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your reference
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Consultation Paper - Exemption for *market making activities* and primary market operations under Regulation (EU) 236/2012 of the European Parliament and the Council on short selling and certain aspects of Credit Default Swaps

Dear Sir, dear Madam,

in its capacity as a trade association representing the common professional interests of securities trading firms and market specialists at the securities exchanges throughout Germany the bwf welcomes the opportunity to comment on the Consultation Paper - Exemption for *market making activities* and primary market operations under Regulation (EU) 236/2012, dated 17 September 2012.

We consider this consultation to be of great importance since the majority of bwf member firms provide *market making activities* on the various German securities exchanges or – to a lesser extent – "OTC", either as their core business or as a business unit within a broader securities services offering. It should be noted that compared to their European peers, most bwf member firms could be categorized as comparably small or mid-size investment firms. However, despite their limited size, bwf members are usually completely "wholesale" firms. Their clients and market counterparts are German and international banks, UCITS, insurance companies and other investment firms alike.

As a result of their business models, all of our members will be directly affected by Regulation (EU) 236/2012 and will be strongly dependent on a practicable and balanced interpretation of the Exemption for "*market making activities*", which meets the regulatory objectives without posing an unnecessary administrative burden on firms and avoiding any undesired negative effects on the functioning and efficiency of securities markets within the Union.

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The bwf therefore expressly supports the work of ESMA in the course of developing similar and consistent standards for the implementation of the various exemptions for the different types of "*market making activities*" as defined in Article 2 (1) (k) and referred to in Recital 26 of Regulation (EU) 236/2012.

General considerations

Before answering the specific questions raised in the Consultation Paper, which are often rather "technical" in nature, we think it is of utmost importance to recall the *"spirit"* of the regulation and its general objectives:

First of all, the regulation expressly acknowledges that short selling *per se* is <u>not</u> a negative or even abusive market practice. On the contrary, it is recognised that the quality and efficiency of markets usually benefit from short selling[1], no matter whether it is conducted in the course of "*market making activities*" or not. Therefore, the Regulation clearly states that *"under normal market conditions, short selling plays an important role in ensuring the proper functioning of financial markets, in particular in the context of market liquidity and efficient price formation."*[2]

Accordingly, the regulatory intent of the Regulation (EU) 236/2012 is clearly targeted at and restricted to certain speculative behavioural patterns of market participants, whose short selling practices – "*in times of considerable financial instability*" – are considered to be able to "*aggravate a downward spiral in prices*" and to generate additional "*systemic risk*".[3]

In the light of this evaluation of an overall beneficial impact of short selling under normal market conditions, the Regulation regards short sales conducted in the course of market making not only as generally inoffensive but rightly acknowledges that the ability to take (uncovered) short positions as an essential precondition for market makers to fulfil their function. Furthermore, Recital 26 emphasises that *"imposing requirements on such activities could severely inhibit their ability to provide liquidity and have a significant adverse impact on the efficiency of the Union markets."*[4]

Conversely, not a single indication can be found in the letter or spirit of the Regulation that any form of market making activity which existed at the time when the text was drafted and negotiated in the legislative process gave rise to any sort of regulatory concern. Therefore, it is evident that the Regulation does not intend to impose any provisions or additional requirements on legal or natural persons providing "*market making activities*" which would result in an alteration or restriction of market practices currently observed within the Union.

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[1] See Recital (5) of Regulation (EU) 236/2012

[2] Ibid.

[3] See Recital (1) of Regulation (EU) 236/2012

[4] Recital (26) of Regulation (EU) 236/2012

In our view, this provides a clear imperative that "*market making activities*" must not be aggravated by the implementation of the Regulation. Furthermore, it defines a binding principle not only for competent authorities' regulatory practice but also for ESMA when developing its guidelines for a consistent and uniform application of the exemption for "*market making activities*" and primary market operations.

Unfortunately, we do not always find this *"spirit"* and intent of the Regulation appropriately reflected in the Consultation Paper. In fact we cannot but state that we are deeply concerned that in core areas the proposal – if remained unchanged – bears a severe risk of damaging well established and resilient market structures, significantly reducing market liquidity and thereby adversely affecting the efficiency and the orderly function of securities markets in the Union.

This said, we would like to answers the questions raised in the consultative document as follows:

Q1: Do you agree with the above approach regarding the definition and scope of the exemption for market making activities? Please, explain.

The starting point for the evaluation of the appropriate definition and scope of the exemption for *market making activities* should necessarily be the definition of those activities. Article 2 (1) (k) of Regulation (EU) No 236/2012 uses the term *"market making activities"* in order to summarize a *set of different activities* which are deemed helpful and necessary for the orderly function of financial markets and therefore should not be inhibited by the Regulation.

Since the Regulation acknowledges that "*market making activities*" in their different forms are generally beneficial to the quality and efficiency of markets, the first objective of the guidelines developed by ESMA should be that market making in all its different occurrences will be covered. Here, it must be kept in mind that the Regulation does not intend to hamper or restrict any form of established *market making activities*. Therefore, the regulatory objective should not be to unduly narrow the scope of the definition itself but to avoid regulatory loop-holes by insuring that the market making exemption cannot be used for activities which, by clear and objective criteria, do not fall within one of the different categories of market making as defined by Article 2 (1) (k).

