

Briefing note

ESMA Q&A on MiFID II and MiFIR market structures topics published by ESMA on 5 April 2017

The European Securities and Markets Authority (ESMA) has published a [Q&A](#) on 5 April 2017 providing further guidance on market structures topics, notably **Organised Trading Facilities (OTF)** and **Systematic Internalisers (SI)**, under MiFID II. Below is a summary followed by a more detailed overview. Previous updates are included in the Q&A.

Organised Trading Facilities:

- **Characteristics:** Prior authorisation for the operation of an OTF is required. Conditions: (i) trading is conducted on a multilateral basis; (ii) the trading arrangements in place have the characteristics of a system, and (iii) the execution of the orders takes place on a discretionary basis.
- **Voice-trading:** MiFID II is technology neutral and the OTF definition includes voice trading in the same way as the definition of regulated markets and MTFs include voice trading systems.
- **MTF v OTF:** OTFs may only trade in non-equity instruments, have less stringent limitations regarding matched principal trading and trading on own account, must exercise discretion and comply with client facing rules.
- **Dealing on own account:** The methodology and criteria for assessing whether a sovereign bond has a liquid market, set out in RTS 2, are also applicable to OTFs dealing on own account.
- **Independent market-making:** The operator of an OTF must have arrangements in place to prevent conflicts of interest from adversely affecting the interests of clients.
- **OTFs and SIs:** MiFID II introduces a blanket prohibition of the combination of the OTF and SI activities by the same legal entity across asset classes and instruments. Two legal entities respectively operating the SI and the OTF should have arrangements in place that prevent information sharing.
- **OTFs and other liquidity pools:** Neither an SI quote nor an order originating from another OTF may be placed on an OTF.
- **Best execution:** Both a firm-level execution policy, and a separate policy outlining best execution on the OTF are required.
- **Discretion:** Applicable only when placing or retracting (“order discretion”, which does not have to be exercised order by order) or deciding not to match orders (execution discretion).
- **Automation:** The exercise of discretion both at execution and order level do not preclude the use of automated systems. However, algorithms are expected to take into account external market factors or other external source of information to demonstrate the exercise of discretion.

Systematic Internalisers:

- Matched principal trading: One of the key characteristic of an SI's activity is to provide liquidity bilaterally to clients by trading at risk. However, SIs which are functionally similar to a trading venue, would need to seek authorization if the following conditions are met: (i) where the SI does not, de facto, undertake risk facing activity; (ii) the arrangements in place are used on a regular basis as opposed to ad-hoc-transactions; and (iii) where transactions arising from multiple third party buying and selling interests are executed OTC.
 - Matched principal trading on an occasional basis: An SI would *not* be undertaking matched principal trading on an *occasional* and *non-regular* basis if it meets *any* of the following criteria: (i) systems or arrangements are *intended* to match opposite client orders; (ii) non-risk facing activities account for a *recurrent* or *significant* source of trading revenue; and (iii) matched principal trading services are marketed.
-

Organised Trading Facilities (OTFs)

Characteristics of OTFs [Question 3]:

- An OTF is a multilateral system as defined in Article 4(1)(19) of MIFID II. [...] Only buying and selling interests in bonds [...] may interact on an OTF **in a way that results in a contract** and [...] the **execution of orders** must be carried out **on a discretionary basis**. OTFs are systems that cross client orders and that arrange transactions and facilitate negotiations between clients.
- Prior authorisation for the operation of an OTF is required, notably where the **three following conditions** are met:
 - a) Trading is conducted on a **multilateral** basis; **trading interest in the system can potentially interact with other opposite trading interests**; on OTFs, the interaction of user trading interest can take place in different ways, **including through matched-principal trading or market-making**, within the limits set out in Article 20(2) and 20(5) of MiFID II.
 - b) The trading arrangements in place have the **characteristics of a system**; a system would be **easily identified when embedded in an automated system, including automated crossing of client trading interests, or repeatable arrangements** that achieve a similar outcome;
 - c) The execution of the orders takes place on a **discretionary basis** through the systems or under the rules of the system; **including where**, once the trade price, volume and terms have been agreed through a firm, the counterparties' names are disclosed, the firm steps away from the transaction and **the transaction is then legally formalized between the counterparties outside a trading venue; if formalized on a regulated market or an MTF, the transaction would not be considered as taking place under the rules of the system** because a transaction cannot be concluded on more than one venue; **the disconnection** between arranging and executing **would not waive the obligation** for the investment firm operating those systems **to seek authorisation as an OTF operator**.
- **Market participants should therefore exercise judgment to assess, based on their business model**, whether they need to seek authorisation for the operation of a multilateral trading facility (MTF), an OTF or, potentially of a regulated market.

