging activity which is attributable to the proprietary activity of the investment firm, and the level which is attributable to the clients of the investment firm. Under this approach, the investment firm should provide this summary to the relevant competent authority which would determine whether the firm has been incorrectly identified as exhibiting a “high intra-day message rate”.

57. One benefit of pursuing this approach is that it may identify clients that exhibit a high message intra-day rate that are not direct members of a venue.

Situation of market makers with respect to the identification of HFT

58. As indicated above, ESMA is recommending at a first stage limiting the identification of HFT to liquid instruments.

59. This temporary limitation would address, at least partially, one of the concerns expressed by a number of respondents which suggested excluding market makers who are subject to a Continuous Quoting Obligation by virtue of a binding written agreement. As a consequence,

firms engaged in market making obligations in illiquid instruments following an agreement signed with the issuer should be excluded from the eventual classification as HFTs.

60. However, the main concern of a significant number of responses to the CP was the situation of firms which run "market making strategies" as defined by Article 17(4) of MiFID II as this is one of the most typical HFT strategies (as indicated by Recital 61 of MiFID II).

61. Firms engaged into a "market making strategy" will have to sign a "market making agreement" following Articles 17(3) and (4) and Article 48(2) and (3) of MiFID II[106].

62. ESMA considers that extracting market makers under the provisions of Article 17 and 48 of MiFID II would limit excessively the scope of application of the relevant provisions because:

    i. The purpose of MiFID II is to impose additional controls on those firms which effectively exploit HFT techniques (and therefore, it addresses market participants which have not previously engaged in a market making or liquidity provision scheme with a trading venue); and

    ii. Market making strategies are just one of the typical strategies that HF traders exploit[107].

Consequences of being captured under the HFT definition

63. In the context of option 2 ESMA consulted about the proposal whereby a firm classified as HFT in one trading venue should be considered as such in all trading venues in the EU.

64. A majority of respondents were not in favour of the solution proposed by ESMA. Arguments they provided include:

    i. ESMA's proposal overlooks the complexity of firms: firm undertaking HFT often have alternative discretionary trading and low volume strategies. A HFT strategy pursued by a firm in relation to part of its business should not characterise the entire firm as a HFT firm (e.g. might use HFT in shares but not in bonds);

    ii. ESMA's proposal could lead to misleading information: respondents point out the risk to dilute the information available and, more generally, the regulatory focus which the definition of HFT is designed to bring about on HFT activities themselves;

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[106] ESMA notes that recital (60) of MiFID II considers that the definition of "market making strategy" is independent from the definition of "market making activity" in the context of Regulation (EU) No 236/2012 of the European Parliament and the Council (the Short Selling Regulation). MiFID II addresses differently high frequency traders and market makers (see for instance recital (18), (20), (23), (50)). In particular recital (112) refers to transactions concluded through the medium of designated market makers appointed by the regulated market which are undertaken under its systems and in accordance with the rules that govern those systems.

[107] See, for instance, Aldridge, I. "High Frequency Trading", pages 165 to 197.

iii. ESMA's proposal would impose additional costs on firms: investment firms considered as performing HFT activities would face additional recordkeeping and operational costs relating to compliance with MiFID II regardless of whether the trading in question is HFT;

iv. ESMA's proposal could have negative effect on non-HFT and small venues: some venues do not offer the necessary connectivity or technicality to perform HFT and, thus, their members should not categorize as HF traders. This might also dissuade firms from becoming members of smaller venues on which they will not trade with high frequency but will nevertheless face more onerous obligations than they should for the nature of the business they engage in on those venues (e.g. low volume trading);

v. ESMA's proposal could also have side-effects: some members stress that, in the future, other pieces of European legislation could refer to the MiFID II classification and, therefore, it is very important for ESMA to be as specific as possible when defining HFT; and

vi. With regard to the correct level of assessment, these respondents consider that a definition at venue level or even at instrument level would be more appropriate.

65. On the contrary, respondents supporting ESMA's proposal welcomed the simplicity of the proposed approach which would decrease the burden of having multiple classifications for the same entity. They also stressed that HF traders are generally implementing their strategies cross-venue, for instance using the information collected on one venue to trade on another venue.

66. ESMA considers relevant to note that the points described above belong to a Level 1 discussion, i.e. the interpretation of MiFID II. As described in the CP being classified as HFT entails two main types of regulatory consequences under MiFID II: authorisation as investment firms, as prescribed by Article 2(1)(d)(iii) of MiFID II and storage in an approved form accurate and time sequenced records of all its placed orders under Article 17(2) of MiFID II.

67. MiFID II provides for a binary outcome: either a firm is considered an HFT firm or not. If a firm meets the HFT definition, the requirement described above will apply across the firm regardless of the fact that HFT strategies are employed within a part of that firm, or that they are employed only on certain venues to which the firm has an access. Therefore, the consequence of being deemed HFT would not change whether such determination is made on a per instrument, per symbol or per contract basis rather than on a per venue basis.

68. The scope of the qualified record-keeping obligations of firms engaged in HFT techniques under Article 17(2) of MiFID II is not affected by the fact of being considered as HFT or not. In line with Article 25(1) MiFIR, the records to be kept by firms should permit NCAs to fulfil their supervisory tasks under MiFIR, MAD and MAR, leading to a situation where firms have to store all elements which are necessary to understand and monitor these firms' trading ac-

tivity[108]. The sole difference between a non-algorithmic investment firm and a HFT is the format that shall be prescribed for HFTs under Article 17(2)(d) MiFID II.

69. As a consequence, ESMA considers that the identification of one firm as HFT should not be limited neither in the scope of instruments nor in its consequences.

Technical advice

1. ESMA recommends the European Commission to adopt the following clarifications with regard to the definition of algorithmic trading:

   i. "where a computer algorithm automatically determines individual parameters of orders such as whether to initiate the order, the timing, the price or quantity of the order or how to manage the order after its submission" means that automated trading decisions and the optimisation of order execution processes by automated means are included in the definition of algorithmic trading;

   ii. "with limited or no human intervention" means that arrangements are considered as algorithmic trading if the system makes independent decisions at any stage of the processes on either initiating, generating, routing or executing orders. It is noted that the reference to "orders" encompasses "quotes" as well.

   iii. "does not include any system that is only used for the purpose of routing orders to one or more trading venues or for the processing of orders involving no determination of any trading parameters" excludes automated order routers that only determine the venue(s) where the order should be submitted without changing any other parameters of the order.

2. ESMA advises the European Commission to follow one of the three options described below as proxies for the identification of "high message intra-day rates":

   i. Absolute threshold per instrument: a participant/member would be deemed to have a "high message intraday rate" when the average number of messages sent per trading day to any single liquid instrument traded on a venue is above 2 messages per second.

   ii. Absolute threshold per trading venue and per instrument: a participant/member submitting on average at least 4 messages per second with respect to all instruments across a venue or 2 messages per second traded with respect to any single instrument traded on

[108] See Discussion Paper, pages 516 to 519.

a venue would be deemed to have a “high message intraday rate”.

iii. Relative threshold: a member or participant in a trading venue would be deemed to have a “high message intraday rate” where the median daily lifetime of its modified or cancelled orders falls under a threshold below the median daily lifetime of all the modified or cancelled orders submitted to a given trading venue. If the Commission decides to follow this approach, ESMA recommends setting that threshold between the 40th and the 20th percentiles of the daily lifetime of modified or cancelled orders from all members or participants on a trading venue.

3. Whichever option the European Commission adopts, it would be necessary to meet the requirements described in Article 4(1)(40) of MiFID II in terms of infrastructure intended to minimise network and other types of latencies.

4. In case any of the options described is preferred by the Commission, ESMA also recommends that:

   i. at least in a first phase (considering as such until the assessment of the report foreseen in Article 90(1)(c) of MiFID II), the identification of HFTs is focused on liquid instruments;

   ii. the calculations are made:

      a. For the absolute approach, on a rolling basis by the trading venue considering the preceding 12-months; or,

      b. For the relative approach, on an annual basis by the trading venues at the same time as the annual transparency calculations.

   iii. firms pursuing market making strategies, as described by Article 17(4) of MiFID II, are considered in the calculations.

5. For the identification of high frequency trading, ESMA is of the view that only proprietary order flow should be considered. Regardless of the approach followed by the Commission to identify high frequency trading, it is proposed that if an investment firm is classified as HFT, the firm may challenge this classification if they believe this is a direct result of their non-proprietary messaging flow. To that end, investment firms should analyse the records under Article 25 of MiFIR to determine the level of messaging activity which is attributable to the proprietary activities of the investment firm, and the level which is attributable to the clients of the investment firm and provide this summary to the relevant competent authority who would determine whether the firm has been incorrectly identified as exhibiting a “high intra-day message rate”.

5.2. Direct electronic access (DEA)

Background/Mandate

Extract from the Commission's request for technical advice (mandate)

ESMA is invited to provide technical advice to further specify the definition of Direct Electronic Access (DEA) to ensure a uniform application and encompasses all types of arrangements that meet this definition.

Article 4(1)(41), MiFID II

'direct electronic access' means an arrangement where a member or participant or client of a trading venue permits a person to use its trading code so the person can electronically transmit orders relating to a financial instrument directly to the trading venue and includes arrangements which involve the use by a person of the infrastructure of the member or participant or client, or any connecting system provided by the member or participant or client, to transmit the orders (direct market access [DMA]) and arrangements where such an infrastructure is not used by a person (sponsored access [SA]).

Analysis following feedback from stakeholders

Direct Electronic Access (DEA) and Automated Order Routers (AORs)

1. ESMA requested the views of market participants about how to further clarify the definition of DEA (and as a consequence, those of DMA and SA) to capture all types of arrangements that might meet this definition.

2. ESMA received 52 answers on the question on whether other activities should be covered by the term "DEA". There was wide disparity in the responses received, with the following as the main underlying topics:

    i. No identification of additional services that should be considered within the scope of the DEA definition;

    ii. Need for a clear differentiation between the activities of automated order routing (AOR), smart order routing (SOR) and DEA.

    iii. A significant number of respondents requested narrowing down the definition of DEA on the basis of the activity of the DEA user, not on the basis of the type of access to the market or the service provided when granting direct access to a trading venue. For these respondents the natural recipients of the DEA requirements are algorithmic and high frequency traders, and expanding the scope of the MiFID II requirements following

Article 2(1)(d)(ii) of MiFID II would trigger a number of consequences for those corporate end users , mainly:

a. Need for authorisation as investment firm and as a consequence falling under the requirements of MiFID II, MiFIR and Capital Requirements Regulation.

b. Following the previous argument, the DEA user would become a "financial counterparty" as defined for the purposes of EMIR. Therefore the DEA user would be subject to higher level obligations imposed by EMIR including mandatory clearing and collateralisation, making irrelevant the EMIR differentiation between OTC derivatives for hedging or speculative purposes.

3. With respect to the differentiation between AOR and DEA, ESMA received 47 responses which did not show a clear majority supporting including or excluding AOR from the DEA scope. The core argument provided by those considering AOR within the concept of DEA was that those orders are not subject to the discretion of the AOR provider.

Conclusion

4. ESMA agrees with market participants on the need to differentiate between the different services provided. In particular, it notes that the use of the concepts of AOR and SOR have raised most of the attention in this respect.

5. ESMA notes that when defining "algorithmic trading", Article 4(1)(39) of MiFID II considers out of that scope systems which are "only used for the purpose of routing orders to one or more trading venues (…) involving no determination of any trading parameters…".

6. On the basis of the responses received to this section of the Consultation Paper (CP) and also the responses provided in relation to the questions about the identification of high frequency trading (HFT), ESMA considers that there are three different elements to consider:

   i. SORs are algorithms used for optimisation of order execution processes and may determine parameters of the order other than the venue/s where the order should be submitted. In particular, SORs are able to slice the original order into "child orders" or determine the time of submission of the order or the "child orders". Examples of SORs falling under this category would be trigger-contingent or delayed start time for an order; a trailing stop-loss order; orders contingent upon entry based on other instrument data and iceberg functionalities. SORs fall within the definition of "algorithmic trading" and the relevant MiFID II articles should apply to them.

   As long as those SORs are not embedded in the client's order generating system, but in the market member's/participant's own routing system, it is considered to be out of the scope of DEA, as the client of the market member has lost control over the time of submission of the order and its lifetime.

ii. AOR systems encompass those functionalities that determine the trading venue/s where the order should be submitted without changing any other trading parameters of the order (Article 4(1)(39) of MiFID II).

An AOR as described above does not qualify for or disqualify from the provision of DEA in case it is embedded in the routing systems of an investment firm. AOR in isolation without the rest of the elements of DEA as described in MiFID II (permission to use the DEA provider's trading code for submitting orders directly to the trading venue either through the infrastructure of the DEA provider or not) should not be considered as the provision of DEA.

DEA and other electronic order transmission systems

7. ESMA noted in its CP the proliferation of electronic order transmission systems provided to investors which have become more sophisticated over time. These systems permit clients to transmit orders to investment firms through those firms' web-based interfaces ("online brokerage").

8. ESMA considered that the key differentiating element between these web-based interfaces and DEA was the use of individual direct connectivity with separate access.

9. ESMA received 52 answers about using shared connectivity arrangements to qualify a connection to the market as DEA. The first conclusion to be drawn from the responses received was that the definition of "shared connectivity arrangement" was unclear for a significant number of respondents as almost all connectivity lines between investment firms and trading venues have some point of shared connectivity. On that basis, ESMA does not rely on the concept of "shared connectivity" as an indicator for "online brokerage".

10. Instead, ESMA considers that the key element to qualify as DEA is the type of control over order execution that each type of service provides to its users. In the case of orders submitted by DEA users the critical element is the ability of the DEA user to decide on the exact fraction of a second of order entry and lifetime of the orders within that timeframe.

11. ESMA considers systems that allow clients transmitting orders to an investment firm in an electronic format (on-line brokerage) to be outside of the scope of DEA as long as the client does not have the ability to determine the fraction of a second where the order should enter the order book or react to incoming market data within those timeframes.

12. ESMA considers that website-based trading systems fall outside the scope of the definition of DEA as long as they do not provide the user that type of control over order entry and order execution. This view corresponds with the IOSCO Consultation Report entitled 'Policies on Direct Electronic Access' (February 2009) which does not consider "trading models of a customer calling the intermediary or sending an internet order to the intermediary" as DEA because, as long as the customer's trading is intermediated, it is not 'direct access'.

Technical advice

1. The definition of DEA as appears in MiFID II does not encompass any other activity beyond the provision of Direct Market Access and Sponsored Access.

2. The critical element to qualify an activity as DEA, regardless of the technology used for those purposes, is the ability to exercise discretion regarding the exact fraction of a second of order entry and the lifetime of the orders within that timeframe.

3. Where a client order is effectively intermediated by the member or participant of the trading venue (and therefore the submitter of the order does not have control over those parameters), the arrangement would be out of the scope of DEA. ESMA considers systems that allow clients transmitting orders to an investment firm in an electronic format (on-line brokerage) to be outside the scope of DEA as long as the client does not have the ability to determine the fraction of a second where the order should enter the order book or react to incoming market data within those timeframes. Nevertheless, the investment firm would conduct algorithmic trading when submitting those client orders if it uses smart order routers and in that case, it should be compliant with Article 17 of MiFID II.

4. With respect to the differentiation between DEA and AOR and SOR, ESMA considers that:

   i. SOR systems are algorithms used for optimisation of order execution processes and may determine parameters of the order other than the venue(s) where the order should be submitted. In particular, SORs are able to slice the original order into “child orders” or determine the time of submission of the order or the “child orders”. Examples of SORs falling under this category would be trigger-contingent or delayed start time for an order; a trailing stop-loss order; orders contingent upon entry based on other instrument data and iceberg functionalities.

      SORs fall within the definition of “algorithmic trading” and the relevant MiFID II articles should apply to them.

      If orders of clients are routed via a SOR of the market member/participant, this arrangement does not constitute DEA. SORs used by the client should be considered as DEA if the client has a permission to use the trading code of the market member/participant to directly access the market and the SOR is embedded into its systems, not into the DEA provider’s.

   ii. AOR systems encompass those functionalities that determine the trading venue(s) where the order should be submitted without changing any other trading parameter of the order (Article 4(1)(39) of MiFID II).

      AOR as described above does by itself not qualify for or disqualify from the provision of

DEA in case it is embedded in the DEA systems. AOR in isolation without the rest of the elements of DEA as described in MiFID II (permission to use the DEA provider's trading code for submitting orders directly to the trading venue either through the infrastructure of the DEA provider or not) should not be considered as DEA.

6. Requirements applying on and to trading venues

6.1. SME Growth Markets

Article 33(3)(a), MiFID II

Background/Mandate

Extract from the Commission's request for technical advice (mandate)

ESMA is invited to provide its technical advice on options as regards each of the requirements that a SME growth market will need to meet in accordance with Article 33(3) of the Directive.

With respect to requirements enacted in Article 33(3)(a) ESMA is notably invited to provide technical advice to specify how to apply the 50% criterion to various predictable situations including where no track record is available for newly created markets or issuers or in case of issuers of non-equity securities only.

In addition, ESMA is invited to provide technical advice to specify rules governing the registration and the deregistration of the SME growth markets, it being specified that pursuant to Article 33(8) these measures shall ensure that refusal to register or de-registration do not occur as a result of a merely temporary failure to meet the SME growth markets eligibility criteria.

Article 33(3), MiFID II

3. Member States shall ensure that MTFs are subject to effective rules, systems and procedures which ensure that the following is complied with:

(a) at least 50 % of the issuers whose financial instruments are admitted to trading on the MTF are SMEs at the time when the MTF is registered as an SME growth market and in any calendar year thereafter;

1. ESMA notes, that one of the aims of MiFID II is to facilitate access to capital for SMEs and the development of specialist markets catering specifically for the needs of SMEs[109.] To that end MiFID II envisages establishing a regime for the registration of MTFs offering facilities to SMEs as 'SME growth markets' (SME-GMs), where they meet certain criteria specified by MiFID. This new category of MTF shall raise the visibility and profile of specialised SME markets and shall establish common pan-European standards while at the same time

[109] Cf. Recital 132 of MiFID II.

providing sufficient flexibility to be able to incorporate the existing current range of successful markets operating in that field.

15. The definition of an SME[110], together with the proportion of issuers admitted to a SME-GM that need to constitute SMEs in order for it to qualify as a potential SME-GM, are dealt with at Level 1.

16. However, Article 33(8) of MiFID II envisages that the Commission will adopt delegated acts further specifying the requirements that a SME-GM will need to meet in order to be registered as such in respect of the various effective rules, systems and procedures SME-GMs have to comply with as established in Article 33(3) of MiFID II.

17. The requirements to be met by a SME-GM[111] shall, according to MiFID II, take into account the need for the requirements to maintain high levels of investor protection to promote investor confidence in those markets while minimising the administrative burdens for issuers on the market so striking the correct balance between those two principles. The requirements are expressed to be without prejudice to the general obligations owed by the operator of an MTF under MiFID II112. In addition, the operator of an SME-GM would be permitted to apply requirements that go beyond the minimum MiFID II requirements.[113]

18. ESMA also notes that, according to Article 33(4) of MiFID, "the criteria in paragraph 3 are without prejudice to compliance by the investment firm or market operator operating the MTF with other obligations under this Directive relevant to the operation of MTFs". Among those other obligations is a responsibility to "...establish and maintain effective arrangements and procedures, relevant to the MTF..., for the regular monitoring of the compliance by its members or participants or users with its rules" (Article 31 MiFID). ESMA notes that, where an MTF is registered as a SME-GM, arrangements and procedures for the monitoring of compliance with the rules of the SME-GM will be "relevant" to the MTF.

19. Apart from the responses to the consultation, ESMA has also received feedback on this topic from the ESMA SMSG which has been integrated into the analysis below.

Analysis following feedback from stakeholders

20. Article 33(3)(a) of MiFID II requires that at least 50% of the issuers whose financial instruments are admitted to trading on the MTF registered as a SME growth market are small and medium-sized enterprises at the time when the MTF is registered as an SME growth market and in any calendar year thereafter.

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[110] Cf. Article 4(1)(13) of MiFID II.
[111] As specified by Article 33(3) and Recital 133 of MiFID II.
[112] For example, see Articles 18 and 19 of MiFID II.
[113] Cf. Article 33(4) of MiFID II.

21. SMEs are defined as companies with an average market capitalisation of less than € 200m on the basis of end-year quotes for the previous three calendar years in Article 4(1)(13) of MiFID II.

22. The aim of this Delegated Act is to further specify how the requirement of at least fifty per cent of issuers on an SME-GM being SMEs is to be applied.

23. The assessment whether at least 50% of issuers on an SME-GM are indeed SMEs shall be made on an annual basis and in a flexible way in order to ensure that a temporary failure to meet this criterion does not lead to an immediate deregistration or a refusal to be registered as an SME-GM in the first place.[114]

24. ESMA suggested in the Consultation Paper that the percentage of issuers whose financial instruments are admitted to trading and which can be classified as SMEs should be assessed on the basis of the number of issuers only, disregarding other factors (e.g. the size/turnover of the enterprise, the issuance size of the financial instruments or the number of different financial instruments issued by the same enterprise).

25. The large majority of respondents, including the SMSG, supported this approach and ESMA will therefore advise the Commission to base this assessment on number of issuers only.

26. In its Consultation Paper ESMA presented three different options for assessing in a flexible way whether the composition of the issuers on an SME-GM meets the at least 50% requirement under Article 33(3)(a) of MiFID II.

27. In order for the assessment to be flexible, ESMA considered that the requirement shall be deemed fulfilled even if the percentage of SMEs falls below the relevant threshold for a period of time in order to provide clarity and legal certainty for the issuers whose instruments are traded on those markets and for the market operators.

28. Therefore checks on the composition of issuers shall be carried out only on an annual basis based on the figures of 31 December of each year and ESMA considered the three following methods as feasible:

    i. at least 50% of the issuers admitted to trading on the SME-GM on that day are SMEs; or

    ii. at least 50% of the issuers admitted to trading on the SME-GM were SMEs for a period of at least 180 days in that year; or

[114] Cf. Recital 135 of MiFID II.

iii. at least 50% of the issuers admitted to trading on the SME-GM were SMEs based on an average of each month of the calendar year (the market capitalisation shall be checked at the end of each calendar month and an average shall be calculated on 31 December).

29. ESMA initially put forward method iii as the preferred one, considering it to be the most precise out of those methods.

30. A large majority of respondents to the consultation, including the SMSG, concurred with this assessment and favoured precision over simplicity. Therefore ESMA advises the Commission to use this option in the future delegated act.

31. In ESMA's view, the prospect of deregistration as a SME-GM should arise only if the SME-GM were to fall below the qualifying 50% threshold for a number of consecutive years, in order to provide sufficient certainty to operators of SME-GMs and the companies they admit to trading.

32. Following the analysis of the responses to the consultation, ESMA considers that an appropriate period before deregistering a market as a SME-GM should be three consecutive years of falling below the threshold. This time period was almost unanimously supported by respondents and was also backed by the SMSG.

33. Should an SME-GM be deemed not to meet the qualifying 50% threshold in one year, ESMA discussed in the Consultation Paper whether the SME-GM should disclose that fact to the market. Whilst ESMA saw a case for such disclosure, to make sure existing and prospective issuers were made aware of the position of the SME-GM, also drawbacks were identified as this may deter SMEs from joining the market and therefore make recovery to the 50% threshold more difficult than it would otherwise be.

34. Respondents to the consultation had mixed views on this point with the majority, including the SMSG, opposing a disclosure obligation but a sizable minority being in favour of transparency. ESMA, on balance, proposes not to require SME-GMs to disclose not meeting the threshold in one year to the public to avoid setting in train potential adverse developments for the SME-GM.

35. In the case of an entirely new market applying to become an SME-GM it shall be granted such authorisation if there is an expectation by the market deemed reasonable by the NCA that at least fifty per cent of the prospective issuers will be SMEs.

36. ESMA considers this a necessary clarification through implementing measures. New markets would not have any issuers yet and so, under a very literal application, would not meet the 50% criterion and could not be granted the status of an SME-GM. However, ESMA considers that new markets specifically designed to cater for SME issuers should not be barred from being granted the SME-GM status from the outset and therefore they shall be deemed

as meeting the 50% requirement if the market can reasonably expect that the issuers' constituency of the market will be comprised of at least 50% SMEs.

37. ESMA also considers that issuers should be counted as SMEs towards the 50% threshold if their market capitalisation upon commencement of trading or at the end of the first two years of trading is below €200m. This is another point that should be clarified through implementing measures because the SME definition in MiFID II refers to end-year quotes for the previous three calendar years which could be interpreted as excluding all SMEs with a lifespan of less than three years from counting towards the 50% threshold. However the SME-GM regime shall especially promote the access of young issuers which are likely to have a low market capitalisation so that such issuers should be taken into consideration when assessing whether the 50% threshold is met. ESMA therefore considers that as an expression of the flexible way of implementing the 50% criterion, SMEs with a history of less than three years should also be counted as SMEs if their market capitalisation upon commencement of trading or based on the end-year quote after the first year of trading or the average of the end-year quotes after the first two years of trading is below €200m.