Accordingly, a sufficiently flexible and proportionate view regarding the practical interpretation of Article 2 (1) (k) and the exemptions under Article 17 (1) is needed. In this context, it should to be noted that *"market making"* is not a legal term *per se*[5], but was developed in the market as a practical description of specific functions attributed to a particular (or a group of) market participant(s). Since market structures in different countries (and within one country for different asset

[5] Even though it is broadly defined in Article 4 (8) of Directive 2004/39/EC

classes) may vary and are always the result of individual historical developments, one must be aware that there is no precise, truly uniform meaning and understanding of *"market making activities"*.

Furthermore, and equally important, the term *"market making"* originates from anglo-saxon "jargon" of describing certain functionalities of financial markets. In many jurisdictions (including Germany) until recently, the term was not even in use or had a rather limited practical relevance. For these jurisdictions, the introduction of *"market making activities"* as a legal category bears the additional challenge that it needs to be introduced and applied to existing structures which are, at least semantically but often also in their practical structures and arrangements divergent.

Liquidity provision as essential qualifying creteria

Talking about *"market making activities"* therefore necessarily means to talk about such activities *for the purpose of this Regulation*. Here, Recital 26 provides us with some clarification and – as we think – a very helpful guideline again: rather than focusing too narrowly on the technical term *"market making"* which has, as we have seen, a limited generality, any interpretation of Article 2 (1) (k) should be lead by the clear objective outlined in Recital 26 that the *"crucial role in providing liquidity to markets within the Union"*[6] should not be hampered by the Regulation and *"it is therefore appropriate to exempt natural or legal persons involved in such activities from requirements which could impair their ability to perform such a function and therefore adversely affect the Union markets."*[7]

A further clarification that the term *"market making activities"*, for the purpose of this Regulation does not describe a single concept but summarizes different forms of practices– as long as the criteria of providing liquidity is met – is given by the remark that *"the exemption should apply to different types of market-making activity"*[8].

Exclusion of proprietary trading

Recital 26 of the Regulation also attempts to draw a demarcation line by excluding *"proprietary trading"* from the scope of *"market making activities"*. However, this exclusion also illustrates how confusing and even misleading it can be when a single technical term is used for legal demarcation without giving further detail on the legislative intention. It must be noted that the text is misleading at least insofar as *"dealing as principal"*, as a necessary requirement for providing additional liquidity to the market and correctly referred to as a necessary precondition for *"market making activities"* in Article 2 (1) (k), from a strictly formal point of

[6] Recital (26) of Regulation (EU) 236/2012

[7] Ibid.

[8] Ibid.

view, also inevitably constitutes nothing else but a mode of *"proprietary trading"* (since a firm's own money is employed).

Here, we think, practical guidance is needed for the analysis of the regulatory intent. To our understanding, the differentiation which the legislator wanted to make is *"proprietary trading"* as a business model which is focussed solely on *"speculation"* and therefore finds its end in the generation of profits (or losses) by the utilization of expected movements in market prices on the one hand and *"proprietary trading"* as a *service for others* which *provides liquidity* in the course of generating competitive two-way prices or by utilizing a firm's capital to execute orders initiated by clients (as it is stipulated as *"market making activities"* in Article 2 (1) (k) of the Regulation) on the other hand.

This interpretation would also be in line with the definition of the scope of market making exemption earlier proposed by CESR:

> *"The exemption would only cover market makers when, in the particular circumstances of each transaction, they are genuinely acting in the capacity of a market maker. They are afforded a certain level of flexibility in anticipating sales as long as this activity is genuine market making in line with their existing general levels of business. Consequently, CESR would not expect market makers to hold significant short positions, other than for brief periods. Proprietary trading, where a firm is acting more as an investor or trader rather than liquidity provider, would not fall within the scope of market-making and would not be exempt."*[9]

In fact, we think that the undifferentiated exclusion of *"proprietary trading"* in Recital 26 of the Regulation, may result from a misinterpretation of the last sentence of this definition which excludes only forms of proprietary trading "*where a firm is acting more as an investor or trader rather than liquidity provider*".

Unfortunately, ESMA does not currently address this interpretational difficulty in the Consultation Paper.[10]

Exemption on per instrument basis

The consultative document claims that the exemption under Article 17 of the Regulation applies *"on an instrument by instrument basis"*[11] and therefore *"The notification submitted when notifying the intent to use the exemption under Article 17(1) and further use of this exemption should, therefore, concern a particular share*

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[9] CESR report, Model for a Pan-European Short Selling Disclosure Regime, March 2010, Ref.: CESR/10-088, Paragraph 53

[10] ESMA mentions *„proprietary trading"* in Paragraphs 12, 41 and 61 of the Consultation Paper but offers no advice on how it should be distinguished from *"dealing as principal"*.

[11] Paragraph 21 of the Consultation Paper

or sovereign issuer"[12] [13]. The only justification given for this – in our opinion clearly erroneous – assumption is the definition of market making *"as dealing as principal in a financial instrument"*[14].

Aside from the fact that *"dealing as principal in a financial instrument"* constitutes a necessary but not sufficient condition to qualify "*market making activities"* for the purpose of the Regulation, the reference to *"financial instruments"* clearly has the simple function to restrict the scope of application of the Regulation[15] and not to establish an overly prescriptive regulatory regime which would – as we will further discuss in our comment referring to the exemption process and the notification of intent procedure – result in a number of circumstances in a factual inability of market makers to fulfill their function and thereby in a potential material disturbance of the Union markets. It must not be further substantiated that such an effect would clearly contradict the intention of the Regulation and therefore would be inacceptable as a consequence of guidelines on the application of the market maker exemption.

