esma European Securities and Markets Authority

MiFID II Review Report

MiFID II review report on the functioning of Organised Trading Facilities (OTF)

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Acronyms and definitions used

AIFM	Alternative Investment Fund Managers
AIFMD	Directive 2011/61/EU of the European Parliament and the European Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010
APA	Approved Publication Arrangement
BCN	Broker Crossing Networks
CP	Consultation Paper
EC	European Commission
EMIR	Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories
EMS	Execution Management Systems
ESMA	European Securities and Markets Authority
EU	European Union
FITRS	Financial Instruments Transparency System
MiFID I	Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC
MiFID II	Markets in Financial Instruments Directive (recast) - Directive 2014/65 of the European Parliament and of the Council
MiFIR	Markets in Financial Instruments Regulation – Regulation 600/2014 of the European Parliament and of the Council
MPT	Matched principal trading
MTF	Multilateral Trading Facility
NCA	National Competent Authority
OMS	Order Management Systems
OTC	Over-the-counter
OTF	Organised Trading Facility
Q&A	Question and answer

RFQ	Request for quote
RTO	Reception and Transmission of Orders
RTS	Regulatory Technical Standard
RTS 10	Commission Delegated Regulation (EU) 2017/573 of 6 June 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council on markets in financial instruments with regard to regulatory technical standards on requirements to ensure fair and non-discriminatory co-location services and fee structures.
SI	Systematic Internaliser
TOTV	Traded on a Trading Venue
UCITS Directive	Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulation and administrative provisions relating to undertakings for collective investment in transferable securities
UCITS ManCo	Undertakings for Collective Investment in Transferable Securities Management Companies

1 Executive Summary

Reasons for publication

Directive 2014/65/EU[1] (MiFID II) and Regulation (EU) No 600/2014[2] (MiFIR) provide for a number of review reports requiring the European Commission (EC), after consulting ESMA, to present a report to the European Parliament and the Council on various provisions. This final report covers the review provision on the functioning of Organised Trading Facilities (OTFs) set out under Article 90(1)(a) of MiFID II. More specifically, this report looks at the number of OTFs authorised in the Union and their market share, examines whether any adjustment to the definition of OTFs is needed and observes their use of matched principal trading (MPT).

Contents

This final report contains proposals aiming at clarifying the MiFID II provisions relating to OTFs and, more generally, multilateral systems to ensure efficient EU market structures and to enhance the level playing field between all firms operating in the EU while reducing the level of complexity for market participants.

Section 2 provides an introduction to the report. Section 3 presents a quantitative analysis of trading on OTFs, including the evolution in volumes traded on OTFs since the application of MiFID II, with a focus on OTF trading in bonds and derivatives.

Section 4 focuses on the definition of an OTF, taking particular note of the definition of a multilateral system. The section also analyses more broadly the boundaries of trading venues' authorisation and includes recommendations aiming at promoting a level playing field in this area. In particular, the report includes a two-step approach with a recommendation to the EC to move Article 1(7) from MiFID II to MiFIR and the proposal for ESMA to publish an Opinion to provide guidance on the trading venue authorisation perimeter. Furthermore, the report recommends to the EC to add a definition of bulletin boards to MiFID II. Section 4 also analyses the use of discretion by OTFs noting that the current regulatory framework remains appropriate.

Finally, Section 5 discusses matched principal trading (MPT) and presents evidence on how OTFs have been making use of MPT, based on a fact-finding exercise performed by ESMA. It also includes a recommendation to align the provisions regarding the prohibition of the use of MPT amongst the different types of trading venues.

Next Steps

This report is submitted to the European Commission and is expected to be taken into consideration by the European Commission for further legislative proposals on the MiFID II regime.

ESMA stands ready to provide additional technical advice on the legislative amendments suggested in the report.

Disclaimer

Data analyses derived from data from the Financial Instruments Transparency System (FITRS) are based on data provided by trading venues, approved publication arrangements (APAs) and National Competent Authorities.

Therefore, in addition to performing its own data quality checks ESMA relies on those reporting entities in respect of the completeness and accuracy of the submitted data. Delayed or incorrect provision of the relevant data may affect the completeness and accuracy of the information displayed in this report.

[1] Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (recast)
[2] Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012 (OJ L 173, 12.6.2014, p. 84).

2 Introduction

Article 90(1) of MiFID II:

Before 3 March 2019 the Commission shall, after consulting ESMA, present a report to the European Parliament and the Council on:

(a) the functioning of OTFs, including their specific use of matched principal trading, taking into account supervisory experience acquired by competent authorities, the number of OTFs authorised in the Union and their market share and in particular examining whether any adjustments are needed to the definition of an OTF and whether the range of financial instruments covered by the OTF category remains appropriate;

[…]

1. MiFID II and MiFIR require the European Commission (EC) to present reports to the European Parliament and the Council, after consulting ESMA, on a number of provisions. This report concerns the functioning of Organised Trading Facilities (OTFs) required under Article 90(1)(a) of MiFID II.

2. The deadline set in Article 90 of MiFID II (3 March 2019) has been modified, in agreement with the EC, due to the impact of Brexit and the Covid-19 crisis[3].

3. ESMA published a consultation paper[4] (CP) with its preliminary findings and proposals on 25 September 2020. During the 2-month period during which the consultation was open, ESMA received 39 responses from a great variety of different areas within the financial markets industry. The final proposals presented in this report take into account the feedback received in the course of this public consultation.

4. In Section 3, this report provides an overview of the evolution of the trading activity on OTFs following the application of MiFID II / MiFIR. The section includes a detailed analysis of those asset classes where OTF trading volumes are more relevant. ESMA further provides an overview of the current landscape, regarding (i) the OTFs currently authorised in the European Union (EU), (ii) the instruments offered for trading and (iii) the most common type of trading systems used.

[3] An overall planning for the MiFID II/MiFIR review reports is available on the ESMA website (here).
[4] Consultation Paper on the functioning of Organised Trading Facilities (OTF) (ESMA-70-156-2013) https://www.esma.europa.eu/sites/default/files/library/esma-70-156-2013_consultation_paper_on_the_functioning_of_organised_trading_facilities.pdf

5. Section 4 of the report discusses the OTF definition and analyses "trading venue boundaries". For this purpose, the report examines in detail the definition of multilateral systems and the implications of the changes introduced in MiFID II with regard to trading venues' authorisation. Considering that the concept of multilateral system and the changes introduced by MiFID II are not limited to OTFs, and that it is not possible to disentangle the definition of OTFs, the concept of multilateral system and the overall trading venue authorisation perimeter, this report keeps the approach taken in the CP and analyses the implications of the MiFID II regime on the overall EU market structures, including regulated markets and Multilateral Trading Facilities (MTFs). Finally, Section 4 provides an overview of the use of discretion by OTFs, based on a fact-finding exercise undertaken by ESMA in Q2 2020.

6. Section 5 of the report focuses on the use of matched principal trading and discusses the extent to which OTF operators make use of matched principal trading in bonds, structured finance products, emission allowances and certain derivatives.

3 Overview of OTF trading

7. One of the main objectives of MiFID II was to extend the principles of organisation and transparency applying to equities to bonds and derivatives. In this respect, the OTF concept was established in order to fill an existing gap, aiming to extend the definition of trading venue to those organised facilities offering trading in non-equity instruments.

8. According to the feedback received to the consultation paper, the implementation of the OTF regime under MiFID II was successful. The OTF has proven to be a positive new concept, useful and efficient in capturing a part of bond and derivative markets which would otherwise be traded over-the-counter (OTC). The table below presents the current landscape of active OTFs in the EU.

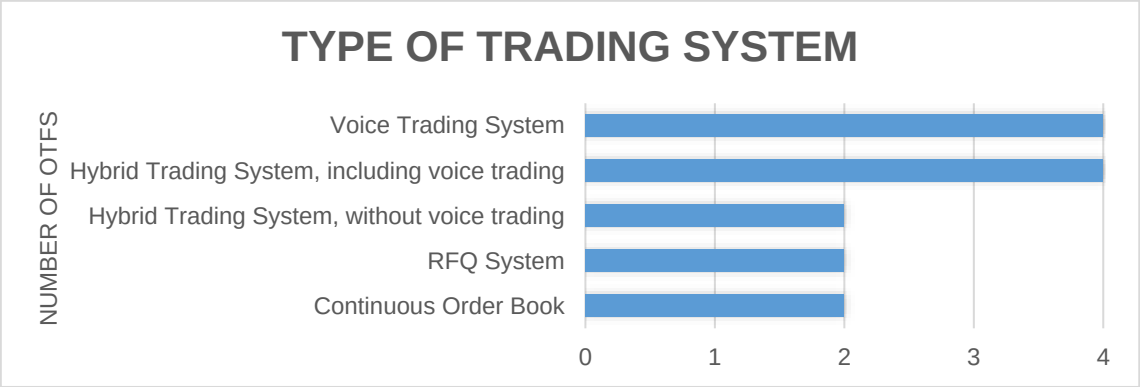
TABLE 1: CURRENT LANDSCAPE OF ACTIVE OTFS

COUNTRY	NAME OF OTF
CZECHIA	42 FINANCIAL SERVICES
FRANCE	KEPLER OTF
FRANCE	TSAF OTC OTF
FRANCE	HPC SA OTF
FRANCE	AUREL BGC OTF
FRANCE	TULLETT PREBON EU OTF
GERMANY	EEX OTF
IRELAND	MAREX SPECTRON EUROPE OTF

NETHERLANDS	TRADEWEB OTF
NETHERLANDS	AFS OTF
NETHERLANDS	OHV OTF
POLAND	POLISH POWER EXCHANGE
SPAIN	CIMD OTF
SPAIN	CAPI OTF

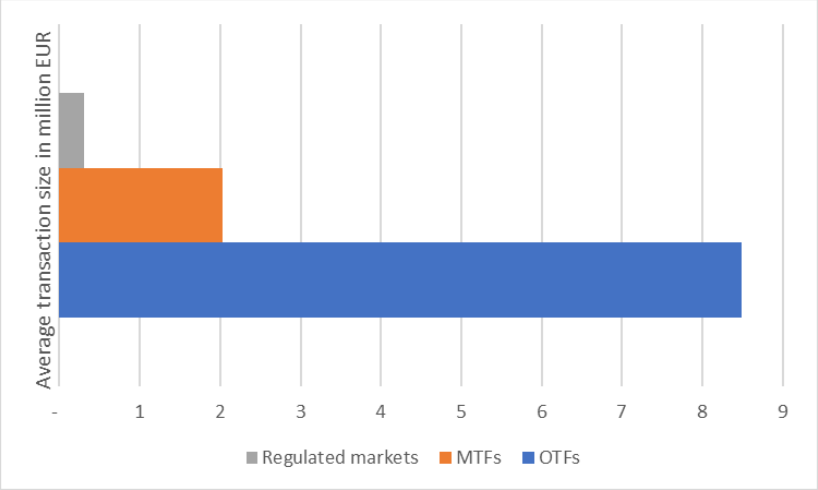
9. In the opinion of the majority of respondents to the consultation paper, the OTF concept rightly acknowledged that trading systems, including voice trading systems, needed specifically tailored regulatory requirements. Furthermore, the OTF regime has shown the effectiveness of the use of discretion and how it plays an important role in non-equity trading price discovery. The distribution of the type of systems used by OTFs is shown in the figure below.