38. ESMA is conscious that the Level 1 text refers to market capitalisation of issuers only which is a concept normally associated with equity issuers. There is a question therefore as to how non-equity issuers which would not have market capitalisation as such would feature when determining whether a market meets the "at least 50% must be SME issuers" criterion.

39. The more extreme alternatives put forward by ESMA in the Consultation Paper of how to deal with this problem were to either count all non-equity issuers as SME issuers (theoretically their market capitalisation could be considered to be zero) or to exclude all non-equity issuers when assessing the 50% criterion (again theoretically as non-equity issuers they could be considered not to have a market capitalisation below €200m). ESMA notes that these more radical options had hardly any support in the consultation.

40. The other options ESMA proposed in the consultation were based on an understanding of the term market capitalisation in a more general sense. A non-equity issuer issuing debt securities only was to be deemed a SME issuer if either the overall outstanding nominal value of the debt securities issued would not exceed €200m or to move to a turnover-based definition for non-equity issuers where ESMA considered using either an annual net turnover threshold of €300m or utilising the SME definition that is used in the Prospectus Directive which is based on annual net turnover not exceeding €50m, on the average number of employees (less than 250) and the total balance sheet (not exceeding €43m).

41. Respondents to the consultation had mixed views on which of these three options proposed they considered as most suitable with any of the options or indeed a combination of the options receiving support. The SMSG supported considering a non-equity issuer as a SME if its overall debt stands below €200m.

42. In the interest of flexibility and workability in this regard, ESMA ultimately decided to propose the use of a combination of options to the Commission. Non-equity issuers shall qualify as SMEs if the nominal value rather than the outstanding nominal value of debt securities issued does not exceed €200m. Non-equity issuers shall also qualify as SMEs if they are classified as SMEs pursuant to Article 2(1)(f) of the Prospectus Directive.

43. In response to queries raised in the consultation, ESMA would also like to point out that any issuer who has a market capitalisation, i.e. has issued equity, will always be assessed by that market capitalisation even if that issuer has only issued non-equity instruments on a particular market. This is to avoid a situation where an issuer would be deemed a SME on one market due to having only a small bond issue while in reality on another market being a large, non-SME equity issuer.

Technical advice

Technical advice on further specifying the requirement laid down in Article 33(3)(a) of MiFID II (SME-Growth Markets Eligibility Criteria)

The 50% criterion

1. The assessment whether at least 50% of issuers on an SME-GM are SMEs should be made on an annual basis.

2. The percentage of issuers whose financial instruments are admitted to trading and which can be classified as SMEs should be assessed on the basis of the number of issuers only, disregarding other factors (e.g., the size/turnover of the enterprise, the issuance size of the financial instruments or the number of different financial instruments issued by the same enterprise).

3. The composition of issuers should be checked based on the figures of 31 December of each calendar year in order to verify whether at least 50% of the issuers admitted to trading on the SME-GM were SMEs based on an average of each month of the calendar year.

Deregistration of SME-GMs

4. A temporary failure to meet the 50% criterion mentioned above should not lead to an immediate deregistration or a refusal to be registered as an SME-GM in the first place.

5. An SME-GM should only be deregistered as such if it were to fall below the qualifying 50% threshold for a number of three consecutive years.

6. An SME-GM, deemed not to meet the qualifying 50% threshold in one year or in two consecutive years, should not be required to disclose that fact to the market.

Application of the 50% criterion to new markets

7. An entirely new market applying to become an SME-GM should be granted such authorisation if there is an expectation that at least fifty per cent of the prospective issuers will be SMEs.

Application of the 50% criterion in the case of young SMEs

8. SMEs with a history of less than three years should also be counted as SMEs if their market capitalisation, upon commencement of trading or based on the end-year quote after the first year of trading or the average of the end-year quotes after the first two years of trading, is below €200m.

Application of the 50% criterion to non-equity issuers

9. Non-equity issuers should be considered as SMEs for the purpose of determining whether an SME-GM meets the requirement of having at least 50% SME issuers if:

    i. the overall nominal value of the debt securities issued by the issuer does not exceed €200m; or

    ii. the issuer is classified as an SME pursuant to Article 2(1)(f) of the Prospectus Directive.[115]

10. Any equity issuer having a market capitalisation will always be assessed by that market capitalisation, even if that issuer has only issued non-equity instruments on a particular market.

[115] 'small and medium-sized enterprises' means companies, which, according to their last annual or consolidated accounts, meet at least two of the following three criteria: an average number of employees during the financial year of less than 250, a total balance sheet not exceeding €43 000 000 and an annual net turnover not exceeding €50 000 000.

Article 33(3)(b), MiFID II

Background/Mandate

Extract from the Commission's request for technical advice (mandate)

With respect to requirements enacted in Article 33(3)(b) to (g), ESMA is invited to provide technical advice taking into account and ensuring consistency with other Union legislations.

Article 33(3), MiFID II

3. Member States shall ensure that MTFs are subject to effective rules, systems and procedures which ensure that the following is complied with:

(b) appropriate criteria are set for initial and ongoing admission to trading of financial instruments of issuers on the market;

Analysis following feedback from stakeholders

1. In formulating this technical advice, ESMA undertook an extensive fact finding exercise with a range of stakeholders in SME-GM.

2. Those discussions revealed that, among existing markets with a focus on SMEs, a broad spectrum of approaches exists in relation to the setting and application of issuer admission and disclosure requirements. Given this level of diversity, the preservation of an appropriate degree of flexibility for market operators under the supervision of NCAs, at member state level, is a central theme of ESMA's advice.

3. Based on the evidence it has gathered, appropriate criteria for the initial and on-going admission to trading of an issuer's securities could consist of a number of discrete elements. Examples of areas covered in the rules of existing markets are:

    i. an issuer's management and board;

    ii. an issuer's systems and controls enabling compliance with the rules of the MTF;

    iii. the adequacy of an issuer's working capital;

    iv. the use of financial reporting standards, such as IFRS;

    v. the maintenance of fair and orderly trading in an issuer's securities; and

    vi. requirements for issuers carrying on specialist activities, such as mineral exploration.

4. Further, the systems of rules and arrangements through which such criteria are applied (referred to, collectively, as the market's 'operating model') differ significantly across markets.

Findings on the operating model of an SME-GM

5. ESMA suggested in the Consultation Paper that the investor protection objectives of the SME-GM regime could be met through the application of a number of different operating models. For example, the investment firm or market operator operating an SME-GM could make its own assessment of whether an issuer is able to demonstrate that it meets the relevant admission criteria. Alternatively, in line with existing practices on a number of growth company markets, the rules of an SME-GM could require this assessment to be made by a third party corporate finance adviser which the issuer appoints, where the SME-GM operates an appropriate oversight regime for such advisers.

6. In the Consultation Paper, ESMA proposed that MiFID should remain neutral as to the operating model of an SME-GM, provided an NCA assesses it to be an effective way of applying the admission to trading requirements. It was noted that any attempt to prescribe one or more acceptable operating models would reduce flexibility for SME-GMs to adopt the model best suited to issuers and investors in its particular jurisdiction. Furthermore, in the case that the SME-GM adopts the adviser model, ESMA suggested that the nature of the oversight regime for the advisers should be left to the discretion of the venue.

7. Respondents to the Consultation Paper broadly agreed that SME-GMs should retain flexibility to develop operating models that take account of the characteristics of local markets, under the supervision of their NCAs to ensure appropriate emphasis is placed on the investor protection objectives of the regime. The SMSG also agreed with this approach.

Findings on the appropriate criteria for the initial and ongoing admission to trading

8. In the Consultation Paper, ESMA suggested that care should be taken in setting, at MiFID II level, requirements for SME-GMs which go beyond the general obligations of an MTF (as they will be reflected in Title II of MiFID II). ESMA notes that the existing regulatory environment has enabled a wide range of SME-GMs to develop, albeit without a common framework or identity.

9. For example, certain SME-focused MTFs have chosen to elaborate, within their rules, upon the particular steps necessary to meet the high level requirement for the maintenance of fair and orderly trading in an issuer's securities. Given the breadth and diversity of market practices, ESMA considers that the decision to elaborate in this way should rest with the market operator under the supervision of its NCA. It is, however, appropriate to recognise that the fair and orderly trading obligations owed by the operator of an MTF extend to its particular functions as an SME-GM, where it is registered as such.

10. In addition, during ESMA's consultation process, a clear consensus emerged for the avoidance of criteria that would supersede an issuer's national legislation or regulatory requirements by imposing one or more acceptable financial reporting standards. In particular, it was noted that the application of IFRS would be a source of significant additional cost for some issuers. ESMA does not therefore consider that such a requirement should be imposed.

11. In formulating its advice, ESMA has focused on the particular features of SMEs and the associated risks posed to investors. ESMA notes that investors in SMEs place significant reliance on the competence and propriety of the individuals directing the affairs of the SME and trust that they will give due regard to the interests of all shareholders. Further, in making a transition from private to publicly-quoted issuer, many SMEs are likely to have their first experience of the disciplines of such markets, particularly as regards matters such as the identification and timely dissemination of price sensitive information. SME-GM issuers are also likely to operate less well established businesses than issuers admitted to Regulated Markets, and may be more dependent on external sources of finance while they develop their businesses towards profitability. In that context, ESMA has considered a possible role for requirements which address:

    i. the appropriateness of an SME-GM issuer's management and board to fulfil the responsibilities of a publicly quoted company; and

    ii. the appropriateness of an SME-GM issuer's systems and controls in providing a reasonable basis for it to comply with its continuing obligations under the rules of the market; and

    iii. the adequacy of an issuer's working capital.

12. ESMA has had regard to the treatment of issuers seeking admission to a Regulated Market, as a benchmark against which to consider the appropriate requirements for SME-GM issuers in these areas. As a general principle, a proportionate approach for SME-GMs should entail a set of standards which are not more burdensome than those for Regulated Markets. In that context, ESMA notes:

    i. The Prospectus Directive does not foresee specific corporate governance requirements for issuers as a pre-condition to the admission of their financial instruments to Regulated Markets. The Prospectus Directive requires an issuer to disclose whether or not it complies with its country of incorporation's corporate governance regime(s). In the event that the issuer does not comply with such a regime, a statement to that effect must be included in the Prospectus together with an explanation regarding why the issuer does not comply with such regime.

    ii. MiFID does not require an issuer seeking admission to a Regulated Market to operate a prescribed set of systems and controls.

iii. In specific cases, the Prospectus Directive requires a statement by an issuer seeking admission to a Regulated Market that, in its opinion, the working capital available to it will be sufficient for its present requirements or, if it is not, how it proposes to provide the additional working capital needed. Accordingly, where an issuer's due diligence reveals that it may not have sufficient working capital, it may still comply with the provisions of the Prospectus Directive provided it has a plan to address the shortfall and discloses this position to investors.

13. Having considered responses to the Consultation Paper, ESMA considers that an attempt to prescribe requirements in relation to corporate governance, systems/controls or working capital at a MiFID II level would diminish the flexibility afforded to market operators. Based on the evidence it has gathered, it appears that the optimal regulatory approach for any given SME market in these areas will be particularly sensitive to local factors. These factors have led existing markets which could be candidates for SME-GM registration to implement a range of different approaches.

14. Consequently, ESMA considers that it is inappropriate for MiFID II or its implementing measures to prescribe detailed eligibility criteria in relation to an issuer's corporate governance or framework of systems/controls.

15. In the particular case of working capital, the Consultation Paper sought views on a proposal to align the SME-GM regime with the Prospectus Directive (PD) by taking a disclosure-based approach, alongside other options. While respondents expressed a range of views, there was a level of support for this approach, including from the SMSG. Consequently, consistent with the PD, ESMA considers that it would be appropriate for an issuer on an SME-GM to be subject to a requirement to make a working capital statement in its admission document, disclosing whether or not it possesses sufficient working capital (and if not how additional capital would be provided). In this way, the SME-GM regime will ensure appropriate investor protection while balancing the need to create a proportionate, transparency-led regime for issuers..

16. In the Consultation Paper, ESMA suggested that a requirement adopted for the purpose of Article 33(3)(b) of MiFID II, should oblige the operator of an SME-GM to satisfy its NCA that it sets and applies criteria which are effective in ensuring that issuers are 'appropriate' for admission to an SME-GM. A number of respondents considered that it would be reasonable for an NCA to consider whether such criteria made provision for the factors described in paragraph 57(i) to (iii) above, though respondents generally again stressed that practices in local markets can differ.

17. In light of consultation responses, ESMA considers that a SME-GM should be required to satisfy its NCA that it operates a process which is sufficient to establish that an issuer is generally appropriate for an SME-GM.

18. In this way, an NCA will retain discretion to grant registration to MTFs exhibiting a broad range of approaches; subject always to a requirement to refuse registration to an applicant whose approach fails to provide a suitable filter against inappropriate companies, viewed holistically. Such a requirement therefore strikes a balance between flexibility and the provision of proper protection for investors.

19. ESMA also notes the existing rules of certain MTFs with a focus on SMEs make provision for specialist types of issuers (for example, investment companies whose strategy is to invest in other businesses/projects rather than to operate their own business, or to carry on specialist activities such as mineral exploration), and/or for the admission to trading of financial instruments other than shares. ESMA does not consider that MiFID II implementing measures should provide for any additional responsibilities in such cases, but that it would be appropriate for an SME-GM to consider the benefits of a tailored approach.

Technical advice

Technical advice on further specifying the requirement laid down in Article 33(3)(b) of MiFID II (appropriate criteria for initial and on-going admission to trading of financial instruments of issuers on the market)

1. A market operator or investment firm operating an SME growth market should apply a regime of objective criteria which is effective in ensuring that issuers are appropriate for admission to the market.

2. An SME growth market should have an operating model which is appropriate for the performance of its functions.

3. An SME growth market should not be required to have rules that impose greater burdens on issuers than those applicable to regulated markets.

4. An SME growth market should not be required to have rules prescribing the use of IFRS.

5. An SME growth market should have rules which are consistent with the maintenance of fair and orderly trading in compliance with the obligations owed by the operator of an MTF under Article 18 of MiFID.

6. An SME growth market should consider whether it would be appropriate to apply tailored rules to issuers carrying on specialist activities, such as mineral exploration.

Article 33(3)(c), MiFID II

Background/Mandate

Extract from the Commission's request for technical advice (mandate)

With respect to requirements enacted in Article 33(3)(b) to (g), ESMA is invited to provide technical advice taking into account and ensuring consistency with other Union legislations.

Article 33(3), MiFID II

3. Member States shall ensure that MTFs are subject to effective rules, systems and procedures which ensure that the following is complied with:

(c) on initial admission to trading of financial instruments on the market there is sufficient information published to enable investors to make an informed judgment about whether or not to invest in the financial instruments, either an appropriate admission document or a prospectus if the requirements laid down in Directive 2003/71/EC are applicable in respect of a public offer being made in conjunction with the initial admission to trading of the financial instrument on the MTF;

Analysis following feedback from stakeholders

Introduction

1. Under EU Regulation, an issuer seeking admission to an MTF is not required to produce a Prospectus under the Prospectus Directive unless it is undertaking a public offer of securities in connection with its application. However, in line with the responsibility of an MTF operator to "…provide, or [be] satisfied that there is access to, sufficient publicly available information to en-able its users to form an investment judgement…" under MiFID II, a majority of primary market MTFs place minimum initial disclosure obligations on issuers, typically in the form of an 'admission document' or 'information memorandum', in circumstances where a Prospectus is not required.

2. Consistent with Article 33(3)(c) of MiFID II, an SME-GM issuer should be considered to meet its initial disclosure obligations where it is required to publish a Prospectus.

3. However, in line with current practices, Article 33(3)(c) of MiFID II recognises that the initial disclosure requirements should be deemed to have been fulfilled where an issuer publishes an "appropriate admission document". The Article envisages that an admission document should contain "…sufficient information…to enable investors to make an informed judgment about whether or not to invest in the instruments". In that context, ESMA suggested in the Consultation Paper that the Delegated Acts could elaborate upon Article 33(3)(c) of MiFID II

by setting requirements for the content of an admission document and any processes for its approval or review.

The content of an admission document

4. The regime established by the Prospectus Directive specifies, as a general principle, that a Prospectus must contain "…all information which…is necessary to enable investors to make an in-formed assessment of the assets and liabilities, financial position, profit and losses and prospects of the issuer…". Issuers must accordingly consider this general principle alongside the detailed disclosure requirements mandated for a Prospectus.

5. In the Consultation Paper ESMA suggested, a similar general principle should govern the content of an SME-GM admission document at MiFID II level, such that NCAs retain discretion to assess whether the package of rules set by individual market operators achieve this outcome. The drafting of such a principle should converge with the intent of MiFID II to ensure there is "…sufficient information published to enable investors to make an informed judgment about whether or not to invest in the instruments…". It should accordingly be expressed in the following terms: the admission document should, as a minimum, contain sufficient information for an investor to make an informed assessment of the financial position and prospects of the issuer, and the rights attaching to its SME-GM securities.

6. The Securities Markets stakeholders Group and the respondents to the Consultation Paper unanimously supported that approach, which ESMA maintained.

7. Existing primary market MTFs take different approaches to the initial disclosure of information by issuers. Certain markets take a 'top down' approach, under which market rules specify categories of disclosure required for a Prospectus that are dis-applied, or modified, for the purposes of an admission document. Other markets take a 'bottom up' approach, under which the rules provide a list of minimum information that must be included in the initial disclosure document.

8. ESMA suggested in the Consultation Paper that it does not appear necessary to prefer the top down or bottom up approach as a means of achieving the general principle set out above. ESMA noted that both approaches are evident among the range of existing growth company markets.

9. The large majority of respondents agreed that the operator of an SME growth market should be able to adopt the approach they believe to be the most adequate regarding admission documents where a Prospectus is not required and in those cases the rules set by governing the content of an admission document should be permitted to take a 'top down' or 'bottom up' approach.

10. The Securities Market Stakeholders group also expressed the view that the proposed approach stroke the right balance between adequate investor protection and necessary flexibility. Therefore, ESMA keeps the piece of advice consulted upon.

11. Irrespective of whether a SME-GM were to take a top down or bottom up approach, ESMA has considered the benefits and drawbacks of elaborating upon the general principle, at MiFID II level, by specifying the detailed disclosures (or categories of disclosure) that would be necessary as a minimum to constitute a MiFID II-compliant admission document.

12. For the purpose of this consideration, ESMA noted that the Prospectus regime has recently been updated to incorporate, among other things, a proportionate disclosure regime for SMEs and companies with reduced market capitalisation. That regime, set out in Annexes XXV to XXVIII of Regulation 486/2012 ('the proportionate schedules'), allows certain limited dispensations for SMEs. The proportionate schedules could provide a starting point for the design of a set of mini-mum disclosures for a SME-GM, further developing the general principle. If such a step were to be taken at MiFID II level, further work would be needed to evaluate which elements of the proportionate schedules would be appropriate for an admission document, noting in particular:

    i. as reflected in ESMA's technical advice , a cautious approach was taken to the proportionate schedules given that the proportionate regime would still form part of the disclosure framework for Regulated Markets. For example, market participants have previously noted that, on a quantitative basis, further significant cost savings could be made by examining the need for an operating and financial review and indebtedness statements;

    ii. existing primary market MTFs which take a 'top down' approach go beyond the proportionate schedules in dis-applying Prospectus requirements; and

    iii. consistent with the drafting of Article 33(3)(c), an 'appropriate admission document' should be differentiated to an appropriate extent from a Prospectus, while providing sufficient in-formation to investors.

13. In its Consultation Paper ESMA proposed that the content of an admission document should, at MiFID II level, be governed by the general principle only, to recognise the plurality of existing approaches. ESMA did not therefore believe that the further work referred to in the paragraph above is necessary, or that MiFID's implementing measures should attempt to prescribe detailed disclosure requirements. However, ESMA expressed the expectation that, on a case by case basis, an NCA would consider whether the package of initial disclosures required by the specific rules of an individual market were such as to achieve the general principle, and to refuse registration to an operator whose approach was inconsistent with the proper information of investors. ESMA invited views on whether, in principle, the detailed disclosures (or categories of disclosure) required for an SME-GM admission docu-

ment should be specified at MiFID II level, or alternatively (as ESMA believed) whether this should be left as a matter for market operators under the supervision of their NCAs.

14. Respondents to the Consultation paper broadly agreed that no detailed disclosure requirements should be set at the MiFID level. It should be for the market operator of the SME-GM to set out the requirements for the admission document, under the supervision of its NCA.

15. As noted above, ESMA considers that the admission document should contain a statement on the adequacy of the issuer's working capital, stating whether the issuer has sufficient working capital and, if not, how it proposes to make up the shortfall.

Responsibility for an admission document

16. In the case of existing primary market MTFs, NCAs generally do not receive or approve admission documents. In certain cases, the admission document's compliance with market obligations forms part of the due diligence responsibilities placed on an issuer's professional adviser.

17. ESMA suggested in the Consultation Paper that the responsibility for ensuring that the information contained in an admission document is accurate should lie unequivocally with the issuer. Consequently, ESMA did not consider it appropriate to require that an admission document is formally 'approved' (by an NCA or market operator) with respect to the accuracy of the information it contains.

18. However, given that the initial admission document is likely to have a significant influence on investment decisions, ESMA considered in the Consultation Paper that it may be appropriate for an SME-GM to make arrangements for a draft admission document to be subject to an appropriate review, such as to ensure that it adequately addresses each of the minimum disclosure requirements (in other words, that it is complete). For the sake of clarity, ESMA did not believe that it should be necessary for the NCA of an SME-GM to be involved in that review, and expects that the operating model of the SME-GM would help determine the appropriate process (e.g. potentially forming part of the role of an issuer's professional adviser, where an adviser-based model is present).

19. The views of the respondents were mixed. A majority of respondents supported the ESMA proposal that the future Level 2 Regulation should require an SME-GM to make arrangements for an appropriate review of an admission document, designed to ensure that the information it contains is complete. A minority of respondents didn't agree with the proposal. Some share the view that it is not appropriate for an SME-GM to make arrangements for a draft admission document to be subject to an appropriate review and the responsibility for ensuring that the information contained in an admission document is complete should lie unequivocally with the issuer alone. Others believe that the decision about the format and procedure regarding the review of the admission document should be left to the market operator.

20. Once more ESMA believes, with the support of the Securities Market Stakeholders's Group that the right balance is struck by giving to the SME-GM operator the ability to define how the admission document should be appropriately reviewed. Key is, however that the admission document clearly states whether or not it has been reviewed or approved and by whom. In this way, admission document readers will not be misled as to the status of the mentioned document.

21. Accordingly, and also following the advice of the Securities Market Stakeholders's Group ESMA is also maintaining the view that the responsibility for the admission document should lie with the issuer.

Technical advice

Technical advice on further specifying the requirement laid down in Article 33(3)(c) of MiFID II (appropriate criteria for the content of and responsibility for an admission document)

1. An issuer which seeks admission of its financial instruments to an SME growth market should publish an appropriate admission document, or a prospectus that complies with the requirements of the Prospectus Directive.

2. The admission document should, as a minimum, contain sufficient information for investors to make an informed assessment of the financial position and prospects of the issuer, and the rights attaching to its SME growth market securities.

3. Provided that a Prospectus is not at any time required by the Prospectus Directive, the rules set by the operator of an SME growth market governing the content of an admission document should be permitted to take a 'top down' or 'bottom up' approach.

4. The admission document should contain a statement disclosing whether or not, in its opinion, the issuer possesses sufficient working capital for its present requirements, and if not how additional capital would be provided.

5. The admission document should clearly state whether or not it has been approved or reviewed and by whom.

6. The responsibility for the admission document should lie with the issuer.

7. A market operator or investment firm operating an SME growth market should make arrangements for a draft admission document to be subject to an appropriate review, consistent with its operating model, such as to ensure that it adequately addresses each of the minimum disclosure requirements.

8. An admission document should be regarded as having been published where a publication method that satisfies Article 33(3)(f) of MiFID II is followed. ESMA's advice on the accepta-

ble methods for the public dissemination of regulatory information under Article 33(3)(f) of MiFID II is set out a below.

Article 33(3)(d) & (e), MiFID II

Background/Mandate

Extract from the Commission's request for technical advice (mandate)

With respect to requirements enacted in Article 33(3)(b) to (g), ESMA is invited to provide technical advice taking into account and ensuring consistency with other Union legislations.

