



FESE Response - ESMA Call for Evidence on Digital Finance

28th July 2021

General information about respondent

Name of the company / organisation	FESE
Activity	Regulated Market
Are you representing an association?	<input checked="" type="checkbox"/>
Country/Region	Europe

Q1 Please insert here any general observations or comments that you would like to make on this call for evidence, including how relevant digital finance may be to your own activities.

FESE fully supports the work of the European institutions aimed at making the EU fit for the digital age and developing a harmonised regulatory framework. Exchanges play an important role in supporting the stability of the financial system. They are taking several measures with regards to cyber resilience defences and integrate new technologies into their day-to-day activities continuously.

As a general comment, we support a legally binding approach, based on existing EU financial market practices, as this would provide legal certainty to reduce regulatory arbitrage, inconsistencies, market fragmentation, and ensure scalability of services within the EU. Scalability is extremely important for EU firms to successfully compete on a global scale and with non-EU entities active within the EU. We would further highlight that technology neutrality and “same business, same risks, same rules” principles should apply within the EU to uphold the values of transparency, fairness, stability, investor protection, and market integrity.

Additionally, in our view, technological innovation provides many benefits and is of utmost importance for the future development of the EU’s financial sector to be competitive and to offer better services to consumers. Consequently, to reap those benefits, the EU regulatory framework for new technologies should be designed in such a way to keep the balance between innovation and safety for financial markets. More specifically, appropriate safeguards should comply with the principles of “same activities, same risks and same rules”, coupled with a technologically-neutral approach, in order for innovation to present low risks for financial market participants and guarantee the proper functioning of the financial system. We see regulators and authorities already addressing these issues providing regulatory frameworks for new technologies (e.g. ESMA Guidelines for Cloud Outsourcing, the Digital Operational Resilience Act (DORA) Regulation and the Markets in Cryptoassets (MiCA) Regulation).

1. More fragmented or non-integrated value chains

Q2 Do you observe changes in value chains for financial services (e.g., more fragmented value chains) as a result of technological innovation or the entry of technology firms? How different is the situation now when compared to pre-Covid?

We have not observed developments of Big Techs in Europe compared to developments in Asia, where big platforms offer the possibility to place dormant cash in money market funds to receive interests (ESMA Report on Trends, Risks and Vulnerabilities, 1/2020, p. 50, RA.13). However, although in early stages, the Distributed Ledger Technology (DLT) and especially the more advanced blockchains providing the possibility of smart contracts might lead to a shortening and fragmentation of traditional value chains in the markets of traditional financial intermediaries. The disruptive technologies of DLT include opportunities for new business models for exchanges but can also raise considerable risks concerning investor protection if completely left unregulated. We, therefore, welcome the MiCA initiative of the Commission to regulate those cryptoassets which do not qualify as financial instruments as defined in the MiFID II/R framework. Overall, the Digital Finance Package should aim to ensure the ‘same business, same risk, same rules’ principle in all relevant regulatory frameworks. As part of this, it provides a technology-neutral sandbox approach by the DLT Pilot Regime to explore the opportunities of new technologies in financial markets.”

Further, we see a trend of “Decentralized Finance” (DeFi) emerging with financial products built on Distributed Ledger Technology (DLT) networks, often on public blockchains. Financial services are offered via pure peer-to-peer layers, to (retail-) clients without a central intermediary implying certain rules automatically (e.g. on the basis of programmed smart contracts). These new and innovative concepts are attracting growing interest. To grasp the full potential of this development, it is necessary to ensure a certain level of protection for consumers/investors.

Q3 Do you consider that financial firms are increasingly relying on technology firms to fulfil critical or important functions? If so, for which particular functions? Are there particular types of technologies (e.g., BigData, artificial intelligence, cloud computing, others) and technology firms involved?

Cloud markets offer technological solutions for financial institutions to innovate, flexible scale-up, save costs through the application of pay per use models and should be supported in general. We acknowledge the limited number of providers, but to favour innovation and not lose competitiveness on the international level, it is crucial that the EU market remains open to non-EU cloud service providers.