A simple comparison with market regulations and admission restrictions in other sectors of the economy can easily demonstrate that ESMA's assumption of an exemption on an *"instrument per instrument basis"* is simply unsustainable and cannot be concluded from the market making definition in Article 2 (1) (k) of the Regulation: otherwise, with a similar justification, one could demand for example that the operation of a pharmacy licensed to sell drugs and narcotics available on a prescription only basis, would need a (renewed) licence for every new pharmaceutical. Such a provision, for good reasons, does not exist since the license is aimed to insure the quality of the service provided and the fulfilment of operational standards. Consequently, from a formal as well as material point of view, we believe, it would be clearly disproportionate to establish more restrictive provisions for market makers in financial instruments than for the distribution of pharmaceutical products which – if applied incorrectly – can have a severe negative impact on the health of citizens.

Furthermore, to put things in perspective and balance, it can be reasonably assumed that if the legislator would have had in mind an exemption regime as prescriptive, bureaucratic and detailed as is proposed in the Consultation Paper, ESMA would have been mandated to draft binding *"technical standards"* as was the case for other parts of the Regulation where implementation measures were expected to be important enough and to reach a certain level of complexity. This

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[12] Ibid.

[13] It must be further noted that referring to a single *"share"* on the one hand and a *"sovereign issuer"* on the other hand, would be an inconsistent application of the asserted requirement of a notification on an *"instrument by instrument"* basis.

[14] Ibid.

[15] The term market maker is by no means restricted to financial instruments but describes a general economic function which can be found in various markets where fungible products are traded.

was obviously not the case for the definition and scope of the market maker exemption.

For the reasons given above, we urge ESMA to abstain from the concept of a market maker exemption on a *"per instrument basis"* for which no sufficient justification can be found in the text of Regulation (EU) 236/2012.

In this context, it is important to note that giving up the concept of an *"instrument per instrument"* based exemption would not result in any impairment of the amount of information available to competent authorities. In particular, regulators – if deemed necessary – could still obtain detailed information on every single instrument for which a natural or a legal person whishes to make use of the market maker exemption. This information could be at any time requested on a regular, ad hoc or periodic basis in accordance with the powers given to competent authorities in Article 17 (11).

Membership requirement

Article 2 (1) (k) of Regulation (EU) 236/2012 stipulates, among other formal requirements, that a market maker needs to be *"a member of a trading venue"*.

According to Paragraph 25 of the Consultation Paper, a market maker who wants to make use of the exemption would be required to be a member of a trading venue on which the instrument in which he conducts *market making activities* is admitted for trading. Such a requirement however, is not covered by the text of Article 2 (1) (k) of Regulation (EU) 236/2012.

As we have already stated above, the whole concept of an exemption on a per instrument basis seems to be inadequate. Accordingly, we object to this requirement for a formal reasons. Nevertheless, it is undisputed that it is desireable for a market maker to have access to one or more additional liquidity pools for the instruments in which he conducts "*market making"* in order to be able to hedge positions – either "long" or "short" – arising from these activities. However, this lies so obviously in the well understood self interest of a market maker that any regulatory provision in this area must appear dispensable. A second, material reason, for such a general requirement to be rejected lies in the simple observation that some financial instruments within the scope of the Regulation, in particular CDS, are solely traded "OTC".

Even though most bwf members conduct their business as recognised market makers or liquidity providers[16] on regulated markets or MTFs, we expressly welcome ESMA's clarification given in Paragraph 26 of the Consultation Document that the recognition by a trading venue is not a requirement for using the market maker exemption.

[16] We assume that the term *„liquidity provider"* is used as a synonym for market maker in this context.

However, the wording of Paragraph 24

> *"[...] should be a member of a trading venue [...] where it deals as principal in a financial instrument in any of the two capacities and related hedging activities specified in Article 2(k)",*

Paragraph 26

> *"[...] the notifying person is not required to conduct its market making activities solely on that venue or market [...]"*

and Paragraph 30

> *"[...] it should at least be member of a trading venue or an 'equivalent' third country market where that related instrument is admitted to trading or traded and where it deals as principal in that related financial instrument in any of the two capacities and related hedging activities specified in Article 2(k) [...]"*

lays ground for the assumption that ESMA could be of the opinion that a natural or legal person needs at least to conduct *"unrecognised" market making activities* on a trading venue in order to make use of the market making exemption. In other words, a market maker who conducts his business solely "OTC" would not qualify for the application of Article 17 (1) of Regulation (EU) 236/2012.

If this assumption should be correct, before discussing its practical consequences, we must admit that it is hard to retrace how ESMA might have come to this conclusion, since we cannot find any basis for such a requirement in the text of the Regulation. The only possible explanation we have, would result from a semantic misunderstanding of the English text version of Article 2 (1) (k) which defines *"market making"* as

> *"[...] the activities of an investment firm, a credit institution, a third-country entity, or a firm as referred to in point (l) of Article 2(1) of Directive 2004/39/EC, which is a member of a trading venue or of a market in a third country, the legal and supervisory framework of which has been declared equivalent by the Commission pursuant to Article 17(2) where it deals as principal in a financial instrument, whether traded on or outside a trading venue, in any of the following capacities: [...]"*

Here, it would be clearly false to assume that *"where"* refers to the *"trading venue"* mentioned above. For at least two reasons, this cannot be the case, because otherwise:

- the interposed clause "*whether traded on or outside a trading venue"* would be semantically inconsistent within the compound sentence, because it clearly states that it is not required to trade on a trading venue in order to conduct *market making activities*. Very obviously, something cannot be not required and required at the same time,

- an analysis of the different text versions in all official languages in which the Regulation was published, reveals that aside from the English version, to our understanding only the Irish text uses a conjunction which principally would allow a reference to a place or location. In all the other 21 languages, a term equivalent to *"when"*, *"if"*, *"provided"*, *"supposed"* or *"in case"* is used[17], clearly indicating that the conjunction fulfils the function of subordinating the following clause "*it deals as principal [...]*". Since the meaning of the English text cannot be divergent from the other official languages, it becomes evident that *"where"*, in Article 2(1)(k), does <u>not</u> serve as a reference to a place (*"trading venue"*) but defines a limiting conditionality with respect to "where *<u>it deals as principal</u> [...]*", similar to the terms *"where justified"*, *"where appropriate"*, *"where applicable"* or *"where the condition is met"*.

Accordingly, it needs to be emphasised that no basis for a requirement to become a market maker on a trading venue before making use of the market maker exemption in the "OTC" market exists and ESMA should not and must not introduce such a provision in its guidelines. We therefore ask for a redraft Paragraphs 24, 26 and 30 in order to avoid any false interpretation or confusion.

Once again, it needs to be recalled that Regulation (EU) 236/2012 does not intend to alter or restrict existing market making practices. On the contrary, it clearly acknowledges in Recital 26 that market making in general is seen as beneficial and, therefore, different forms of "*market making activities*" should be eligible for the application of the exemption stipulated in Article 17 (1). Conversely, a requirement to become market maker on a trading venue before being able to apply the exemption rule in the "OTC" market, would heavily conflict with existing market structures which have proven to be resilient and efficient even under conditions of severe stress and turbulences.

In this context, it needs to be recognized that market making on regulated markets and other trading venues is very often conducted by different firms than those who provide market making activities "OTC". Such differentiated structures, which become most prominent in the sovereign debt markets, can be described as a "devision of labour" among different firms providing liquidity in different market segments for different groups of investors ("retail" and "institutional") with different needs and expectations with respect to market models, trading sizes etc.

Together, these different market segments form a stable pattern of liquidity pools which can be regarded as essential for the orderly function and efficiency of the Union markets. Discriminating the "OTC" market by *de facto* forcing firms to become market makers on trading venues at the same time, would inevitably create

[17] [bg] *"когато"*, [cs] *"pokud"*, [da] *"når"*, [de] *"wenn"*, [el] *"όταν"*, [en] *"where"*, [es] *"si"*, [et] *"eeldusel"*, [fi] *"jos"*, [fr] *« et que »*, [ga] *« i gcás »*, [hu] *"ha"*, [it] *"quando"*, [lt] *"kai"*, [lv] *"ja"*, [mt] *"meta"*, [nl] *"wanneer"*, [pl] *"w przypadku"*, [pt] *"caso"*, [ro] *"atunci când"*, [sk] *"ak"*, [sl] *"kadar"*, [sv] *"när"*

serious distortion and could be expected to result – sooner or later – in a material change of the established market structures.

In the short run, we see a potential danger in particular for the institutional bond markets where "OTC" market makers would be likely to react to the inability to enter into uncovered short sales by concentrating their liquidity in the most liquid sovereign debt papers of large member states, resulting in a liquidity drain – and consequently higher spreads and risk-premia – for smaller issuers. While such a scenario would be already undesirable under normal market conditions, it becomes clearly irresponsible in the light of the current sovereign debt crisis.

Against this background, for formal reasons (no justification can be found in the text of the Regulation) as well as with regard to its practical implications, any attempt to restrict the application of the exemption rule of Article 17 (1) to firms which are (also) conducting market making activities on a trading venue, should and must be emphatically rejected.

Paragraph 27 states that *"It should be acknowledged that market making activities as defined in Article 2 (1) (k) of the Regulation might be carried out not only on shares, sovereign debt or CDS on sovereign issuer but also on other financial instruments that are related to them."*

This statement is certainly correct but also incomplete, since the definition of a *"financial instrument"* according to Article 1 (a) is wider than the group of instruments presented in Paragraph 27 which includes only those instruments for which an exemption under Article 17 (1) can be used (and for which it might be needed). E.g. a financial instrument which is related to a sovereign issuer outside the Union which is not covered under Article 2 (d) could be subject to "*market making activities"* without stipulating any obligations or prohibitions according to the Regulation.

It should be also noted and we would like to ask ESMA to include a clarifying remark in its guidelines that no restrictions on uncovered short sales are stipulated for financial instruments related to shares, sovereign debt or CDS within the scope of the Regulation. Accordingly a market maker exemption would be only needed with respect to the notification to competent authorities of significant net short positions and only if the positions resulting from *market making activities* in such instruments might reach the thresholds for notification.

Q2: Do you agree that when determining the RCA for notification purpose the third country entity should be assessing the turnover in relation to its market making activities as defined in Article 2(1)(k) of the Regulation? Please, explain,

We have no comments on Question 2.