Article 33(3), MiFID II

3. Member States shall ensure that MTFs are subject to effective rules, systems and procedures which ensure that the following is complied with:

(d) there is appropriate ongoing periodic financial reporting by or on behalf of an issuer on the market, for example audited annual reports;

(e) issuers on the market as defined in point (21) of Article 3(1) of Regulation (EU) No 596/2014, persons discharging managerial responsibilities as defined in point (25) of Article 3(1) of Regulation (EU) No 596/2014 and persons closely associated with them as defined in point (26) of Article 3(1) of Regulation (EU) No 596/2014 comply with relevant requirements applicable to them under Regulation (EU) No 596/2014;

Analysis following feedback from stakeholders

Article 33(3)(d), MiFID II

1. ESMA notes that requirements concerning appropriate on-going periodic financial reporting for issuers on regulated markets are, at the European level, established by the Transparency Directive (Directive 2004/109/EC as amended by Directive 2013/50/EU). Under the rules imposed by the Transparency Directive issuers on regulated markets are obliged to publish annual financial reports (Article 4) and half-yearly financial reports (Article 5) (the obligation to publish interim management statements was deleted in the recent review of the Directive).

2. ESMA also notes that the requirements in the Transparency Directive do not apply to issuers whose instruments are traded on MTFs only, although some national legislators may have decided to extend those requirements to MTFs. Therefore ESMA considers that on the one hand requirements applying to SME-GMs potentially should not be as onerous as the ones applying to regulated markets, while on the other hand, as the requirements applicable need to be of a standard "to maintain high levels of investor protection to promote investor confidence in those markets", therefore a middle ground should be found.

3. ESMA has looked at the rules applicable in existing markets which have a focus on issuers from the SME segment. While the rules applying when it comes to the detail quite naturally differ significantly, it seems that the majority of venues ask for the publication of annual and half-yearly reports. The SMSG agrees with this approach. Therefore ESMA suggests that implementing measures should require issuers on SME-GMs to publish annual and half-yearly reports. This would be with the intention of establishing a minimum standard which appears to be the prevailing best practice in existing markets. As to the content of financial reports, reference is made to the deliberations above in respect of financial reporting standards.

4. Respondents to the Consultation Paper generally supported a requirement for the publication of annual and half-yearly reports in line with the Transparency Directive. Respondents broadly agreed that, in setting their rules, SME-GMs should retain flexibility to allow use of financial reporting standards permitted by local laws and regulations.

5. Several respondents to the Consultation Paper offered further suggestions on the content of the annual and half-yearly report (for example, to incorporate elements of the requirements under the Transparency Directive). ESMA suggests that, beyond the need for reports to comply with any applicable financial reporting standards, SME-GMs should set rules that establish a clear expectation of the information they should contain, against which they are able to supervise. However, MiFID should not prescribe those rules and it should be a matter for operators of SME-GMs to determine the information investors reasonably require based on structures and practices in local markets. NCAs should ensure that investors will receive appropriate information, in light of any financial reporting standards applicable under local law or regulation and practices in its markets. ESMA has in the past taken the position that MTFs should offer SMEs the option to use the specialised IFRS for SMEs.116 ESMA considers that operators of SME-GMs should also offer that option to their issuers.

6. When it comes to establishing deadlines for publishing such reports, the Transparency Directive requires issuers on regulated markets to make public their annual reports at the latest four months after the end of each financial year and the half-yearly reports shall be made public at the latest three months after the relevant period.

7. Another precedent for establishing deadlines can be found in Article 26a(2) of the Regulation implementing the Prospectus Directive where the circumstances are determined when an issuer admitted to an MTF can make use of a proportionate disclosure regime for rights issues. According to that provision issuers shall make public annual reports within six months after the end of each financial year and half-yearly financial statements within four months after the end of the first six months of each financial year. ESMA's Consultation Pa-

[116] Cf. ESMA's letter to the IASB of 18 February 2013 (http://www.esma.europa.eu/system/files/2013-228.pdf).

per asked for views on whether these more generous deadlines could be suitable for issuers admitted on SME-GMs.

8. The views of respondents were mixed with regard to the appropriate timeframes. A number supported alignment with the periods allowed by the Transparency Directive, while others, including the SMSG, considered that the more generous periods are better suited to the needs and circumstances of smaller issuers. Having considered these responses, ESMA suggests that a minimum standard equivalent to the requirement to be met by an MTF making use of the proportionate disclosure regime for rights issues would be most appropriate (i.e. 6 and 4 months respectively for annual and half-yearly reports), taking into account existing market practices.

Article 33(3)(e), MiFID II

9. Consistent with the new Market Abuse Regulation (MAR), which extends the scope of the market abuse framework to any financial instrument admitted to trading on an MTF or on an OTF, as far as SME-GMs are concerned, Article 33(3)(e) of MIFID II states that issuers on an SME-GM and persons discharging managerial responsibilities in the issuer and persons closely associated with them shall comply with relevant requirements applicable to them under MAR.

10. Applying the new market abuse framework in an undifferentiated manner to all MTFs, including SME-GMs, however, may impose a significant burden on issuers on those markets,. The scope and size of the business of SME-GMs issuers is more restricted and the events giving rise to the need to disclose inside information typically reflects this.

11. MAR does take the situation of SME issuers into account to an extent as SME-GM issuers can disclose inside information in a modified and simplified market-specific way. Such inside information may be published by the SME-GMs, on behalf of their issuers, in accordance with the implementing technical standards to be developed by ESMA. In particular, according to Article 17(9) of MAR, inside information relating to issuers of a financial instrument, whose financial instruments are admitted to trading on an SME-GM, may be posted by the trading venue on its website instead of on the website of the issuer where the trading venue chooses to provide this facility for issuers on that market. In that event such issuer is deemed to have fulfilled its obligation.

12. SME-GMs issuers are also exempt, under certain conditions, from the obligation to draw up an insiders' list. According to Article 18(6) of MAR, issuers whose financial instruments are admitted to trading on an SME-GM shall be exempt from drawing up an insiders' list, provided that the following conditions are met: first, the issuer takes all reasonable steps to ensure that any person with access to inside information acknowledges the legal and regulatory duties entailed and is aware of the applicable sanctions; and second, if requested to do so by the NCA as part of the exercise of its supervisory or investigatory functions, that issuer is able to provide the NCA, upon request, with such a list.

13. ESMA deems sufficient the aforementioned requirements that MAR introduces specifically for issuers on SME-GMs and therefore does not propose establishing any additional or different provisions or any additional relief for SME-GM issuers. On the contrary as far as potential market abuse is concerned ESMA considers it necessary to have a consistent and ambitious regime across all trading venues MiFID II envisages in order to have an adequate level of market integrity and investor protection.

Technical advice

Technical advice on further specifying the requirement laid down in Article 33(3)(d) of MiFID II (appropriate on-going periodic financial reporting)

1. Issuers on SME-GMs should publish annual and half-yearly reports. Such reports should be regarded as having been published where a publication method that satisfies Article 33(3)(f) of MiFID II is followed.

2. Issuers should make public annual reports within six months after the end of each financial year and half-yearly financial statements within four months after the end of the first six months of each financial year.

3. The content of those reports should follow local financial reporting rules as a minimum. Market operators are free to require adherence to additional requirements and should be ready to accept the use of standards adhering to additional requirements by their issuers. NCAs have to assess that investors will receive appropriate information, in light of any financial reporting standards applicable under local law or regulation and practices in its markets.

Technical advice on further specifying the requirement laid down in Article 33(3)(e) of MiFID II (Compliance with MAR)

4. In the interests of consistent rules across all MiFID II trading venues, including SME growth markets, and taking into account the importance of efficiently combating market abuse on SME growth markets, issuers on SME growth markets shall comply with the same rules as established in MAR, except for those specific cases where MAR grants additional exemptions to SME growth market issuers.

Article 33(3)(f) & (g), MiFID II

Background/Mandate

Extract from the Commission's request for technical advice (mandate)

With respect to requirements enacted in Article 33(3)(b) to (g), ESMA is invited to provide technical advice taking into account and ensuring consistency with other Union legislations.

Article 33(3), MiFID II

3. Member States shall ensure that MTFs are subject to effective rules, systems and procedures which ensure that the following is complied with:

(f) regulatory information concerning the issuers on the market is stored and disseminated to the public;

(g) there are effective systems and controls aiming to prevent and detect market abuse on that market as required under the Regulation (EU) No 596/2014.

Analysis following feedback from stakeholders

Article 33(3)(f), MiFID II

1. Once more the Transparency Directive is the benchmark for issuers whose instruments are admitted to trading on a regulated market. It specifies that regulated information which comprises all information as established in the Transparency Directive plus information to be disclosed under MAD I has to be disclosed in a manner ensuring fast access to the information and it has to be made available to the officially appointed storage mechanism.

2. ESMA considered in the Consultation Paper that the rules on dissemination and storage under the Transparency Directive would be burdensome for issuers on SME-GMs and therefore a different approach needs to be adopted which was largely supported by respondents to the consultation.

3. Having conducted a fact finding regarding existing markets and having had discussions with market operators and SME issuers ESMA considers that the primary means for publishing and also disseminating information should be the internet.

4. The pre-dominant current market practice appears to be that information needs to be published either on the website of the issuer, the website of the market or both. ESMA also notes that MAR (Article 17(9)) stipulates that inside information specifically can be posted on the website of the trading venue.

5. Therefore ESMA in the Consultation Paper considered as one option establishing as a minimum requirement for SME-GMs that regulatory information, where permitted under MAR, can be published on the website of either the issuer or the market operator, which should also be considered as dissemination for the purposes of this provision.

6. The alternative option ESMA considered was that all regulatory information should always be published on the website of the market operator in order to use the market website as a natural point of convergence of information for investors on SME-GMs.

7. The consultation responses were mixed with some stakeholders favouring publication on the issuer website only, the market website only, the issuer or the market website or the issuer and the market website. The SMSG raised as an additional option that the information should be accessible via a direct link from the website of the market to the website of the issuer.

8. ESMA decided to opt in favour of requiring the publication of all regulatory information on the website of the market, for the website of the market operator to become a one-stop-shop for investors seeking information on SME-GM issuers. However, ESMA considers that a publication on the website of the market operators can also be effected by providing a direct link to the website of the issuer in case the information is published there. This link has to go directly to the relevant part of the website of the issuer where the regulatory information can be easily found by investors.

9. As far as the storage of information is concerned ESMA following the input from the consultation is of the view that regulatory information should be stored on the website of the market for a period of five years, in line with general MiFID record-keeping obligations and to ensure that investors have access to a range of historical information.

Article 33(3)(g), MiFID II

10. MAR aims to ensure a level playing field among all trading venues and facilities within its scope by requiring them to adopt the necessary structural provisions aimed at preventing and detecting market manipulation practices.

11. According to Article 16 of MAR, any person who operates the business of a trading venue shall adopt and maintain effective arrangements and procedures (in accordance with Article 31 of MiFID II concerning MTFs and OTFs, and with Article 54 concerning RMs) aimed at preventing and detecting market abuse.

12. In addition to this, Article 16 MAR states that any person professionally arranging or executing transactions in financial instruments shall have systems in place to detect and report orders and transactions that might constitute insider dealing, market manipulation or an attempt to engage in market manipulation or insider dealing. If that person reasonably suspects that an order or transaction in any financial instrument, whether placed or executed on

or outside a trading venue, might constitute insider dealing, market manipulation or an attempt to engage in market manipulation or insider dealing, the person shall notify the NCA without delay.

13. In line with MAR, Article 33(3)(g) of MIFID II states that SME-GMs should have effective systems and controls aimed at preventing and detecting market abuse.

14. ESMA considered already in the Consultation Paper that the aforementioned requirements envisaged by MAR are adequate for the objectives to be pursued. In the interests of consistency and an adequate level of market integrity and investor protection no additional specifications at the MiFID level should be implemented for SME-GMs. This assessment by ESMA was unanimously supported by respondents to the consultation, including the SMSG, and therefore ESMA has maintained its advice to the European Commission.

Technical advice

Technical advice on further specifying the requirement laid down in Article 33(3)(f) of MiFID II (storage and public dissemination of regulatory information concerning the issuers on the market)

1. All regulatory information should be published on the website of the market operator of the SME-GM so that this website can be used as a natural point of convergence of information for investors.

2. Such publication can also be effected by the market operator providing a direct link to the part of the website of the issuer where the regulatory information is published.

3. A publication on the website of the market should be considered as dissemination for the purposes of this provision.

4. The information published and disseminated should be available on the website of the market operator for a period of at least five years.

Technical advice on further specifying the requirement laid down in Article 33(3)(g) of MiFID II (systems and controls aimed at preventing and detecting market abuse)

5. In order to maintain an adequate level of consistency of rules applying across all MiFID II trading venues no additional specifications to the rules laid down in MAR and MiFID II for MTFs should be implemented specifically for SME growth markets.

6.2. Suspension and removal of financial instruments from trading

Background/Mandate

Extract from the Commission's request for technical advice (mandate)

ESMA is invited to provide technical advice on a non-exhaustive list of situations constituting significant damage to the investors' interests and the orderly functioning of the market which could be the basis of a decision not to follow a suspension or removal notification.

Article 52(2), MiFID II (the provision in Article 32(2) MiFID II is worded similarly)

The competent authority, in whose jurisdiction the suspension or removal originated, shall require that other regulated markets, MTFs, OTFs and systematic internalisers, which fall under its jurisdiction and trade the same financial instrument or derivatives as referred to in points (4) to (10) of Section C of Annex I to this Directive that relate or are referenced to that financial instrument, also suspend or remove that financial instrument or derivatives from trading, where the suspension or removal is due to suspected market abuse, a take-over bid or the non-disclosure of inside information about the issuer or financial instrument infringing Articles 7 and 17 of Regulation (EU) No. …/2014 except where such suspension or removal could cause significant damage to the investors' interests or the orderly functioning of the market.

Analysis following feedback from stakeholders

Introduction

1. The aim of this Delegated Act is to specify the circumstances constituting significant damage to investors' interests or the orderly functioning of the market, which could then be the basis of a decision not to follow a suspension or removal notification.

2. ESMA is of the view that financial stability is a key component of orderly functioning of markets and vice versa. Article 52(1) of MiFID II empowers a Market Operator (MO) to suspend or remove from trading financial instruments which no longer comply with the rules of the regulated market, unless such a step would be likely to cause significant damage to investors' interests or the orderly functioning of the market.

3. Article 32 of MiFID II applies the same rules as outlined above where the operator of an MTF or OTF suspends or removes a financial instrument and/or related derivatives from trading. All the explanations and statements in this section in respect of Article 52 of MiFID II shall be read as applying to Article 32 of MiFID II as well.

4. According to Article 52(2)(2) of MiFID II the NCA in whose jurisdiction the suspension or removal originated has to decide whether one of the three reasons to start the EU-wide

suspension process (suspected market abuse, a take-over bid or the non-disclosure of inside information about the issuer or financial instrument in breach of Article 7 and 17 MAR) is given. If the NCA comes to the conclusion that none of the three reasons apply the NCA is not required to expand the suspension or removal and to communicate its decision to ESMA and the NCAs of the other Member States.

5. In the event of a suspension by an MO, Article 52(2) of MiFID II details the process that must then be followed:

   i. The MO suspends the derivatives where this is necessary to support the objectives of the suspension or removal of the underlying financial instrument.

   ii. The MO makes public its decision to suspend the financial instrument and any related derivatives and communicates relevant information to its relevant NCA.

   iii. If the NCA comes to the conclusion that the suspension is due to suspected market abuse, a take-over bid or non-disclosure of inside information about the issuer or financial instru-ment in breach of Articles 7 and 17 MAR, the NCA orders suspension of the financial instru-ment and any related derivatives on other RMs, MTFs, OTFs and SIs in its jurisdiction trad-ing the suspended instruments or any related derivatives, unless this could cause significant damage to investors' interests or the orderly functioning of the market.

   iv. This NCA makes public such a suspension decision and communicates it to ESMA and other NCAs ('notified NCAs') including an explanation if the decision was not to follow the suspension.

   v. The notified NCAs order suspension of trading on other RMs, MTFs, OTFs and SIs in their jurisdictions trading the suspended instruments or any related derivatives, unless this could cause significant damage to investors' interests or the orderly functioning of the market in the notified NCAs jurisdiction.

   vi. The notified NCAs communicate their decision on whether to follow the suspension to ESMA and other NCAs, including an explanation if the decision was not to follow the suspension.

6. The process detailed above also applies – in general - in the case of removal of a financial instrument from trading and when a suspension is lifted, whereas a removal decision by the originating NCA does not necessarily lead to mandatory removal by the notified CA(s) but could lead to a 'suspension' as well.

7. Article 52(2) of MiFID II also stipulates that the above notification process applies in the case where the decision to suspend or remove a financial instrument from trading is taken by the NCA pursuant to Article 69(1) of MiFID II.

Implementing Measures Envisaged in MiFID II

8. Article 52 of MiFID II contains three empowerments for implementing measures in Level 2. The first one in Article 52(3) of MiFID II requires ESMA to develop implementing technical standards to determine the format and timing of all the communications and publications that are the object of a separate consultation process. The second one requires ESMA to specify such derivatives sufficiently related to the initially suspended instrument which should also be suspended. Such standards are discussed in the ESMA DP on technical standards.

9. The third empowerment in Article 52(4) of MiFID II empowers the Commission to adopt delegated acts in order to specify a list of circumstances constituting significant damage to investors' interests and the orderly functioning of the market which could then be the basis of a decision not to follow a suspension or removal notification.

10. Article 32 of MiFID II contains a parallel set of empowerments for MTFs and OTFs. Therefore all the proposals should be read as applying to regulated markets, MTFs and OTFs.

Exceptional circumstances constituting damage to the investors' interest or to the orderly functioning of the market

11. A suspension or removal is mandatory for the originating and notified NCAs where the suspension/removal is due to suspected market abuse, a take-over bid or non-disclosure of inside information about the issuer or financial instrument in breach of Articles 7 and 17 MAR.

12. As mentioned above, originating and notified MOs and NCAs may only abstain from the decision to remove or suspend a financial instrument from trading in cases where this would be likely to or could cause significant damage to the investors' interest or the orderly functioning of the markets. According to Articles 32(4) and 52(4) of MiFID II, the Commission shall be empowered to adopt delegated acts to specify the list of circumstances constituting significant damage to the investors' interests and the orderly functioning of the market referred to in Articles 52(1) and (2) and Articles 32(1) and (2) of MiFID II.

13. Convergence in the understanding of this exception will help to ensure that market participants in a Member State where trading in financial instruments has been suspended or financial instruments have been removed are not disadvantaged in comparison to another Member State, where trading is still on-going. However, ESMA recognises that a rigid ex ante list of situations meeting the exception would fail to allow for all the factors which could be relevant to determinations in individual cases. In addition, ESMA, upon consulting the legislative material from the trilogues and the way the legislative text has developed, considers that setting-up a non-exhaustive list was intended by the European co-legislators.

14. Therefore, ESMA considers that the optimum approach would be to set up a non-exhaustive list of situations which satisfy the criteria, to act as a framework for the exercise of judgement by NCAs.

15. The number of cases since the application of MiFID I where a notified NCA has not followed the suspension by an originating NCA has been extremely limited even though ESMA acknowledges that that number could go up due to the emergence of OTFs and due to the new legal framework in MiFID II where suspensions and removals need to be followed by notified NCAs regardless of the type of trading venue where the suspension originates.. On balance, not following suspensions does not seem to be a major regulatory concern and setting-up a non-exhaustive list of examples leaving a necessary degree of flexibility seems to suffice in order to attain a satisfactory degree of harmonisation in this area.

16. Having consulted on whether a non-exhaustive list would be the most appropriate regulatory approach, the overwhelming majority of respondents agreed to the proposal of a non-exhaustive list.

17. ESMA considers that the examples constituting the non-exhaustive list with the exception of the rather technical reason not to follow a suspension in paragraph 4(i) to be of a severe nature with potentially grave consequences for particular market participants, such as the shareholders of an issuer, or for the market as a whole. This underlines that not to follow a suspension requires the risks posed to investors' interests or the market to be significant and any situation not covered by the examples listed would need to be just as severe.

18. When determining if an exception applies, an NCA's assessment should focus specifically on whether a similar action in its jurisdiction would be likely to or could cause significant damage to the investors' interest or the orderly functioning of the markets.

19. Whilst one respondent advocated not precising the advice beyond this point, ESMA feels there is value to list some factors, among others, to be taken into consideration. This is an area where the supervisory convergence is important and ESMA is therefore, keen in defining the action of the NCAs as much as possible, without endangering the necessary flexibility. The Securities Market Consultative Working Group supports this approach.

20. The costs or risks posed to markets, and to their market participants, are likely to be more significant where those markets are more relevant in terms of liquidity (and therefore may be relied upon to a greater extent for trading and price formation purposes) than the market in which the initial decision was made. The result of the assessment must ensure that the level playing field between markets is not affected.

21. In addition, actions with a sustained or lasting impact on the ability of investors to trade a financial instrument on trading venues, such as removals, are likely to have a greater impact on investors than other actions.

22. Several respondents expressed the view that NCAs should be able to consider the concrete situations, and feel free whether or not to consider the knock-on effects of a suspension or removal on derivatives, indices or benchmarks for which the removed or suspended instrument serves as an underlying or constituent should be taken into consideration as well as the effects of a suspension on the interests of market end users from the real economy, such as entities trading in financial instruments to hedge commercial risks

23. The Securities Market Stakeholder's Group expressly agreed with the proposal of mandating NCAs to take into consideration the knock-on effects of a suspension or removal of instruments serving as underlying or constituent of derivatives, indices, or benchmarks.

24. Therefore, although ESMA considers that NCAs when deciding on a suspension or removal from trading should bear in mind all relevant considerations and criteria, ESMA is, in this respect, maintaining the piece of advice it consulted upon. In fact, in a majority of situations the two criteria above could be of relevance and, furthermore, the advice is merely to consider these as factors among other.

25. ESMA accordingly considers that an NCA should pay due regard to all factors relevant to a suitably comprehensive assessment of potential market impacts, such as those set out above, when considering if significant damage could arise in any particular case.

Technical advice

Technical advice on the specification of a list of circumstances constituting significant damage to investors' interests and the orderly functioning of the market, which could then be the basis of a decision not to follow a suspension or removal notification – Articles 52(4) and 32(4) of MiFID II.

1. The optimum approach for further specifying when a suspension or a removal from trading of a financial instrument which is traded in several countries, is likely to cause significant damages to the investor's interest or to the orderly functioning of the market would be to set up a non-exhaustive list of situations, to act as a framework for the assessment to be made by the NCAs.

2. A non-exhaustive list will impose the necessary level of convergence, while at the same time enabling notified NCAs to take into account potential new cases which cannot be foreseen from the outset and offer a degree of flexibility necessary in dynamic market circumstances.

3. The exceptions apply, in general terms, if following the suspension or removal would cause significant damage to the investors' interests, or the orderly functioning of the markets in the notified jurisdiction.

4. The following circumstances could in ESMA's view cause such significant damage to inves-

tors' interests and the orderly functioning of the market:

i. the reason for the suspension was momentary and has elapsed when the relevant notification would be acted upon;

ii. the same set of circumstances does not exist in the notified jurisdiction (such as where in-side information about an issuer whose instruments are traded on a MTF or OTF has been properly disclosed in the notified jurisdiction or where the structure of a takeover or other corporate transaction has been fully disclosed to investors in the notified jurisdiction);

iii. following the suspension would create a systemic risk undermining financial stability (such as where the need exists to unwind a dominant market position, or where settlement obligations would not be met in a significant volume);

iv. where the continuation of trading on the market is necessary to perform critical post-trade risk management functions when there is a need for the liquidation of financial instruments due to the default of a clearing member under the default procedures of a CCP and a CCP would be exposed to unacceptable risks as a result of an inability to calculate margin requirements; and

v. the financial viability of the issuer would be threatened (such as where it is involved in a corporate transaction or capital raising).

5. An NCA deciding not to follow on a suspension or removal basing the decision on circumstances not covered by the non-exhaustive list in the paragraph above should make sure that the damage to investors' interests or the orderly functioning of the market is at least as severe as in the situations listed in the paragraph above.

6. For determining whether a suspension or a removal would be likely to cause significant damage to the investors' interest or the orderly functioning of the markets in any particular case, NCAs should consider all relevant factors, including:

i. The relevance of the market in terms of liquidity, as the consequences of the actions are likely to be more significant where those markets are more relevant in terms of liquidity (and therefore may be relied upon to a greater extent for trading and price formation purposes) than in other markets.

ii. The nature of the envisaged action, as actions with a sustained or lasting impact on the ability of investors to trade a financial instrument on trading venues, such as removals, are likely to have a greater impact on investors than other actions.

iii. The knock-on effects of a suspension or removal of sufficiently related derivatives, indices or benchmarks for which the removed or suspended instrument serves as an un-

derlying or constituent.

iv. The effects of a suspension on the interests of market end users who are not financial counterparties, such as entities trading in financial instruments to hedge commercial risks.