Many FESE Members already use cloud services in their operations. However, exchanges are aware that using cloud services for core functions might include the risk of losing data sovereignty and being dependent on third party support in case of incidents. Therefore, they apply a cautious approach. For example, exchanges primarily use the infrastructure provided by cloud service providers rather than using applications developed by cloud service providers for core functions. The concept of ‘Infrastructure as a Code’ (IaC) allows exchanges even to shape the used infrastructure of the cloud service providers themselves. This allows them to keep control of the infrastructure architecture and encapsulate critical parts from others on the cloud. Used together with state-of-the-art data encryption, it ensures that even the service providers do not have access to that data.

Further, firms are already subject to the ESAs and NCAs supervision when it comes to outsourcing, regardless of the technology used. Therefore, firms conduct proper risk

management. On a general note, we welcome the Commission's proposal of DORA (see e.g. Art 25, 26, 29 or 31) and ESMA's outsourcing guidelines (Guideline 2, 9) from 2020, which tackle this issue as well. These regulatory/supervisory frameworks will further support the use of Cloud technology in the financial sector.

Artificial Intelligence tools are also deployed by financial markets in, for example, market surveillance operations in order to detect suspicious trades and prevent insider trading and market manipulation. However, such tools are provided by a range of technology firms other than Big Techs, often by small and highly specialised companies.

Q4 Do you have examples of technology companies providing financial services in the EU, either directly or through arrangements with financial firms? If so, please briefly describe their business model and the type of financial services that they provide.

We see large technology companies providing payment services in the area of e-commerce in cooperation with established financial institutions. Also, we see technology companies cooperating with financial institutions in the realm of asset management ("robo-advisor"). Further, in non-EU jurisdictions, we notice large technology companies acting as "one-stop-shop" offering financial and non-financial services.

We believe that every market participant offering financial services should be required to follow "same risks, same business, same rules" as other service providers, regardless of the technology used. However, in principle, this kind of cooperation between technology and financial firms can bring innovation and should therefore not only be seen as a risk.

Q5 Do you have examples of technology companies being used by financial institutions in the EU to fulfil critical or important functions? If so, please briefly describe their business model and the way in which they contribute to, or facilitate, these critical or important functions.

As stated above, financial institutions use cloud service providers for their various services (PaaS, SaaS, IaaS). This topic is already addressed by regulators within the recent DORA proposal from the Commission and ESMA cloud guidelines.

Q6 Do you see changes in the way or extent to which financial market data are being collected, used and disseminated by unregulated data service providers?

FESE has observed significant changes in the way market data is being collected, used, and disseminated, not only within unregulated data service providers but also across the complete market data value chain. In general, there has been a big shift in consumption of data from display to non-display activities reflecting the ongoing automation of activities using market data (including algorithmic trading) driven through technological developments. Complex trading algorithms, some with machine-learning capabilities, first replaced trades where the price of what was being sold was easy to determine on the market. These new data users (e.g. quant, robotic, and artificial intelligence systems) require constant investments in hardware and software by trading venues in order to keep up with the new technologies used by these systems. The industry is currently in a transition period from a human-driven world (terminal use of data) into a more digital-driven world (electronic use of data). The structural changes due to digitalisation also impact competition with trading venues. For example, in the case of equity markets, trading venues provide data enabling direct or indirect competitors to disintermediate these markets. While trading venues are at the forefront of transparent, secure, and

stable markets, we lack the same contributions from less transparent markets. Market data is an essential element of efficient price discovery and helps support fair and efficient markets.

Besides a shift in consumption of data from display to non-display activities, also new types of unregulated data providers are emerging with a different (new) type of earnings model. In a vast majority of cases, if a website displays market data, the website derives commercial benefits from it, such as search engines, online platforms, and media/TV companies as well as financial institutions driving footfall to attract customers to other paid services. The revenue model might be indirect (e.g. advertising with the number of clicks, or the number of subscriptions from the same page where traffic converged thanks to market data). Furthermore, Big tech companies are now also entering the data products market by offering and disseminating the market data over the cloud that has the potential to become the new market places for financial market data.

FESE encourages ESMA to clarify the concept of “data service providers” in order to understand if they would be subject to the existing EU regulatory framework or if they are left unregulated.

Q7 What implications, if any, do changes in value chains (e.g., more fragmented value chains) have on your own activities? To which extent are you taking an active role in these changes?

