MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

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Via Electronic Submission

Ugo Bassi, Director for Financial Markets
DG for Financial Stability, Financial Services and Capital Markets Union
European Commission
Rue de Spa 2
1000 Brussels
Belgium

Dear Mr. Bassi,

Re: Draft Delegated Regulation amending the MiFID 2 Delegated Regulation (EU) 2017/565 on the specification of the definition of systematic internalisers for the purposes of the Directive

Managed Funds Association ("MFA")[1] welcomes the opportunity to provide comments to the European Commission ("Commission") on its draft Delegated Regulation issued on 19 June 2017[2] to amend Delegated Regulation (EU) 2017/565 by inserting a further technical specification in Article 16a as an element of the definition of "systematic internaliser" ("SI") as defined in Article 4(1)(20)[3] of Directive 2014/65/EU ("MiFID II"). MFA members, as investors in European markets and professional asset managers for European institutional investors, appreciate the opportunity to comment as stakeholders on the draft wording as part of the Commission's better regulation agenda. MFA supports the policy objectives of the Commission under MiFID II and related Regulation (EU) No 600/2014 ("MiFIR") to achieve greater transparency for both equities and non-equities, and to

[1] Managed Funds Association ("MFA") represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent, and fair capital markets. MFA, based in Washington, DC, is an advocacy, education, and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry's contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk, and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, North and South America, and many other regions where MFA members are market participants.

[2] Available at: http://ec.europa.eu/info/law/better-regulation/initiatives/ares-2017-3070825_en.

[3] Article 4(1)(20) of MiFID II defines a systematic internaliser as an investment firm which, on an organised, frequent systematic and substantial basis, **deals on own account when executing client orders** outside a regulated market, an MTF or an OTF **without operating a multilateral system**. Thus, MFA understands that the intention of SIs is that large investment firms with significant inventory of financial instruments can "internalise" orders on their own books. According to Article 1(7) of MiFID II, all multilateral systems in financial instruments shall operate as MTFs, OTFs or Regulated Markets. Recital (17) of MIFID II further provides that a systematic internaliser should not be allowed to bring together third party buying and selling interests in functionally the same way as a trading venue.

bring more trading of suitable equity and non-equity instruments onto regulated venues by imposing trading obligations[4] for shares and derivatives, as well as establishing a clear separation between bilateral own account trading when executing client orders and multilateral trading.

MFA appreciates that the Commission's draft Delegated Regulation seeks to promote and preserve these objectives by narrowing, in new Article 16a MiFID II (*Participation in matching arrangements*), the concept of "dealing on own account when executing client orders" in the SI definition, with the result that fewer firms will fall within the SI definition. The Commission's proposed amendment to the SI definition aims to "avoid circumvention" of MiFID II obligations by investment firms that may intend to create a multilateral trading system by linking up their systems to engage in matched principal trading or other types of "de facto riskless back-to-back transactions" in a financial instrument outside a trading venue.[5]

While we support the underlying policy objectives and desired policy outcome for the draft Delegated Regulation, we have strong reservations about the Commission's proposed drafting approach for the Article 16a amendment in the draft Delegated Regulation to achieve them. As we explain below, we are concerned that the proposed approach of defining "dealing on own account" for the purposes of the SI definition will have unintended consequences for asset classes of financial instruments that are not subject to the trading obligation. The Commission's suggested approach would mean that, where an investment firm transacts in financial instruments on an over-the-counter ("OTC") riskless back-to-back basis, that investment firm will not be "dealing on own account". Any such OTC trading therefore would never be counted towards the SI qualitative and quantitative thresholds and so would never meet the SI definition in Article 4(1)(20) MiFID II[6], and thus need not comply with the MiFID II SI obligations, including in respect of transparency obligations.

One consequence of the Commission's draft Delegated Regulation, which MFA supports, is that riskless back-to-back transactions would need to occur on a trading venue for asset classes with a trading obligation (*i.e.* shares and certain derivatives), in line with the Commission's policy intent.