7. These principles should also be taken into consideration whenever an NCA decides not to follow on a suspension or removal basing the decision on circumstances not listed above

6.3. Substantial importance of a trading venue in a host Member State

Background/Mandate

Extract from the Commission's request for technical advice (mandate)

ESMA is invited to provide advice on how to establish the criteria under which the operations of a trading venue in a host Member State could be considered as being of substantial importance for the functioning of the securities markets and the protection of the investors in that host Member State in order to determine under which circumstances proportionate cooperation arrangements are required to be put in place between the respective Member States in accordance with Article 79(2) of the Directive. These criteria should take into account the nature and scale of the impact on the securities markets and the investor protection in the other Member State. ESMA should take account of the criteria set out in Article 17 of the Commission Regulation (EC) No 1287/2006, taking into account any need to develop these standards in light of market and technological developments.

Article 79(2), MiFID II

When, taking into account the situation of the securities markets in the host Member State, the operations of a trading venue that has established arrangements in a host Member State have become of substantial importance for the functioning of the securities markets and the protection of the investors in that host Member State, the home and host competent authorities of the trading venue shall establish proportionate cooperation arrangements.

Analysis following feedback from stakeholders

1. Article 79(2) of MiFID II requires home and host NCAs to establish proportionate cooperation arrangements if a trading venue that has established arrangements in a host Member State has become of substantial importance for the functioning of the securities markets and the protection of investors in that host Member State.

2. Article 79(8) of MiFID II empowers the Commission to adopt delegated acts establishing the criteria under which a trading venue in a host Member State could be considered to be of such substantial importance. Furthermore, that provision requires ESMA to develop draft implement-ing technical standards to establish standard forms, templates and procedures for cooperation between NCAs.

3. Article 56 of MiFID I already encompassed a similar set of provisions (rule in paragraph 2, em-powerment for implementing measures in paragraph 5) which was applicable to regulated markets only. Article 16 of Regulation (EC) No 1287/2006 specified the following criteria for determining the substantial importance of a regulated market in a host Member State:

Article 16 (Article 56(2) of MiFID I) Determination of the substantial importance of a regulated market's operations in a host Member State

The operations of a regulated market in a host Member State shall be considered to be of substantial importance for the functioning of the securities markets and the protection of investors in that host State where one of the following criteria is met:

(a) the host Member State has formerly been the home Member State of the regulated market in question;

(b) the regulated market in question has acquired through merger, takeover, or any other form of transfer the business of a regulated market which had its registered office or head office in the host Member State.

4. A fact-finding exercise among NCAs revealed that the supervisory experience with applying Article 16 of Regulation (EC) 1287/2006 is very limited indeed. A majority of NCAs considered the criteria set by Article 16 of Regulation (EC) 1287/2006 as still appropriate and did not see a need for changing them for regulated markets.

5. As a result any move or acquisition of a regulated market triggers the right of the host Member State to benefit from proportionate cooperation arrangements automatically based on the assumption that due to the important functions regulated markets serve for capital markets any change in their status will always be a sensitive issue for the then host Member State which will want to remain closely involved and kept up-to-date regarding the future development of the regulated market.

6. Therefore, in the Consultation Paper, ESMA suggested to maintain the criteria set by Article 16 as they were considered to be relevant still. The large majority of respondents agreed with this approach – close to unanimity – and ESMA will therefore advise the Commission to maintain these criteria.

7. After studying the reactions received in response to the Consultation Paper, ESMA realised that it had not pointed out the fact that a minor adaptation to the wording of Article 16 of Regulation (EC) 1287/2006 was included in the Technical Advice. This concerns the entering of the wording 'the whole or part of' in the second criterion before 'business of a trading venue'. This adaptation is meant to take into account the option where not the entire trading venue is procured, but rather a part of it, for instance a single, separate market or segment. As no respondents commented on these words or their inclusion, ESMA has decided to keep this additional nuance in the Technical Advice.

8. For MTFs and OTFs, ESMA considers it important that not any move or acquisition of an economically insignificant MTF or OTF automatically triggers the establishment of the cooperation arrangements envisaged in Article 79(2) of MiFID II.

9. Therefore, in the Consultation Paper, ESMA proposed a test requiring the MTF or OTF to have a market share of at least 10% of trading in terms of total turnover in monetary terms in on-venue trading in the host Member State in at least one asset class subject to MiFIR transparency obligations at the time of the move or acquisition of the MTF or OTF. This test should ensure that only markets with a significant economic importance in asset classes which MiFIR considers important enough for the orderly functioning of markets to put them under a wide ranging set of transparency requirements.

10. In addition, an MTF registered as an SME-GM shall be deemed to be of substantial importance. The intention of the SME-GM concept is to help SME financing and SMEs traded on such Growth Markets will tend to be almost exclusively issuers based in the host Member State. Given that SMEs are the backbone of many European economies and that facilitating their access to capital markets is a major concern for most Member States ESMA considers it as justified to also let host Member States benefit from the Article 79(2) of MiFID II proportionate cooperation arrangements in the case of an SME-GM moving or being acquired.

11. A large majority of the respondents to the Consultation Paper agreed with the additional criteria for establishing the substantial importance in the cases of MTFs and OTFs. Some comments were made on the fact that those criteria are backward looking instead of based on the current status. However, basing substantial importance on current status would require some kind of measurement of importance, which is a difficult – if not impossible – task. On balance, ESMA advises the Commission to base substantial importance on historical evidence.

Technical advice

Technical advice on measures to establish the criteria under which the operations of a trading venue in a host Member State could be considered as being of substantial importance for the functioning of the securities markets and the protection of the investors in that host Member State.

1. The criteria for determining when the operations of a regulated market become of substantial importance in a host Member State in Article 16 of Regulation (EC) 1287/2006 are still relevant and should be maintained.

2. Those criteria should also be applied in the cases of MTFs and OTFs following the application of MiFID II, however, for MTFs and OTFs there should be an additional test in order to ensure that the cooperation arrangements envisaged by Article 79(2) of MiFID II are not automatically triggered in the case of small and therefore economically not highly significant MTFs and OTFs.

3. Therefore a trading venue should be deemed to be of substantial importance for the func-

tioning of the securities markets and the protection of investors in a host Member State in one of the two following cases:

i. the host Member State used to be the home Member State of the trading venue in question;

ii. the trading venue in question has acquired through a merger, a takeover or any other form of transfer of the whole or part of the business of a trading venue which was previously operated by a market operator or investment firm registered in the host Member State.

4. If the trading venue subject to one of the cases described in paragraph 3 is an MTF or an OTF, it should only be deemed to be of substantial importance if at least one of the following additional criteria apply:

i. before one of the cases described in the paragraph above occurred it had a market share of at least 10% of trading in terms of total turnover in monetary terms in on-venue trading and systematic internaliser trading in the host Member State in at least one asset class subject to MiFIR transparency obligations;

ii. it is registered as an SME growth market.

6.4. Monitoring of compliance – information requirements for trading venues

Background/Mandate

Extract from the Commission's request for technical advice (mandate)

ESMA is invited to provide its technical advice on a non-exhaustive list of circumstances that would trigger the information requirement referred to in Articles 31(2) and 54(2).

Aticle 54(2), MiFID II (Article 31(2) MiFID II is worded similarly)

Member States shall require the market operators of the regulated markets to immediately inform their competent authorities of significant infringements of their rules or disorderly trading conditions or conduct that may indicate behaviour that is prohibited under Regulation (EU) No 596/2014 or system disruptions in relation to a financial instrument.

The competent authorities of the regulated markets shall communicate to ESMA and to the competent authorities of the other Member States the information referred to in the first subparagraph.

1. According to Article 54(2) of MiFID II, Member States shall require the market operators of the regulated markets to immediately inform their NCAs of significant infringements of their rules or disorderly trading conditions or conduct that may indicate abusive behaviour that is prohibited under MAR or system disruptions in relation to a financial instrument. The same requirement applies to MTFs and OTFs (Article 31(2) of MiFID II).

2. A similar provision can already be found in Article 43(2) of MiFID I which states that Member States shall require the operators of the regulated markets to report significant breaches of their rules or disorderly trading conditions or conduct that may involve market abuse to the NCA of the regulated market.

3. Whereas MiFID I neither specified the circumstances which trigger the information requirement nor included a corresponding empowerment of the Commission to adopt implementing measures, the Commission is now – pursuant to Articles 31(4) and 54(4) of MiFID II – empowered to adopt delegated acts for further clarification.

4. The following proposals have been developed by working groups of the Secondary Markets Standing Committee (SMSC) and the Market Integrity Standing Committee (MISC) of ESMA and published in the Consultation Paper. The analysis and technical advice under the following Section covering the issues "significant infringements of rules", "disorderly trading conditions" and "system disruptions" have been discussed with the SMSC working group, whereas the analysis and technical advice on "conduct that may indicate abusive behaviour

that is prohibited under MAR" under the next section have been discussed by the MISC working group.

Analysis following feedback from stakeholders

5. The information requirements under Articles 54(2) and 31(2) of MiFID II shall ensure that NCAs can fulfil their regulatory tasks and are informed in a timely manner about relevant incidents which may have a negative impact on the functioning and integrity of the markets. NCAs shall be provided with the necessary information to identify and assess risks for the markets and their participants as well as to react efficiently and to take action if necessary.

6. In general, ESMA suggested in the Consultation Paper that it would not be appropriate to set up an exhaustive list of circumstances, but to outline the rationale of this information requirement and to give some examples in which this information requirement should be assumed in order to give market operators a guideline regarding supervisory expectations. In this context ESMA considers, as a general principle, it to be prudent for market operators to consult with their NCAs on a regular basis on the NCAs' expectations of what should be reported. A majority of respondents agreed with the approach of a non-exhaustive list of circumstances on an abstract level. Though some respondents indicated that the abstractness of the list of circumstance could lead to uncertainty, ESMA considers the suggestion to consult NCAs on their expectations to be an adequate measure to eliminate any possible uncertainty. Therefore, ESMA advises the Commission to publish the non-exhaustive list of high-level circumstances, included in the Annex to this Technical Advice.

Significant infringements of rules

7. Pursuant to Articles 54(2) and 31(2) of MiFID II the information requirement is triggered when trading venues observe significant infringements of their rules. In ESMA's view the term rule should be understood in a broad sense and should comprise all rules, rulings, orders as well as general terms and conditions of contractual agreements between the trading venue and its participants which contain the conditions for trading and admission to the trading venue.

8. As the information requirement is only triggered in cases of significant infringements, not all infringements would have to be reported, but only those which are of significant importance from the perspective of the NCAs. The essential question in this regard is to what extent the orderly functioning and integrity of the trading venue are impaired and whether significant interests of other market participants could seriously be affected. One respondent argued that the definition of 'significant' should be clarified. ESMA considers that conditions in different Member States and on different market are not comparable, a general term is to be used in the Technical Advice, so that by consultations between CAs and Market Operators an understanding can be achieved, attuned to local conditions. Therefore, ESMA advises the Commission to make use of the word 'significant' without any further definition of this adjective.

9. In ESMA's view an infringement should be considered significant if the underlying rule aims to protect the market integrity, the orderly functioning of the market or the ability of market participants to interact on a fair and properly informed basis, for example: infringements may concern the rules for the admission to trading of financial instruments on the market or rules, if given, governing the on-going periodic reporting of financial information which are essential for investors to make an informed investment decision. As market makers and liquidity providers can play an essential role in facilitating and supporting the trading in certain instruments on a trading venue, market integrity may also be concerned if those persons do not comply, on a regular or sustained basis, with their obligations to provide liquidity into the market. Infringements of the venue's rules designed to safeguard against the potential risks posed by algorithmic trading and direct electronic access (DEA) including Sponsored Access (SA) should also be considered significant. It is also relevant, for the assessment of 'significant', to consider whether a rule has been infringed on an incidental manner, continuously or intentionally.

10. Where a trading venue considers that an infringement is of sufficient severity or impact to justify consideration of disciplinary action, it should generally inform its NCA. One respondent suggested to limit the reporting of cases where disciplinary action is considered to those where permanent suspension is considered. ESMA, however, would consider that too limitative and advises the Commission to include all cases where disciplinary action is considered.

Disorderly trading conditions

11. Under MiFID II, trading venues are required to have rules and procedures that provide for fair and orderly trading. However, in certain circumstances, the proper functioning of the trading protocols and/or transparency arrangements facilitating such fair and orderly trading can break down, leading to potentially disorderly trading conditions.

12. In ESMA's view, such disorderly trading conditions would exist in all cases where the ability for supply and demand to interact in an orderly way in a venues' systems, according to its transparent rules and procedures, is seriously compromised: this could be a result of difficulties with the venue operator's own systems or controls, such as the performance of its trading platform, or issues resulting from the behaviour of market participants on the venue. ESMA noted that irrespective of the cause of the incident, the trading venue will need to make a notification if disorderly trading conditions occur. A minority of respondents asked for more focus on market conditions that constitute disorderly trading such as a lack of availability of information in the market or rumours affecting trading. ESMA considers such conditions to be a component of the failure of the price discovery process for a significant period of time, so ESMA advises no additional conditions to be considered as disorderly trading conditions.

13. Notification should only be required in cases of significant events which have the potential to jeopardise the role and function of trading venues as part of the financial market infrastruc-

ture. This is, for example, the case when the capacities of the trading systems are reached or exceeded, or it is otherwise unable to receive and process orders/quotes in a timely way in accordance with its rules and pre-trade risk controls, leading to interference with the price discovery process over a significant period of time. In these cases the continuity and regularity of the performance of the trading venue may no longer be ensured and the need for further action may arise. An extraordinary decline in the price of a financial instrument does not, as such, automatically indicate the existence of disorderly trading conditions (for example, where it can be explained as a reaction to price sensitive information). Another reason for concern could be repeated claims of mis-trades by market makers as these raise the question of whether the venues are organised appropriately to fulfil their obligation to provide the market with liquidity on a continuous and reliable basis.

14. ESMA would like to emphasise that the proposed implementing measures under Article 48 of MiFID II also make reference to disorderly trading conditions. In that section of the ESMA DP they are defined as referring to a market where the maintenance of a fair, orderly and transparent execution of trades is compromised. The way the MiFID II system is set-up to work is that under Article 48 of MiFID II organisational measures are designed to prevent disorderly trading conditions. Should they occur nonetheless trading venues have to inform NCAs under Articles 31 and 54 of MiFID II. Therefore such an information obligation is triggered if critical mechanisms in the context of Article 48 of MiFID II which are designed to protect the trading venue against the risks of algorithmic trading break down or fail.

System disruptions

15. Furthermore trading venues are required to immediately inform their NCAs of system disruptions. Whereas the disorderly trading conditions as described above primarily comprises circumstances in which the trading functionality is concerned, systems disruptions should not be narrowly read and limited to disruptive incidents which lead to a trading interruption as such but should also include situations in which major malfunctions of systems occur which are directly related with the trading. Respondents to the Consultation Paper pointed out that in the Technical Advice, the main point of the matching engine itself failing, was not included. ESMA has added this to the Technical Advice, while also including potential problems concerning market access.

16. In addition, as the ability to trade certain instruments is conditional on the availability of a real time information flow, typically the case of certain derivatives contracts on indices regarding the respective index, NCAs should be also be informed.The information requirement should furthermore be triggered if a major malfunction or break-down of the systems to monitor and control the trading activities of the market participants occur, such as the systems of the trading surveillance to monitor and prevent market abuse as well as the systems applied for position management controls with regard to the commodity derivatives trading on a trading venue.

17. As the market relies and depends on the pre- and post-trade transparency data and other relevant data published by trading venues in accordance with their obligations under MiFID II and MiFIR, system disruptions should furthermore be assumed if trading venues encounter major malfunctions or breakdowns of their systems to publish and disseminate such market data.

18. As trading venues are required to have arrangements to facilitate the efficient and timely finalisation of the transactions executed under their systems, such venues should also be required to inform their NCA about major malfunctions and breakdowns of their links with CCPs and CSDs that provide clearing/settlement services to their participants, if these incidents have a repercussion on the trading system of the trading venue.

Technical advice

Technical advice to determine circumstances that trigger the requirement of operators of trading venues under Article 54(2) and 31(2) of MiFID II to immediately inform its NCA of significant infringements of their rules or disorderly trading conditions or system disruptions in relation to a financial instrument.

1. The information requirements shall ensure that NCAs can fulfil their regulatory tasks and are informed in a timely manner about relevant incidents which may have a negative impact on the functioning and integrity of the markets. NCAs shall be provided with the necessary information to identify and assess risks for the markets and their participants as well as to react efficiently and to take action if necessary.

2. Notification should only be required in cases of significant events which have the potential to jeopardise the role and function of trading venues as part of the financial market infrastructure.

3. ESMA considers that it would not be appropriate to set up an exhaustive list of circumstances, but to give some examples in which this information requirement should be assumed in order to give market operators a guideline regarding supervisory expectations. In this context ESMA considers, as a general principle, it to be prudent for market operators to consult with their NCAs on a regular basis on the NCAs' expectations of what should be reported.

Annex

Significant Infringements of the Rules of a Trading Venue

4. Significant infringements triggering an information requirement should be assumed if:

    i. market participants infringe rules of the trading venue which aim to protect the market integrity, the orderly functioning of the market or the significant interests of the other

market participants; and

ii. a trading venue considers that an infringement is of sufficient severity or impact to justify consideration of disciplinary action.

Disorderly Trading Conditions

5. Disorderly trading conditions triggering an information requirement should be assumed if:

i. the price discovery process is interfered with over a significant period of time;

ii. the capacities of the trading systems are reached or exceeded;

iii. market makers/liquidity providers repeatedly claim mis-trades; or

iv. break down or failure of critical mechanisms under Article 48 of MiFID II and its implementing measures which are designed to protect the trading venue against the risks of algorithmic trading.

System Disruptions

6. Systems disruptions triggering an information requirement should be assumed if:

i. any major malfunction or breakdown of the system for market access that results in Participants losing their ability to enter, adjust or cancel their orders;

ii. any major malfunction or breakdown of the system for the matching of transactions, that results in Participants losing certainty over the status of completed transactions or live orders as well as unavailability of information indispensable for trading (e.g., index value dissemination for trading certain derivatives on that index);

iii. any major malfunction or breakdown of the systems for the dissemination of pre- and post-trade transparency and other relevant data published by trading venues in accordance with their obligations under MiFID II and MiFIR;

iv. any major malfunction or breakdown of the systems of the trading venue to monitor and control the trading activities of the market participants; and

v. any major malfunction or breakdown in the sphere of other interrelated services providers, in particular CCPs and CSDs, that has repercussions on the trading system.

6.5. Monitoring of compliance with the rules of the trading venue - deter-mining circumstances that trigger the requirement to inform about conduct that may indicate abusive behaviour

Background/Mandate

Extract from the Commission's request for technical advice (mandate)

ESMA is invited to provide its technical advice on a non-exhaustive list of circumstances that would trigger the information requirement referred to in Articles 31(2) and 54(2).

Article 54(2), MiFID II (Article 31(2) is worded similarly)

Member States shall require the market operators of the regulated markets to immediately inform their competent authorities of significant infringements of their rules or disorderly trading conditions or conduct that may indicate behaviour that is prohibited under Regulation (EU) No 596/2014 or system disruptions in relation to a financial instrument.

The competent authorities of the regulated markets shall communicate to ESMA and to the competent authorities of the other Member States the information referred to in the first subparagraph.

In relation to conduct that may indicate behaviour that is prohibited under Regulation (EU) No 596/2014, a competent authority shall be convinced that such behaviour is being or has been carried out before it notifies the competent authorities of the other Member States and ESMA.

Analysis following feedback from stakeholders

1. Under Articles 31(4) and 56(4) of MiFID II, ESMA is mandated to provide technical advice to the Commission to determine circumstances that trigger the requirement of operators of a RM, a MTF or an OTF to immediately inform its NCA of conduct that may indicate abusive behaviour within the scope of MAR.

General approach

2. In order to assist trading venues in fulfilling their information requirement duty, ESMA considered in the CP that it would be useful to draw up an indicative and non-exhaustive list of signals of market abuse behaviours.

3. As indicated in the consultation paper on MiFID II/MiFIR (2014/549) published on 22 May 2014 (CP), the list to be included in the final ESMA technical advice has been prepared mainly on the basis of the existing 1st set of CESR guidance on the application of MAD I (CESR/04-505b) applied from the perspective of trading venues. In particular, unlike in-

vestment firms, a trading venue does not necessarily the exact identity of the client, has no knowledge of the client's profile and neither can it be aware of the size of the position held by the client. The second basis is the ESMA guidelines on systems and controls in an automated trading environment for trading platforms, investment firms and NCAs (ESMA/2012/122) (HFT guidelines). Along the same lines, ESMA also adapted some of the indicators listed in Annex I of MAR, and the list in this technical advice is taking into account the more extensive scope of MAR compared to MAD I. The feed-back to the CP has also been considered in finalising this list as well as the one received on the consultation paper on draft technical advice on possible delegated acts concerning the Market Abuse Regulation (2014/808) published on 11 July 2014.

4. The vast majority of the 26 respondents (mainly operators of trading venues) supported the approach presented in the CP. They particularly agreed with (i) the non-exhaustive nature of the indicators list and with the need to be flexible to take into account developments and changes in trading activity; (ii) the proportionate approach to take into account the conditions and characteristics of the market of a particular financial instrument, and (iii) the principles-based approach allowing trading venues to exercise judgment based on their expertise.

5. This list is intended to provide indications of orders, transactions or behaviours that may indicate a possible market abuse conduct. These "possible signals of market abuse" are not intended to trigger per se the "duty to immediately inform the NCA", being just indications to be taken into consideration, within the more general framework of MAR, in order to fulfil that duty. The list is neither exhaustive (a particular order, transaction or behaviour may be reportable even if it matches none of the indications) nor determinative (an order, transaction or behaviour may not necessarily be reportable simply because it matches one or more of the indications). Further to the public consultation, this is now better reflected in the advice. Operators of trading venues will have to exercise judgment before deciding to inform the relevant NCAs; they should give particular attention to deviations from what is usual on the trading characteristics of the financial instruments listed/traded on their markets and also, as suggested in the responses to the CP, to lack of apparent economic rationality of some practices.

6. A couple of respondents questioned the need for a separate list under MiFID considering the one to be drawn under MAR, as the repetition of signals and the existence of two distinct lists may create confusion. ESMA acknowledges that the list of indicators aiming at specifying Annex I of MAR and the list proposed for this advice under MIFID II are, on purpose, similar. However, as the scope of the signals are different, ESMA is of the view that it is necessary to have different lists, one adapted to the specific characteristics of the trading venues activity and another one applicable to financial intermediaries and other market participants. Besides, the MiFID II list has a wider scope as it also includes indicators of possible insider dealing, which is out of the scope of the mandate under MAR. In this respect, ESMA would like to invite the Commission, when drafting and adopting the implementing texts under MiFID II and MAR, to ensure that consistency is maintained.

Proportionality

7. The operators of trading venues should follow a proportionate approach with respect to the signals listed in the technical advice, taking in consideration the conditions and characteristics of the market of a particular financial instrument: market size, number of participants, liquidity…. In particular, this approach should take into account the rules of the relevant trading venues, which should be assessed and approved by the NCAs, as particular signals may refer to transactions that are legitimate trades when carried out in conformity with the rules of the relevant trading platform (e.g. crossing trades). Trading venues should not exclude however that signals not specifically included in the Technical Advice can be relevant to their particular markets.

8. In the CP, ESMA considered that operators of trading venues should inform the relevant NCAs when they have identified a conduct that may indicate abusive behaviour affecting related financial instruments, both when these instruments are traded on the same venue or when they are traded on several venues operated by the same operator. For example, financial instruments which are traded on the same trading venue may be targets for cross-product market manipulation in which orders or transactions in one financial instrument are used to influence the price of another financial instrument (e.g., financial instruments relating to the same underlying such as an equity share and a subscription right or a structured bond). Transactions or orders to trade may also be undertaken in an underlying financial instrument in order to influence the price of the derivative in another trading venue. Therefore, ESMA included particular signals in the list.

9. In addition, ESMA noted that trading venues have different levels of information available or accessible depending on their nature (e.g. trading capacity of the member client versus own account; detailed information about the issuer…). In particular, this includes the inside information disclosed by an issuer of a SME-GM when the operator of such a market provides the publication facility referred to Article 12(6) of MAR.

10. A majority of respondents explicitly supported the approach of using all information publicly available when conducting their market surveillance, considering that the main implication is that the trading venue can make more informed and reasoned decision. However, they highlighted their concerns in terms of resources and cost implication on the trading venue internal surveillance tools and processes for collecting, integrating and analysing information that are not in a standardised format; thus asking for the application of the proportionality principle. Other respondents challenged this approach on the ground that it would be costly, unfeasible in practice, increase the risks of legal challenges against the trading venue. Overall they found disproportionate to require trading venues to monitor not just the trading venue they operate, but the whole market, arguing that this should be the duty of the competent authorities.