The usage of third-party service providers allow exchanges to provide our core services more efficiently and a reduction of costs. The adoption of new technologies creates additional growth opportunities, fosters operating efficiency, and enhances customer experience. Exchanges will continue to invest in cloud technology, distributed ledger technology (DLT), and other clearly defined areas.

Concerning Cloud technologies, exchanges are following a “multi-cloud” strategy, in order to manage the inherent risk of “vendor lock-in” effects.

As a general remark, in the fast-changing world of new technologies, it often makes sense for financial firms to incorporate the specialized knowledge of third-party service providers to offer better services to clients. Some of this knowledge/expertise would be difficult to adhere to for every financial firm at the same level. Furthermore, this also contributes to a high level of security as third-party service providers must provide state of the art technology when it comes to security, to be competitive.

Q8 Do you see new or exacerbated risks (e.g., to investor protection, financial stability, market integrity, security or level playing field) in relation to the reliance on technology firms by financial firms?

As a general remark, we would highlight that the principles of technology neutrality, level playing field, and “same business, same risks, same rules” should apply to uphold the values of transparency, fairness, stability, investor protection, and market integrity.

Cloud services are becoming increasingly important for trading venues. In today’s practice, financial entities use third-country service providers as a common practice. We recognise the limited number of providers but, to favour innovation and not lose competitiveness on an international level, it is crucial that the EU market remains open to non-EU cloud service providers. Acknowledging the context, we would like to put emphasis on the asymmetries of power in negotiation between customer and service providers (i.e. the extraordinary efforts and time required to agree on regulatory compliant contracts with cloud services providers in the financial sector). Therefore, we actively support the EU’s work on regulatory minimum standards to be included in

contracts with critical third-party service providers included in the Digital Operational Resilience Act (DORA) and the Commission proposal to design “Voluntary Standard Contract Clauses” to facilitate future negotiations.

Q9 Do you see new or exacerbated risks (e.g., to investor protection, financial stability, market integrity, security or level playing field) in relation to the provision of financial services by technology companies?

Q10 Do you see new or exacerbated risks (e.g., to investor protection, financial stability, market integrity, security or level playing field) in relation to the collection, use and dissemination of financial market data by unregulated data service providers?

FESE sees new risks in relation to the collection, use, dissemination, and consumption of financial market data by and through unregulated data service providers. The majority of financial market data is consumed through unregulated market data providers. For instance, trading venues’ market data is often aggregated and complemented by market data redistributors and vendors. As such, ESMA rightly acknowledged in 2014¹ that there is a risk that any price reduction at the trading venue level will not be passed on to the end-users and noted that data vendors and connectivity providers are not within the scope of MiFID II/MiFIR.

This results in less transparency and an opaque operating environment. More transparency on the total market data bill borne by end-users is sorely needed and key to making progress in this important and complex debate. The vast majority of users source their data indirectly from non-regulated intermediaries and most of those do not support granular data disaggregation.

In addition, there is a large share of OTC data which represent a risk for investors and the quality of the market in general. Lack of quality OTC data makes it difficult for unregulated data providers to offer such data to clients, resulting in less transparent markets. Furthermore, the lack of OTC data quality will prevent the emergence of a consolidated tape that can be useful for investors. Therefore, OTC data quality should be brought up to the same standard as that of trading venues.

Besides the above-mentioned issue on market data collection and consumption, we would draw your attention also to other types of activities like social and mirror trading that should be scrutinised by regulators and authorities. Not only does it have the potential to destabilise market integrity, but it could negatively impact most private investors following such trading practices. In this regard, we support clear rules and supervisory practices. In particular, concerning OTC retail products sold to private investors and in terms of enforcement of rules applicable to online advertising. Clear rules and supervision would avoid mis-selling of complex financial products usually not traded on regulated markets neither collateralized, including CFDs and binary options. ESMA has already highlighted the lack of transparency related to the marketing and distribution of OTC retail products, including CFDs and binary options. In this regard, suitability assessment and client categorisation methodologies used by online platforms should be carefully assessed, ensuring that ESMA indications are applied. According to the latter, CFDs providers should de-incentivise their retail clients to ask with ease-of-use the status of professional client (ref. Statement of ESMA on the Application of Product Intervention Measures under Article 40 and 42 of Regulation EU 600/2014 by CFD providers)”

Further, social media platforms offering market access or online brokers should provide full transparency on risk-checks, investor profiling, disclosure of costs, and any agreement in place providing for no-fee trading (including PFOF, routing of orders, etc.).