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

V.I. General Principles

ESMA suggests six *"General Principles"* market makers would have to comply with in order to make use of the exemption. We would like to comment on the proposed principles as follows:

For the reasons given in our comments on Question 1, we suggest to alter the first indent of Paragraph 41 as follows:

– *"be a member of the trading venue ~~where the financial instrument in question is admitted to trading or traded and in which it conducts a market making activity on that instrument~~;"*

Indent two of Paragraph 42 stipulates that a person which intends to make use of the exemption must

– *"Comply with the general rules and particular requirements for market making activities imposed by the trading venue or market in the third country;"*

While it is a matter of course that a registered market maker on trading venue has to comply with requirements for *market making activities* on that venue, these provisions are usually only binding if a market maker is registered. Since registration with a trading venue, according to Paragraph 26, shall not be a prerequisite to make use of the exemption, we think that indent two of Paragraph 42 needs further clarification.

According to indent three of Paragraph 41 a person must

– *"implement separate arrangements for the middle and back-office with respect to the market making activities for which it claims the exemption;"*

We have to admit that we find it difficult to interpret the general term *"separate arrangements"* in a meaningful and unambiguous way. If ESMA wants to say that firms should have separate securities accounts in their back-offices (respectively with their clearing agents if they have outsourced the clearing & settlement functionality), we can easily agree as long as the management of different accounts still can be conducted on a firm-wide basis. Conversely, if ESMA would require a separate organizational middle and back-office function/department related to "*market making activities*", this would pose a clearly disproportionate administrative burden in particular on small and medium size investment firms.

Indent five of Paragraph 41 requests a person to

- *"maintain its records of orders and transactions relating to its market making activities for which it requests the exemption separately from its records of its proprietary trading activities;"*

Once again, we find this formulation very vague. Furthermore, investment firms and credit institutions already have to comply with detailed, legally binding record-keeping, accounting and risk management provisions. From a technical point of view, the necessary segregation or aggregation of data will always depend on given "external" requirements. E.g. for risk management purposes or in order to calculate regulatory capital requirements, all transactions have to be aggregated on a firm-wide basis. We therefore think it would be more appropriate to require records to be maintained in a way that orders and transactions relating to "*market making activities"* can be easily and unambiguously identified.

Furthermore, before requiring any kind of "separation" on the level of middle and back-office or with respect to record keeping, it would be much more obvious and understandable to demand in the first place effective arrangements in the front office, in order to avoid "*market making activities"* being mingled with other parts of a firm's business.

Paragraph 41 intend six demands that a person making use of the exemption needs to

- *"be able to demonstrate at any time to the competent authority that its market making activity meets the principles and criteria in the Guidelines."*

To our understanding, this Principle specifies the power given to competent authorities in Article 17 (11) of the Regulation. Accordingly, the compliance with the ESMA guidelines, in particular the principles and qualifying criteria laid down in Chapters V.II., V.III., V.IV. and V.V., must be demonstrated on *"request"*. This information needs to be clearly distinguished from the information to be provided in the course of the notification required to make use of the market maker exemption. Any such request must not be arbitrary and must be in accordance with the general principle of proportionality. – We kindly ask ESMA for a clarification at this point.

Q4 Do you agree with principles applicable to persons carrying out market making activities in accordance with Article 2(1)(k)(i) of the Regulation? In your view which of the two options in paragraph 44 should apply to quotes entered when carrying out market making activities? Do you see another alternative to the two options pro-posed? Please, provide explanations.

First of all, we fully agree with the judgement provided in Paragraph 42 that *"The over-riding applicable principle is that market making activity must provide liquidity to the market."*

However, since we disagree with the notification requirement on an *"instrument per instrument basis"* proposed by ESMA *and* since the Principles must be applicable to existing market makers as well as to persons which intend to start to conduct "*market making activities"* alike, we suggest that Paragraph 43 should be altered as follows:

> *"A person undertaking market making activities must be present on the order book for the relevant financial instrument(s) for which it ~~requests~~ uses the exemption for a sufficient proportion of the mandatory trading period such that investors can observe, during the whole trading session, the existence of an effective bid/ask spread with proposed competitive prices. Time presence should be expressed as a percentage of the total duration of the trading session, but may vary according to both the trading venue or an 'equivalent' market in a third country and the financial instrument in question."*

Furthermore, it needs to be noted that such requirements can only be fulfilled (and meaningfully applied) to fully "quote driven" market models. They are not appropriate for "hybrid" market models, e.g. a continuous auction supported by market makers model, where additional liquidity is provided when needed, absorbing a possible overhang on the buy or sell side and thereby increasing the trading volume and the number of orders executed.

Although this issue is partly addressed (with respect to a specific case) in Paragraph 56, we would like to ask ESMA to take account of various existing market models on the level of its "Principles" and in a more general form, either by amending Paragraph 43 or by inserting a new Paragraph which clarifies that *"where market making is conducted on the basis of a "hybrid" market model, e.g. a continuous auction supported by market makers, market makers must comply with the requirements laid down in Paragraph 43 to the extent which the market model allows."*

Since it becomes evident in the light of recital 26 that the application of Article 2 (1) (k) (i) shall not be limited to the "classic" market maker model where the market maker becomes a buyer for every seller and a seller for every buyer in the market as long as the activities result in *"providing liquidity on a regular and ongoing basis"*, it must become irrelevant whether the market-model refers to the required functionality expressly as *"market maker"*, *"specialist"*, *"liquidity provider"* or by any other technical description.