11. ESMA would like to clarify that the analysis of the publicly available information is meant as a complementary tool, within the broader assessment by the trading venue, to understand

whether a case identified needs to be reported. This should be part of the process for better informing and reasoning a particular case, and should not be understood as a requirement to monitor all information published or disclosed European wise on all issuers and financial instruments. ESMA is not asking for complete and overreaching oversight. Nevertheless, the analysis of publicly available information is useful in order to understand the activity on the trading venue. Furthermore, ESMA considers that any kind of restriction of the public available information that can be used, namely by listing the type of specific public information to take into account or by limiting the scope of official information only (i.e. Regulated information), is not useful as it could result in excluding relevant information.

12. With regard to cross-market surveillance, ESMA would like to specify that trading venues are not expected to monitor the whole market and other trading venues. Nevertheless, in their analysis, the operators of a trading venue should take into account not only the trading activity by their members/participants, in their systems, but also public available information about the trading in other trading venues (e.g. price movements in a given timeframe), or any other relevant publicly available information. They should apply a proportionate approach in this respect, as they do not have to conduct an exhaustive analysis, but rather take into consideration publicly available information that are easy to access and appears to be related to the situation they are analysing.

13. A similar proportionate approach should be applied when an operator operates several trading venues where the same or related financial instruments are traded and where the same members are acting. Taking into account the legal framework that impose requirements on individual trading venues, a single operator of different venues could have in place adequate and proportionate technical and human resources to monitor possible cases of market abuse, by not only conducting segregated analysis on an individual trading venue basis, but instead by interconnecting the relevant information across trading venues, to the extent that it is permissible by law. Where different legal entities within the same group operate a trading venue, arrangements to exchange the relevant information to allow the cross-product or cross-market surveillance could be developed.

14. As highlighted in Recital 62 of MiFID II and despite the benefits it provides, algorithmic trading or high frequency algorithmic trading techniques can lend themselves to certain forms of abusive behaviour if misused. Therefore, the proposed list contains indicators relating to the specificities arising in an automated trading environment. As set out in the ESMA "HFT guidelines", different types of manipulation strategies can be implemented using algorithms (such as spoofing, layering and quote stuffing). In such situations the signals relate to orders entries, updates and/or cancellation. However, these signals are not intended to suggest that the same strategies carried out by non-automated means would not also be abusive.

15. Finally, ESMA remains of the view that even if a particular potentially abusive conduct is difficult to spot, the operator of a trading venue that comes to know of a conduct that may

indicate an abusive behaviour by whatever means or ways should report that conduct to the relevant NCA in accordance with MiFID II requirements.

16. However, unlike suggested by a couple of respondents, ESMA considers to be out of the scope of the mandate to require the trading venues to inform the national competent authorities of any investigations conducted even if they do not lead to a report under Articles 31(2) and 54(2).

List of possible signals indicating abusive conduct

17. In the list of signals proposed by ESMA, reference to a trading venue should be understood as a reference to a regulated market, a MTF or an OTF, and financial instruments are meant to also include emission allowances. In addition, reference to order to trade is meant to encompass all sorts of orders, modifications and cancellations of orders, irrespective of whether there is an intention to trade or not.

18. The list presented in the advice intends to cover:

    i. possible signals of insider dealing or market manipulation;

    ii. possible signals of insider dealing, a specific signal in relation to research or investment recommendation; and

    iii. possible signals of market manipulation including signals for cross-product across different trading venues or not as well as signals particularly relevant in an automated trading environment though not exclusively related to such trading.

19. All but one respondent broadly agreed with the signals listed in the draft technical advice of the CP, including the market manipulation signals relating to position reversal and improper matched orders by different members/participants, as well as the insider trading signal in relation to research or investment recommendation.

20. ESMA slightly amended the drafting of some of the indicators listed in the TA in order to ensure consistency with the list of indicators and practices identified for the purpose of specifying the indicators of market manipulation listed under Annex I of MAR and publicly consulted upon (see Consultation Paper on draft technical advice on possible delegated acts concerning the Market Abuse Regulation, published on 11 July 2014).

'Front running' behaviour

21. As already noted in the CP, front running (i.e. trading ahead of a client order) is a practice that can be enforced on the ground of the rules of conduct applicable to investment firms but can constitute under certain circumstances a market abuse.

22. In some instances, a client's pending order can constitute inside information (CESR 2nd set of Guidance; CESR/06-562b) and therefore a market member trading ahead of its client's pending order can constitute insider dealing (by acquiring or disposing of, for its own account financial instruments to which the information relates).

23. ESMA acknowledges that in many circumstances such a signal will be spotted by the market operator provided that it has available through the order book the information about whether the order is placed for own account of the member or on behalf of a member's client.

24. Responses to the CP were evenly split between supporters (11) and opponents (11) of including front running in the monitoring duties of operators of trading venues.

25. ESMA acknowledges that investments firms have a duty to detect and prevent front running, and that the NCAs have a crucial role to play in this respect, as they would have a fuller picture through transaction reporting information, but disagrees with those respondents claiming that trading venues should not be concerned. On the contrary, ESMA notes that under the current market abuse regime, certain trading venues have already integrated detection of front running in their monitoring process.

26. Some opponents argued that trading venues lack sufficient information about the firm's activities. In this regards, ESMA stresses that, under MiFIR, activity indicators will be inserted in the order book data information that trading venues operators must record, allowing thus to distinguish for example between "proprietary" trading and "agency" trading (client). Furthermore, identifiers of the traders operating within a member/participant should also be included in the order book data. This provides for more granular information to assist in the analysis, although it is likely to be dependent on the internal organisation of trading operations of the member/participant.

27. In addition, front running detection by the operator of a trading venue should take place at the level of the trading venue; it is not required from such an operator to monitor other trading venues for front running detection, as it will be missing information of the members/participants activity indicators on the other venues. It should be noted though that where the single operator of several trading venues has interconnected the information of its venues, such a cross-venue monitoring may be envisaged.

28. ESMA therefore complemented the advice with an additional paragraph on front running but did not elaborate a specific and useful indicator/signal in this respect.

29. In the consultation paper on MAR technical on indicator manipulation, ESMA has been considering the practice of "phishing". In line with the respondents to this consultation, the definition presented was not accurate. However, ESMA considers that the practice of phishing, as described below, would be relevant for the purpose of this technical advice for trading venue.

30. In this context, phishing could be described as follows: Executing orders to trade or a series of orders to trade, in order to uncover orders of other participants, and then entering an order to trade to take advantage of the information obtained. This behaviour is usually associated to high frequency trading, allowing to explore the differences between private and public data flows but, as all the others behaviours, can be used by other market participants

Technical advice

Technical advice on determining the circumstances that trigger the requirement of operators of trading venues to immediately inform their NCA of conduct that may indicate abusive behaviour within the scope of MAR

1. In this advice, reference to 'order to trade' is meant to encompass all types of orders, including initial orders, modifications, updates and cancellations of orders, irrespective of whether or not they have been executed and irrespective of the means used to access the trading venue

2. The list set out in the Annex contains a set of indicators/signals of insider dealing and market manipulation that are not considered to constitute market abuse or attempts of market abuse per se, but that should be taken into account by operators of trading venues to determine whether they should inform the relevant NCA of a conduct that may indicate abuse behaviour within the scope of MAR. They shall be taken into account where transactions or orders to trade are examined.

3. This list is neither exhaustive nor determinative of market abuse or attempts of market abuse. Transactions and/or orders to trade meeting one or more signals may be conducted for legitimate reasons and/or in compliance with the rules of the trading venue and may not give reasonable grounds for suspicion of an abusive conduct. Behaviour which is in line with the rules of the trading venue should not preclude it from being considered as potential market abuse and informing the NCA.

4. The points xiv, xv, xvi, xvii, xviii and xix of the Annex identify the signals of market manipulation that are particularly relevant in a context of an automated trading environment.

5. The operator of a trading venue, or of several trading venues, where a financial instrument and/or related financial instrument are traded should apply a proportionate approach and needs to exercise judgment on the indicators/signals triggered, including any relevant signals not specifically included in this Advice, before deciding to inform the relevant NCAs taking into account:

    i. the deviations from the usual trading pattern of the financial instruments admitted to trading or traded on its trading venue; and

ii. the information available or accessible to them, whether be internally as part of the operations of the trading venue or publicly available.

6. The operator of a trading venue, or of several trading venues, should also take into account front running behaviours - which consist in a market member/participant to trade, for its own account, ahead of its client - and should use for that purpose, among other elements, the order book data information that are required to be recorded by the trading venue as per Article 25 of MiFIR, in particular those relating to the way of the member/participant conducts its trading activity.

7. Irrespective of any signal being triggered, the operator of a trading venue that comes to know of a conduct that indicates abusive behaviour by whatever means or ways should report that conduct to the relevant NCAs.

Annex

Signals of possible insider dealing or market manipulation

8. Unusual concentration of transactions and/or orders to trade in a particular financial instrument with one member/participant or between certain members/participants.

9. Unusual repetition of a transaction among a small number of members/participants over a certain period of time.

Signals of possible insider dealing

10. Unusual and significant trading or submission of orders to trade in the financial instruments of a company by certain members/participants before the announcement of important corporate events or of price sensitive information relating to the company; orders to trade/transactions resulting in sudden and unusual changes in the volume of orders/transactions and/or prices before public announcements regarding the financial instrument in question.

11. Whether orders to trade are given or transactions are undertaken by a market member/participant before or immediately after that member/participant or persons publicly known as linked to that member/participant produce or disseminate research or investment recommendations that are made publicly available.

Signals of possible market manipulation

12. The signals described below in points xiv, xv, xvi, xvii, xviii and xix are particularly relevant in an automated trading environment.

    i. Orders to trade given or transactions undertaken which represent a significant proportion of the daily volume of transactions in the relevant financial instrument on the trading

venue concerned, in particular when these activities lead to a significant change in the price of the financial instruments.

ii. Orders to trade given or transactions undertaken by a member/participant with a significant buying or selling interest in a financial instrument which lead to significant changes in the price of the financial instrument on a trading venue.

iii. Orders to trade given or transactions undertaken which are concentrated within a short time span in the trading session and lead to a price change which is subsequently reversed.

iv. Orders to trade given which change the representation of the best bid or offer prices in a financial instrument admitted to trading or traded on a trading venue, or more generally the representation of the order book available to market participants, and are removed before they are executed.

v. Transactions or orders to trade by a market/participant with no other apparent justification than to increase/decrease the price or value of, or to have a significant impact on the supply of or demand for a financial instrument, namely near the reference point during the trading day, e.g. at the opening or near the close.

vi. Buying or selling of a financial instrument at the reference time of the trading session (e.g. opening, closing, settlement) in an effort to increase, to decrease or to maintain the reference price (e.g. opening price, closing price, settlement price) at a specific level – (usually known as marking the close).

vii. Transactions or orders to trade which have the effect of, or are likely to have the effect of increasing/decreasing the weighted average price of the day or of a period during the session.

viii. Transactions or orders to trade which have the effect of, or are likely to have the effect of, setting a market price when the liquidity of the financial instrument or the depth of the order book is not sufficient to fix a price within the session.

ix. Execution of a transaction, changing the bid-offer prices when this spread is a factor in the de-termination of the price of another transaction whether or not on the same trading venue.

x. Entering orders representing significant volumes in the central order book of the trading system a few minutes before the price determination phase of the auction and cancelling these orders a few seconds before the order book is frozen for computing the auction price so that the theoretical opening price might look higher or lower than it otherwise would do.

xi. Engaging in a transaction or series of transactions which are shown on a public display facility to give the impression of activity or price movement in a financial instrument (usually known as painting the tape).

xii. Transactions carried out as a result of the entering of buy and sell orders to trade at or nearly at the same time, with the very similar quantity and similar price by the same or different but colluding market members/participants (usually known as improper matched orders).

xiii. Transactions or orders to trade which have the effect of, or are likely to have the effect of bypassing the trading safeguards of the market (e.g. as regards volume limits; price limits; bid/offer spread parameters; etc).

xiv. Entering of orders to trade or a series of orders to trade, executing transactions or series of transactions likely to start or exacerbate a trend and to encourage other participants to accelerate or extend the trend in order to create an opportunity to close out/open a position at a favourable price (usually know as momentum ignition).

xv. Submitting multiple or large orders to trade often away from the touch on one side of the order book in order to execute a trade on the other side of the order book. Once that trade has taken place, the manipulative orders will be removed (usually known as Layering and Spoofing).

xvi. Entry of small orders to trade in order to ascertain the level of hidden orders and particularly used to assess what is resting on a dark platform (usually know as ping order).

xvii. Entry of large numbers of orders to trade and/or cancellations and/or updates to orders to trade so as to create uncertainty for other participants, slowing down their process and to camouflage their own strategy (usually known as quote stuffing).

xviii. Posting of orders to trade, to attract other market members/participants employing traditional trading techniques ('slow traders'), that are then rapidly revised onto less generous terms, hoping to execute profitably against the incoming flow of 'slow traders' orders to trade (usually known as smoking).

xix. Executing orders to trade or a series of orders to trade, in order to uncover orders of other participants, and then entering an order to trade to take advantage of the information obtained (usually known as phishing).

xx. The extent to which, to the best knowledge of the operator of a trading venue, orders to trade given or transactions undertaken show evidence of position reversals in a short period and represent a significant proportion of the daily volume of transactions in the relevant financial instrument on the trading venue concerned, and might be associated with significant changes in the price of a financial instrument admitted to trading or trad-

ed on the trading venue.

Signals for cross-product market manipulation, including across different trading venues

13. The signals described below should be particularly considered by the operator of a trading venue where both a financial instrument and related financial instruments are admitted to trading or traded or where the above mentioned instruments are traded on several trading venues operated by the same operator.

    i. Transactions or orders to trade which have the effect of, or are likely to have the effect of increasing/decreasing/maintaining the price of a financial instrument during the days preceding the issue, optional redemption or expiry of a related derivative or convertible;

    ii. Transactions or orders to trade which have the effect of, or are likely to have the effect of maintaining the price of the underlying financial instrument below or above the strike price, or other element used to determine the pay-out (e.g. barrier), of a related derivative at expiration date;

    iii. Transactions which have the effect of, or are likely to have the effect of modifying the price of the underlying financial instrument so that it surpasses/not reaches the strike price, or other element used to determine the pay-out (e.g. barrier), of a related derivative at expiration date;

    iv. Transactions which have the effect of, or are likely to have the effect of modifying the settlement price of a financial instrument when this price is used as a reference/determinant, namely, in the calculation of margins requirements;

    v. Orders to trade given or transactions undertaken by a member/participant with a significant buying or selling interest in a financial instrument which lead to significant changes in the price of the related derivative or underlying asset admitted to trading on a trading venue;

    vi. Undertaking trading or entering orders to trade in one trading venue or outside a trading venue (including entering indications of interest) with a view to improperly influencing the price of a related financial instrument in another or in the same trading venue or outside a trading venue (usually known as cross-product manipulation (trading on financial instrument to improperly position the price of a related financial instrument in another or in the same trading venue or outside a trading venue)).

    vii. Creating or enhancing arbitrage possibilities between a financial instrument and another related financial instrument by influencing reference prices of one of the financial instruments can be carried out with different financial instruments (like rights/shares, cash markets/derivatives markets, warrants/shares, …). In the context of rights issues, it could be achieved by influencing the (theoretical) opening or (theoretical) closing price

of the rights.

7. Commodity derivatives

7.1. Financial instruments definition - specifying Section C 6, 7 and 10 of Annex I of MiFID II

Technical Advice on specifying the derivative contracts referred to in Section C.6 of Annex I

Background/Mandate

Extract from the Commission's request for technical advice (mandate)

ESMA is invited to provide technical advice on specifying the derivative contracts referred to in Section C.6 of Annex I that have the characteristics of wholesale energy products as defined in Article 2(4) of Regulation (EU) No 1227/2011 that must be physically settled and "C.6 energy derivative contracts" defined in Article 4 (2), point (16) of this Directive, in particular specifying the notion of must be physically settled taking into account the criteria listed in recital 10.

Article 4(1)(2), MiFID II

The Commission shall adopt delegated acts in accordance with Article 89 measures specifying:

(a) the derivative contracts referred to in Section C.6 of Annex I that have the characteristics of wholesale energy products that must be physically settled and C.6 energy derivative contracts;

Article 4(1)(16), MiFID II

'C 6 energy derivative contracts' means options, futures, swaps, and any other derivative contracts mentioned in Section C.6 of Annex I relating to coal or oil that are traded on an OTF and must be physically settled;

Article 4(1)(58), MiFID II

'wholesale energy product' means wholesale energy products as defined in point (4) of Article 2 of Regulation (EU) No 1227/2011;

Analysis following feedback from stakeholders

1. ESMA would like to point out that it understands the MiFID II text in relation to the definition of C 6 as follows:

2. The definition of Section C 6 of Annex I under MiFID I has been changed significantly under MiFID II by classifying options, futures, swaps and other derivative contracts relating to

commodities that can be physically settled and are traded on an OTF as financial instruments, in addition to those instruments that trade on MTFs and RMs.

3. However, Section C 6 of Annex I excludes wholesale energy products within the scope of REMIT that are traded on an OTF and that must be physically settled. Therefore, these excluded wholesale energy products do not qualify as financial instruments and are consequently outside the scope of MiFID, EMIR and the CRD IV package.

4. Wholesale energy products within the scope of REMIT which are derivatives contracts, and therefore are within the scope of this exemption, are derivatives with electricity (or power[117]) or natural gas as the underlying.

5. In addition, Article 95 of MiFID II establishes a transitional regime for "*C 6 energy derivatives contracts*" which, upon agreement by an NCA, can be exempted from the EMIR clearing obligation and risk mitigation techniques requirements and do not count towards the clearing threshold for non-financial counterparties for a transitional period of 6 years after MiFID II enters into force.

6. C 6 energy derivatives contracts are defined as options, futures, swaps, and any other derivatives with coal or oil as an underlying and which are traded on an OTF and must be physically settled. While derivative contracts with coal as an underlying appear to be an easily identifiable section of instruments in ESMA's view, the same does not hold true for contracts with oil as an underlying.

7. In the Consultation Paper ESMA asked the question whether only different grades of crude oil should qualify as C 6 energy derivatives contracts or whether also other contracts where the underlying is derived from crude oil (i.e. contracts related to refined oil products) should be within the scope of the exemption[118].

8. The respondents to the consultation unanimously favoured a wide definition of oil. Limiting the definition just to crude oil, in the view of respondents would have cost and liquidity implications for markets and end customers and reduce working capital available for commercial and industrial activities of market participants. Also some sub-sections of the intertwined oil market deemed outside the definition would be put at a disadvantage. Respondents emphasised that biofuels should be added with them being a mandated component of gasoline and diesel and that ESMA should take into account new extraction technologies which may render any definition based on crude oil only too narrow.

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[117] The terms "power" and "electricity" are used interchangeably in this paper.
[118] Definitions of oil and petroleum products are given on pages 38-42 of the Energy Statistics Regulation http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:02008R1099-20130314&qid=1396893804389&from=EN

9. ESMA agrees with these arguments and as a consequence proposes a wider definition of oil in the technical advice. ESMA considers that pure biofuel could not be classified as oil, however adding biofuel as a mandated minority component to gasoline or diesel should not prevent such gasoline or diesel to be caught by the wider definition of oil now proposed by ESMA.

10. In addition, ESMA decided to include broad definitions of coal as an underlying to a derivative contract as well as of the wholesale energy products caught by the C 6 exemption by reference to the derivative definitions in REMIT.

11. ESMA also noted in the Consultation Paper that this exemption should expressly be narrow in its scope to avoid a loophole leading to regulatory arbitrage[119].

12. ESMA's draft technical advice focused on further clarifying the notion of "*must be physically settled*" which has to be applied to wholesale energy contracts traded on OTFs which may benefit from the permanent exemption foreseen in Section C 6 of Annex 1 and the temporary exemption for *C 6 energy derivatives contracts* from certain EMIR obligations only, foreseen in Article 95 of MiFID II.

13. In respect of the notion of "*must be physically settled*" ESMA noted that Section C of the MiFID II Annex specifies a number of options for settlement in cash or physically (as discussed further below in this chapter) which serve as prerequisites for characterising contracts as financial instruments under the various definitions of Section C.

14. As per Recital 10 of MiFID for further specifying the meaning of what "*must be physically settled*" ESMA has to take into account at least the creation of an enforceable and binding obligation to physically deliver, which cannot be unwound and with no right to cash settle or offset transactions except in the case of a *force majeur*e event or other *bona fide* inability to settle physically and without prejudice to the rights of the parties to net their cash payment obligations.

15. Respondents to the consultation had diametrically opposed views in relation to how the concept of "must be physically settled" should be applied in this context and ESMA outlines the main arguments and how it is dealing with them below.

16. The first large group of respondents asked for the advice to be closer to the text of Recital 10, i.e. referring to "an enforceable and binding obligation to physically deliver which cannot be unwound" which shall be understood as allowing certain exemptions for cash settlement. Among these exemptions shall be the case of default and any contractually agreed termination event.

[119] Cf. Recital 10.

17. Another large group of respondents emphasised their concerns about this exemption creating a loophole and therefore jeopardising the achievements of some of the main MiFID goals. These respondents propose adding a fourth condition to the three determining when a contract “must be physically settled” proposed by ESMA, saying that the parties to the contract have to be able to demonstrate that the overall sum obligations to be physically settled does not exceed the volume of its commercial activities. The respondents also propose taking into consideration a provision from the International Accounting Standards thereby limiting “must be physically settled” to transactions with the purpose of commercial risk reduction.

18. Respondents also frequently refer to the regulatory treatment of physical transactions in the US and Canada and highlight the practical problems potentially arising out of a different regulatory treatment in the Union.

19. ESMA has taken some of the proposals received in the consultation on board and slightly amended the criteria for when a contract is to be assessed as “must be physically settled” with the aim of providing more legal certainty for all market participants when MiFID II enters into application.

20. ESMA at the same time has to point out though that it has to take the Level 1 text, the Level 2 empowerment and the mandate by the European Commission as it is and therefore does not have carte blanche in how to frame this exemption. ESMA consider some of the proposals from respondents as going beyond what is legally feasible at Level 2 and therefore has not adopted them. ESMA also appreciates the desirability of an alignment with legal rules and guidance in the US and Canada on how to treat physical transactions, but, of course, any such alignment is limited by decisions taken by the European co-legislators on Level 1.

21. In the Consultation Paper ESMA was looking for input from stakeholders on how operational netting arrangements work in practice with a view to establish criteria on how they should be treated in the MiFID II context.

22. Many respondents to this question urged ESMA to acknowledge that operational netting arrangements do not prevent contracts from being characterised as “must be physically settled”. They claim that no netting takes place between contracts or transactions equivalent to cash settlement or offsetting of transactions but rather that nominations to the Transmission System Operator (TSO) happen on a net basis for administrative convenience in accordance with the instructions and operational rules of the TSOs. Operational netting in this sense is seen as a type of (must be) physical settlement rather than offsetting of transactions. Operational arrangements are said not to involve the netting of contracts or transactions which remain separate and provide for transfer of title. By contrast, contracts not for physical settlement are characterised as those which do not require entering into contractual arrangements with system operators, registering of contracts with system operators, submitting of schedules and are not subject to balancing rules.

23. Another large group of respondents also seem to appreciate that operational netting as a "normal" technical netting process should not cause a contract to be considered as not "must be physically settled". However, they describe the process of operational netting to which this applies on a narrower basis by referring to the non-discretionary practice conducted by the energy network operator only netting the contract that can be netted at portfolio level of a company.

24. ESMA acknowledges the views of these respondents that operational netting in power and gas markets should not be considered as offsetting of contracts in a sense which would render a contract as not "must be physically settled". ESMA considers operational netting as an event happening post trade which is performed out of operational convenience and is instigated by the rules or requests of a TSO or an entity performing an equivalent function at the national level. ESMA does not consider that the performance of such practices in energy markets should in itself become the sole determinant for the application of financial regulation.

25. Therefore ESMA has clarified in the technical advice that operational netting does not prevent a contract from being considered as "must be physically settled". At the same time, ESMA specifies in the technical advice how it understands operational netting, namely as a process required by the rules or requests of a TSO or an entity performing an equivalent function at the national level which must not be at the discretion of the parties to the contract. ESMA is also aware that operational netting is handled in different ways in different Member States of the Union. The description supplied is intended not to require changes in the existing energy market practices solely to eliminate such divergences but rather lead to a consistent application of the future delegated act in recognition of different operational netting practices.

26. In addition, ESMA considers that a C 6 wholesale energy product contract can only be categorised as "must be physically settled" when the parties entering into the contract are actually capable of delivery or receipt of the agreed amount of gas, power, oil or coal. Therefore, the terms of a C 6 wholesale energy product contract or the rules of the OTF on which it is traded must require that both buyer and seller should have proportionate arrangements in place to make or receive delivery of the underlying commodity upon the expiry of the contract. The principle of proportionality should, in this case, be understood as requiring that the parties to the contract have arrangements in place which are adequate considering, for example, the size of their commercial activities or their production, storage or consumption capabilities.