OTFs and voice trading [Question 4]:

- MiFID II is technology neutral and **the OTF definition includes voice trading** in the same way as the definition of regulated markets and MTFs include voice trading systems. An investment firm executing transactions through voice negotiation would be considered as falling under the definition of an OTF where the arrangements in place would meet the conditions set out in Answer 3.

Distinction between OTFs and MTFs [Question 5]:

MTFs and OTFs both are multilateral trading systems that can be operated by an investment firm or a market operator. However, compared to MTFs, **OTFs have a number of key distinct features:**

- a) **OTFs may only trade in bonds**, structured finance products, derivatives and emission allowance (non-equity instruments);
- b) There are **less stringent limitations** for the operator of an OTF **regarding matched principal trading and trading on own account**. Also, **an OTF and a SI cannot be operated by the same legal entity**;
- c) As opposed to RMs and MTFs governed by non-discretionary rules, the OTF operator **must exercise discretion** either when deciding to place or retract an order on the OTF and/or when deciding not to match potential matching orders available in the system;
- d) As opposed to RMs and MTFs that have members or participants, **OTFs have clients**. As a consequence, transactions concluded on **OTFs have to comply with client facing rules**, including best execution rules, regardless whether operated by an investment firms or a market operator;

Allowed activities for OTFs: concept of liquid sovereign debt [Question 6]:

- The operator of an OTF may engage in dealing on own account other than matched-principal trading only with regard to sovereign debt instruments that do not have a liquid market.
- ESMA notes that **RTS 2 sets out how to determine whether a financial instrument has a liquid market**, and should serve as a reference, for the purpose of Article 20(3) of MiFID II.

Allowed activities for OTFs: carrying out market making on an independent basis [Question 7]:

- [...] The independence test is met when the investment firm carrying out market making has **no close links with the operator of the OTF** as defined under Article 4(1)(35) of MiFID II.
- ESMA recalls that, under Article 18(4) of MiFID II, an investment firm operating **an OTF must have arrangements in place to prevent conflicts of interest from adversely affecting the interests of clients**.

Operation of an OTF and a SI [Question 8]:

- ESMA is of the view that the very general wording of Article 20(4) of MiFID II **introduces a blanket prohibition of the combination of the OTF and SI activities by the same legal entity across asset classes and instruments**.

Operation of an OTF and a SI [Question 9]:

- ESMA is of the view that the two legal entities respectively operating the SI and the OTF should have arrangements in place that **prevent information sharing** on each other's relevant activities regarding the operation of the OTF and the SI.
- This would **include** for instance **having distinct management and operational teams and physical separation of activities**. Similarly, whereas some elements of the IT infrastructure could be shared, **execution systems would be expected to be segregated** and safeguards in place **to ensure that there is no information leakage across the SI and the OTF activities**.

- Outsourcing from one legal entity to the other should only be considered where the arrangements in place meet a similar test.

Connection of an OTF to other liquidity pools [Question 10]:

- Article 20(4) of MiFID II limits the circumstances under which an OTF may connect with other liquidity pools [...]. Accordingly, **an SI quote may not be placed on an OTF. Nor can an order originating from another OTF.**
- **ESMA highlights that a trading interest in an OTF may not be executed against an opposite order or quote on another execution venue.** For a transaction to take place, the two opposite trading interests must be placed with the same execution venue.
- However, this does not prevent the investment firm or the market operator operating an OTF from retracting the order from the OTF and sending it to another venue (OTF, SI, MTF or RM).

Operation of an OTF and best execution [Question 11]:

- **A firm-level execution policy is required:** Setting out the various execution venues, including its own OTF, that it will be considering when receiving a client order and explain in which circumstances an execution venue would prevail over the others.
- **A separate policy or an additional section in the firm-level execution policy is required with respect to the OTF:** Setting out how the best possible result for the client is achieved taking into account the trading interests [...] and the different execution mechanisms [...].
- [...] The document should also set out in details the area(s) in which the OTF operator intends to exercise discretion and the basis on which such discretion will be exercised (Article 20(6) of MiFID II) in line with its best execution policy.
- Equivalent requirements apply to a market operator operating an OTF.

Does the exercise of any form of discretion mean that a venue is an OTF? [Question 12]:

- No. According to Article 20(6) of MiFID **discretion must be exercised by an OTF only (i) when deciding to place or retract an order on the OTF they operate; and (ii) when deciding not to match a specific client order** with other orders available in the systems at a given time [...].
- ESMA understands “execution on a discretionary basis” and “exercise of a discretion” as meaning that [...] the operator of the OTF has **options to consider** for the execution of a client’s order and exercises a judgement as to the decision to make and the way forward. **The exercise of discretion can therefore usefully be split into a) order discretion and b) execution discretion.**
- **Exercise of discretion at order level** refers to the judgement exercised by the OTF operator **whether to place the order at all** on the OTF, whether to place **the whole order or just a portion** of it on the OTF, **and when** to do so. [...] Where clients would be providing a specific instruction to the operator of the OTF, the OTF operator would not be considered as exercising order discretion when complying with that specific instruction.
- **Exercise of discretion at execution level** has to be **in compliance with client specific instructions and the best execution policy.** ESMA is of the view that the mere implementation of client specific instructions or of best execution obligations would not be the exercise of discretion. **The operator of the OTF is expected to exercise a judgement as to if, when, and how much of two matching orders in the system should be matched.**
- Finally, ESMA highlights that [...] **discretion has to be actually implemented by the operator of the OTF as part of its ordinary course of business and should be a key part of its activities. It is not expected that any quantitative threshold would be set to assess the exercise of discretion.**

- The operator of an OTF should be able to provide to its national competent authority a detailed **description of how discretion will be exercised** [...] and explain the **rationale underpinning the exercise of discretion**, such as the set of reasons and the logical basis for not matching two opposite buying and selling interests.
- Random placing, retracting, matching or non-matching of orders on the OTF **would not** be considered as the exercise of discretion. Nor would the exercise of pre-trade controls by the operator of the OTF to ensure fair and orderly trading; or post-trade decisions, for example over where transactions are settled.

Does discretion have to be exercised on an order by order basis? [Question 13]:

- ESMA is of the view that discretion at order level (see Answer 12) **does not have to be exercised order by order**. However, the OTF operator must have the ability to exercise discretion at order level if circumstances so require, for instance in case of prior execution of an order on another trading venue.
- Conversely, ESMA is of the view that, at execution level, discretion whether not to match two potential matching buying and selling interests can only be meaningfully exercised at order level.

Does a fully automated system exclude the exercise of discretion and should therefore be automatically classified as an MTF? [Question 14]:

- No. **MiFID II is 'technology neutral'** and permits any trading protocol to be operated by an OTF, provided it is consistent with fair and orderly trading and the exercise of discretion.
- ESMA is of the view that **the exercise of discretion** as to if and when to place or retract an order **could possibly be automated** through artificial intelligence and algorithms, without necessarily the exercise of human judgement on a case by case basis. [...]
- [...] ESMA is of the view that the **exercise of discretion at execution level would not preclude the use of automated systems**, provided that certain conditions are met. In particular, the sophisticated algorithms supporting automated matching would need to anticipate the circumstances under which the orders would not be matched [...].
- As one of the **differentiating factors** from execution algorithms operated by MTFs, **the algorithms operated by the OTF would be expected to take into account external market factors or other external source of information** to demonstrate the exercise of discretion.

Systematic internalisers (SI) and riskless transactions

SI and matched principal trading [Question 15]:

- ESMA clarifies that the **key characteristic** of an SI's activity is to **provide liquidity bilaterally to clients by trading at risk**. However, **SIs which are functionally similar to a trading venue**, would need to seek **authorisation**. This would be the case for SIs meeting the following criteria:
 - a) Where arrangements between the SI and a client go **beyond a bilateral interaction** and where the SI **does not, de facto, undertake risk facing** activity;
 - b) Where the arrangements in place are used **on a regular basis and qualify as a system or facility**, as opposed to ad-hoc transactions; and
 - c) Where transactions arising from bringing together multiple third party buying and selling interests are **executed OTC**, outside the rules of a trading venue.

- ESMA highlights that the above does not prevent SIs from hedging the positions arising from the execution of client orders as long as it does not lead to the SI de facto executing non riskfacing transactions and bringing together multiple third party buying and selling interest

Providing matched principal trading on an occasional basis [Question 16]:

- ESMA is of the view that an SI would not be undertaking matched principal trading on an occasional and non-regular basis if it meets any of the following criteria:
 - a) The investment firm operates one or more **systems or arrangements**, be they automated or not, **intended to match opposite client orders**. The investment firm may accidentally receive two opposite matching buying and selling interests and match them but it should not have systems in place aimed at increasing opportunities for client order matching;
 - b) When executing client orders, **non-risk facing activities account for a recurrent or significant source of revenue for the investment firm's trading activity**;
 - c) The investment firm markets, or otherwise promotes, its matched principal trading activities.

Prepared by:
Gabriel Callsen, ICMA, April 2017

This paper is provided for information purposes only and should not be relied upon as legal, financial, or other professional advice. While the information contained herein is taken from sources believed to be reliable, ICMA does not represent or warrant that it is accurate or complete and neither ICMA nor its employees shall have any liability arising from or relating to the use of this publication or its contents. Likewise, data providers who provided information used in this report do not represent or warrant that such data is accurate or complete and no data provider shall have any liability arising from or relating to the use of this publication or its contents. © International Capital Market Association (ICMA), Zurich, 2017. All rights reserved.