FIGURE 1: TRADING SYSTEMS OF OTFS



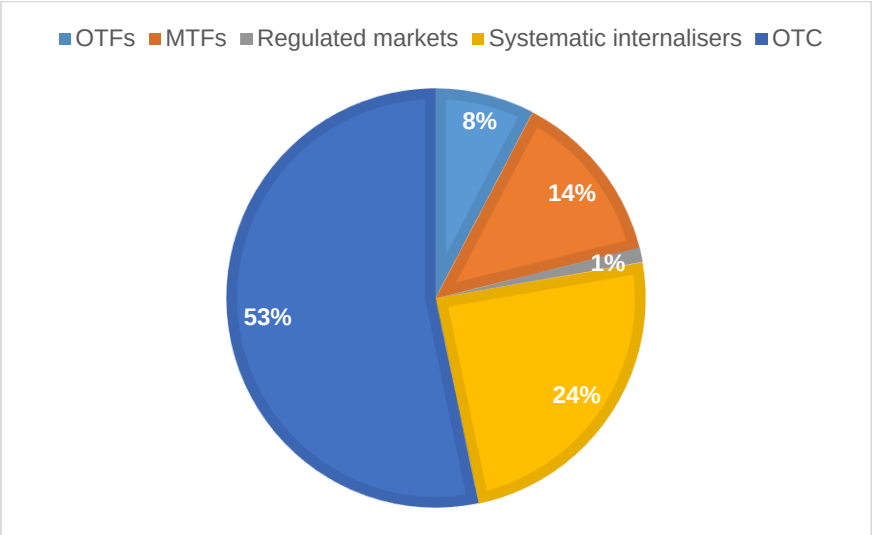
10. Trading on OTFs mainly takes place in bonds and derivatives. Wholesale market participants choose to trade on OTFs mainly for the market knowledge and network, which allow them to execute larger transactions, while limiting transaction costs. According to the feedback received, OTFs play a key role especially in the interdealer market, allowing dealers to manage risks effectively. This is confirmed by the data reported to the ESMA Financial Instruments Transparency System (FITRS), where the average transaction size that takes place on an OTF is significantly larger than on other types of trading venues.

FIGURE 1 AVERAGE TRANSACTION SIZE IN BONDS PER TYPE OF TRADING SYSTEM 2018-2019[5]



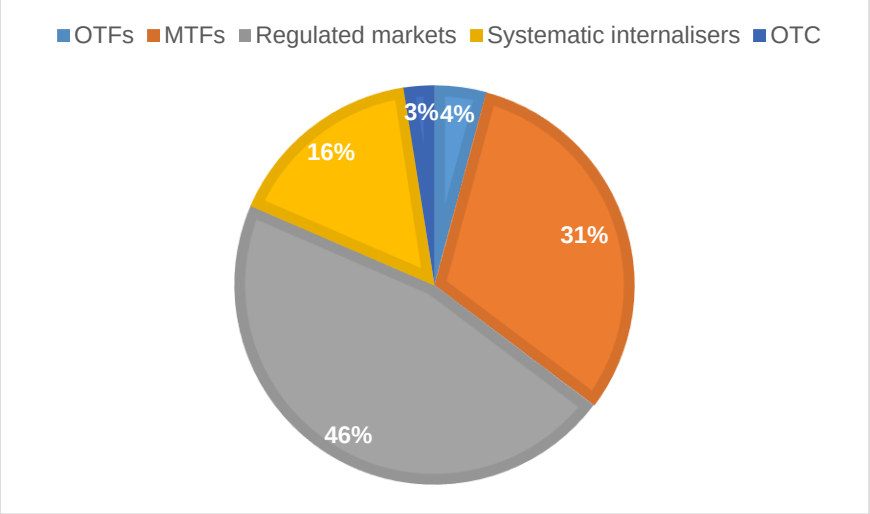
11. According to respondents, the stable OTFs' market share demonstrates that, despite the rise of electronification of trading, the human factor (which is prominent in OTFs) remains key, particularly for large and complex transactions. The share of trading on OTFs in bonds and derivatives reported to FITRS in 2018 and 2019 is presented in the graphs below.

FIGURE 2: BOND VOLUMES PER TRADING SYSTEM DURING 2018-2019[6]



[5] Figure includes data from the UK.
[6] Figure includes data from the UK.

FIGURE 3: DERIVATIVES VOLUMES PER TRADING SYSTEM DURING 2018-2019[7]



Source: FITRS. Only TOTV derivatives are considered, therefore OTC volumes are understated

12. Regarding future expectations, several respondents foresee OTFs to further continue to use technology developments to enhance their offerings across trade lifecycles. Few respondents think that the number of registered OTFs will increase in the future, while others state that the number and volumes of activity should remain stable.

4 OTF definition and trading venue boundaries

4.1 Legal framework and general background

13. Market infrastructures have evolved over the years from traditional exchanges to include other types of organised systems also supported by detailed rules where members could interact and deal in financial instruments. Throughout the years, co-legislators have extended the regulatory perimeter defining a trading venue, from traditional exchanges to other trading facilities. The main objective of such measures was to promote more competitive markets while ensuring fair and orderly trading, market integrity and a level playing field within financial markets.

14. Directive 2004/39/EC on markets in financial instruments[8] (MiFID I) provided for a new type of alternative multilateral trading system that operates in a similar way to exchanges (or regulated markets in MiFID terminology). These are the MTFs[9] and their definition was

[7] Figure includes data from the UK.
[8] Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC (OJ L 39, 28.04.2006, p.1).
[9] Article 4(22) of MiFID II: "'multilateral trading facility' or 'MTF' means a multilateral system, operated by an investment firm or a market operator, which brings together multiple third-party buying and selling interests in financial instruments – in the system and in accordance with non-discretionary rules – in a way that results in a contract in accordance with Title II of this Directive".

similar to that of regulated markets[10], characterised by systems that operate in accordance with non-discretionary rules bringing together multiple buying and selling trading interests in a way that results in a contract. This definition however was not covering all multilateral systems and in particular those that brought together buying and selling interests but which exercised discretion when matching orders and therefore operated outside the trading venue regulatory perimeter (e.g. certain Broker Crossing Networks or BCNs).

15. As a response to the 2008 financial crisis and in light of the G20 commitment to move trading to organised, multilateral venues, in particular taking into account the role of non-equity markets in the crisis, MiFID II introduced a new type of trading venues aimed at capturing those multilateral systems that, by using discretion in matching orders, were not categorised as regulated markets or MTFs and, hence, operated outside the perimeter of MiFID I. The objective of the introduction of such venues was to bring more trading to regulated venues in order to increase market transparency, add more quality to the price discovery process, increase investor protection and access to liquidity. This also aimed at contributing to levelling the playing field between entities offering multilateral trading services.

16. MiFID II requires this new type of trading venue to exercise discretion in the execution of orders recognising the important role played by interdealer brokers for the execution of less liquid instruments. In order not to create further fragmentation in the equity space, MiFID II limits its scope to non-equity instruments.

17. OTFs are defined in Article 4(23) of MiFID II as “a multilateral system which is not a regulated market or an MTF and in which multiple third-party buying and selling interests in bonds, structured finance products, emission allowances or derivatives are able to interact in the system in a way that results in a contract in accordance with Title II of this Directive”.

18. A common feature between regulated markets, MTFs and OTFs is that they are multilateral systems where trading interests are able to interact in the system in a way that results in a contract. What differentiates OTFs from the other type of trading systems is the requirement for the operator to exercise discretion when executing orders.[11] This section of the report provides an analysis of the two key concepts of the definition of OTFs, the concept of multilateral system and the use of discretion by OTFs.

19. Despite the report being overall focused on the OTF regime, it is not possible to disentangle the concept of multilateral system from the more general issue of trading venues’

[10] Article 4(21) of MiFID II: “‘regulated market’ means a multilateral system operated and/or managed by a market operator, which brings together or facilitates the bringing together of multiple third-party buying and selling interests in financial instruments – in the system and in accordance with its non-discretionary rules – in a way that results in a contract, in respect of the financial instruments admitted to trading under its rules and/or systems, and which is authorised and functions regularly and in accordance with Title III of this Directive”.
[11] As a consequence of the exercise of discretion, transactions concluded on an OTF have to comply with the client facing rules set out in Article 24, 25,27 and 28 of MiFID II.

authorisation. ESMA therefore keeps in this report the approach taken in the CP and does not limit the analysis and proposals in this section to OTFs but expands to all types of trading venue.

4.2 Multilateral Systems

A. Background

20. In the CP, ESMA signalled the changes introduced by MiFID II to the trading venue landscape. In particular, and in line with the objective of extending the regulatory perimeter of trading venues, MiFID II introduces a definition of multilateral systems which is common to any type of trading venue. The definition is specified in Article 4(19) of MiFID II: a multilateral system "means any system or facility in which multiple third-party buying and selling trading interests in financial instruments are able to interact in the system".

21. Furthermore, MiFID II complemented the definitions of regulated market, MTF and OTF, together with the definition of multilateral system with an obligation for all multilateral systems to operate under a trading venue authorisation, either as a regulated market, MTF or OTF (depending on the asset class). Such requirement is spelled out in Article 1(7) of MiFID II[12].

22. ESMA understands that the combination of the changes introduced in MiFID II, notably the obligation under Article 1(7) of MiFID II and the definition of a multilateral system under Article 4(19), has the effect of recognising that any multilateral system must request authorisation as a trading venue. That means that any multilateral system should operate in accordance with the definitions of regulated market, MTF or OTF, regardless of the changes the facility needs to incur to comply with the requirements associated with the operation of a trading venue. Therefore, the mere fact that the facility does not fall within the definition of any type of trading venue does not mean that such facility is outside of the trading venue boundaries. Operating in accordance with the multilateral system definition is sufficient to be required to seek authorisation as a trading venue.