27. ESMA would also like to flag that it did not consult on the concept described in the paragraph above since it has only been developed late in the ESMA deliberations. ESMA did receive some initial feedback in respect of this concept from energy regulators who were concerned that it may be detrimental to liquidity in energy markets and therefore may go against the goals of the Third Energy Package. ESMA however agreed to include it in the technical advice, in order to frame the C 6 exemption in line with the principles described in Recital 10

of MiFID II. Considering that such contracts, which according to MIFID should carry an enforceable and binding obligation to physically deliver, could be in theory sized in a manner that would render delivery or receipt physically impossible in comparison with the storage, consumption or production capabilities of the counterparties would, in ESMA's view, run contrary to the line expressed in Recital 10 of MiFID II.

28. ESMA notes in the case of *force majeure* that no instrument can be a 100% accurately described as *"must be physically settled"*, as practically all instruments appear to contain such *force majeure* provisions that would prevent physical delivery.

29. Therefore ESMA considered in the Consultation Paper that the existence of *force majeure* provisions should not prevent a contract from being characterised as "*must be physically settled*" for the purposes of further specifying wholesale energy products under Section C 6 and C 6 energy derivative contracts. The same applies to other *bona fide* inability to perform the contract on a physical settlement basis.

30. ESMA was looking for views from stakeholders on how to further specify the concepts of force majeure and bona fide inability to perform.

31. There seemed to be agreement among the respondents that force majeure and bona fide inability to settle provisions should be defined in an abstract way rather than by a list of concrete cases in order not to create legal uncertainty and to respect differences in national civil or case laws.

32. Respondents also agreed to a large extent on how to frame force majeure in this context and ESMA has inserted a description of how force majeure should be understood into the technical advice.

33. When it came to framing bona fide inability to settle provisions respondents had different views. One large group provided a definition for bona fide inability which should supplement force majeure provisions but which ESMA considers not to be materially different from them and considered any default or termination events separately. Another group of respondents however considered that bona fide inability to settle does not add anything and should be understood in the light of the phrase "other than by reason of default or other termination event" in Section C 10 to encompass all kinds of default or termination events such as failure to deliver, breach of agreement etc.

34. ESMA does not agree with the latter view. Default is separately mentioned in Recital 10 and defaulting on the contract by one party cannot be seen as a bona fide non-performance. A party not performing its contractual obligation is normally liable to damages but any such non- or defective performance cannot change the nature of the contract from the outset.

35. ESMA has inserted an abstract description of bona fide inability to perform clauses into the technical advice which supplements the force majeure descriptions without going into detail

of where the exact delineation between the two is as this may be different due to national civil laws.

36. Respondents to the consultation pointed out that clauses opening up a contract to cash settlement or to offsetting of transaction in the case of default are also mentioned in Recital 10 of Directive 2014/65/EC and ESMA has accordingly introduced a necessary clarification into the technical advice.

37. ESMA is of the view that the term "*physically settled*" has to be further specified as well by clarifying that it can incorporate a broad range of delivery methodologies including:

    i. physical delivery of the relevant goods themselves;

    ii. delivery of a document giving rights of an ownership nature to the relevant goods or the relevant quantity of the goods concerned (such as a bill of lading or a warehouse warrant); or

    iii. another method of bringing about the transfer of rights of an ownership nature in relation to the relevant quantity of goods without physically delivering them (including notification, scheduling or nomination to the operator of an energy supply network) that entitles the recipient to the relevant quantity of the goods.

38. ESMA considered it appropriate in the Consultation Paper to develop its advice based on the following considerations in respect of the concepts of what "***can***" and what "***must*** *be physically settled*", by looking at Sections C 5 to C 7 and the various alternatives described in those sections and by explaining in more detail how those concepts work together and how the various sections apply.

39. Respondents to the consultation generally agreed with ESMA's thinking on delineating "can be" and "must be" physical settlement however this was subject to a number of caveats and clarifications.

40. Some respondents argued that the possibility by mutual consent to cash settle should not trigger a contract to be assessed as "can be" physically settled and other respondents urged ESMA to clarify in Level 2 how such a mutual consent option would impact the determination of "can be" or " must be" physically settled.

41. ESMA has to emphasise that any specification of "can be" physically settled is outside the mandate given by the Commission and therefore cannot be part of the technical advice. However, ESMA has in the meantime addressed this particular topic in draft Guidelines in

respect of MiFID I[120] and ESMA would like to refer stakeholders to the discussion and the responses received there. Also addressing this via Guidelines for MiFID II would be an option for the future but it cannot form part of this advice to the European Commission.

42. Finally, in response to questions raised during the consultation ESMA would emphasise that it understands that contracts that have been excluded from the MiFID scope by virtue of the application of the exemption in C 6 are not again tested to determine whether they are a financial instrument under C 7.

43. However in order for this to apply in the correct context, ESMA confirms that the prerequisite for a C 6 wholesale energy product contract not to be tested again under C 7 is that the platform the contracts are traded on is a MiFID-authorised OTF. If the platform that the contracts are traded on is not a MiFID OTF due to it only trading "non-financial instruments" then this means that the C 6 exemption cannot be and has not been applied to these contracts in the first place and therefore they must be considered against the C 7 definition to determine if they are financial instruments.

Technical advice

1. For the purposes of further specifying wholesale energy contracts under Section C 6 and C 6 energy derivatives contract, a contract must be physically settled if:

   i. it contains provisions which ensure that parties to the contract have proportionate arrangements in place to be able to make or take delivery of the underlying commodity;

   ii. it establishes unconditional, unrestricted and enforceable obligations of the parties to the contract to deliver and take delivery of the underlying commodity;

   iii. it is not possible for either party to replace physical delivery with cash settlement; and

   iv. the obligations under the contract cannot be offset against obligations from other contracts between the parties concerned, without prejudice to the rights of the parties to the contract, to net their cash payment obligations.

2. Operational netting in power and gas markets shall not be considered as offsetting of obligations under a contract against obligations from other contracts as described in 1 iv and does not preclude a contract from being considered as must be physically settled.

3. Operational netting shall be understood as any nomination of quantities of power and gas to

[120] http://www.esma.europa.eu/consultation/Consultation-draft-guidelines-application-C6-and-C7-Annex-I-MiFID.

be fed into a gridwork upon being so required by the rules or requests of a Transmission System Operator as defined in Article 2 No. 4 of Directive 2009/72/EC or an entity performing an equivalent function to a Transmission System Operator at the national level. Any nomination of quantities based on operational netting must not be at the discretion of the parties to the contract.

4. The existence of force majeure or bona fide inability to settle provisions do not prevent a contract from being characterised as “must be physically settled” for the purposes of further specifying wholesale energy products under Section C 6 and C 6 energy derivative contracts.

5. Force majeure should be understood as an event or a set of circumstances which are outside the control of the parties to the contract, which the parties to the contract could not have reasonably foreseen or avoided and which prevent one or both parties to the contract from fulfilling their contractual obligations. Force majeure characteristically provides for a temporary suspension of contractual obligations while the force majeure event or set of circumstances is in place rather than an outright termination of the contract and for the contract to be set aside when the fulfilment of the contractual obligations becomes impossible.

6. Bona fide inability to settle should be understood as any event or set of circumstances, not qualifying as force majeure, which are objectively measurable as reasons defined in the contract terms for one or both parties to the contract not to fulfil their contractual obligations. Bona fide inability to settle clauses also characteristically provide for a temporary suspension of contractual obligations while the relevant event or set of circumstances is in place rather than an outright termination of the contract and for the contract to be set aside when the fulfilment of the contractual obligations is excluded by contractual terms.

7. The existence of default clauses providing that a party is entitled to financial compensation in the case of non- or defective performance of the contract should not prevent the contract from being characterised as “must be physically settled” for the purposes of further specifying wholesale energy products under Section C 6 and C 6 energy derivative contracts,

8. Contracts that are physically settled can have a broad range of delivery methods including the following:

   i. physical delivery of the relevant commodities themselves;

   ii. delivery of a document giving rights of an ownership nature to the relevant commodities or the relevant quantity of the commodities concerned (such as a bill of lading or a warehouse warrant); or

   iii. another method of bringing about the transfer of rights of an ownership nature in relation to the relevant quantity of goods without physically delivering them (including notification, scheduling or nomination to the operator of an energy supply network) that enti-

tles the recipient to the relevant quantity of the goods.

9. C 6 energy derivative contracts relating to oil shall be understood as contracts having mineral oil, of any description and petroleum gases, whether in liquid or vapour form, including products, components and derivatives of oil and oil transport fuels, including those with biofuel additives, as an underlying.

10. C 6 energy derivative contracts relating to coal shall be understood as contracts with coal, defined as a black or dark-brown combustible mineral substance consisting of carbonised vegetable matter, used as a fuel, as an underlying.

11. Derivative contracts that have the characteristics of wholesale energy products as defined in Article 2(4) of Regulation (EU) No 1227/2011 are derivatives with electricity or natural gas as an underlying, in accordance with Article 2(4) letters (b) and (d) of Regulation (EU) No 1227/2011.

Technical Advice on specifying derivative contracts mentioned in Section C 7 of Annex I

Background/Mandate

Extract from the Commission's request for technical advice (mandate)

ESMA is invited to consider whether any amendments to Article 38 of the MiFID I Commission Regulation N° 1287/2006 are necessary, in particular whether the list of criteria contracts that are not spot contracts should satisfy to be classified as financial instruments needs to be amended taking into account the introduction of the new OTF trading venue category and bearing in mind that the clearing and margining requirement should be removed.

Article 4(1)(2), MiFID II

The Commission shall adopt delegated acts in accordance with Article 89 measures specifying:

(b) the derivative contracts referred to in Section C.7 of Annex I that have the characteristics of other derivative financial instruments;

Analysis following feedback from stakeholders

1. The aim of the Delegated Act is to specify options, futures, swaps, forwards and other contracts relating to commodities, that can be physically settled not otherwise mentioned in Section C 6 of Annex I of MiFID II and not being for commercial purposes, which have the characteristics of other derivative financial instruments.

2. ESMA notes that Section C 7 of Annex I of MiFID II was already included in MiFID I but with slightly different wording as the last half sentence of the provision ("*having regard to whether, inter alia, they are cleared and settled through recognised clearing houses or are subject to regular margin calls*") has been deleted in the MiFID Review.

3. ESMA also notes that Section C 7 of Annex I of MiFID I was already further specified in Article 38 of Regulation (EC) No 1287/2006 the relevant sections of which are displayed below.

Article 38

(Article 4(1)(2) of Directive 2004/39/EC)

Characteristics of other derivative financial instruments

1. For the purposes of Section C(7) of Annex I to Directive 2004/39/EC, a contract which is not a spot contract within the meaning of paragraph 2 of this Article and which is not covered

by paragraph 4 shall be considered as having the characteristics of other derivative financial instruments and not being for commercial purposes if it satisfies the following conditions:

(a) it meets one of the following sets of criteria:

(i) it is traded on a third country trading facility that performs a similar function to a regulated market or an MTF;

(ii) it is expressly stated to be traded on, or is subject to the rules of, a regulated market, an MTF or such a third country trading facility;

(iii) it is expressly stated to be equivalent to a contract traded on a regulated market, MTF or such a third country trading facility;

(b) it is cleared by a clearing house or other entity carrying out the same functions as a central counterparty, or there are arrangements for the payment or provision of margin in relation to the contract;

(c) it is standardised so that, in particular, the price, the lot, the delivery date or other terms are determined principally by reference to regularly published prices, standard lots or standard delivery dates.

2. A spot contract for the purposes of paragraph 1 means a contract for the sale of a commodity, asset or right, under the terms of which delivery is scheduled to be made within the longer of the following periods:

(a) two trading days;

(b) the period generally accepted in the market for that commodity, asset or right as the standard delivery period.

However, a contract is not a spot contract if, irrespective of its explicit terms, there is an understanding between the parties to the contract that delivery of the underlying is to be postponed and not to be performed within the period mentioned in the first subparagraph.

[…]

4. A contract shall be considered to be for commercial purposes for the purposes of Section C(7) of Annex I to Directive 2004/39/EC, and as not having the characteristics of other derivative financial instruments for the purposes of Sections C(7) and (10) of that Annex, if it is entered into with or by an operator or administrator of an energy transmission grid, energy balancing mechanism or pipeline network, and it is necessary to keep in balance the supplies and uses of energy at a given time.

4. In summary a contract qualifies as a financial instrument under this provision if the conditions in paragraph 1 are fulfilled on a cumulative basis and the contract is neither a spot contract as defined in paragraph 2 nor for commercial purposes as defined in paragraph 4. Based on feedback from regulators and market participants alike ESMA considers that this provision has provided clarity in respect of the application of Section C 7 of Annex I in practice and therefore takes the view that one approach would be to include some or most of the factors of this provision again in the future MiFID II Delegated Act.

Spot Contract and Commercial Purpose

5. In the Consultation Paper, ESMA considered that the definition of a spot contract in paragraph 2 of the provision above as well as the definition of a contract being for commercial purposes in paragraph 4 were still valid and therefore intended to advise the Commission to include them in the future MiFID II Delegated Act.

6. In respect of the definition of spot contract, a group of respondents agreed to maintain the current abstract definition. A number of respondents, in addition, suggested addressing any differing national applications via ESMA Guidelines in the future. Another group of respondents did not agree with keeping the current definition and suggested for ESMA to conduct a survey of different spot definitions in use in different markets.

7. ESMA considers that the past consultation was an opportunity for all market participants to come back with different spot definitions across markets that ESMA could have taken into account. Due to the deadlines ESMA has to adhere to there is no time for conducting an additional survey. Therefore, ESMA will propose maintaining the current definition to the Commission while keeping the option open of looking at this topic again via future Guidelines, once MiFID II reaches the implementation stage.

8. ESMA also indicated that the definition of a contract being for commercial purposes is rather narrowly framed and limited to the energy sectors. ESMA therefore asked stakeholders if there were other contracts that could be considered to be for commercial purposes only.

9. While respondents mostly considered the existing definition to remain valid they also deemed it too narrow and recommended to expand it to other contracts, such as those from the agricultural sector and those aimed to cover insurance risks. In addition, respondents from the energy sector sought the inclusion of electricity balancing contracts as contracts for commercial purposes.

10. ESMA notes that contracts as far as they are entered into with an energy balancing mechanism are already covered by the existing exemption. ESMA also notes the calls for substantially expanding the use of the commercial purposes test but makes respondents aware that the current commercial purposes test applicable in the energy sector is dependent on the conditions that a contract is entered into by an operator and if “it is necessary to keep in balance the supplies and uses of energy at a given time”. ESMA understands this as a con-

dition limiting the scope of the commercial purposes test to very specific situations whereas the commercial purposes test must not be used to carve-out entire sectors of the commodity derivatives market indiscriminately. ESMA would be willing to consider other narrowly specified applications of the commercial purposes test, for example, in the agricultural or metals sectors if they could be phrased and justified in an equivalent fashion to the already existing cases of the test in the energy sector. However, respondents to the consultation have not come forward with specific examples in that sense. Therefore, ESMA advises the European Commission to maintain the commercial purposes test in its current shape, limited to the energy sector but to remain open to any potential additions in the further course of the Level 2 procedure, in case other specific examples, equivalent to the existing one, can be identified.

11. The other factors listed in Article 38(1) Regulation (EC) No 1287/2006, i.e. the conditions in relation to the trading, the clearing and the degree of standardisation, required close inspection in the Consultation Paper.

12. In that context, ESMA noted that since the entry into force of MiFID I other pieces of legislation have either taken effect already or are in the process of being finalised for which the scope of MiFID I and II, as defined by the Delegated Act contemplated here, is important and has a direct effect.

13. The first one is the Market Abuse Regulation (MAR)[121] which replaces the existing Market Abuse Directive[122] and which will become applicable 6 months before MiFID II except for those provisions which explicitly depend on MiFID II.

14. The new MAR predominantly applies to financial instruments. However, it also expressly extends the scope of the market manipulation and insider trading prohibitions to spot commodity contracts where any transaction or order in them or any behaviour in relation to them is likely to have an effect on the price or value of a financial instrument[123]. For such contracts the classification as a financial instrument or a spot commodity contract *prima facie* does not seem to be that crucial as the main pillars of an anti-market abuse regime would apply in both cases.

15. However there is a difference with regard to the ability of financial supervisors to detect market abuse because the transaction reporting regime in MiFID I and II only applies to financial instruments whereas spot commodity contracts remain outside the scope of the MiFID I and II transaction reporting regime. ESMA also notes that the extension of the market manipulation and insider trading prohibitions in MAR will expressly exempt “wholesale energy products” as defined in Article 2(4) of REMIT.

[121] Regulation (EU) No 596/2014.
[122] Directive 2003/6/EC.
[123] Article 2(2a) MAR.

16. This observation leads to the second piece of legislation which it is important to take into consideration when designing this Delegated Act. Regulation (EU) No 1227/2011 (REMIT) on wholesale energy market integrity and transparency establishes a framework applying to wholesale energy products encompassing spot and derivative contracts in electricity and gas[124].

17. While the REMIT obligation to publish inside information applies to both spot and derivative contracts in electricity and gas[125], the prohibitions of insider trading and market manipulation do not apply to financial instruments (i.e. derivatives in electricity and gas) where at the moment the Market Abuse Directive, in the future MAR, prevail and financial regulators are the competent authorities. In short, this combination of exemptions can be summarised by stating that wholesale energy products are exempted from the scope of MAR, except for the prohibitions of market manipulation and insider trading in electricity and gas derivatives where REMIT declares MAR as applicable.

18. The combination of exemptions highlights the importance of determining whether an instrument is classified as a financial instrument according to the Delegated Act contemplated here because, depending on whether market abuse occurs in a spot contract or a derivative contract in electricity or gas (outside the exemption under Section C 6), a different set of rules applies (REMIT versus MAR), along with different authorities being responsible for market monitoring, investigation and enforcement (ACER and national energy regulators versus national financial regulators).

19. Therefore ESMA recognised the importance of the definition of financial instrument as specified in this Delegated Act setting out clear and dependable rules for market participants and regulators alike so that the regime applying in cases of market abuse can be easily determined.

Article 38(1) Letter b – The Clearing Criterion

20. The third relevant piece of legislation is EMIR. EMIR establishes a number of obligations applying to derivatives with derivatives being defined by reference to Sections C 4 to C 10 as implemented by Article 38 and 39 of Regulation (EC) No 1287/2006[126]. Therefore any change to the scope of the definitions of derivatives in MiFID will have a direct effect on the scope of EMIR.

21. One of the most prominent regulatory measures EMIR establishes is the clearing obligation for derivatives[127] according to which OTC derivative contracts, if certain conditions are ful-

[124] Cf. Article 2(4) REMIT.
[125] Article 4 REMIT.
[126] Cf. Article 2(5) EMIR.
[127] Cf. Article 4 EMIR.

filled, have to be cleared by authorised European CCPs or recognised third-country CCPs. ESMA considers that the existence of the clearing obligation in EMIR has an impact on how to design the future Delegated Act due to the interdependence of MiFID I and II and EMIR.

22. In simplified terms, EMIR requires commodity derivatives as defined in MiFID I to be cleared if certain conditions are fulfilled. If MiFID II were to then continue defining commodity derivatives as instruments which are (already) cleared, as it currently does in Article 38(1) Letter b of Regulation (EC) No 1287/2006, this would establish a circularity between the two pieces of legislation.

23. As a consequence, ESMA considered that the future Delegated Act should not include any criteria requiring instruments to be cleared in order to be considered as commodity derivatives. The change to the Level 1 text in Section C 7 of Annex I (deletion of "having regard to whether, inter alia, they are cleared and settled through recognised clearing houses or are subject to regular margin calls") also indicated in ESMA's view that the existence of clearing arrangements shall not be taken as an indicator of whether an instrument is a financial instrument anymore.

24. Some respondents agreed with ESMA's reasoning regarding the deletion of the clearing criterion while others did not see the circularity as described by ESMA and claimed that removing the clearing criterion here would limit the scope of EMIR.

25. ESMA does not agree with the latter reasoning and taking into account the change to the Level 1 text as described above maintains its proposal to delete the clearing criterion.

Article 38(1) Letter c – The Standardisation Criterion

26. Article 38(1) Letter c of Regulation (EC) No 1287/2006 states that a contract must also be standardised to be considered as having the characteristics of other derivative financial instruments. ESMA considered in the Consultation Paper that standardisation should remain an important indicator for classifying contracts as derivatives in the MiFID sense, i.e. as financial instruments.

27. ESMA noted that standardisation of derivatives is also an important feature of the EMIR clearing obligation where a certain degree of standardisation, including for example whether OTC derivative contracts incorporate common legal documentation, is to be taken into account when determining whether a specific class of OTC derivatives shall be subject to the clearing obligation[128].

[128] Article 7 Commission Delegated Regulation (EU) No 149/2013.

28. While EMIR is about the degree of standardisation of an OTC derivative, the prerequisites listed in Article 38(1) Letter c are about whether to qualify a contract as a derivative in the first place. Maintaining Article 38(1) Letter c would therefore not establish a circularity between MiFID II and EMIR but rather one would supplement the other by MiFID II having abstract standardisation criteria for establishing whether a contract is a derivative while EMIR looks at degrees of standardisation of contracts already classified as financial instruments.

29. Therefore ESMA considered that Article 38(1) Letter c of Regulation (EC) No 1287/2006 should be maintained in the future Delegated Act.

30. Most respondents agreed that the standardisation of a contract is an important indicator of whether to categorise it as a financial instrument. Those disagreeing mostly argued that standardisation alone is not a good indicator and that it should be complemented by the clearing and the trading criterion. Some respondents suggested adding that commodity derivatives are also characterised by standardised product specifications for the underlying commodity.

31. ESMA decided not to introduce the latter point into the technical advice as having standardised product specifications for the underlying being a prerequisite of any functioning contract would not add much in terms of substance.

Article 38(1) Letter a – The Trading Criterion

32. Regarding the trading criterion as expressed in Article 38(1) Letter a of Regulation (EC) No 1287/2006 ESMA notes that the three alternatives listed are intended to cover situations where (i) a contract is traded on a third country facility, (ii) is conducted bilaterally and is then brought on venue (negotiated trade) or (iii) where a contract off-venue is expressly stated to be the equivalent of an on-venue contract. Article 38(1) Letter a needs to be read in conjunction with Section C 6 of the MiFID II Annex which already classifies all contracts traded on one of the MiFID trading venues (except for certain OTF contracts) as financial instruments.

33. ESMA considered in the Consultation Paper that the first two of the three above-mentioned alternatives of the trading criterion are still useful indicators for determining whether to qualify a contract as a financial instrument and proposed to maintain them in the new Delegated Act.

34. Respondents to a large extent agreed with this assessment and ESMA therefore maintains those criteria.

35. In the Consultation Paper, ESMA had raised the issue of the third alternative of the trading criterion where a contract has been expressly declared to be the equivalent of an on-venue contract. ESMA was looking for a more objective alternative which does not depend on the choices of the two counterparties concerned and accordingly proposed a new draft.

36. Respondents mostly did not agree with changing the third limb of the trading criterion to a pure equivalence test, claiming that it would reduce objectivity and may bring commercial transactions for the physical delivery of agricultural products into scope. ESMA however still sees the benefit of raising objectivity by introducing this wording and removing the complete discretion by the parties to the contract which would also lead to more consistency in the application of the third limb and would reduce the potential for avoidance. Therefore, ESMA decided to maintain its proposal.

37. ESMA notes that the emergence of the OTF as a new MiFID trading venue needs to be taken into account in the new Delegated Act. ESMA confirms that C 7 should only be applied to those contracts not caught by C 6 and not within the scope of the C 6 exemption given that a number of respondents asked for such clarification. The technical advice now contains a statement to that effect.

38. ESMA also introduces the term “third country trading venue” as it appears in Article 28 MiFIR in this context for describing third country facilities in order to have a consistent terminology across the MiFID II framework.

Technical advice

1. A contract should be considered as having the characteristics of other derivative financial instruments if it is standardised and if it trades in line with conditions outlined in the following paragraphs. The contract must neither be a spot contract nor a contract for commercial purposes only in line with the conditions outlined below. Contracts within the scope of the exemption in C 6 should not be tested again under C 7.

2. A contract should be considered as standardised if parameters such as the price, the lot, the delivery date or other terms are determined principally by reference to regularly published prices, standard lots or standard delivery dates.

3. A contract should be considered as traded in such a way as having the characteristics of other derivative financial instruments if:

    i. it is traded on a third country trading venue that performs a similar function to a regulated market, an MTF or an OTF;

    ii. it is expressly stated to be traded on, or is subject to the rules of, a regulated market, an MTF, an OTF or such a third country trading venue; or

    iii. it is equivalent to a contract traded on a regulated market, an MTF, an OTF contract or such a third country trading venue, with regards to the price, the lot, the delivery date or other terms.