To our understanding, Paragraph 45 (a) simply duplicates the transparency requirements, already defined in Paragraph 43 without providing any further advice. In order to be more specific and to provide further clarity, we would suggest that Paragraph 45 (a) should refer to the relevant pre trade transparency requirements under MiFID. Paragraph 45 (a) therefore should read as follows:

> *"a. Be displayed on the order book or quote book in accordance with the requirements defined in Annex II table 1 of Regulation (EC) No 1287/2006;"*

With respect to the alternative requirements proposed in Paragraph 45 (b)/(c) we would first like to note that any such requirement should not be interpreted in a way that empirical evidence on an *"instrument by instrument"* basis must be provided *ex ante* before a person is allowed to make use of the exemption but rather as a commitment to comply with the guidelines for which evidence on request by the relevant competent authority must be provided. Any other interpretation would be clearly disproportionate in the course of a "notification" process as defined in Article 17 (5) of the Regulation. This said, we would opt for option (b) which we think is more precise and directly aligned to the wording of Article 2 (1) (k) (i) of the Regulation.

Deviating from Chapter V.III. of the Consultation Document, Chapter V.II. currently does not provide any guidance with respect to the notification of persons who wish to start "*market making activities"* and therefore want to notify the relevant competent authority about a future use of the exemption. Consequently, a comparable provision should be added which could read as follows:

> *"Where a person is not yet posting firm, simultaneous two-way quotes of comparable size and at competitive prices, with the result of providing liquidity on a regular and ongoing basis to the market, the competent authority should take into account whether it has a reasonable expectation that it will do so in the future, and the basis for that expectation and the business assumptions that justify it."*

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

The substantial difference between "*market making activities"* in accordance with Article 2 (1) (k) (i) and Article 2 (1) (k) (ii) lies in the fact that in the first case a person holds itself out to the market by quoting bidirectional prices and consequently contracting with any market counterpart while in the second case a person employs its own capital (and thereby provides liquidity to the market) in order to fulfil orders initiated by someone with whom he has an established client relationship. Obviously, the conduct of business obligations – as stipulated by MiFID – in the latter case, are different from the first.

More specifically, in *"market making activities"* according to Article 2 (1) (k) (i) the market maker contracts with market counterparts which, as mentioned above, are not his *"clients"* in the sense of MiFID. Depending on the market-model and the technological framework, he often does not even know with whom he is trading at the moment he enters into a transaction. Furthermore, when acting as market maker on a trading venue, he often has an obligation to contract with every market participant admitted for trading at this venue. In other words, under Article 2 (1) (k) (i), the market maker provides a service for the market as a whole.

As distinguished from Article 2 (1) (k) (i), following the wording of Article 2 (1) (k) (ii), activities which result from orders being executed on the basis of an established client relationship should also be qualified as *"market making activities"* for the purpose of the Regulation. In this context, the reasons and circumstances under which a client wants to trade with an investment firm or a credit institution as principal may vary. However, in all cases, these activities can be categorized as services provided for an individual client and with regard to his specific investment needs. Unfortunately this essential difference is currently not adequately reflected in ESMA's draft guidelines.

When executing client orders as principal, a person needs to conduct this activity as *"part of its usual business"* in order to qualify as market maker and to be enabled to make use of the market maker exemption. We agree with ESMA's proposal laid down in Paragraph 47 indent one in so far as an activity performed on an *"irregular"* basis would not constitute *"usual business"*. However, the proposed definition that a person needs to deal on a *"frequent and systematic basis"* clearly would be an overextended assumption, which would unduly restrict the scope of application of Article 2 (1) (k) (ii).

In particular, a requirement to deal on a *"frequent and systematic basis"* could give grounds for the false assumption that "*market making activities*" according to Article 2 (1) (k) (ii) could be restricted to *"systematic internalisers"* as defined by MiFID. While a systematic internaliser clearly would fulfil the requirements of Article 2 (1) (k) (ii), there is no evidence provided in the Regulation that the application of this provision should be limited to such a business model. On the contrary, the only specific requirement[18] to be met, is to deal, as part of ones *"usual business"*, on own account *"by fulfilling orders initiated by clients or in response to clients' requests to trade"*.

Therefore, the operating requirements for dealing *"as part of its usual business"* should be clearly distinguished from the qualifying requirements of becoming a systematic internaliser. Once again the "spirit" of recital 26 which acknowledges different forms of market making to be equally beneficial, should be taken into account. Accordingly, we are of the opinion that the *"as part of its usual business"* requirement is met when a natural or legal person satisfactorily demonstrates that dealing on own account by fulfilling client orders is a documented part of its business strategy and that appropriate personal and technical resources are employed for this purpose and that appropriate proceedings and arrangements for risk management, record keeping, accounting, compliance and auditing are in place. Furthermore, since market making is not considered a suspicious but a clearly beneficial and necessary activity, it should be self-evident that the opera-

[18] Aside from the general requirements laid down in Article 2(1)(k) which are to be *„an investment firm, a credit institution, a third-country entity, or a firm as referred to in point (l) of Article 2(1) of Directive 2004/39/EC, which is a member of a trading venue or of a market in a third country, the legal and supervisory framework of which has been declared equivalent by the Commission pursuant to Article 17(2)"*.

tional requirements must not be higher than for any other offering of investment services.

Q6 Do you agree with the qualifying criteria for the comparable size of orders? Please explain.

Here, we think that the formulation of Paragraph 50, talking about *"orders posted by market makers"* is not very felicitous. We strongly suggest that ESMA strictly retains the wording of Article 2 (1) (k) by referring to *"posting quotes"* and *"fulfilling orders"*.

