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Vice-President of the European Commission

Brussels

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Dear Honourable Members,

I am writing in response to your letter of 24 February 2017 relating to broker crossing networks. My services have undertaken a preliminary investigation concerning the establishment of broker crossing networks involving investment banks that act as systematic internalisers (SIs) and other firms that engage in high frequency trading (HFT). On the basis of our stakeholder contacts, we conclude as follows.

The concern about the establishment of broker crossing networks originates with a group of exchange operators. They are aware that attempts are in progress to create electronic communication networks which would link several investment firms operating under the SI status with liquidity providers or "high frequency traders".

These plans envisage the establishment of a network in which both SIs and HFT firms interact, in a manner that the market operators describe as being multilateral. For example, a participating SI would collect client orders (including orders from retail clients) and route them through the HFT firms for back-to-back execution involving other participants in the network. Market operators argue that this network amounts to a multilateral trading facility (MTF) and should be authorised as such. As there is a risk that such broker crossing networks may not be considered as a multilateral trading system by all competent national authorities, market operators fear that some variants of broker crossing networks may not be required to be authorized as MTFs.

Market operators are also concerned that the potential broker crossing networks will be used to execute retail orders. They believe that all retail orders referring to the acquisition or sale of equity should be executed on regulated stock exchanges. They also believe that allowing the above-described broker crossing networks to proliferate will lead to fragmentation and hamper price discovery, a result they argue as running counter to the goals pursued with MiFID II.

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Investment firms, on the other hand argue that the establishment of electronic links between SIs and other liquidity providers would not amount to the creation of a MTF. They argue that each SI participant in such a crossing network would not cease to trade on own account, even when communicating with other SIs in a network in order to search for trades that cover their client orders. They contest that such communication between network participants is akin to a back-to-back execution of their client orders.

In addition, investment firms stress that all communication within the potential electronic links would remain bilateral in nature, i.e., that a SI interested to cover a client order would only contact one other SI in the network in order to see whether its trading exposure could be matched. Each SI would therefore remain a dealer in the securities at issue. They argue that the crossing network would essentially result in a network of bilateral links between own account dealers and that no central (riskless) matching of orders would take place within the crossing network.

Market operators remain unconvinced that such a network of bilateral relations would be compatible with own account trading of an SI, arguing that the speed of bilateral communication that could be achieved between SIs and liquidity providers within a technologically enhanced broker crossing network would make such a network akin to a MTF. This is essentially because technology would enable network participants to rapidly consult each other in rapid succession, calling into doubt the 'bilateral' nature of their contact. While the network would potentially not infringe the letter of MiFID II as it stands, such interconnected networks would not reflect the spirit of the MiFID II reforms.

Market operators would therefore suggest that either the Commission or ESMA issue guidance to the effect that broker crossing networks involving rapid exchange of order information between participating SIs would constitute MTFs and need to be authorised as such.

In light of the above, we propose to engage in a dialogue with both ESMA and the competent national regulators in order to determine the jurisdictions in which the alleged broker crossing networks could be potentially established. We would then engage with the relevant authorities on how to address the establishment of such broker crossing networks within the MiFID II rules.

Yours sincerely,



Valdis Dombrovskis