4. A spot contract should be defined as a contract for the sale of a commodity, asset or right,

under the terms of which delivery is scheduled to be made within the longer of the following periods:

iv. two trading days;

v. the period generally accepted in the market for that commodity, asset or right as the standard delivery period.

5. A contract should not be classified as a spot contract if there is an understanding between the parties to the contract that delivery of the underlying is to be postponed and not to be performed within two trading days or the period generally accepted in the market. This rule should apply irrespective of the explicit terms contained in the contract.

6. A contract should be considered to be for commercial purposes and as not having the characteristics of other derivative financial instruments for the purposes of Sections C 7 and C 10 if it is entered into with or by an operator or administrator of an energy transmission grid, energy balancing mechanism or pipeline network and it is necessary to keep in balance the supplies and uses of energy at a given time.

Technical Advice on specifying derivative contracts mentioned in Section C 10 of Annex I

Background/Mandate

Extract from the Commission's request for technical advice (mandate)

ESMA is invited to consider whether any amendments to Article 38(3) and Article 39 of the Mi-FID I Commission Regulation N° 1287/2006 are necessary, in particular to reflect the addition of the OTF as a new type of trading venue on which these instruments may be traded and taking into account that clearing and margining requirement should be removed as a criteria. ESMA is also invited to consider whether the list of derivative contracts in Article 39 is still comprehensive or needs to be supplemented.

Article 4(1)(2), MiFID II

The Commission shall adopt delegated acts in accordance with Article 89 measures specifying:

(c) the derivative contracts referred to in Section C.10 of Annex I that have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are traded on a regulated market, an MTF or an OTF;

Analysis following feedback from stakeholders

1. The aim of the Delegated Act is to specify options, futures, swaps, forward rate agreements and other contracts relating to climatic variables, freight rates, inflation rates, other official economic statistics that have to be or can be settled in cash as well as contracts relating to assets, rights, obligations, indices and measures not otherwise mentioned in Section C 10 of Annex I, which have the characteristics of other derivative financial instruments. Here the Delegated Act shall have regard to whether the instruments are traded on one of the MiFID trading venues.

2. ESMA notes that Section C 10 of Annex I was also already included in MiFID I and the MiFID II text has changed Section C 10 by adding the OTF as one of the trading venues these instruments may be traded on as well as deleting the last half sentence whereby other instruments were to be assessed by looking at the existence of clearing arrangements ("*are cleared and settled through CCPs or are subject to regular margin calls*").

3. ESMA also notes that Section C 10 of Annex I was already further specified in Articles 38 and 39 of Regulation (EC) No 1287/2006 the relevant sections of which are displayed below.

Article 38

(Article 4(1)(2) of Directive 2004/39/EC)

Characteristics of other derivative financial instruments

1. For the purposes of Section C(7) of Annex I to Directive 2004/39/EC, a contract which is not a spot contract within the meaning of paragraph 2 of this Article and which is not covered by paragraph 4 shall be considered as having the characteristics of other derivative financial instruments and not being for commercial purposes if it satisfies the following conditions:

(a) it meets one of the following sets of criteria:

(i) it is traded on a third country trading facility that performs a similar function to a regulated market or an MTF;

(ii) it is expressly stated to be traded on, or is subject to the rules of, a regulated market, an MTF or such a third country trading facility;

(iii) it is expressly stated to be equivalent to a contract traded on a regulated market, MTF or such a third country trading facility;

(b) it is cleared by a clearing house or other entity carrying out the same functions as a central counterparty, or there are arrangements for the payment or provision of margin in relation to the contract;

(c) it is standardised so that, in particular, the price, the lot, the delivery date or other terms are determined principally by reference to regularly published prices, standard lots or standard delivery dates.

[…]

3. For the purposes of Section C(10) of Annex I to Directive 2004/39/EC, a derivative contract relating to an underlying referred to in that Section or in Article 39 shall be considered to have the characteristics of other derivative financial instruments if one of the following conditions is satisfied:

(a) that contract is settled in cash or may be settled in cash at the option of one or more of the parties, otherwise than by reason of a default or other termination event;

(b) that contract is traded on a regulated market or an MTF;

(c) the conditions laid down in paragraph 1 are satisfied in relation to that contract.

Article 39

(Article 4(1)(2) of Directive 2004/39/EC)

Derivatives within Section C(10) of Annex I to Directive 2004/39/EC

In addition to derivative contracts of a kind referred to in Section C(10) of Annex I to Directive 2004/39/EC, a derivative contract relating to any of the following shall fall within that Section if it meets the criteria set out in that Section and in Article 38(3):

(a) telecommunications bandwidth;

(b) commodity storage capacity;

(c) transmission or transportation capacity relating to commodities, whether cable, pipeline or other means;

(d) an allowance, credit, permit, right or similar asset which is directly linked to the supply, distribution or consumption of energy derived from renewable resources;

(e) a geological, environmental or other physical variable;

(f) any other asset or right of a fungible nature, other than a right to receive a service, that is capable of being transferred;

(g) an index or measure related to the price or value of, or volume of transactions in any asset, right, service or obligation.

4. Based on feedback from market participants and regulators the existing MiFID I Level 2 provisions have for the most part worked well in practice. Therefore ESMA proposed in the Consultation Paper that the existing parameters in Article 38(3) of Regulation (EC) No 1287/2006 should be kept and only updated as necessary due to changes in the Level 1 text.

5. The large majority of respondents agreed with this approach and therefore ESMA has kept the main parts of the technical advice unchanged compared to the Consultation Paper. However, upon proposals from a number of respondents, ESMA has included as an additional alternative that contracts can also qualify if they are traded on a third country venue, similar to a regulated market, MTF or OTF.

6. As explained for Section C 7 of Annex I of MiFID II the existence of clearing arrangements will no longer be considered as an indicator for determining whether an instrument is a financial instrument due to the circularity this creates with EMIR and to the change in the MiFID Level I text described above where the reference to clearing arrangements has been deleted.

7. This would mean cash settlement or the option to settle a contract in cash (Article 38(3) Letter a) shall remain a condition for classifying the instruments in Section C 10 as having the characteristics of other derivative financial instruments.

8. The condition of trading the contract on a regulated market or MTF in Article 38(3) Letter b would need to be supplemented by trading a contract on an OTF.

9. The condition imposed by reference to the existing Article 38(1) in Article 38(3)(c) would be maintained in the new Delegated Act and automatically be updated due to the changes to the former provision as described in the previous section.

10. ESMA considered the list of additional derivative contracts in Article 39 of Regulation (EC) No 1287/2006, to be close to comprehensive and in the Consultation Paper proposed to maintain it.

11. A very large majority of respondents agreed with this assessment so ESMA has kept the technical advice unchanged except for a small clarification taking into account that emission allowances are now a financial instrument under MiFID II.

12. ESMA however was considering one addition to the list which is in relation to derivative contracts relating to actuarial statistics.

13. Respondents were sceptical in respect of this proposal, considering that they do not see much reason for expanding the scope to contracts with actuarial statistics as the underlying. One respondent, in addition, cited concerns that introducing actuarial statistics may cause an overlap and inconsistencies with insurance regulation. Hence, ESMA decided not to pursue this proposal further.

Technical advice

1. Derivative contracts relating to an underlying in Section C 10 of Annex I should be classified as having the characteristics of other derivative financial instruments if they fulfil one of the following conditions:

    i. they are settled in cash or may be settled in cash at the option of one or more of the parties to the contract, other than by reason of default or other termination event;

    ii. they are traded on:

        a. a regulated market;

        b. an MTF;

c. an OTF; or

d. a third country trading venue that performs a similar function to a regulated market, an MTF or an OTF

iii. they fulfil the conditions imposed for derivative contracts under Section C 7.

2. Derivative contracts relating to the following underlyings should also be considered as derivative contracts within the scope of Section C 10 of Annex 1 if they meet the criteria established in that Section and those established in the paragraph above:

i. telecommunications bandwidth;

ii. commodity storage capacity;

iii. transmission or transportation capacity relating to commodities, whether cable, pipeline or other means;

iv. an allowance, credit, permit, right or similar asset which is directly linked to the supply, distribution or consumption of energy derived from renewable resources, except if the contract is already within the scope of C 4;

v. a geological, environmental or other physical variable;

vi. any other asset or right of a fungible nature, other than a right to receive a service, that is capable of being transferred;

vii. an index or measure related to the price or value of, or volume of transactions in any asset, right, service or obligation.

7.2. Position reporting thresholds

Background/Mandate

Extract from the Commission's request for technical advice (mandate)

ESMA is invited to provide technical advice on the thresholds referred to in respect of both the number of persons and their open positions which if exceeded means that the last subparagraph of paragraph 1 of Article 58 does not apply.

Article 58, MiFID II

1. Member States shall ensure that an investment firm or a market operator operating a trading venue which trades commodity derivatives or emission allowances or derivatives thereof:

(a) make public a weekly report with the aggregate positions held by the different categories of persons for the different commodity derivatives or emission allowances or derivatives thereof traded on their trading venue, specifying the number of long and short positions by such categories, changes thereto since the previous report, the percentage of the total open interest represented by each category and the number of persons holding a position in each category in accordance with paragraph 4 and communicate that report to the competent authority and to ESMA; ESMA shall proceed to a centralised publication of the information included in those reports;

[…]

The obligation laid down in point (a) shall only apply when both the number of persons and their open positions exceed minimum thresholds.

[…]

6. The Commission shall be empowered to adopt delegated acts in accordance with Article 89 to specify the thresholds referred to in the second subparagraph of paragraph 1 this Article, having regard to the total number of open positions and their size and the total number of persons holding a position.

Analysis following feedback from stakeholders

1. The Commission has requested ESMA to advise it on the delegated acts to be adopted under Article 58(6) of MiFID II specifying the minimum thresholds that are referred to in Article 58(1). These thresholds are the levels above which the aggregate COT reports that have been prepared by trading venues, and also submitted to competent authorities and ESMA, will be published.

2. In determining the appropriate thresholds for publication, the Commission will have regard to:

   i. the total number of persons that hold a position in the relevant instrument; and

   ii. the total size of their open positions.

3. The second subparagraph of Article 58(1) of MiFID II sets out that the COT report under Article 58(1)(a) of MiFID II should only be published when both of the thresholds above are exceeded.

4. ESMA's proposed thresholds are based on achieving an appropriate balance between the two competing objectives of providing transparency to market stakeholders, and ensuring the prevention of market abuse and preservation of confidentiality by not disclosing details of position holders to the extent that they may be identifiable. They are also aimed at facilitating efficient and effective arrangements that generate timely and meaningful reports. ESMA has based its thresholds on the existing arrangements for US CFTC and EU trading venue COT reporting. However, as these reports are limited to their core and most liquid contracts, there is little data available on the number of COT reports that such thresholds would generate for less-liquid contracts. On the evidence available, it is likely that lower thresholds than those advised by ESMA would result in the publication of reports that provide little additional benefit to stakeholders but would raise significant confidentiality concerns for position holders.

5. For the avoidance of doubt, the thresholds only apply to the publication of COTs reports. The reporting by members or participants of trading venues of positions in commodity derivatives, emission allowances, and derivatives thereof (collectively "commodity derivatives") must continue to be made on a daily basis, regardless of whether COT reports are published.

Position Holders

6. ESMA proposed that the number of position holders across all five categories of persons is set at a total of 30 persons. This figure aims to set a balance between: a) setting the threshold too low which might undermine market integrity if the persons holding individual positions could be identified; and b) setting the threshold too high which might reduce transparency of the market.

7. In proposing this number of position-holders, ESMA has had regard to the position reporting regimes that are established in other jurisdictions. ESMA notes that where jurisdictions have determined the number of position-holders to be at a lower level than 30, there are fewer categories into which the position-holders are placed. ESMA therefore considers that the level proposed for the Article 58 of MiFID II regime strikes a comparable balance between transparency and confidentiality when taken across all categories.

8. The majority of respondents agreed with a minimum threshold of 30 persons that hold positions in a contract as appropriate for the publishing of COT reports. Some respondents suggested that there should be a higher minimum for the number of persons published in a category to protect the confidentiality of those persons. A small number of respondents considered the minimum threshold to be too high as they suggested there were likely to be fewer participants active on EU markets compared to the number that are active on US markets.

9. To determine the total number of position-holders, a position holder is counted only once whether or not the position-holder appears more than once in a report. For example, a position-holder may be reported twice as regards holding long and short positions. This could mean that the sum of the number of position holders identified in each category of the COT report, could exceed the number of position-holders reported in that contract.

Size of Open Positions

10. ESMA proposed that publication of COT reports takes place when the absolute value of the gross long or short volume of total open interest, expressed in the number of lots of the relevant commodity derivative exceeds a level of four times the deliverable supply for the same commodity derivative, as expressed in number of lots. This threshold would apply to the contract as a whole, covering the aggregate of open interest in both spot and forward months.

11. ESMA believes that this measure, made in relation to deliverable supply, offers market participants transparency and certainty. The multiple selected is intended to be effective in providing transparency of commodity derivatives where there is significant trading interest and an indication that the volume of trading exceeds that necessary to provide sufficient liquidity to support participants that ultimately require physical delivery or engage in trading for commercial risk management purposes.

12. The calculation for the option positions will be expressed on a delta-equivalent basis converted to a future on the same commodity derivative. ESMA proposes that position holders can apply their own or trading venues' publicly published delta calculation values to all option positions.

13. Therefore, a COT report would need to be published under Article 58(1)(a) of MiFID II, for a commodity derivative traded on a trading venue, when both: a) 30 or more persons hold a position in that commodity derivative and b) when the value of the gross long or short volume of total open interest of their positions for that commodity derivative exceeds four times the deliverable supply for that commodity derivative.

14. With regard to the measure of open interest a majority of respondents supported a minimum threshold for requiring the publication of commitment of trader reports of open interest representing four times the deliverable supply for that contract. A small number of respondents suggested the minimum threshold should be that open interest in both the spot and the for-

ward months equals deliverable supply as they suggested that this would be the point when squeezes or delivery issues could occur if a significant proportion of participants decided subsequently to take delivery.

Application of Reporting Thresholds

15. ESMA proposed that COT reports should be reported by trading venues as soon as feasibly practical and no later than three weeks after a contract exceeds both thresholds and for a period of three months after a contract fails to exceed both the thresholds for the number of position holders and the value of open contracts. In the event of a contract not exceeding the threshold during that period, the requirement to report positions for that contract should cease.

16. ESMA considers that such an approach would be preferable to contracts being reported on a sporadic basis in the event of such contracts intermittently exceeding both thresholds. The publication of COT reports will automatically cease should a contract expire or be otherwise delisted during the reportable period.

17. Such an approach means that the number of position holders may, from time to time, fall beneath the reporting threshold of 30 persons. Therefore, ESMA proposes that in such cases, in order to reduce the risks of a breach of confidentiality towards such position holders, and in a similar manner to existing position reporting regimes, that where there are 4 or fewer position holders active in a given category, the number of position holders in that category is not reported, but that the position holders in the other categories are.

18. Most respondents supported COT reports being published by trading venues and ESMA three weeks after the minimum thresholds for a contract had been exceeded and for a period of three months subsequently after the threshold was passed. Differing views were expressed by trading venues who wanted more time to produce COT reports whilst some participants considered that reports could be published more quickly.

Technical advice

1. The obligation for a trading venue to make public a weekly position report for commodity derivatives or emission allowances or derivatives thereof (collectively “commodity derivatives”) will apply when both of the following two thresholds are met:

   i. 30 open position holders exist in a given contract on a given trading venue; and

   ii. the absolute amount of the gross long or short volume of total open interest, expressed in the number of lots of the relevant commodity derivative, exceeds a level of four times the deliverable supply in the same commodity derivative, expressed in number of lots.

2. These thresholds are cumulative and both must be met before the obligation to make public

a report applies. The thresholds shall apply separately to each commodity derivative that is listed on a trading venue.

3. The 30 position holders threshold shall apply in aggregate across all of the categories of person and there does not have to be a minimum number of position holders in any single category.

4. However, where there are four or fewer position holders active in a given category, the number of position holders in that category shall not be published.

5. Where the thresholds above are triggered for the first time, that trading venue shall publish its first weekly report as soon as it is feasibly practical, but in any event no later than 3 weeks from the date on which the thresholds are first triggered.

6. Where the thresholds are no longer being met, that trading venue shall continue to publish the weekly report for a period of three calendar months after which, if the thresholds have not been met during the period, publication of the report for that contract may cease.

7. The publication of the weekly reports will automatically cease should a contract expire or be otherwise delisted during the reportable period.

7.3. Position management powers of ESMA

Background/Mandate

Extract from the Commission's request for technical advice (mandate)

ESMA is invited to provide technical advice on:

- the existence of a threat to the orderly functioning and integrity of financial markets, including commodity derivative markets in accordance with the objectives listed in Article 57(1) of Directive .../.../EU and including in relation to delivery arrangements for physical commodities, or to the stability of the whole or part of the financial system in the Union as referred to in Article 45 paragraph 2(a) taking account of the degree to which positions are used to hedge positions in physical commodities or commodity contracts and the degree to which prices in underlying markets are set by reference to the prices of commodity derivatives;*

- the appropriate reduction of a position or exposure entered into via a derivative referred to in Article 45 paragraph 1(b);

- the situations where a risk of regulatory arbitrage as referred to in Article 45 paragraph 3(b) could arise.

Those criteria and factors shall take into account the regulatory technical standards referred to in Article 57(3) of the Directive and shall differentiate between situations where ESMA takes action because a competent authority has failed to act and those where ESMA addresses an additional risk which the competent authority is not able to sufficiently address pursuant to Article 69(2)(j) or (o) of the Directive.

Article 45(10), MiFIR

The Commission shall adopt in accordance with Article 50 delegated acts to specify criteria and factors to determine:

(a) the existence of a threat to the orderly functioning and integrity of financial markets, including commodity derivative markets in accordance with the objectives listed in Article 57(1) of Directive 2014/61/EU and including in relation to delivery arrangements for physical commodities, or to the stability of the whole or part of the financial system in the Union as referred to in paragraph 2(a) taking account of the degree to which positions are used to hedge positions in physical commodities or commodity contracts and the degree to which prices in underlying markets are set by reference to the prices of commodity derivatives;.

(b) the appropriate reduction of a position or exposure entered into via a derivative referred to in para-graph 1(b) of this Article;

(c) the situations where a risk of regulatory arbitrage as referred to in paragraph 3(b) of this Article could arise.

Those criteria and factors shall take into account the regulatory technical standards referred to in Article 57(3) of Directive 2014/61/EU and shall differentiate between situations where ESMA takes action because a competent authority has failed to act and those where ESMA addresses an additional risk which the competent authority is not able to sufficiently address pursuant to Article 69(2)(j) or (o) of Directive 2014/61/EU.

1. One of the stated aims of MiFID II is to implement the 2009 G20 commitment to improve the regulation, functioning and transparency of financial and commodity markets to address excessive commodity price volatility (Recital 125, MiFID II). In November 2009, the G20 also endorsed IOSCO's Principles for the Regulation and Supervision of Commodity Derivatives Markets and called for market regulators to have formal position management powers.

2. For the first time, mandatory position limits and position reporting will be introduced across the EU and NCAs, who will supervise the adherence to these position limits, will be granted a minimum set of powers in relation to: requiring information on commodity derivative positions; requesting a person to reduce the size of a position and having the ability to limit a person from entering into a commodity derivative.

3. Under Article 45 of MiFIR, ESMA is granted comparable position management powers to NCAs and Article 45(1) specifies that ESMA, in specific circumstances and subject to certain conditions, has the power to:

   i. request relevant information from any person on their derivative positions;

   ii. require the reduction or elimination of those positions; and

   iii. as a last resort, limit the ability of a person from entering into a commodity derivative.

4. ESMA's position management powers are to be used in exceptional circumstances and only where there exists both an emergency situation and a failure or inability of a NCA to take appropriate action. Article 45(2) of MiFIR sets out that ESMA will only be able to exercise these powers if they:

   i. "address a threat to the orderly functioning and integrity of financial markets, including com-modity derivative markets in accordance with the objectives listed in Article 57(1) of Directive 2014/61/EU and including in relation to delivery arrangements for physical commodities, or to the stability of the whole or part of the financial system in the Union; [and]

   ii. a competent authority or competent authorities have not taken measures to address the threat or the measures taken do not sufficiently address the threat."

5. Article 45(10) of MiFIR envisages that the Commission will adopt delegated acts further specifying the criteria and factors which must be taken into account when determining whether it is appropriate for ESMA to use its position management powers. ESMA has been asked for technical advice by the Commission on those criteria and factors and has therefore established some initial views on which it seeks feedback.

Analysis following feedback from stakeholders

6. The requirements under Articles 45(10)(a), 45(10)(b) and 45(10)(c) of MiFIR (see above) and the requirement that ESMA considers how to differentiate between situations where ESMA takes action because an NCA has failed to act and those where ESMA addresses an additional risk which the NCA is not able to sufficiently address, are discussed in sequence below. In further analysing such circumstances, it is important to note the following points in relation to ESMA's use of these powers:

   i. ESMA's powers to request information and to require the reduction or elimination of a position are not restricted to commodities derivatives and the definition of an emergency situation is not restricted to factors directly connected with commodities; and

   ii. the "threat" in the context of derivatives markets to the stability of the financial system in the EU or to the orderly functioning and integrity of the market (financial and commodities) is not necessarily caused by the activity in those derivatives markets.

45(10)(a) of MiFIR threat to the orderly functioning and integrity of financial markets, including commodity derivatives markets in accordance with the objectives listed in Article 57(1) of MiFID II and including in relation to delivery arrangements for physical commodities, or to the stability of the whole or part of the financial system in the Union.

7. In addressing this requirement, ESMA notes that it is granted powers to act in exceptional circumstances elsewhere in EU legislation which require consideration of factors that are very similar to, or mirror, those under Article 45(10) MiFIR. Under Article 40 of MiFIR, ESMA may temporarily prohibit or restrict in the EU the marketing, distribution or sale of certain financial instruments or a type of financial activity or practice when there is a significant investor protection concern or "*threat to the orderly functioning and integrity of financial markets or commodity markets and to the stability of the whole or part of the financial system in the Union*".

8. Article 24(1) and (3) of the Short Selling Regulation (No 918/2012 of 5 July 2012) already makes reference to various scenarios which may constitute "*a threat to the orderly functioning and integrity of financial markets or to the stability of the whole or part of the financial system in the Union*". These are, in summary:

   i. serious financial, monetary or budgetary problems which may lead to financial instability concerning a Member State or a bank and other financial institutions deemed important

to the global financial system;

ii. a rating action or a default by any Member State or banks and other financial institutions deemed important to the global financial system;

iii. substantial selling pressures or unusual volatility causing significant downward spirals in any financial instrument related to any banks and other financial institutions deemed important to the global financial system;

iv. any relevant damage to the physical structures of financial institutions from a natural disaster or terrorist attack; and

v. any relevant disruption in any payment system or settlement process, in particular when it is related to interbank operations.

9. ESMA's preliminary view is that the factors and criteria set out in the Short Selling Regulation, presented in points (i.) to (v) above, are relevant criteria for determining the existence of a threat to the stability of the (whole or part of the) financial system in the EU. There may, however, be other factors to consider. ESMA also believes that these circumstances may be of different relevance for the financial and commodities derivatives.

10. ESMA believes the orderly functioning and integrity of financial, commodity derivatives and physical markets are endangered whenever such markets are no longer able to efficiently fulfil their economic function. The function of the markets can be defined as:

    i. allowing for an efficient and fair method of price discovery through the matching of supply and demand;

    ii. providing a mechanism for physical delivery of a given commodity (where relevant) or financial underlying;

    iii. providing (commercial) participants with the ability to hedge physical commodity market exposure / exposure on the spot market; and

    iv. allowing for a common inter-linkage and convergence between physical and financial commodity markets or the derivatives and spot financial markets.

11. ESMA has primarily identified the following factors and criteria to determine the existence of a threat to the orderly functioning and integrity of financial markets or commodity markets:

    i. disruption to the supply of a commodity, leading to a significant reduction of deliverable supply (through, for example, a production outage);

    ii. significant and abrupt rise in the demand of a commodity;

iii. a significant position in a certain commodity held by one person, or persons acting in concert, in one or several trading venues, through one or several market members; and

iv. *de facto* inability by a trading venue to exercise its own position management powers because a business continuity event prevents it from carrying on business in the normal way.

12. In weighting the factors mentioned above, particular attention will be given to the extent to which there is a necessity for third parties to obtain that commodity (e.g. some agricultural commodities).

13. The objectives of setting position limits, enumerated under Article 57(1) of MiFID II, are to prevent market abuse and to support orderly pricing and settlement conditions, including preventing market distorting positions and ensuring convergence between prices of derivatives in the delivery month and spot prices for the underlying commodity. ESMA considers that the above factors and criteria for commodity derivatives markets are also appropriate indicators in relation to when these objectives for commodity derivatives markets are under threat.