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[4] Article 23 MiFIR establishes the trading obligation for shares, which mandates investment firms to undertake all trades, including trades dealt on own account and trades dealt when executing client orders, on a regulated market, multilateral trading facility (MTF), systematic internaliser or an equivalent third-country trading venue. Article 28 MiFIR establishes the trading obligation for derivatives pertaining to a class of derivatives that has been declared subject to the trading obligation, which mandates certain financial counterparties and non-financial counterparties to conclude transactions in such derivatives on a regulated market, MTF, organised trading facility (OTF) or equivalent third-country trading venue.

[5] *See supra* note 2 for a link to Commission Explanatory Memorandum and Recital 3 to Commission Draft Delegated Regulation.

[6] Under Article 4(1)(20) MiFID II, the current definition of "systematic internaliser" means "an investment firm which on an organised, frequent systematic and substantial basis, deals on own account when 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 a systematic internaliser shall apply only where the pre-set limits for a frequent and systematic basis and for a substantial basis are both crossed and where an investment firm chooses to opt-in under the systematic internaliser regime".

However, MFA is concerned that, in the case of asset classes for which the trading obligation does not apply, a large volume of such transactions will be concluded outside a trading venue and outside the SI regime and thus would not be subject to any pre-trade transparency regime. As a result, there would be a loss of transparency for such transactions. We do not believe this outcome is consistent with the intention of the Commission and co-legislators when agreeing on MiFID II, and creates significant transparency concerns.

MFA therefore asks the Commission to consider our concerns and if needed, offers to assist the Commission with specific wording changes to the proposed Article 16a amendment.

Unintended consequences for the fixed-income and ETF markets and many derivatives

The Commission's approach in the draft Delegated Regulation seeks to ensure that an investment firm conducting riskless back-to-back transactions outside a trading venue (Regulated Market, Multilateral Trading Facility (MTF) or Organised Trading Facility (OTF)) will not be considered to be dealing on own account for purposes of the SI definition in Article 4(1)(20) MiFID II. We appreciate that the aim of this approach is to ensure a strict separation between bilateral trading on own account when executing client orders and multilateral trading which must occur on a regulated trading venue.

However, as mentioned above, the Commission's suggested approach would mean that, where an investment firm transacts in financial instruments on a riskless back-to-back basis even where dealing on own account, such activity would not be counted towards the thresholds for considering whether an investment firm is an SI as per the definition in Article 4(1)(20) MiFID II and thus such firm need not comply with the MiFID II SI obligations, including in respect of transparency obligations.

For classes of instruments that are not subject to a trading obligation (and thus not mandated for trading venue execution), such as fixed-income instruments, Exchange-Traded Funds (ETFs) and many derivatives[7], if the Commission's approach is implemented as currently proposed, riskless back-to-back transactions in such instruments would fall outside of the SI regime, without any obligation for investment firms to execute these transactions on a trading venue. Consequently, Article 18 MiFIR[8] would not apply, and transactions in these instruments would not be subject at all to the MiFIR pre-trade transparency framework.

Investment firms could therefore elect to execute these transactions purely bilaterally OTC on a riskless principal basis while still dealing as principal with a client, but since such investment firms would fall outside the SI definition, they would not be subject to transparency requirements equivalent to those applying to an SI. Trading in these instruments could thus become less transparent than intended or expected, as there would be no pre-trade transparency requirement and potentially no best execution reporting obligation on the part of the entity concluding the transaction with the client.

[7] Certain classes of derivatives will become subject to a trading obligation under Article 28 MiFIR. Investment firms will be required to execute such derivative transactions on multilateral venues and not SIs. *See supra* note 4.

[8] Article 18 MiFIR imposes an obligation for systematic internalisers to make public firm quotes in respect of bonds, structured finance products, emission allowances and derivatives.

This outcome would be inconsistent with ensuring more transparent trading, a key policy objective of MiFID II.