23. In addition, regarding systems operating in a similar way to a trading venue but without proper authorisation, ESMA considers that any system that allows third party trading interests in financial instruments to interact, including information exchange between parties on essential terms of a transaction (being price, quantity) with a view to dealing in those financial instruments is sufficient to require authorisation as a trading venue. The information exchanged does not need to lead to a contractual agreement within the system between parties for the interaction to occur.

[12] Article 1(7) of MiFID II: "All multilateral systems in financial instruments shall operate either in accordance with the provisions of Title II concerning MTFs or OTFs or the provisions of Title III concerning regulated markets. (…)"

24. Despite the fact that clear language was introduced in MiFID II regarding the conditions under which a facility has to seek an authorisation as a trading venue, ESMA put forward in the CP a two-way approach in order to (1) provide market participants with legal certainty in the long term by proposing an amendment to Level 1, and (2) have a short term solution by publishing an ESMA Opinion clarifying the boundaries of trading venue's authorisation.

25. Regarding the amendments to Level 1 texts, and in order to ensure more legal certainty, to foster EU-wide consistency and convergence in the application of the framework, and to avoid any issues with transposition, ESMA proposed in the CP that 1) the obligation set out in MiFID II in Article 1(7) is moved into MiFIR, and 2) this obligation is worded as a prohibition so as to make it suitable for direct applicability in Member states. The CP proposed to that the following could be stipulated in MiFIR:

    1) It is forbidden to operate any type of multilateral system that does not also fit the definition of a regulated market, MTF or OTF; and

    2) All multilateral systems in financial instruments are required to seek authorisation as a regulated market, MTF or OTF and where necessary modifying their operating arrangements to comply with the applicable trading venue definition.

26. Regarding the publication of the Opinion, ESMA proposed in the CP to further clarify the conditions under which a facility should request authorisation as a trading venue.

B. Feedback to the consultation

27. There was a significant split in views amongst respondents in relation to ESMA's proposed amendment of Level 1. Those respondents who agreed with ESMA's proposal were mostly trading venues. On the other side of the spectrum, there were market participants from both the buy- and sell-side as well as technology providers who did not agree with ESMA's proposal to change Level 1 nor with its interpretation of the application of Article 1(7) and 4(19) of MiFID II.

28. Respondents who concur with ESMA, believe it is necessary to move Article 1(7) from MiFID to MiFIR and emphasize that, in order to prevent regulatory arbitrage, a broad interpretation of the trading venue perimeter is necessary. However, these respondents underline that the regulatory framework is clear and existing regulation should be enforced rather than changed. Some of these respondents call for ESMA to gain additional enforcement powers in order to be able to create a level playing field in the EU.

29. On the other hand, those who do not agree with ESMA's proposal are of the view that the interpretation of the trading venue perimeter as presented in the consultation paper is too broad and would capture a number of software providers and other fintech companies that in their view should not be regarded as trading venues. Some respondents, despite disagreeing with ESMA's broad interpretation, would still see a need for clarification of

some aspects of the regulatory framework. These respondents are however not very clear as to which aspects would deserve further attention from legislators.

30. Feedback received from stakeholders also points out that in their view where a broker only arranges trades that are ultimately crossed on a trading venue this should not require authorisation as a trading venue. The argument presented is that the objective of MiFID II is to bring more trading to multilateral platforms and that this is achieved when the ultimate execution of the transactions is carried out on a venue even when arranged via a broker.

31. A small number of participants are of the view that where a system enables the interaction of many counterparties with one entity, such as the case of Request For Quote (RFQ) systems, that should not be considered as a multilateral system since, in their view, such a system provides for a multitude of bilateral interactions rather than a single multilateral interaction.

32. On ESMA's two-step approach, a slight majority of respondents disagree with ESMA's view.

33. Most of the respondents who disagree with ESMA's approach do not question the need for additional guidance but rather question the supervisory tool proposed by ESMA. These respondents call for further consultation with the industry which, in their view, may not be the case with an ESMA Opinion. The most suggested approach is for ESMA to develop Regulatory Technical Standards (RTS) to allow for a wide industry consultation and give more legislative strength to any measures taken in this area.

34. To note that a small number of respondents reiterate their view that ESMA should clarify that an RFQ is not a multilateral system and that enforcement of existing rules would tackle the issue effectively.

35. Finally, a broad range of respondents from a wide variety of activities and regardless of their views on ESMA's proposals converge in two aspects: firstly the need of further enforcement measures from NCAs rather than a revamp of the legislative framework; and, secondly, the importance for ESMA to further consult the industry when taking this subject further.

C. ESMA's assessment and recommendations

36. ESMA notes that a significant number of respondents agree with the proposal to move Article 1(7) of MiFID II to MiFIR whilst noting at the same time that the legislative text as it stands is quite clear and does not require significant changes. In light of the feedback received, ESMA proposes to keep its proposal to move Article 1(7) of MiFID II to MiFIR, in order to avoid any issues of transposition into national law, but also takes on board the feedback received to keep the legislative text unchanged. This proposal would require a Level 1 amendment.

37. With regards to the publication of an Opinion, many respondents were against this proposal. However, the main argument for the disagreement brought forward by respondents does not relate to the lack of necessity for further guidance but rather questions the instrument itself. Most respondents suggested that this topic should be dealt with by an RTS given the need to further consult on this.

38. ESMA understands the arguments put forward by the industry and reiterates that it intends to further engage with market participants on this issue. However, it still believes that in order to have guidance published in a relatively short term, an ESMA Opinion is still the best instrument at its disposal. ESMA notes that, in accordance with the revised ESMA Regulation[13] an Opinion "may include a public consultation" which ESMA intends to make use of.

39. As noted in the feedback to the consultation, some market participants view ESMA's interpretation of when a facility should require authorisation as a trading venue as too broad given that it may bring into scope a number of technology providers[14] and bilateral systems. ESMA understands that this view may have, to some extent, resulted from the language introduced in paragraph 43[15] of the CP.

40. ESMA would like to clarify that a multilateral system is characterised by allowing multiple third party trading interests to interact within a system and it is not its intention to capture any bilateral systems and bring them into scope of the trading venue authorisation requirements. ESMA reiterates however that any system that **allows multiple third party interest** in financial instruments to interact, including information exchange between parties on essential terms of a transaction (this being price and quantity) with a view to dealing in those financial instruments is sufficient to require authorisation as a trading venue. ESMA also keeps its view that the information exchange does not need to lead to a contractual agreement between parties within the system for the interaction to occur.

41. In terms of the point raised by many market participants with regards to the possible requirement for requesting authorisation of systems where the transactions are pre-arranged and ultimately executed on authorised trading venue and the question regarding the scope of authorisation of RFQs, ESMA provides its views in section 4.2.4 of this report.

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[13] REGULATION (EU) 2019/2175 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 18 December 2019 amending Regulation (EU) No 1093/2010 establishing a European Supervisory Authority (European Banking Authority), Regulation (EU) No 1094/2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), Regulation (EU) No 1095/2010 establishing a European Supervisory Authority (European Securities and Markets Authority), Regulation (EU) No 600/2014 on markets in financial instruments, Regulation (EU) 2016/1011 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds, and Regulation (EU) 2015/847 on information accompanying transfers of funds (OJ 334, p. 1 27.12.2019)

[14] The issue of technology providers will be analysed in further detail is section 3.2.4.

[15] Paragraph 43: "In addition, regarding systems operating in a similar way to a trading venue but without proper authorisation, ESMA considers that any system that allows trading interests in financial instruments to interact, including information exchange between parties on essential terms of a transaction (being price, quantity) with a view to dealing in those financial instruments is sufficient to require authorisation as a trading venue. The information exchanged does not need to be a contractual agreement between parties for the interaction to occur."

4.2.1 Multilaterality applied to non-automated systems

A. Background

42. The definition of OTF notably extends the perimeter of trading venues to systems where transactions between clients are arranged by brokers. ESMA has received comments from certain concerned stakeholders about the burden an authorisation as an OTF represents for them.

43. ESMA signalled in the CP that it would be ready to consider possible amendments to the OTF regime aiming at reducing the regulatory burden and facilitating the operation of an OTF for less sophisticated brokers. While the authorisation regime would remain applicable to all entities, certain obligations applicable to OTFs could be amended to facilitate their application by all OTF operators. ESMA invited market participants to provide input regarding the provisions in MiFID II that can create barriers to entry for smaller entities and the possible amendments to the MiFID II/MiFIR framework that would address those identified issues.

44. Furthermore, the CP also noted that introducing more proportionality regarding the OTF authorisation regime would require either to leave discretion to NCAs regarding the application of the MiFID II rules at the expense of supervisory convergence or to establish an EU threshold delineating which activity that is within the OTF regime and which is excluded. However, ESMA did not go forward with any proposal in that direction.

45. Finally, ESMA also requested market participants' views on whether there is a need for further guidance on the difference between the operation of an OTF, or other multilateral systems, and other investment services (primarily Reception and Transmission of Orders and Execution of Orders on behalf of clients).

B. Feedback to the Consultation

46. On ESMA's proposal not to amend the OTF authorisation regime and not to exempt smaller entities from the scope of the OTF regime, almost all respondents that provided comments agreed with ESMA and did not see it fit to provide for any exemption to smaller entities. The feedback received points out that changes in this area can create incentives to avoid the regulatory perimeter.

47. Some respondents, in particular trading venues and trade associations, indicated some tweaks that could be made to the authorisation regime and supervisory approaches by NCAs. In particular one trading venue called for a reduction of the capital requirements for obtaining an OTF licence as it may constitute a barrier to enter the market. The respondent noted that the requirements should be calibrated to the risk profile of the products traded on the OTF in question. In addition, another respondent suggested that the supervisory regime should be rule-based and proportional to the size and risk of the OTF.

48. The small number of respondents that would like to see changes to the authorisation regime suggested to include a principle of proportionality based on the level of activity. These stakeholders argue that introducing a degree of proportionality in the attached obligations would enhance competition and not discourage the entry of newcomers.

49. On the feedback sought with regards to which provisions applied to OTFs are deemed particularly burdensome ESMA received very little feedback.

50. Those respondents that called for changes to the regulatory regime mentioned in particular the provisions relating to fees structure. Respondents note that RTS 10[16] does not take into consideration instruments with different liquidity profiles such as those normally traded on OTFs. Other suggested remedy actions from regulators include the requirement to produce best execution reports.

51. Other respondents suggested that no changes should be introduced to the regulatory regime but, should changes be introduced, these should be applied to all market participants equally and not limited to less sophisticated firms.

52. Finally, in relation to the question on whether ESMA should publish further guidance on the difference between the operation of an OTF, or other multilateral systems, and other investment services (primarily Reception and Transmission of Orders and Execution of orders on behalf of clients) respondents had mixed feedback.