Otherwise, we have no principle objections to require market makers to post quotes which are valid for an *"average trading size"* for a given financial instrument on a specific venue, or to be willing to fulfil a client order up to this size. However, for certain instruments and in particular in "OTC" markets, the determination of an *"average trading size"* may be difficult. Furthermore, it remains absolutely unclear, who shall be responsible for the determination of an *"average trading size"* for each instrument and on every possible venue.

Q7 Do you agree with the qualifying criteria for competitive price of orders? Please explain.

Once again, Article 2 (1) (k) (i) requires "quotes" (not "orders") to be posted at competitive prices. In order to avoid confusion and misunderstandings, we suggest that ESMA should strictly use the Level I terminology, when defining its guidelines.

We also think that the concept proposed to demonstrate that prices are "competitive" is overly complex, detailed and prescriptive (an observation which holds true for the "qualifying criteria" in the Consultation Document in general). At this point, we would like to kindly remind ESMA that it was not mandated to develop *"technical standards"* for the application of the market maker exemption but decided to develop general *"guidelines"*. This twofold legislative concept would become meaningless if the requirements defined in *"guidelines"* were to be as demanding and binding as *"technical standards"*.

Furthermore, we think that such formal calculations go beyond the intention of the Level I text. The legislative intention of Article 2 (1) (k) (i) cannot be a formalistic "performance measurement". For the purpose of the regulation, prices are required to be *"competitive"*, because otherwise there would be no liquidity provision. Accordingly, as long as a market maker can demonstrate that he has significant turnover in a given financial instrument, prices could be reasonably assumed to be *"competitive"*. What the Regulation obviously wants to avoid (and what the assessment of regulators should focus on), is a person claiming to be a *"market maker"* in order to make use of the exemption, while posting quotes which are prohibitively wide.

Q8 Which option do you favour? Please, justify.

As explained in our response to Question 7, we think that both options go well beyond the Level I requirement.

Q9 Do you agree with the qualifying criteria for ongoing presence on the market? Do you think different criteria should apply when conducting market making activities in sovereign debt? Please explain.

With respect to the terminology being used and the overly detailed requirements within a concept of *"guidelines"*, please refer to our response to Question 7.

For the purpose of the Regulation, we think that the requirement of *"regular and ongoing"* should be deemed to be fulfilled as long as a person can demonstrate his daily presence on the market for a significant period of time.

We expressly acknowledge that ESMA has addressed in Paragraph 56 the issue of auction based trading models supported by market makers. However, as mentioned in our response to Question 4, a more general exemplification that *"presence on the market"* needs to take into account the specific nature of the relevant market model, would be deemed helpful.

Q10 Do you agree with the ESMA approach towards assessment of notification of intent to make use of the exemption? Please explain.

While we strongly agree with the proposal made by ESMA in Paragraph 59 (a) that

> *"Where a person can demonstrate that it is party to a market making or liquidity provision contract or programme with a trading venue or an issuer which meets or exceeds the above three criteria there is a presumption that its notification should be accepted by the competent authority",*

we remain concerned with respect to the practical interpretation of Paragraph 59 (b) which requires

> *"Where a person is not party to a contract or programme as described above it should provide evidence that it deals as principal on a trading venue in accordance with the criteria set out above."*

Against the background of ESMA's *"instrument by instrument"* approach – which we think is not supported by the Level I text – and the overly detailed concept of the *"qualifying criteria"* a further clarification about what is reasonably meant by *"provide evidence"* is necessarily required.

In this context, it must be remembered and clearly stated that Article 17 (5) does not call for a *licensing procedure* for which higher standards with respect to the amount and the level of detail could be appropriate but for a simple *notification*.

For a notification, however, it must be deemed sufficient if information is provided which enables the relevant competent authority to give a general judgement on whether it can be reasonably expected that the activities for which a person wants to make use of the exemption under Article 17 (1) fall within the scope of the definition of "*market making activities*" as defined.

It must be clearly stated that such information to be provided along with a notification – with a minimum sense of proportionality of regulatory intervention being retained – cannot be a catalogue of exemplifications and complex calculations on the basis of empirical data being demonstrated for every single financial instrument and with respect to all *"principles"* and *"qualifying criteria"* being defined.

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

As already mentioned in our response to Question 5, there is no justification to generalise the operational requirements for systematic internalisers under MiFID with respect to the requirements to be fulfilled for activities defined in Article 2 (1) (k) (ii). Furthermore, neither *"frequency"* nor *"systemic basis"* are requirements which can be derived from the Level I text.

On an *"instrument by instrument"* basis, *"frequency"*, among other factors, would depend on a firm's size, number of clients and client's investment preference. In other words, the ability to actively influence the number of orders executed in a particular financial instrument is very limited or nonexistent. From a market perspective, applying a *"frequency"* requirement could result in less liquid instruments becoming even more illiquid as a result of a no longer applicable market maker exemption – a clearly undesired and absurd result in the light of the regulatory intent which is to avoid liquidity provision by market makers being negatively affected by Regulation (EU) 236/2012.

Q12: In your opinion, what would be the most appropriate qualifying criteria in terms of percentage to assess scale of activity eligible for exemption under Article 2(1)(k)(ii) capacity in comparison to overall proprietary trading?

We do not see any justification for a *"percentage criteria"* on the basis of the Level I text nor do we consider such a criteria to deliver a useful basis of information. E.g. a market making unit within a universal bank might be very small in relative terms but in absolute figures its business could still be large compared to a small investment firm conducting solely *market making activities*.

Q13 Do you agree that the above information needs to be provided in the notification form? Should historical data be also provided with the notification form? Please, provide justifications.