Ensuring consistency with the provisions of MiFID II & MiFIR

In our view, the Commission's proposed approach creates uncertainty and ambiguity regarding the interpretation of several recitals and provisions in MiFID II and MiFIR and the exact scope of transactions covered.

First, the proposed approach seems to conflict with Recital (24) of MiFID II, which clearly states that "dealing on own account when executing client orders" should include arrangements whereby an investment firm "[…] is executing orders from different clients by matching them on a matched principal basis (back-to-back trading)". The draft Delegated Regulation, as currently worded, would deem all back-to-back transactions as not dealing on own account in the context of the SI definition, which presents an internal inconsistency.

Second, the concept of "de facto riskless back-to-back transactions" demonstrates striking similarities with the definition of "matched principal trading" in Article 4(1)(38) MiFID II. These similarities raise the question of whether both concepts are different or identical in terms of transactions concerned. This creates legal uncertainty for market participants. If the Commission intended for both concepts to be identical, we suggest that the Commission should simply reference in Article 16a the definition of matched principal trading.

Third, the Commission's approach creates uncertainty regarding the rules applicable to riskless back-to-back transactions. Pursuant to the Level 1 text of MiFIR, such back-to-back transactions are excluded from the scope of a Regulated Market or MTF. Recital (7) of MiFIR expressly states that: "The definitions of [Regulated Market and MTF] should exclude bilateral systems where an investment firm enters into every trade on own account, even as a riskless counterparty interposed between the buyer and seller." The proposed approach now excludes these transactions from the bilateral SI regime. This leads to a lack of clarity as to which rules these transactions should be subject if they are not subject to either the rules on multilateral trading platforms or to the rules on bilateral SI trading.

An alternative approach

Based on the foregoing, we suggest that the Commission reconsider its approach to the issue. In particular, we support an approach whereby any proposed changes to the definition of SI define certain activities that cannot be undertaken under the SI regime, rather than generally excluding a range of transactions and activities from the SI regime. This alternative approach should be based on the work undertaken by ESMA in its Q&As adopted in the context of the SI regime.

In its Q&As last updated on the 7th of July 2017 (Link), and in particular Question 17 and 18 (previously 15 and 16), ESMA provided explanations on the SI concepts of:

- matching arrangements that amount to Matched-Principal Trading, and
- the meaning of occasional/non-regular basis.

We agree with ESMA's approach around both concepts. Focusing on the activities that an SI should not be allowed to undertake would avoid the adverse outcome that riskless back-to-back transactions in fixed-income, certain derivatives and ETFs migrate to a less transparent trading environment. To that end, MFA would be pleased to work with the Commission on specific drafting, if needed.

Clarifying the status of intragroup transactions

Some investment firms, when dealing on own account to execute transactions in certain asset classes, enter into riskless back-to-back transactions whereby, after having concluded a transaction with a client, the entity concludes a mirror transaction with another legal entity in the same group. These transactions are concluded for risk-management purposes within a group. While these transactions may not be risk-facing for the investment firm, they are risk-facing for the overall group of which the investment firm is part.

We believe that these transactions should fall outside any proposed approach to restricting "de facto riskless back-to-back transactions" on the part of investment firms. Regardless of the approach taken by the Commission, we suggest that the Commission (via a recital to the proposed Delegated Regulation) and/or ESMA provide an explicit clarification around the treatment of intragroup transactions to enhance legal certainty for firms operating or planning to operate an SI.

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MFA would like to reiterate its thanks to the Commission for the opportunity to engage constructively on these issues. We would welcome the opportunity to discuss our views and concerns in greater detail. Please do not hesitate to contact Laura Harper Powell, Michael Pedroni or the undersigned at +1 (202) 730-2600 with any questions that the Commission or its staff may have regarding this letter.

Respectfully submitted,

/s/ Stuart J. Kaswell

Stuart J. Kaswell

Executive Vice President & Managing Director, General Counsel