53. Some respondents note that despite guidance not being needed, there is still an issue in this area coming from the fact that the regulators have not enforced the perimeter. These respondents consider the requirements as clear and instead of further guidance, they call for regulators to use enforcement measures.

54. A number of respondents also note that they understand that broker activity can take place outside of a trading venue. The specific example raised by a number of participants notes that a broker that simply collects trading interests with the aim of transmitting those to a trading venue should not be required to request authorisation as an OTF. These requirements would only bring a proliferation in the number of trading venues that would only exist to send trades to other venues for execution. The relevant element to note is that the ultimate trade would always be executed on a trading venue. With regards to this particular example, one trade association notes that OTFs can also act as brokers when arranging trades above LIS which then would be concluded on a trading venue. This should only be allowed, in accordance with the respondent, if the trade is ultimately executed on a trading venue.

[16] COMMISSION DELEGATED REGULATION (EU) 2017/573 of 6 June 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council on markets in financial instruments with regard to regulatory technical standards on requirements to ensure fair and non-discriminatory co-location services and fee structures. (OJ L 87, 31.3.2017, p. 145)

55. ESMA also received feedback from some stakeholders who ask for further guidance on the difference between the operation of an OTF, or other multilateral systems, and other investment services. Most of the comments received focus their remarks on systems such as online communication platforms. These respondents would like ESMA to clarify that technology tools that provide solutions that enable counterparties to interact efficiently on a bilateral basis with each other do not constitute multilateral systems. For example, where a buy-side firm creates a message to be sent to one or more dealers separately, thereby creating separate chats to request a quote in a financial instrument should not be considered as a multilateral system. These respondents argue that a chat functionality is genuinely bilateral, since (1) a dealer would not know whether or which other dealers were engaged by the buy side, and (2) dealers would not be able to see or react to quotes or terms provided by other dealers.

C. ESMA's assessment and recommendations

56. ESMA notes the feedback received and keeps its intention not to make any changes to the authorisation regime and does not intend to provide for any exemption for smaller entities. ESMA remains of the view that authorisation of OTFs should be independent of the scale and complexity of the concerned entities.

57. With regards to the changes proposed by market participants in relation to fee structures and in particular with the comments made on RTS 10, ESMA notes that this RTS was subject to a recent public consultation in the context of ESMA's MiFID II/MiFIR review report on algorithmic trading[17]. Should any changes be considered necessary, ESMA will communicate those when finalising the review report on algorithmic trading.

58. On the specific example raised by a number of participants where a broker that simply collects trading interests with the aim of transmitting those to a trading venue should not be required to request authorisation as an OTF, ESMA provides its view in Section 4.2.4 of this report. Furthermore, the perimeter issue will indeed be part of ESMA's Opinion as proposed in this report.

4.2.2 Systematic Internalisers (SI) and Network of SIs

A. Background

59. As flagged in the MiFIR report on systematic internalisers in non-equity instruments[18] ESMA has been made aware of concerns about the blurred distinction between multilateral and bilateral trading and the development of other types of arrangements that facilitate the

[17] See Section 5.4 of the report - https://www.esma.europa.eu/sites/default/files/library/esma-70-156-2368_mifid_ii_consultation_paper_on_algorithmic_trading.pdf
[18] MiFIR report on systematic internalisers in non-equity instruments esma70-156-2756_mifidii_mifir_report_on_systematic_internalisers.pdf (europa.eu) para. 109, page 37.

execution of transactions between multiple buyers and sellers without being authorised as a regulated market, an MTF or an OTF.

60. In particular, concerns have been expressed by some stakeholders that the build-up of some SIs' activity, including via a network of SIs, results in some SIs operating de facto as multilateral systems without being subject to similar authorisation and operating requirements.

61. The issues expressed by respondents in the context of the review report on SIs are threefold. First, some market participants noted that the distinction between bilateral trading and multilateral trading is being blurred due the setting up of networks of SIs, and invited ESMA to further look into this issue. Second, they stressed that some SIs do not comply with the prohibition, when dealing on their own account, from entering into matching arrangements with entities outside their group to carry out de facto riskless back-to-back transactions through arrangements with third party liquidity providers[19]. Third, trading venues claimed that BCN trading volumes under MiFID I have shifted to SIs instead of moving to authorised trading venues. In their view, this demonstrates the failure of MiFID II to move more trading to lit venues.

62. In the run-up to the application of MiFID II, ESMA worked on a number of clarifications in an attempt to clarify some boundaries in relation to the SI activity, in particular on the boundaries between multilateral and bilateral trading. In particular, ESMA clarified that:

    - Based on the SI definition provided in Article 4(1)(20) of MiFID II, ESMA understands that the trading activity of an SI is characterised by risk-facing transactions that impact the profit and loss account of the firm;

    - Where an SI would receive, and execute, two potentially matching buying and selling interests from clients as one matched principal trade or where it would try to find the buyer for a sell order (or the other way around) and execute the first leg contingent on the second leg, those transactions would not qualify as risk facing transactions. As such, they could only be executed by an SI on an occasional basis, as provided for by Recital (19) of the Commission Delegated Regulation (EU) 2017/565; and,

    - A system that provides quote streaming and order execution services for multiple SIs should be considered a multilateral system and would be required to seek authorisation as a regulated market, MTF or OTF in accordance with Article 1(7) of MiFID II.

63. In ESMA's view, the clarifications included in the Q&As are sufficiently clear to determine where the trading activity of an SI is purely bilateral and which arrangements should be

[19] 'Article 16a of Commission Delegated Regulation 2017/2294: "Participation in matching arrangements An investment firm shall not be considered to be dealing on own account for the purposes of Article 4(1)(20) of Directive 2014/65/EU where that investment firm participates in matching arrangements entered into with entities outside its own group with the objective or consequence of carrying out de facto riskless back-to-back transactions in a financial instrument outside a trading venue."

considered as multilateral activity. As such, any arrangements operating without the proper authorisation under MiFID II should be subject to NCA supervisory measures. ESMA is committed to work together with NCAs and identify such cases in order to ensure a uniform application of MiFID II rules and enhance supervisory convergence.

64. ESMA sought stakeholders' views as to whether such clarifications are sufficiently clear or whether a Level 1 amendment should be proposed to give market participants more legal certainty.

B. Feedback to the Consultation

65. A large majority of respondents, coming from the sell-side, did not share the concerns expressed in the CP about networks of SIs and expressed doubts about the existence of such networks. According to those respondents, SIs access a variety of execution venues, including other SIs, to handle client orders and discharge their best execution obligation, but would always be trading on a one-to-one bilateral basis with those other SIs. The same holds true when SIs deal on own account for risk management purposes either on-venue or with other SIs. Those respondents also explained that BCN activity cannot be claimed to have been transferred to SIs as volumes reported as SI remain a mix of bilateral trading and non-addressable technical trades.

66. Trading venues shared the concerns expressed in the CP and noted that the fact that there is still no clear view from a market supervisory and regulatory perspective on the existence, relevance and proliferation of these networks, does shed some light on the still prevailing opacity around SI activities. To have more clarity on SI activities, they suggested introducing an authorisation requirement.

67. The question raised in the CP regarding the potential need to further specify the line differentiating bilateral and multilateral trading in the context of SIs attracted a similar split of responses. A large majority of respondents from the sell-side considered that the delineation between multilateral and bilateral trading in the context of SIs was sufficiently clear and that no Level 1 amendment was needed. Trading venues that responded to the CP supported some further clarification in Level 1 or 2 of the concept of bilateral system under MiFID II/MiFIR which does not appear to be uniformly understood, especially in the context of SIs, but did not provide specific suggestions.

C. ESMA's assessment and recommendations

68. ESMA notes that no further evidence or precise example of networks of SIs has been provided by stakeholders in their response to the CP. The claim about the transfer of BCN activity to SIs has not been further substantiated either by the stakeholders that expressed

this concern in their response to the SI Report[20]. Taking into account the views expressed by a large majority of respondents, ESMA considers that the clarifications included in the Q&As above are sufficiently clear and is not minded to suggest a Level 1 or a Level 2 amendment regarding the delineation between bilateral and multilateral trading activity in the specific SI context.

4.2.3 Technology providers

A. Background

69. In the CP, ESMA explained that another source of concerns received relates to new technology providers, often referred to as "software or middleware providers" and which, arguably, operate *de facto* multilateral systems without adequate authorisation. Those technology providers typically facilitate communication with and access to various sources of trading interests, e.g. trading venues, liquidity providers, single banks platforms.

70. In the CP, ESMA explained that the concerns come from the fact that those firms are *de facto* operating multilateral systems without being authorised as trading venues and being subject to the relevant MiFID II/MiFIR provisions. This creates an unlevel playing with EU trading venues which have to comply with the MiFID II regime and the large number of regulatory obligations it contains.

71. In addition, the client-related provisions applicable to trading venues also contribute to making trading on unauthorised platforms more attractive. For instance, it was stressed to ESMA that Article 26(5) of MiFIR, which defines the transaction reporting obligations, require trading venues to collect a significant amount of information on their clients. Beyond the costs associated with the collection, storing and processing of the necessary information for trading venues, this creates an indirect incentive for the clients to rather execute their trades on unauthorised platforms which appear less intrusive regarding the information they collect on their clients.

72. In the CP, ESMA agreed that the same authorisation regime should apply to all market participants regardless of the technology they use. ESMA considered it important that new business models, when they consist in multilateral trading, are appropriately regulated in order to ensure an appropriate level of protection for investors and to reinforce the resilience of EU markets as well as establish a level playing field between all firms operating in the EU.

73. However, ESMA noted that there is a broad variety of business models and activities co-existing within those technology providers. In addition, while some of those technology

[20] MiFIR report on systematic internalisers in non-equity instrument
https://www.esma.europa.eu/sites/default/files/library/esma70-156-2756_mifidii_mifir_report_on_systematic_internalisers.pdf

providers are operating without any MiFID II authorisation, others are authorised for reception and transmission of orders (RTO) in relation to one or more financial instruments.

74. Considering this broad variety of business models, it appeared difficult to propose any one-size-fits-all supervisory guidance in the CP and, instead, ESMA asked for feedback regarding possible criteria to categorise those technology providers. Those criteria could be used to establish some guiding principles as an attempt to enhance supervisory convergence regarding the authorisation of those new players.

75. The differences between technology providers also extend to where the transactions are ultimately executed. While in certain cases the transactions are executed OTC, in other cases the transactions are formalised on a trading venue.

76. In this respect, ESMA has clarified in a Q&A[21] that a transaction cannot be concluded on more than one trading venue at the same time and that a trading venue cannot use its trading system and platform to arrange transactions that are then reported and executed on another trading venue.