As already demonstrated in our response to Question 1, a notification requirement on an *"instrument by instrument"* basis would clearly go beyond the requirements defined on Level I. Conversely, if the legislator would have intended that notifications should be provided on an *"instrument by instrument"* basis, with respect to the far reaching consequences of such an approach, he could and must have given a clear indication within Article 17 (5). In this case, it also could have been reasonably expected that ESMA would have been mandated to develop *"technical standards"* (e.g. on data formats, communication interfaces, authentication procedures etc.) for such a comprehensive and complex reporting obligation. In fact the Regulation itself does not even call for *"guidelines"* with respect to the implementation of the market maker exemption[19].

Just to shed some light on the administrative burden associated with a notification on an *"instrument by instrument"* basis from a practitioner's point of view: while some bwf member firms make markets for more than 100,000 different financial instruments, our largest member manages a portfolio of more than 600,000 order book mandates. We think it does not require further clarification that a notification on an *"instrument by instrument"* basis in this case would represent a tremendous administrative challenge.

Even though firms might not necessarily need to make use of the market maker exemption for every instrument, in particular because an instrument may only be *"related"* to shares or sovereign debt and positions arising from "*market making activities"* are not expected to breach the regulatory thresholds for *"significant net short positions"* at any time, the administrative task in selecting, filing and managing financial instruments for which the use of the exemption is requested (and others for which it is not) would be an extremely costly and cumbersome process. Beside the fact that we cannot identify any requirement for an *"instrument by instrument"* notification procedure on Level I, we do not see any practical justification for such an administrative burden under cost-/benefit considerations.

Furthermore, and equally important, an *"instrument by instrument"* notification together with the *30 days in advance notification period* would result in the requirement to "notify" the relevant competent authority more or less on a daily basis and a month before a person can make use of the market maker exemption for newly introduced financial instruments. In practical terms, this would – as already mentioned in our response to Question 1 – be often impossible and could lead to severe negative effects for markets and investors. – A few examples given:

[19] Recital 41 as well as Article 41 call for guidelines only with respect to *"penalties and administrative measures applicable to infringements of the provisions"* of the Regulation.

- 30 days in advance of an IPO a share normally would not even have an ISIN assigned (beside the fact that it would not formally fall under the Regulation as long as it is not officially *“admitted for trading”*). Accordingly, in the often high volatile IPO-phase, a market maker would not be able to make use of the exemption when it is most needed.

- A corporate action, e.g. a share split, which formally results in the creation of a new financial instrument, would impede a market maker from making further use of the exemption on a continuous basis.

- A registered market maker on an exchange is chosen by lottery to make markets for a new financial instrument, with the market operator expecting him – according to his contractual obligations – to start this activity the next trading day. With a notification requirement on an *“instrument by instrument”* basis, he would not be able to make immediate use of the exemption.

- In the case of insolvency of a market maker on a trading venue, the market operator will have to reallocate the order book mandates of the insolvent firm in an emergency process to the other market makers on this venue.

In all these cases – and numerous others could be found – there is no persuasive or comprehensible reason, even from the most cautious regulatory perspective, why market makers should be prohibited from making immediate use of the market maker exemption, which is – as recital 26 clearly acknowledges – an essential prerequisite for market makers to provide liquidity. Consequently the notification process, and thereby regulation itself, would hinder the orderly function of the Union markets, an obviously absurd consequence which would be neither in line with the letter nor the “spirit” of Regulation (EU) 236/2012.

Furthermore, since the exemption is needed to effectively manage the risks arising from employing a firm’s regulatory capital in the course of “*market making activities*”, it should be in the vital interest of regulators themselves that market makers have immediate access to the exemption under Article 17 (1).

For the reasons given above, we urgently ask ESMA to reconsider its approach and to give up the concept of an *“instrument by instrument”* notification and to replace it with a category based procedure.

In case regulators would find it indispensible to receive information regarding *market making activities* on an *“instrument by instrument”* basis, they could – as already mentioned above – still use their powers under Article 17 (11) in the course of a notification (without being formally a part of the notification) or at any other time to request information at any possible level of detail.

Such a decoupling of the notification itself from the information process, could at least avoid the serious problems otherwise arising from the 30 days in advance notification period. In this context, it must be finally noted that the 30 days period was obviously intended to give legal certainty to notifying persons in due time and it would be more than absurd if it were to become a "mantrap" because of ESMA's interpretation. Furthermore, the execution of regulatory powers would in no way be confined by such a decoupling since competent authorities are entitled, in accordance with Article 17 (7), to prohibit the use of the exemption at any time within or after the 30 days period.

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

We clearly think that notifications filed and accepted by competent authorities before ESMA's guidelines were published should provide legal certainty to the affected firms. Therefore, we see no formal or material justification or need for a "review". In particular, market makers should not be confronted with additional costs or other disadvantages just because ESMA was not able to publish its guidelines in due time.

Q15: Do you agree that a list of market makers and authorised primary dealers published on the ESMA website according to Article 17(13) should at least include the above information? What additional information should be included? Please justify.

We cannot find any indication in the Level I text why the publication of a list of financial instruments for which a market maker is using the exemption would be required. Technically to set up and to maintain such a webpage would be certainly a costly undertaking which would be hard to justify from a cost-/benefit perspective.

Otherwise, we have no objections with respect to the proposed content of information to be published.

Yours sincerely,

Michael H. Sterzenbach
Secretary General