On-line investment brokers, platforms, or apps that offer execution-only services to retail investors are subject to the relevant investor protection rules for such services under the MiFID II/R framework. While such online investment platforms may offer advantages for retail investors, including low fees level and ease of access to a large variety of investment products, they may also present risks (e.g. in case of inadequacy of appropriateness checks, lack of understanding of individual investors, lack or inadequate disclosure of costs, etc.).

¹ESMA. “*Technical Advice to the Commission on MiFID II and MiFIR.*” Paris, 2014.

Q11 Do you consider that some adaptations to the EU regulatory framework are needed to address the risks brought by changes in value chains?

Q12 Do you consider that some adaptations to the EU regulatory framework are needed to unlock the benefits brought by changes in value chains?

Q13 Do you consider that there is a need to enhance supervisory practices, e.g., cross-border or cross-sectoral cooperation, in relation to changes in value chains?

FESE believes that coordination between the authorities on all levels becomes increasingly important. However, we would also highlight the need for increased efficiency in contrast to adding more complexity. We acknowledge the work of the EU institutions on DORA to address possible concentration risks if many financial institutions rely on the same third-party service provider, especially with regards to big techs. In such cases, systemic risks of the financial sector could swap over to these critical third-party service providers. Further, sector-specific rules should have precedence over cross-industry rules (e.g. NIS2 / CER), therefore a “lex specialis approach” should be taken.

From a more general perspective, this oversight approach could be used as a blueprint for big techs activities also in other sectors. Small EU countries might not possess the necessary resources for in-depth oversight activities of Big techs.. Instead, it should safeguard the approach of “same activity, same risk, same rules”, enforcing the existing and upcoming rules (Digital Markets Act (DMA) and Digital Service Act (DSA)) also to these new platform companies. The European oversight approach for the financial sector could be adapted also for other sectors. With regards to regulatory data supervision, we agree that templates and formats for reporting requirements need to be harmonised. Financial Markets Infrastructures (FMIs) are subject to strict and detailed incident reporting requirements, which are mandated by their primary regulator in the jurisdiction they operate in. This regime has been in place for many years and has worked well so far. Changing the approach to create a centralised reporting structure, while seemingly an attractive option because of the uniformity, might, in reality, introduce issues due to lack of familiarity with and understanding of local markets. Primary financial regulators should remain responsible for FMIs in the jurisdiction they operate in. Furthermore, regulators across multiple jurisdictions should work to harmonise their testing requirements.

Q14 Which recommendations, if any, would you make to EU regulators/supervisors to address opportunities and challenges brought by changes in value chains?

As technologies and use-cases are currently evolving rapidly, it is difficult for any rule-setting authority to act properly, without accurate and up-to-date information about the trends in the markets. From the perspective of market participants, this can lead to uncertainty about whether and how the use of any new technology and the corresponding products and services are/will be regulated. In consequence, this uncertainty on both ends can delay investments and prevent economic growth or even lead to an unordered situation, which can be at the expense of the consumers and to the detriment of trust in new technologies. Experience from FESE Members indicates that the constant dialogue between companies/business associations and regulators/competent authorities is a beneficial solution for this problem. Companies are called to explain their concrete use-cases to authorities, in order not only to make them aware of new trends but also to support the evolvement of the regulatory framework. As a precondition, authorities should have the capacity to be involved effectively in these discussions, to process the information and to provide a clear regulatory framework addressing possible risks without hampering innovative developments.

Q15 Do you have any other observations or comments in relation to changes in value chains?

2. Platforms and bundling of various financial services

Q16 Do you have examples of platforms bundling different financial services from different financial firms in the EU? If so, please provide a brief description of the most prominent ones.

Q17 Do you consider that the use of platforms by financial firms for the marketing or the conclusion with customers of financial products and services is widespread in the EU? Do you observe an increase in the use of platforms compared to pre-Covid?