77. ESMA explained in the CP that this guidance was primarily meant to allow for an adequate allocation of responsibilities noting that it does not explicitly exempt from the MiFID II authorisation regime all technology providers that pre-arrange transactions that are ultimately formalised on authorised trading venues.

78. Regarding authorisation, ESMA therefore suggested that where a technology provider operates a multilateral system but without executing trades (the transaction being formalised on another authorised venue), this technology provider may be authorised as a trading venue. It could be considered that the technology provider operates an OTF or MTF but with an execution system outsourced to another trading venue (acting here not as a trading venue but as a simple service provider).

79. This approach was considered consistent with the approach proposed in other sections of the CP and in particular the view that it is the design of the system that should determine whether or not this system is a multilateral system and not whether transactions are formalised on this system or outside the system. ESMA requested feedback on this proposed approach.

B. Feedback to the Consultation

80. Respondents to the CP generally agreed that the current legal framework remains appropriate and does not need to be updated to accommodate innovation and/or new market developments. They concurred that the issue (if any) is more about providing more

[21] Q&A 7 of Section 5 of the ESMA Questions and Answers on MiFID II and MiFIR market structures topics, ref. ESMA70-872942901-38 (here).

supervisory guidance and ensuring appropriate enforcement of existing rules. Some respondents insisted in this respect about the importance to undertake an activity-based supervision. The authorisation regime should remain primarily related to the actual activity undertaken and not linked only to the technology used or how the service provider characterises itself.

81. Some respondents also call ESMA to be cautious regarding possible supervisory actions. The possible benefits of more stringent supervision of technology providers should be duly analysed together with the possible impacts this could have on innovation (which typically comes from unregulated entities and not trading venues), on the efficiency of order management and on the implementation of enhanced straight through processes. Similarly, some respondents insisted on the importance to maintain a clear distinction between the operation of a multilateral system and the reception and transmission of orders.

82. Respondents suggested different possible criteria to determine whether a system is genuinely multilateral and should therefore be authorised as such.

83. Firstly, some argued that it is important to consider whether or not transactions are effectively executed within the system. This echoes the issue discussed earlier in the CP about whether the fact that the transaction is formally executed in the system should be regarded as a necessary condition for a system to be authorised as a trading venue under MiFID II. In the same vein, some considered that where a system supports the conclusion of transactions that are ultimately formalised on an authorised trading venue, this system should not itself be authorised for a similar service.

84. Other respondents suggested to distinguish “distributed trading mechanisms” from “insourced trading mechanisms”. The former refers to cases where a software is licensed to each client individually allowing them to interact for trading purposes on a “peer-to-peer” or “point-to-point” basis. In the case of “insourced trading mechanisms”, the technology provider does not retain any interest in the trading activities. The software is operated by an investment firm, typically a broker authorised for Reception and Transmission of orders. Some respondents also noted that even authorised trading venues can use software and systems developed and commercialised by other firms.

85. Regarding “distributed trading mechanisms” some respondents considered that because of their “peer-to-peer” design, they should not be subject to authorisation as multilateral systems (those being bilateral by design). Others argued that this is not necessarily the case and mentioned the case of software that is clearly designed and serviced with the aim to bring together trading interest from multiple clients.

86. Another aspect many respondents insisted on is that only systems that are characterised by “many-to-many” interactions should be authorised as trading venues. There are

however more diverging views regarding what precisely constitutes a “many-to-many” system or what constitutes a genuine bilateral system.

87. For example, respondents did not seem to agree on whether authorisation is required (i) for systems that allow market participants to send a request simultaneously to a network of liquidity providers or (ii) for systems that enable a given entity to benefit from an aggregated view of several potential counterparty interests. Respondents presenting aggregators as simple bilateral systems insisted on the fact that they are used to manage more efficiently pre-existing trading relationships and that they allow buy-side firms to simply operate in a more cost-effective manner (e.g. facilitating the price discovery process).

88. Similarly, some respondents raised questions about systems that operate under a RFQ model (i.e. systems where a client can send a request to multiple liquidity providers at the same time who can reply with quotes). Some considered that those systems are not “many to many” systems and should therefore not be authorised as multilateral systems (even though trading venues can operate such systems).

89. Finally, some respondents invited ESMA and NCAs to consider whether the decision to trade is made through automation. For them, where the decision to trade is taken between individual firms (which are typically regulated entities), the system should be regarded more as a communication tool and therefore not be regulated. This is usually the case for Order Management Systems (OMS) and Execution Management Systems (EMS) which are commonly used by buy-side and sell-side firms to operate more efficiently.

90. Regarding the second question asked (i.e. whether, in case systems formalising transactions on an authorised trading venue, those systems should still themselves be authorised as trading venues outsourcing the execution of transactions to another entity), many respondents reiterated the points they made earlier in the paper, i.e. execution of transactions is a key characteristic of trading venues.

91. Those who disagreed with ESMA’s interpretation insisted on the importance of pre-arranged transactions (for non-equity instruments in particular) and raised concerns about the possible impacts a boarder authorisation regime could have on this activity and, more generally, on EU markets’ competitiveness.

92. Some respondents considered that where pre-arranged transactions are executed on a trading venue, the pre-arranging activity should never itself be authorised as a trading venue. This might otherwise create confusion regarding the regulatory responsibilities to be complied with.

C. ESMA's assessment and recommendations

93. With regards to the regulatory framework, the feedback received during the consultation confirmed that the requirements are appropriate and allow for an adequate supervision and authorisation of technology providers (where appropriate). Respondents confirmed that there is no need to amend Level 1 provisions beyond what is proposed in other sections (e.g. moving provisions relating to authorisation of trading venues into MiFIR). ESMA therefore does not propose further changes in this respect.

94. Regarding the authorisation of technology providers, ESMA agrees that authorisation should ultimately be assessed on a case-by-case basis. It is crucial for NCAs to take into account the specific activity of concerned firms when assessing whether they operate a multilateral system and should be authorised as such.

95. ESMA nevertheless considers that there is merit in providing more guidance on the authorisation of new technology providers. The authorisation as a trading venue under the MiFID II regime is indeed impactful for the concerned firm which, as a consequence, has to comply with a series of regulatory requirements. It is therefore essential to ensure a high degree of convergence regarding the approaches followed at national level for the authorisation of technology providers.

96. ESMA considers that more convergence could first be achieved by the adoption of further guidance regarding the authorisation of technology providers. The feedback received to the consultation shows that market participants do not necessarily agree on what activity should be captured by the definition of multilateral systems and there are still many areas where diverging interpretations of MiFID II provisions co-exist. ESMA therefore proposes to also include some guiding principles in the Opinion mentioned above with respect to the authorisation of technology providers.

97. In parallel, ESMA will discuss with its members the cases of specific technology providers which could be subject to authorisation in the EU. While ESMA has no mandate to adopt formal opinions regarding the authorisation of specific firms under MiFID II, such case-specific discussions generally help NCAs to form a better view regarding their respective supervisory approach. This can also help to identify issues where more supervisory convergence is needed.

98. As mentioned above, the consultation has already revealed certain points of disagreement. While some of those issues would require further discussions and input from the industry, it might be appropriate for ESMA to provide preliminary feedback in order to frame and, hence, facilitate future discussions.

99. Regarding first the scope of the multilateral system definition, ESMA considers too restrictive the approach advocated for by certain respondents to consider as "multilateral" only those systems that allow "many to many" interactions. This would limit the authorisation regime under MiFID II to systems which are designed on an "order book"

model while leaving outside the scope of authorisation many other trading systems which are commonly used in the EU. For instance, RFQ systems, i.e. systems where quotes are provided in response to a request submitted by one firm, are generally regarded as multilateral systems and as requiring authorisation as a trading venue under MiFID II. ESMA will continue monitoring the use and adaptation of existing trading models in the future.

100. Similarly, "distributed trading systems", i.e. software which is not operated centrally but licensed to individual clients allowing them to interact for trading purposes on a "point-to-point" basis, can constitute multilateral systems. While cases need to be analysed carefully taking into account the exact operation of the software, it cannot be concluded that those systems are allowing by design only "multiple bilateral interactions" (as opposed to the simultaneous interactions of multiple trading interests) and should be exempted from authorisation.

101. Finally, ESMA acknowledges the concerns raised with respect to Order Management Systems (OMS) and Execution Management Systems (EMS). OMS and EMS allow trading firms to manage their orders more efficiently with evident benefit in terms of costs, access to markets and latency of execution. However, ESMA notes that those systems can, under certain circumstances, be operated in a way which is similar to trading systems operated by trading venues. If it is crucial to ensure a supervisory approach which does not hinder financial innovation, it is also important to look more closely at those order and execution management systems to define more precisely their regulatory boundary and what should differentiate them from trading venues.

102. As already evocated in the CP, one crucial element to take into consideration when assessing whether a system should be authorised as a trading venue is the ultimate place of execution of the transactions. ESMA appreciates in this respect the limited support received for the approach suggested in the CP, i.e. in case a system allows multilateral interactions of trading interests but ultimately sends the transactions for formal execution to an authorised trading venue, this system (where negotiation occurs) should still be authorised as a trading venue outsourcing the execution of transactions to another entity.

103. ESMA agrees that a clear distinction should be made between systems depending on where transactions are eventually formalised. On-venue executions generally contribute to more transparent markets and better protection for investors and it is sensible to also reflect this in the authorisation process. ESMA would therefore agree that where a system only arranges transactions which are ultimately executed on a trading venue, the pre-arranging system should not itself be authorised as a trading venue.

104. It is however important to ensure that this approach does not result in making de facto redundant some MiFID II provisions applicable to trading venues. As clarified in a Q&A[22],

[22] Q&A 11 of section 5 of the ESMA Q&As on transparency topics (ref. ESMA70-872942901-35).

"when trading venues execute pre-arranged transactions under the rules of their system, they must ensure that these transactions comply with the regulations, including those concerning market abuse and disorderly trading. Venues have an obligation to monitor these trades on possible violations of the rules".

105. In particular where the system where transactions are negotiated is multilateral, ESMA considers this system could be regarded as an outsourced service from the trading venue where the transaction are executed. The trading venue should therefore ensure, through contractual arrangements, that all relevant MiFID II provisions are complied with including rules relating to non-discriminatory access and fees.

4.2.4 Boundaries between TV and bulletin boards

A. Background

106. There have been projects in the EU, mainly related to crowdfunding and crypto-assets platforms, where the boundaries between bulletin boards and trading venues, in particular OTFs, have been subject to an intense debate. Some of these projects are looking to offer a secondary market to their clients in a way where these arrangements would fall outside the trading venue scope, in particular by considering themselves as bulletin boards, with different levels of complexity.