14. When considering the existence of a threat to the integrity and functioning of financial markets, commodity derivatives markets and delivery arrangements for physical markets, ESMA must also take account of "*the degree to which positions are used to hedge positions in physical commodities or commodity contracts and the degree to which prices in underlying markets are set by reference to the prices of commodity derivatives."* ESMA is of the view that this consideration is sufficiently taken into account in the above factors where its definition of a functioning market explicitly covers *"providing (commercial) participants with the ability to hedge physical commodity market exposure / exposure on the spot market*".

Summary of the responses received

- On the identification of a threat to the orderly functioning and integrity of the markets, there was considerable support for the proposed advice, the following points being made: the factor of "*a significant and abrupt rise in the demand of a commodity*" may be due to market evolution and not indicate dysfunction;
- Some of the listed factors will only be observable *ex post* when ESMA only has a short time to react; and
- The factors are too broad and do not provide participants with certainty as to when ESMA would intervene: ESMA should be expressly be required to take into account the particular circumstances of each commodity market before concluding there is an issue.

Main points supporting the advice to the Commission

Taking these comments into consideration, ESMA has decided to maintain the advice it consulted upon. Whilst it is true that each factor may not *per se* dictate the existence of a threat and there is a need for assessing the situation, these are in all likelihood the relevant factors upon which a decision should be taken. As in all rules and particularly regarding emergency powers (such as ESMA Position Management powers), legal certainty can only be pursued up to a certain extent. The consideration of the particular circumstances of each commodity market has been added to the Technical Advice.

45(10)(b) of MiFIR: Appropriate reduction of a position or exposure

15. ESMA, under Article 45(10)(b) of MiFIR and for the purpose of adoption of delegated acts, has been mandated by the Commission to provide advice specifying the criteria and factors to determine the appropriate reduction of a position or exposure entered into via a derivative.

16. After analysing the necessary information regarding the size and purpose of a derivatives position, ESMA may require the "*appropriate reduction of a position or exposure*" entered into via a derivative. Exactly what "*appropriate*" is may differ according to the particulars of each case, but, the type and size of the market participant that holds the position, and the related commodity market in which this is held, will be taken into account.

17. Further, Article 45(3) of MiFIR specifies that ESMA may only require a person to reduce the size or to eliminate their position or exposure if:

    i. it does address the threat to the stability of the financial system in the EU or to the orderly functioning and integrity of markets;

    ii. it does not create regulatory arbitrage; and

    iii. it does not detrimentally impact markets by reducing liquidity, creating uncertainty or being disproportionate.

18. ESMA considered that "appropriate" action may differ on a case by case basis and has identified in the Consultation Paper the following factors and criteria that could be relevant:

    i. Nature of the holder of the position (e.g. producer, consumer, financial institution, etc.);

    ii. Size of the position vis-a-vis the size of the market in the relevant derivatives;

    iii. Size of the position vis-a-vis the market in the physical market, e.g. deliverable supply;

    iv. The direction of the position (short/long);

    v. The purpose of the position (hedging or financial exposure);

vi. The experience of a position holder in holding positions of a given size, and, if applicable, of making/taking delivery of a given commodity;

vii. Other positions held by the position-holder in the underlying market (related physical positions) or in different maturities of the same derivative; and

viii. Method of delivery.

19. In weighting the factors mentioned above, particular attention will be given to the extent to which there is a necessity for third parties to obtain that commodity (e.g. some agricultural commodities).

Summary of the responses received

20. ESMA's proposal received support from a majority of respondents and suggestions to include the following factors:

i. market liquidity and impact of the measure on other market participants;

ii. delta or ranges of delta; and

iii. maturity of the instruments.

21. Several participants suggested that ESMA's position management powers should also respect the exemption for risk-reducing activities, in which cases ESMA should not be able to impose position limits. In addition, the "natural position" of utility firms should be taken into account, entailing the consequence that for a power producer that is naturally long in power, the position limit should not be imposed on selling power.

22. The nature of the position holder and purpose of the position were among the factors deemed more important. Other respondents identified, however, size and direction as most important. Even the need to prioritise some factor over others was in no way unanimous with several respondents advocating against such a prioritisation.

Main points supporting the advice to the Commission

23. ESMA decided to maintain its advice to a large extent, while incorporating the suggested factors of market liquidity and impact of the measure on other market participants and delta or ranges of delta.

24. ESMA notes. however, that exempting the positions benefitting from the hedging exemption or the "natural positions" of certain markets participants is outside its scope, as no element in MiFID or MiFIR underpins such a rule. A different question, however, is whether these elements should be considered as factors to determine what the appropriate reduction is. To this question ESMA answers affirmatively and considers them to be adequately reflected in

the advice. For the sake of clarity, ESMA is adding “the maturity of the instrument” to the list factors to be considered.

25. ESMA does not consider it useful to prioritise or distinguish major from minor factors.

45(10)(c) of MiFIR: Situations where risk of regulatory arbitrage could arise

26. ESMA, under MiFIR Article 45(10)(c) and for the purpose of adoption of delegated acts, has been mandated by the Commission to provide advice specifying the criteria and factors to determine the situations where a risk of regulatory arbitrage could arise.

27. ESMA must ensure that any measure taken does not create a risk of regulatory arbitrage. Such arbitrage typically arises in uneven playing fields, i.e., where different rules apply to participants in essentially the same or substantially similar cases.

28. ESMA’s preliminary view is that regulatory arbitrage could arise from:

    i. applying restrictions in relation to some derivatives and not correlated ones, i.e., inconsistent approaches to interrelated markets; or

    ii. applying restrictions with the result that certain participants face limitations on their activity and other similar participants do not.

29. Therefore, in order to determine the situations where a risk of regulatory arbitrage could arise ESMA has identified the following preliminary criteria and factors:

    i. Whether the same contract is traded in a different venue, as a result of fragmentation of liquidity across different trading venues, or OTC;

    ii. Whether a substantially equivalent contract is traded on a different venue or OTC (similar and interrelated, but not considered part of the same fungible open interest);

    iii. The effects of the decision on the market of the underlyings;

    iv. The effects of the decision on markets and participants not subject to ESMA’s position management powers: and

    v. Likely impact on the orderly functioning and integrity of the markets if no decision were taken (do-nothing-scenario).

Summary of the responses received

30. Respondents generally agree that the suggested factors adequately determine situations where a risk of regulatory arbitrage arises. Several respondents pointed out the risk of inconsistent approaches, within the EU, and globally, from inconsistent approaches between

ESMA and other non-EU regulators. Cooperation and information sharing among regulators, especially with non-EU counterparts, which would allow the early identification of trends in the market, were identified as the tools for managing this risk.

Main points supporting the advice to the Commission

31. ESMA agrees with the risks outlined by respondents, however, those are more of an operational nature. Therefore, ESMA has decided not to amend the Technical Advice it consulted upon.

Differentiate between situations where ESMA takes action because an NCA has failed to act and those where ESMA addresses an additional risk which the NCA is not able to sufficiently address pursuant to Article 69(2)(j) or (o) of MiFID II

32. ESMA, under Article 45(10) of MiFIR and for the purpose of adoption of delegated acts, has been mandated by the Commission to provide advice specifying how ESMA would differentiate between those situations where ESMA takes action because an NCA has failed to act and those where ESMA addresses an additional risk which the NCA is not able to sufficiently address pursuant to Article 69(2)(j) or (o).

33. ESMA considered that it will principally distinguish between situations caused by a NCA's failure to act as opposed to its inability to sufficiently address a threat through an analysis of the powers available to the NCA. If the NCA has at its disposal sufficient regulatory powers to address fully the threat at that time, without further reference to another NCA, but does not take such action ESMA will consider this to be a strong indicator that the NCA has failed to act.

34. The key differences between the scope of the position management powers under MiFID II for ESMA and the NCAs are:

35. ESMA can request from any person information regarding the size and purpose of a position and exposure in a derivative under Article 45(1)(a) of MiFIR whereas an NCA can require or demand such information but only in relation to a commodity derivative under Article 69(2)(j). However, ESMA notes that in the transposition of the MiFID II Directive, Member States may decide to extend the power of NCAs to request information on an exposure to all derivatives, in which case this difference in scope will not always apply.

36. NCAs will be limited to exercising their powers to persons operating within their Member State whereas ESMA will have the ability to use its powers across the whole of the EU.

37. Given these differences, in practice, ESMA believes that an NCA may be unable to address fully a threat where one or more of the factors listed pursuant to Article 45(10)(a) of MiFID II occur in one or more other jurisdictions as well as in its own jurisdiction. In such a case,

ESMA intervention will be a more complimentary action whereas ESMA intervention due to an NCA's failure to act implies an overriding of an NCA.

Technical advice

45(10)(a) of MiFIR: threat to the orderly functioning and integrity of financial markets, including commodity derivatives markets in accordance with the objectives listed in Article 57(1) of MiFID II and including in relation to delivery arrangements for physical commodities, or to the stability of the whole or part of the financial system in the Union.

1. In describing those scenarios which may constitute "a threat to the orderly functioning and integrity of financial markets or to the stability of the whole or part of the financial system in the Union", the scenarios under Article 24(1) and (3) of the Short Selling Regulation (No 918/2012 of 5 July 2012) should be taken into account and alignment between the two pieces of legislation effected to the ex-tent possible. The following factors and criteria set out in the Short Selling Regulation are relevant criteria for determining the existence of a threat to the stability of the (whole or part of the) financial system in the Union.

    i. serious financial, monetary or budgetary problems which may lead to financial instability con-cerning a Member State or a bank and other financial institutions deemed important to the global financial system;

    ii. a rating action or a default by any Member State or banks and other financial institutions deemed important to the global financial system;

    iii. substantial selling pressures or unusual volatility causing significant downward spirals in any financial instrument related to any banks and other financial institutions deemed important to the global financial system;

    iv. any relevant damage to the physical structures of financial institutions from a natural disaster or terrorist attack; and

    v. any relevant disruption in any payment system or settlement process, in particular when it is related to interbank operations.

2. The above list of circumstances is not exhaustive[129] and may be of different relevance for the financial and commodity derivatives markets. Therefore, in addition to the above circumstances enumerated under the Short Selling Regulation, the following factors and crite-

[129] Subject to decision regarding the Judgment of the ECJ (Grand Chamber) of 22 January 2014, United Kingdom of Great Britain and Northern Ireland v European Parliament and Council of the European Union, Case C-270/12, which discussed, *inter alia*, the interpretation of the powers of intervention conferred on ESMA in exceptional circumstances by Regulation (EU) No 236/2012.

ria should also be considered as relevant in determining the existence of a threat to the orderly functioning and integrity of financial markets and commodity derivative markets, having in mind the particular circumstances of the concrete commodities markets in consideration:

i. disruption to the supply of a commodity, leading to a significant reduction of deliverable supply (through, for example, a production outage);

ii. significant and abrupt rise in the demand of a commodity;

iii. a significant position in a certain commodity held by one person, or persons acting in concert, in one or several trading venues, through one or several market members; and

iv. de facto inability by a trading venue to exercise its own position management powers because a business continuity event prevents it from carrying on business in the normal way.

45(10)(b) of MiFIR: appropriate reduction of a position or exposure

3. In relation to ESMA requiring "the appropriate reduction of a position or exposure entered into via a derivative", "appropriate" action may differ on a case by case basis. The following factors and criteria are relevant indicators when determining what is "appropriate":

i. nature of the holder of the position (e.g. producer, consumer, financial institution, etc.);

ii. maturity of the instrument;

iii. size of the position vis-a-vis the size of the market in the relevant derivatives;

iv. size of the position vis-a-vis the market in the physical market, e.g. deliverable supply;

v. the direction of the position (short/long) and delta or ranges of delta;

vi. the purpose of the position (hedging or financial exposure);

vii. the experience of a position holder in holding positions of a given size, and, if applicable, of making/taking delivery of a given commodity;

viii. other positions held by the position-holder in the underlying market (related physical positions) or in different maturities of the same derivative;

ix. liquidity of the market and impact of the measure on other market participants; and

x. method of delivery.

45(10)(c) of MiFIR: situations where risk of regulatory arbitrage could arise

4. The following criteria and factors are relevant when determining the situations where a risk of regulatory arbitrage could arise:

   i. whether the same contract is traded in a different venue, as a result of fragmentation of liquidity across different trading venues, or OTC;

   ii. whether a substantially equivalent contract is traded on a different venue or OTC (similar and interrelated, but not considered part of the same fungible open interest);

   iii. the effects of the decision on the market of the underlyings;

   iv. the effects of the decision on markets and participants not subject to ESMA's position manage-ment powers; and

   v. likely impact on the orderly functioning and integrity of the markets if no decision were taken (do-nothing-scenario).

Differentiate between situations where ESMA takes action because an NCA has failed to act and those where ESMA addresses an additional risk which the NCA is not able to sufficiently address pursuant to Article 69(2)(j) or (o) of MiFID II

5. Situations caused by an NCA's failure to act as opposed to its inability to sufficiently address a threat should be distinguished principally by analysis of the powers available to the NCAs. If the NCA has at its disposal sufficient regulatory powers to address fully the threat at that time, without further reference to another NCA, but does not take such action this will be considered a strong indicator that the NCA has failed to act. Where one or more of the factors listed pursuant to Article 45(10)(a) occur in one or more other jurisdictions as well as in its own jurisdiction, it should be considered that an NCA may be unable to address fully a threat rather than has failed to address the threat.

8. Portfolio Compression

Background/Mandate

1. MiFIR defines portfolio compression, and rules that should apply to investment firms when providing compression.

2. The Commission is required to specify through delegated acts the elements of portfolio compression and the information to be published.

3. In order to prepare for this delegated act, the Commission has requested ESMA to provide technical advice. ESMA has built on the work performed when developing the EMIR technical standards on portfolio compression and on answers received from stakeholders following the consultation paper.

Extract from the Commission's request for technical advice (mandate)

ESMA is invited to provide technical advice on the elements of portfolio compression and the information to be published pursuant to paragraph 2 of Article 31 of this Regulation, in such a way as to make use as far as possible of any existing record keeping, reporting or publication requirements (Article 31 par. 4 of the Regulation).

For this purpose, ESMA is first invited to provide technical advice specifying further the criteria of the definition of portfolio compression set out in Article 2(1)(47), including further specifications for the process whereby derivatives are wholly or partially terminated and replaced by a new derivative in particular the steps of the process, the legal documentation as well as the economic outcome of the process.

ESMA is also invited to provide technical advice on the further the measurements for determining that, following portfolio compression, the combined notional value is less than the combined notional value of the terminated derivatives.

Finally, ESMA is invited to provide technical advice on the appropriate scope of the publication requirement pursuant to Article(2)as well as time limits within which publication shall be made by applying the time limits specified in Article 10. In its advice, ESMA should consider the need to make use as far as possible of any existing record keeping, reporting or publication requirements.

Article 31, MiFIR

1. *When providing portfolio compression, investment firms shall not be subject to the best execution obligation in article 27 of Directive 2014/65/EU, the transparency obligations in articles8, 10, 18 and 21 of this Regulation and the obligation in Article 1(6) of Directive*

2014/65/EU. The termination or replacement of the component derivatives in the portfolio compression shall not be subject to Article 28 of this Regulation.

2. *Investment firms and market operators providing portfolio compression shall make public through an APA the volumes of transactions subject to portfolio compressions and the time they were concluded within the time limits specified in Article 10.*

3. *Investment firms and market operators providing portfolio compressions shall keep complete and accurate records of all portfolio compressions which they organise or participate in. These records shall be made available promptly to the relevant competent authority or ESMA upon request.*

4. *The Commission may adopt, by means of delegated acts in accordance with Article 50, measures specifying the following:*

(a) the elements of portfolio compression.

(b) the information to be published pursuant to paragraph 3,

In such a way as to make use as far as possible of any existing record keeping, reporting or publication requirements.

Analysis following feedback from stakeholders

Criteria for the definition of portfolio compression

Steps and process

6. In the consultation, ESMA indicated that in order to develop elements of portfolio compression it is necessary to take into consideration the fact that portfolio compression can be performed between two or more counterparties i.e. on a bilateral or on a multilateral basis. Bilateral compression is the process whereby two parties agree to perform portfolio compression between the two of them, and on the terms of such compression. Multilateral portfolio compression allows a broader range of counterparties to participate in the compression and therefore a possibly higher number of contracts to be compressed. Multilateral compression is usually a service provided by a third party service provider within a legal and contractual framework that applies to all participants in the compression.

7. Some stakeholders noted that the criteria for bilateral and multilateral compression should be aligned and sufficiently high level to allow the development of further compression services. For instance, stakeholders noted that a third type of portfolio compression should be taken into account i.e. compression with a CCP also called “unilateral compression”, as this service could be offered in the future. The process of compression with a CCP would allow counterparties to reduce the notional value of contracts in their books against that CCP.

8. Stakeholders supported the ESMA proposal to adopt criteria that would allow counterparties to retain control on their risk profile and proposed to adopt a more high level approach for the same reasons as expressed in the previous paragraph.

9. In view of the above, ESMA revised the technical advice in order to set the balance so that criteria are granular enough to prevent other transactions than compression to benefit from the MIFIR exemption and broad enough to allow the development of further compression services such as compression through CCPs, and its extension to other instruments such as FX. For this purpose the determination of the steps is streamlined and the details limited to the core characteristics of portfolio compression. The distinction between multilateral compression and bilateral compression is replaced by a distinction between portfolio compression performed between two or more parties with a service provider and performed directly between counterparties

Legal documentation

10. Stakeholders generally support the approach requiring that legal documentation be in place and stress that the form of the documentation should not be prescribed. This is in line with the approach that was adopted in the consultation and no major redraft was performed on that part of the technical advice.

Economic outcome of the process

11. Some respondents noted that compression is sometimes performed without reduction in the notional value of the portfolio but for the purpose of simplification. Portfolio compression can be used to aggregate contracts into fewer contracts without reduction of the notional amount. The purpose of this exercise could be to standardise the coupons and coupons period, to make them eligible for clearing or to facilitate the management of the contract.

12. The mandate the Commission granted to ESMA refers explicitly to the compression as a mean to reduce the notional value of portfolio. The simplification of the management of the transaction is not considered although it may bring an economic benefit to the party that will reduce time and cost to manage the contracts resulting from compression. Therefore the process to simplify the management of the portfolio without reduction of the notional value is not covered in the scope of portfolio compression.

Measurement of the portfolio compression

13. The provisions on measurement introduced in the mandate are understood as the comparison of the aggregated notional value of the portfolio submitted to compression before compression with the aggregated notional value of the portfolio resulting from compression.

14. The determination of the measurement is based on the approach adopted under the economic outcome of the compression.

Information to be published

15. Stakeholders stressed that the publication of information should not result in disclosing identities of firms or their actual positions and that therefore reporting by category of participant should not be required. Indeed, depending on the instruments and the manner to perform compression between two or more counterparties (with a service provider or without a service provider), the information published could be explicit or easy to interpret by market participants.

16. Respondents agree to report per currency and type of product and asked to clarify the granularity of the products proposing to use the asset class approach. On the timing they generally consider that indeed the communication to all participants that the compression is legally binding should be the point to determine the "as close as real time" publication and note that when there is no service provider, the process may be heavy and more time would be required for reporting.

17. The draft technical advice is revised and proposed to publish information per asset class and currency without reference to the participant category. On the determination of the point in time when the timeframe for publication should tick the approach supported by stakeholders was proposed by ESMA and therefore remains. It is clarified that although publication by service provider should be a matter of minutes, it should be by the next business day when no service provider is involved.

Technical advice

Criteria of the definition of portfolio compression

1. The criteria for the definition of portfolio compression should cover the process, the legal documentation and the economic outcome of portfolio compression.

The process and steps

2. The portfolio compression between two or more counterparties should result in the reduction of the notional value of their derivative portfolio. In order to achieve this reduction, the risk management framework of the counterparties should be respected. It is therefore necessary that the service provider or the counterparties allows the participants in the portfolio compression activity to apply the criteria set in its risk management framework when performing compression. The participant should inform the service provider or the counterparties which should consider and apply those criteria.

3. Before the compression exercise is initiated, for each compression exercise, the counterparties or the service provider, the investment firm and market operator providing portfolio compression should allow the participant to provide criteria reflecting its risks tolerance for instance a limit to counterparty risk, a limit to market risk, a cash payment tolerance.

4. In the absence of service provider, counterparties should exchange their respective criteria when they analyse the interest of compression and at the latest before starting the compression exercise.

5. The portfolio compression should respect the risk framework of the participants.

6. The service provider or the counterparties should establish links between transactions submitted for compression.

7. As a result, the service provider should submit to the participant a compression proposal that includes at the minimum the identification of the counterparties, the related change to the notional value of the transaction proposed by the counterparties, the variation compared with the risk criteria provided. This compression proposal would allow the participant to have a view on the outcome of the compression exercise and to adapt some criteria in order to maximise the efficiency of the compression exercise within the respect of its risk framework.

8. In case where there is no service provider, counterparties should exchange simulation of the compression outcome so that each counterparty can ensure that its risk framework would be complied with.

9. The service provider could, but would not be obliged to, give some time to the participant to add transactions that would increase the pool of trades eligible for termination or reduction, to adjust the risk limits in order to maximise the efficiency of the compression exercise.

10. When there is no service provider, counterparties could agree, but would not be obliged to, add transactions or perform adjustments in order to maximise the volume of transactions for compression and comply with their risk policy.

11. Participants in a portfolio compression activity should not use the process to submit bids and offers to enter into specific transaction. They should not use portfolio compression for the purpose of circumventing the clearing or trading obligation.

12. Finally, the service provider or the counterparties should perform compression when all participants agree on the compression proposal. Agreement could be given on the initial compression proposal or on a subsequent compression proposal.

Legal documentation

13. Compression between two or more counterparties results in some derivative transactions to be reduced or terminated and replaced by other transactions with a reduced notional value. It means that the contractual documentation between the counterparties to the transactions, when there is no service provider, and between the participants to compression and its service provider, when there is one, should provide for the compression process and its legal effects.

14. The relevant legal documentation should therefore be in place in order to ensure, at the minimum, that the compression exercise allows to amend or terminate a trade that has been submitted to compression and to replace such trades by the transactions resulting from the compression exercise as need be.

Economic outcome of the process

15. The process whereby contracts are aggregated into fewer contracts or are simplified e.g. by standardising the coupons and coupons period, without reduction of notional value, should not be in the scope of portfolio compression.

16. The total aggregated notional value of portfolio submitted by all participants to compression should have decreased.

17. The economic outcome of the compression process should be assessed at portfolio level and not at the level of individual transactions within a portfolio.

18. The notional value of the portfolio submitted by each participant to compression should decrease. The notional value of the portfolio of a participant could however remain at the same level as before compression, if the notional value of the portfolio of other participant(s) decreases.

Measurement of the portfolio compression

19. In order to specify the measurements for determining that the combined notional value following compression is less than the combined notional value of the submitted derivative portfolio, the aggregated notional value of the portfolio submitted to compression before compression should be compared with the aggregated notional value of the portfolio after compression.

20. In line with the approach adopted with respect to the economic outcome of the portfolio compression, the measurement should focus on the reduction of the aggregated notional value of the portfolio submitted for compression for all participants on an aggregated basis. This measure will allow determining the efficiency of the compression globally per compression exercise.

21. The measure should also be performed at the level of each individual participant in a portfolio compression activity. In this case the notional value of the portfolio of the participant should be compared with the value of the portfolio of that participant resulting from the compression. The outcome of the compression should be a reduction of the notional amount or a status quo. The compression should not result in an increase of the notional value of the portfolio of a participant.

Information to be published

22. Investment firms and market operators that are providing portfolio compression services are required to publish the volumes of transactions subject to portfolio compression and the times they were concluded within the time limit specified in MIFIR i.e. for the purpose of post-trade transparency “market operators and investment firms operating a trading venue shall make details of all such transactions public as close to real-time as is technically possible”.

23. The volume of transactions to be published should be expressed in number of transactions and in value. Concerning the value, it should be expressed in notional amount given that the information is provided by the firm providing portfolio compression that aims at decreasing the notional value of derivatives. The marked-to-market value should not be considered an appropriate measure of the volume for the purpose of post-trade transparency as it differs over time and may depend on counterparties.

24. The publication should cover the transactions submitted to portfolio compression, the replacement transactions and the transactions reduced or terminated. The value and number should be provided per compression exercise, per asset or product class, and per currency.

25. The publication should be made shortly after the compression proposal is a confirmed as legally binding by the service provider or the counterparties following the acceptance by all participants. That information is known by the firm providing portfolio compression as it is the one respectively receiving the acceptance and informing participants that compression is legally binding. The publication should refer to each compression exercise, provide information per category of product (such as Rates, Credit, …), and per currency. The service providers usually have sophisticated systems that would allow them to perform publication in a matter of minutes following the confirmation as indicated above. For compression performed between counterparties, the process may be more manual and they may need more time which should however not extend behind the next business day.