Q18 (To financial firms) As a financial firm, are you using platforms for the marketing or the conclusion with customers of your financial products and services? If yes, please provide a brief description of (i) the types of services provided by the platform, (ii) the arrangement in place with the platform (e.g., are you or the platform responsible for the governance and/or maintenance of the technical infrastructure and the interactions with customers), (iii) the extent and way in which the arrangement is disclosed to the customer, (iv) the tools and processes in place to ensure that the risks attached to the financial products and services are properly disclosed to the customers.

[]

Q19 (Same question to platforms) As a platform, do you facilitate the marketing or the conclusion with customers of financial products and services? If yes, please provide a brief description of (i) the types of services provided to financial firms, (ii) the arrangement in place with the financial firms (e.g., are you or the financial firm responsible for the governance and/or maintenance of the technical infrastructure and interactions with customers), (iii) the extent and way in which the arrangement is disclosed to the customer, (iv) the tools and processes in place to ensure that the risks attached to the financial products and services are properly disclosed to the customers.

[]

Q20 Which key opportunities and challenges do you see in relation to the use of platforms by financial firms?

[]

Q21 Do you consider any of the following risks to be new/exacerbated where financial firms use platforms for the marketing or conclusion with customers of contracts for financial products and services? Please explain (i) risk to financial stability, (ii) risk to investor protection, (iii) risks in relation to conduct of business, (iv) ICT and security risks, (v) money laundering/terrorism financing, (vi) risk to data protection and privacy, (vii) risk to fair competition, (viii) market manipulation, or (ix) other risks.

On a general note, FESE believes that a predictable, consistent and straightforward legal environment should be promoted. As already reiterated, technology neutrality and “same business, same risks, same rules” principles should apply to uphold the values of transparency, fairness, stability, investor protection, and market integrity.

It is important to find a careful balance between “data privacy” and the use of data for public interests. Society can benefit from the larger use of data from various sources, allowing for analysis and monitoring for research and developments purposes. However, not all data can be considered as a ‘common good’ and it is fundamental to consider the incentives that the data originator needs to have in order to produce innovative and valuable data, including a satisfactory yield on their investments. It is, therefore, important not to create disincentives towards data collection/standardisation and product developments, i.e. allowing for commercialisation of data.

Q22 (For financial firms) Which controls, and processes are in place to oversee the specific risks emerging from the use of platforms?

[]

Q23 Do you consider that some adaptations to the EU regulatory framework are needed to address the risks brought by the use of platforms?

Q24 Do you consider that some adaptations to the EU regulatory framework are needed to unlock the benefits brought by the use of platforms?

Q25 Does the use of platforms give rise to any challenges regarding the cross-border supervision of financial sector activities in the EU? Do you consider that there is a need to enhance supervisory practices, including convergence measures, in relation to the use of platforms?

Q26 Which recommendations, if any, would you make to regulators/supervisors to address opportunities and challenges brought by the use of platforms?

3. Risks of groups combining different activities

Q27 Are you aware of mixed activity groups (MAGs), including BigTech groups, whose core business is not financial services but that have subsidiary undertakings that provide financial services in the EU?

FESE wishes to request clarifications surrounding the concept of mixed activity groups (MAGs). Whilst we understand that the Commission aims to provide a framework for coordinated supervision on a cross-sectoral basis for emerging types of mixed activity groups, FESE would caution against separating individual ‘financial firms’ to ‘MAGs’ based on pre-defined activities that would be undertaken. The latter would risk undermining the principle of “same business, same risks, same rules”.

Q28 Which types of financial services do these entities provide?

Q29 In such MAGs, how and to what extent the dependency of a subsidiary financial firm on its parent company and/or other subsidiaries of the same group influences the provision of the financial service?

Q30 Do you see new or exacerbated risks in relation to MAGs?

Q31 Do you consider that there is a risk of unlevel playing field between individual (‘solo’) financial firms and MAGs?

Q32 In your opinion, is the current EU regulatory framework adequate for MAGs?

Q33 Do you consider there is a need for new cooperation and coordination arrangements between financial supervisors and other authorities (data, competition, consumer protection, AML/CFT, cyber) within the EU and/or with 3rd countries in order to ensure effective supervision of MAGs?