107. A bulletin board exclusively advertises trading interests without facilitating in any way the interaction of those interests, unlike a trading venue. It might include prices, quantities available, and even display the contact details of potential buyers and sellers, however it cannot organise the bringing together of these interests, nor use a centralised order book or any other kind of trading system. Consequently, the negotiation and conclusion of transactions should be performed bilaterally, outside of the system.

108. MiFID II recognises that such systems should not be required to be authorised as a trading venue[23]. Also, ESMA considers that there should be a principle-based approach on what should be considered a bulletin board to ensure that those systems where it is not possible for users to act upon advertised interests are not subject to authorisation as a trading venue.

109. ESMA is therefore of the view that a system or facility with the below characteristics should be considered as a bulletin board:

[23] See Recital 8 of MiFIR: "(…) [OTF] should not include facilities where there is no genuine trade execution or arranging taking place in the system, such as bulletin boards used for advertising buying and selling interests (…)".

a) an interface that only aggregates and broadcasts buying and selling interests in financial instruments (including financial securities registered in a distributed ledger[24]);

b) the system neither allows for the communication or negotiation between advertising parties, including any notification of any potential match between buying and selling interests in the system, nor imposes the mandatory use of tools of affiliated companies; and,

c) there is no possibility of execution or the bringing together of buying and selling interests in the system.

110. Considering the increase in the number of crowdfunding or crypto assets platforms seeking to offer a platform for secondary market trading, ESMA recommended in the CP a Level 1 change in order to include a definition of bulletin boards, taking into account the characteristics listed above.

B. Feedback to the Consultation

111. Most of the respondents to the consultation paper agreed with ESMA's definition of a bulletin board and that a Level 1 amendment should be done to incorporate this definition. A further definition of bulletin boards was generally welcomed by the participants.

112. One of the respondents stated that setting a more descriptive definition of bulletin boards is necessary, but not using the same characteristics used by ESMA in the consultation paper. For this respondent the issues are with paragraphs (b) and (c) of ESMA's proposal. The participant states that the paragraph (b) removes the possibility of communication between advertising parties, which is deemed too restrictive, and paragraph (c) suggests that the bringing together of a buying and selling interest is enough to bring a platform into scope of a multilateral system. The respondent proposes the following as characteristics of bulletin boards:

a) an interface that only receives, pools, aggregates and broadcasts buying and selling interests in financial instruments, (including financial securities registered in a distributed ledger);

b) the system does not impose the mandatory use of tools of affiliated companies; and;

c) there is no possibility of execution in the system.

[24] The reference to financial securities registered in a distributed ledger is notwithstanding any initiatives from the EC on this topic, in particular the Digital Finance Package adopted on 24 September 2020.

113. Another participant also considered that if ESMA were to proceed with the Level 1 amendment as proposed in the consultation paper, it should be clear that if a software solution is not classified as a bulletin board, this is not sufficient condition to conclude that such software provider falls within the definition of multilateral system or the MiFID II regulatory perimeter. The respondent further suggests that bilateral communication tools (one to one communication) should be explicitly excluded from the regulatory perimeter.

114. However, even amongst the respondents that agreed with ESMA's proposal, several considered that displaying the contact details in an bulletin board should not be allowed, justifying this by stating that the indication of interest owner can be identified without displaying telephone numbers or email addresses.

115. The few respondents that did not agree with ESMA's view considered either bulletin boards as multilateral trading, or that such a new category is not necessary.

C. ESMA's assessment and recommendations

116. Taking into account the feedback received, ESMA keeps its recommendation to add to MiFID II a definition of bulletin boards, which takes into account the characteristics described in the CP and characterise a bulletin board as:

a) an interface that only aggregates and broadcasts buying and selling interests in financial instruments (including financial securities registered in a distributed ledger);

b) the system neither allows for the communication or negotiation between advertising parties, including any notification of any potential match between buying and selling interests in the system, nor imposes the mandatory use of tools of affiliated companies; and,

c) there is no possibility of execution or the bringing together of buying and selling interests in the system.

117. Regarding the proposals put forward by respondents, in particular the suggestion that removing the possibility of communication between advertising parties as being too restrictive, ESMA disagrees with this view. ESMA reiterates that a bulletin board can display in the system the contact details of potential buyers and sellers. However, a system that allows participants to communicate or negotiate on essential terms to agree on a transaction within the system should be regarded as a multilateral system and hence, should be subject to trading venue authorisation.

4.2.5 Operation of internal crossing systems by fund managers

A. Background

118. An issue related to the regulatory treatment of the transfer of financial instruments between investment funds managed by the same fund management company or between investment funds managed by different fund management companies and whether such transfers might fall within the definition of multilateral trading system under MiFID II was brought to ESMA's attention. Relevant fund management companies include UCITS management companies (UCITS ManCos) and alternative investment fund managers (AIFMs).

119. Fund management companies or their delegates typically buy and sell financial instruments, for the funds they manage, from or through brokers either OTC or via trading venues. However, some fund managers, depending on the size and the number of funds managed, may operate internal matching systems whereby a transaction takes place between two funds managed by the same fund manager rather than on a market.

120. Despite the benefits for investors through reduced trading costs, the concern is that such transactions are taking place internally. Funds may be exposed to risks and practices that would otherwise be subject to regulation and supervision if the transaction were carried out on a trading venue.

121. In the context of ESMA's considerations to date, it appears that the matching of such trades may arise between: a) funds managed by the same UCITS ManCos or AIFMs; and b) funds managed by different UCITS ManCos or AIFMs but where the UCITS ManCos or AIFMs are within the same group.

122. In the consultation paper, ESMA sought to clarify the extent to which matching of trades may meet the definition of multilateral systems under Article 4(1)(19) of MiFID II. However, in such situation it is not clear how such transactions can reasonably be viewed as involving third parties as the funds are all managed by the same entity. It would appear that the definition would not contemplate or cater for an arrangement as between funds within the same UCITS ManCo or AIFM.

123. However, one could consider that, where different fund managers within the same group transact between themselves, the funds are not legally related and, so, could be categorised as third parties. Additionally, it would be possible for them to conclude a contract as they would be represented by different contracting management companies. For those reasons, one could wonder whether transfers done between funds not managed by the same UCITS ManCo or AIFM should be regarded as multilateral activity in the context of MiFID II.

124. While it is true that the MiFID II framework applies neither to UCITS ManCos nor to AIFMs directly, it is not clear whether these inter-fund transfers should be regarded as an investment management function covered under the Directive 2011/61/EU of the European Parliament and the European Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010[25] (AIFMD) and Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulation and administrative provisions relating to undertakings for collective investment in transferable securities[26] (UCITS Directive) and, as such, be excluded from the scope of MiFID II.

125. The question about the regulatory framework applicable to internal crossing systems is not straightforward. Therefore, in the CP, ESMA aimed to gather more input on the functioning of those systems before possibly developing guidance about whether the regulation of internal crossing systems falls within the remit of MiFID II or the UCITS Directive / AIFMD and whether it would be useful to clarify this through targeted Level 1 changes.

B. Feedback to the Consultation

126. Most respondents did not provide any opinion or comment to this topic. Also, only a few participants emphasised the positive points of having internal crossing systems, such as saving costs on execution, but did not provide any details on scale of the activity, geographical coverage, instruments concerned, etc.

127. Several respondents also explained that the crossing price is typically based on an externally provided mid-price with zero commission to ensure a fair treatment of both selling and buying parties, and that these practices are normally explained to investors prior to the commencement of the investment mandate to ensure that they understand the controls that are in place to achieve consistency and fairness across funds and accounts.

128. One of the respondents recommended that any operator of a system (whether SI, MTF, crossing network) should run through an authorisation procedure to use an internal crossing system, which must include a description of the business activities, fees, instruments, etc. Furthermore, the respondent added that it could also be helpful to regularly assess the compliance with the authorisation requirements and to grant competent authorities the possibility to request further information, if necessary.

[25] Directive 2011/61/EU of the European Parliament and the European Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010 (OJ L 174, 1.7.2011, p.1).
[26] Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulation and administrative provisions relating to undertakings for collective investment in transferable securities (OJ L 302, 17.11.2009, p. 32).

129. To the question if the participants agreed that internal crossing systems allowing different fund managers within the same group to transact between themselves should be in scope of MiFID II or regarded as an investment management function covered under the AIFMD and UCITS, ESMA only received two responses, one agreeing, and one disagreeing.

130. The respondent that agreed stated that trading volumes conducted on internal crossing networks should be subject to the same strict MiFIR/MiFID requirements as those conducted on regulated trading venues.

131. The respondent that disagreed justified its view by stating that the internal crossing systems are part of the workflow management of the investment manager, which has definite benefits. Since these internal crossing systems do not constitute any form of multilateral trading imposing OTF obligations would increase costs, diminish efficiencies, and potentially impact investment performance.

C. ESMA's assessment and recommendations

132. Given the above considerations on the complexity of this issue and the lack of substantial feedback received, in particular in relation to the scale of activity of internal crossing systems, their geographical coverage and instruments covered, ESMA considers it prudent to further reflect on this issue.

133. In order to decide on the best way forward, further analysis should be conducted to understand how fund managers prevent conflicts of interest when operating internal crossing systems and how end-investors' interests are safeguarded in particular when comparing to execution of relevant transactions via brokers or trading venues. Therefore, ESMA does not recommend any changes to the legislative text at this stage but may come back to this issue in due course.

4.3 Use of Discretion

A. Background

134. One of the distinct characteristics of OTFs is the requirement to use discretion when executing orders. Unlike regulated markets and MTFs which are required to execute orders in accordance with non-discretionary rules, Article 20(6) of MiFID II requires that OTFs execute orders on a discretionary basis[27]. Such discretion can be exercised (i) when placing or retracting an order; or (ii) when deciding not to match a specific client order with

[27] As a consequence of the discretion in the executing orders, transactions concluded on an OTF have to comply with the client facing rules set out in Articles 24, 25, 27 and 28 of MiFID II.

other orders available in the systems at a given time, provided that it is in compliance with the specific instructions received by the client and the best execution obligations.

135. As clarified in a Q&A[28], ESMA understands "execution on a discretionary basis" and "exercise of a discretion" as meaning that, in the circumstances foreseen in Article 20(6), 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. ESMA further clarified that the exercise of discretion can be split in order discretion and execution discretion and that the use of fully automated systems does not preclude the exercise of discretion.

136. For the drafting of the CP, ESMA collected feedback from NCAs on how OTFs apply discretion on their trading venues. From the analysis of the responses provided, the application of discretion varies significantly depending on the type of system operated by the OTF.

137. Those OTFs that operate voice trading systems apply discretion to the orders received by clients regularly. Hybrid systems that would for instance use a combination of both voice and quote-driven trading apply discretion differently according to the execution system. For electronic trading systems, the use of discretion does not seem to be applied in practice where the order meets the conditions set out in the order book.

138. For OTFs that operate an RFQ system, discretion is exercised differently than for those who use voice. In particular, the role of the OTF brokers becomes active where the orders sent by the client are not executed by an electronic RFQ.

139. Based on the feedback received from NCAs, ESMA considers that the "exercise of discretion" and "execution on a discretionary basis" does not create any supervisory concern and ESMA did not deem it necessary to propose further clarifications.

140. Hence, in the CP ESMA sought views of market participants regarding a possible need for further clarifications on how discretion should be applied and requested further information on which type of discretion is applied more often, i.e. discretion in order placement or discretion in order execution. ESMA furthermore sought views specifically from OTF clients, to know if they have been facing any issue on how OTFs apply discretion.

A. Feedback to the Consultation

141. The large majority of respondents, when asked if further clarifications are to be provided on how discretion should be applied, stated that they share ESMA's view on how discretion should be applied. Furthermore, respondents supported the view that the Q&A published

[28] Q&As on MiFID II and MiFIR in Market Structure Topics, Multilateral and bilateral systems, Question 19, https://www.esma.europa.eu/sites/default/files/library/esma70-872942901-38_qas_markets_structures_issues.pdf

by ESMA[29] offers sufficient guidance on how to apply discretion and at this stage there is no need for further clarifications.

142. Concerning the application of discretion to order placement and execution, three respondents stated that they apply discretion to order placement and execution in equal measure. Two respondents specified that the application of discretion to placement or execution of orders is influenced by the type of trading model adopted. Other respondents seemed to apply discretion to order placement and execution in equal measure. One respondent, commenting on the specificities of the FX market, stated that discretion might consist in offering diverse pricing for similar trades depending on some factors including the nature of the transaction, the relationship between the counterparty and the institution, and the market conditions prevailing at the time pricing is determined.

143. Among OTF clients, the majority of respondents, stated that they did not encounter issues with the way OTFs apply discretion. Few respondents noted that rules and information about the application of discretion can be found in the Rulebook of the OTF or on its website. OTF clients noted that discretion is explained in a transparent manner and exercised keeping in mind the client's best interest and best execution policies. One respondent highlighted that discretion is used widely and regularly.

C. ESMA's assessment and recommendations

144. Considering both the feedback received from NCAs and the responses to the consultation on the use of discretion, ESMA believes that there is no need to further clarify how discretion should be applied by OTF operators. In fact, ESMA understands that the Q&A on the use of discretion, provides enough guidance to the market. Furthermore, the responses received highlight that discretion is applied both to order placement and execution, depending on the type of trading system used by the OTF.

145. As per the responses from OTF clients, ESMA further understands that sufficient transparency is applied to OTF rulebooks and websites, to inform clients about the use of discretion as a practice applied by the OTF.

146. In light of the previous considerations, ESMA does not think that any legislative initiative should be undertaken with regards to this matter at this stage.

[29] Q&As on MiFID II and MiFIR in Market Structure Topics, Multilateral and bilateral systems, Question 19, https://www.esma.europa.eu/sites/default/files/library/esma70-872942901-38_qas_markets_structures_issues.pdf

5 Matched Principal Trading

5.1 Use of matched principal trading by OTFs

A. Background

147. Matched principal trading (MPT), as defined in Article 4(1)(38), requires three conditions to be fulfilled: (i) the facilitator should take no market risk exposure in the transaction, (ii) the timing of execution of the two sides of the transaction shall be simultaneous, (iii) the remuneration of the facilitator should be based on a previously disclosed fee or charge for the transaction.

148. Recital 24 of MiFID II specifies that MPT should be considered as dealing on own account when executing client orders. Dealing on own account is defined in MiFID II as "trading against proprietary capital resulting in the conclusion of transactions in one or more financial instruments." In principle, as per Article 20(1) of MiFID II, OTF operators may not execute client orders against proprietary capital of the operator or of any entity that is part of the same corporate group or legal person. The same rule applies to MTF and regulated market operators, as per Articles 19(5) and 47(2) of MiFID II.

149. Nevertheless, for OTF operators, Article 20 of MiFID II allows two exceptions. Firstly, under Article 20(1) of MiFID II, an OTF can engage in MPT in bonds, structured finance products, emission allowances and certain derivatives where the client has consented to the process. The use of MPT remains forbidden for derivatives pertaining to a class of derivatives that has been declared subject to the clearing obligation in accordance with Article 5 of Regulation (EU) No 648/2012[30] (EMIR).

150. Additionally, Article 20(2) of MiFID II allows OTFs to engage in dealing on own account other than MPT with regard to sovereign debt instruments for which there is not a liquid market. The monitoring is performed by the NCAs.

151. In the CP, ESMA stated that it does not consider that the use of MPT raises any supervisory concerns. The use of MPT appears to be limited to few instruments and ESMA further understands that the consent of the client is either requested before engaging in MPT or included in the rulebook with details as to the fees applied, to which the client has to agree.

152. As mentioned in the CP, ESMA would not see a need for any clarifications unless deemed relevant by market participants.

[30] Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories.

B. Feedback to the Consultation

153. In the CP, ESMA asked market participants if any aspect of MPT should be clarified or if any specific measure in relation to MPT should be recommended.

154. The majority of respondents opposed any clarifications. Some respondents who did not see a need for further clarifications argued that this could add further complexity and harm the competition and diversity in markets. Instead, it was proposed for possible issues to be addressed through supervisory convergence.

155. There was one suggestion for further clarification, relating to the SI restriction for MPT which is stipulated in Level 2 and 3 text. In order to create a level playing field, such clarification should be specified in the Level 1 text, as is also currently the case for MTFs, OTFs and regulated markets.

156. ESMA also asked market participants about what they view as the differences between MPT and riskless principal trading and if any difference in this regard should be clarified in the Level 1 text. Furthermore, ESMA requested market participants to state what they view as the main incentives for firms to engage in MPT rather than in agency cross trades.

157. In relation to this question, views were split. A few respondents supported a clarification between MPT and riskless principal trading, though not necessarily in the Level 1 text. Respondents noted that there are subtle differences between MPT and riskless principal trading. Some respondents acknowledged that at times these terms may not differ much in practice and are used interchangeably. However, some also explicitly noted that MPT should be seen as a subset of riskless principal trading.

158. In terms of differences and incentives, respondents noted that an MPT transaction will provide for a higher level of anonymity as the counterparties remain unknown to each other. Additionally, there will be one single point of settlement and only the need to assess the credit risk of the intermediary firm and not of all possible counterparties (uniformity of credit risk). Another characteristic of MPT that was named is that it would be more suitable for complex transactions that can be arranged involving multiple trade legs.

159. An incentive that was named for carrying out agency cross trades was that these may come with a higher degree of operational efficiency compared to MPT.

160. Two specific issues for clarification that were mentioned were cost transparency requirements in relation to MPT and whether MPT is possible for spread-based trading.

C. ESMA's assessment and recommendations

161. Considering the feedback received to this question, ESMA understands that market participants only view subtle differences between the terms of MPT and riskless principal trading. Taking this into account, as well as the facts that no major issues were raised and

that stakeholders overall preferred not to pursue any Level 1 changes in relation to this point, ESMA maintains its view that no further clarifications are currently needed.

162. In relation to the point brought up by some market participants with regards to the SI restriction on MPT, ESMA believes those provisions are already clear in the legislative text[31] and ESMA Q&As as stated in section 4.2.3.

5.2 Restriction to matched principal trading on regulated markets and MTFs

A. Background

163. MiFID II prohibits operators of regulated markets and MTFs to engage in MPT. In particular, Article 19(5) of MiFID II states that "Member States shall not allow investment firms or market operators operating an MTF to execute client orders against proprietary capital, or to engage in matched principal trading". Article 47(2) of MiFID II applies an analogous prohibition to regulated markets.

164. As mentioned in the CP, ESMA understands that there might be diverging interpretations in this matter. Due to the different wording used in those provisions a broad interpretation of Article 19(5) of MiFID II could be that an investment firm operating an MTF could never act in a principal capacity.

165. Such interpretation would not seem to be supported by the policy intent of MiFID II. It would create an unlevel playing field between operators of regulated markets and MTFs as the prohibition under Article 47(2) of MiFID II for market operators of regulated markets to execute client orders against proprietary capital is clearly limited to the regulated markets they operate.

166. In the CP, ESMA expressed that it would be relevant to clarify in Level 1 that the restriction on dealing on own account in Articles 19(5) of MiFID II should be interpreted as applying only to the MTF operated by the investment firm and not that an investment firm operating an MTF could not act in a principal capacity. ESMA sought market participants views on aligning the wording in Articles 19(5) and 47(2) of MiFID II.

B. Feedback to the Consultation

167. In response to the CP, most respondents supported the proposal, mostly without further comments. One of the respondents supporting the proposal suggested that this could be

[31] In particular Article 16a of Commission Delegated Regulation 2017/2294.

addressed with a Q&A. One respondent not supporting the proposal considered supervisory convergence measures as more effective.

C. ESMA's assessment and recommendations

168. Considering the positive response to the proposal, ESMA recommends that the wording under Articles 47(2) and 19(5) MiFID II is aligned to clarify that the restriction on executing client orders against proprietary capital, or to engage in matched principal trading, should be interpreted as applying only to the MTF operated by the investment firm and not that an investment firm operating an MTF could not act in a principal capacity for its non-MTF activity, i.e. the investment firm should be permitted to act in its principal capacity for any activity not related to the operation of the MTF.

169. Hence, ESMA would suggest a change to Level 1.

6 Annexes

6.1 Annex I

Feedback to the consultation paper

Q1: What are your views about the current OTFs landscape in the EU? What is your initial assessment of the efficiency and usefulness of the OTF regime so far?

The respondents unanimously believe that the OTF regime has proven to be a positive new concept under MiFID II. The creation of OTFs was useful and efficient in capturing a part of bonds and derivatives markets which would otherwise be traded OTC. The OTF concept rightly acknowledged that the trading systems including voice trading needed a specific regulation. Furthermore, the OTF regime has showed the effectiveness of the human element of discretion and how it plays an important role in price discovery.

Q2: Trading in OTFs has been fairly stable and concentrated in certain type of instruments throughout the application of MiFID II. How would you explain those findings? What in your view incentivizes market participants to trade on OTFs? How do you see the OTF landscape evolving in the near future?

Wholesale market participants choose to trade on OTFs mainly for the market knowledge and network, which allow them to execute larger transactions, while limiting transaction costs. OTFs play a key role especially in the interdealer market, allowing dealers to manage risks effectively. The sector's stable market share demonstrates that, despite the rise of electronification of trading, the human factor remains key, particularly for large and complex transactions. Several respondents expect OTFs to further continue to use technology to enhance their offerings across trade lifecycle. Few respondents think that the number of registered OTFs will increase in the future, while others that their number and volumes of activity should remain stable.

Q3: Do you concur with ESMA's clarifications above regarding the application of Article 1(7) and Article 4(19) of MiFID II? If yes, do you agree with the ESMA proposed amendment of Level 1? Which other amendment of the Level 1 text would you consider to be necessary?

Respondents were split in relation to ESMA's proposed amendment of Level 1. Respondents who agreed with ESMA were mostly trading venues whilst those from a variety of other market participants did not agreed with ESMA's proposal nor with its interpretation of the application of Article 1(7) and 4(19) of MiFID II.

Those who concur with ESMA, believe it is necessary to move Article 1(7) to MiFIR emphasize that in order to prevent regulatory arbitrage a broad interpretation of the trading venue perimeter is necessary. Furthermore, the vast majority of respondents who agree with ESMA

underline that the regulatory framework is clear and existing regulation should be enforced. Some of these respondents call for ESMA to gain additional enforcement powers in order to further enhance the level playing field in the EU.

On the other hand, those who do not agree with ESMA are of the view that ESMA's interpretation of the trading venue perimeter is too broad and would capture a number of software providers and other fintech companies that in their view should not be regarded as trading venues. Some respondents despite disagreeing with ESMA's broad interpretation still would see a need for clarification of some aspects of the regulatory framework. These respondents are however not very clear as to which aspects would deserve further attention from legislators.

Some respondents are of the view that where a broker only arranges trades that are ultimately crossed on a trading venue should not require authorisation as a trading venue.

A small number of participants are of the view that where a system enables the interaction of many counterparties with one entity, such as the case of RFQs, that should not be considered as a multilateral system since, in their view, such a system would be proving for a number of bilateral interactions and not a single multilateral system.

Finally, a broad range of respondents from a variety of different areas within the financial industry and regardless of their views as to whether a Level 1 amendment is necessary, convergence in two aspects: the first is the need of further enforcement measures from NCAs; and, second the desire for ESMA to further consult the industry when taking this subject further.

Q4: Do you agree with ESMA's two-step approach? If not, which alternative should ESMA consider?

A slight majority of respondents does not agree with ESMA's two-step approach.

Most of the respondents who disagree with ESMA's approach do not question the need for further clarifications on the perimeter issue but rather question whether an Opinion is the most appropriate regulatory tool at ESMA's disposal. These participants argue that an Opinion does not require further consultation which in their view is essential. A small number of those respondents that disagree with the Opinion as a tool, would rather suggest ESMA to develop RTS to give more legislative strength to any measures taken in this area.

One respondent suggests that the legislative framework is quite clear and the regulatory response to this issue should be based on the risk presented to the market of the entity in question.

To note that a small number of respondents reiterate their view that ESMA should clarify that an RFQ is not a multilateral system and that enforcement of existing rules would tackle the issue more effectively than the issue of guidance.

Q5: Do you agree with ESMA's proposal not to amend the OTF authorisation regime and not to exempt smaller entities? If not, based on which criteria should those smaller entities potentially subject to an OTF exemption be identified?

Out of the 16 respondents that provided comments to this question almost all (14) were of the view that there should not be an amendment to the OTF authorisation regime nor an exemption to smaller entities. These respondents are mainly of the view that changes can create incentives to avoid the regulatory perimeter.

Some respondents, in particular trading venues and trade associations, have noted that some tweaks could be made to the authorisation regime and supervision approaches by NCAs but no exemptions should be created.

In particular one trading venue called for a reduction of the capital requirements for obtaining an OTF licence as it may constitute a barrier to enter the market. The respondent noted that the requirements should be calibrated to the risk profile of the products traded by the OTF in question.

One trade association representing trading venues, suggested that the supervision regime should be rules based and proportional to the size and risk of the OTF.

The two respondents that would like to see changes to the authorisation regime suggested to include a principle of proportionality based on the level of activity of the firm in question. Respondents argue that introducing a degree of proportionality in the attached obligations would enhance competition and not discourage the entry of newcomers.

Q6: Which provisions applicable to OTFs are particularly burdensome to apply for less sophisticated firms? Which Level 1 or Level 2 amendments would alleviate this regulatory burden without jeopardising the level playing field between OTFs and the convergent application of MiFID II/MiFIR rules in the EU?

ESMA did not receive many responses to this question.

About half of those that provided comments suggested that no changes should be introduced but, should that be the case, these should be applied to all market participants equally and not limited to less sophisticated firms.

Those respondents that called for changes to the regulatory regime mentioned in particular the provisions relating fees structure. Respondents note that RTS 10 does not take into consideration instruments with different liquidity profile such as those normally traded on OTFs. In particular, as one respondent notes, it is burdensome for an OTF to comply with cost transparency rules when transactions are made at an all-in cost basis.

One respondent also notes that the obligation to charge the same fee to all users does not take into account that the amount of work to match orders in illiquid instruments vary significantly and that the range of fees should be more adaptable to cater for these circumstances.

Finally, one respondent noted that the requirement to produce best execution reports should be reviewed. Such measure should however not be limited to less sophisticated firms .

Q7: Do you consider that ESMA should publish further guidance on the difference between the operation of an OTF, or other multilateral systems, and other investment services (primarily Reception and Transmission of Orders and Execution of orders on behalf of clients)? If yes, what elements should be considered to differentiate between the operation of multilateral systems and these other investment services?

Respondents to this question are split with regards to the need to provide further guidance on the difference between the operation of an OTF, or other multilateral systems, and other investment services.

Some respondents note that despite guidance not being needed, they are of the view that ESMA and NCAs have not enforced the perimeter. These respondents understand that the requirements are clear and, instead of further guidance, urge regulators to use enforcement measures.

A number of respondents also note that they understand that broker activity can take place outside of a trading venue. The specific example notes that a broker that simply collects trading interests with the aim of transmitting those to a trading venue should not be required to request authorisation as an OTF. These requirement would only bring a proliferation in the number of trading venues that would only exist to send trades to other venues for execution. The relevant element to note is that the ultimate trade would always be executed on a trading venue. With regards to this particular example, one trade association notes that OTFs can also act as brokers when arranging trades above LIS which then would be concluded on a trading venue. This should only be allowed, in accordance with the respondent, if the trade is ultimately executed on a trading venue.

A number of respondents ask for further guidance on the difference between the operation of an OTF, or other multilateral systems, and other investment services. Most of those focus their remarks on system such as online communication platforms. These respondents would like ESMA to clarify that technology tools that provide platforms which enable counterparties to interact efficiently on a bilateral basis do not constitute multilateral systems. For example, where a buy-side firm create a message to be sent to one or more dealers in separate, thereby creating separate chats to a request a quote in a financial instrument it should not be considered as a multilateral system. These respondents argue that a chat functionality is genuinely bilateral, since (1) a dealer would not know whether or which other dealers were

engaged by the buy side, and (2) dealers would not be able to see or react to quotes or terms provided by other dealers.

One respondent noted that further guidance would be welcomed specifically with examples to clarify the difference between trading venues, OMS, EMS and bulletin boards.

Q8: Do you consider that there are networks of SIs currently operating in such a way that it would in your view qualify as a multilateral system? Please give concrete examples.

A large majority of respondents from the sell-side explained that they were not aware of such networks of SIs and did not share the concerns expressed in the CP.

Those respondents are of the view that SIs interact with each other legitimately either for handling client orders and discharging their best execution obligations or for own account risk management. The typical set up is that investment firms/international banks who are execution service providers have connections to a number of electronic liquidity provider (ELP) SIs, their own bank SI and the major trading venues across Europe. Upon receipt of a client order, the order management system polls the SIs for quotes (sometimes routing the order to their own SI first before polling the external SIs) and the liquidity offered in the lit book. The system then selects the most appropriate routing option dependent on best execution parameters. In all cases, each investment firm will be trading on a one-to-one bilateral basis with the selected SI. Those respondents consider that ESMA Market structure Q&A 26 guidance on back to back transactions is clear, well understood and fit for purpose. In their views, if concerns exist with individual participants, the existing rules should be enforced rather than pursuing further legislative change. In addition, they note that BCN activity cannot be claimed to have transferred to SIs. Volumes reported as SI remain a mix of bilateral trading and non-addressable technical trades.

On the opposite, trading venues that responded to the CP shared the concerns expressed in the CP. They note that the fact that there is still no clear view from a market supervisory and regulatory perspective on the existence, relevance and proliferation of these networks of SIs sheds some light on the still prevailing opacity around SI activities. To have more clarity on SI activities, those respondents suggest introducing an authorisation requirement for SI activities, which would include a detailed description of their business activities as part of their application documents with periodic regulatory scrutiny.

Q9: Do you agree that the line differentiating bilateral and multilateral trading in the context of SIs is sufficiently clear? Do you think there should be a Level 1 amendment?

A majority of respondents representing mainly sell side firms and their trade associations, considered that the delineation between multilateral and bilateral trading in the context of SIs is sufficiently clear and that no Level 1 amendment is needed. One of those stakeholders further noted that any technological advances and market structure diversity that supports SIs' contribution to markets (in terms of liquidity, efficiency and best execution outcomes) within

the current regime should be protected and retained, while agreeing that any qualifying multilateral system must request authorisation as a trading venue.

Some respondents representing trading venues supported some further clarification in Level 1or 2 of the concept of bilateral system under MiFID II/MiFIR which, in their view, does not appear to be uniformly understood, especially not in the context of SIs. However, no specific suggestion was provided. Noting the increased share of OTC and SI trading which they consider contrary to the MiFID II/MiFIR objectives, a couple of those stakeholders referred to their earlier response to ESMA's previous consultations on equity and non-equity transparency where they suggested to restrict the scope of bilateral trading and to regulate SIs more tightly, including by applying the same transparency rules as for trading venues and comparable reporting rules.

Q10: What are the main characteristics of software providers and how to categorise them? Amongst these business models of software providers, which are those that in your view constitute a multilateral system and should be authorised as such?

Respondents generally agreed that the current legal framework remains appropriate and does not need to be updated to accommodate innovation and/or new market developments. They concurred that the issue (if any) is more about providing more supervisory guidance and ensuring appropriate enforcement of existing rules. Some respondents insisted in this respect about the importance to undertake an activity-based supervision. The authorisation regime should remain related to the actual activity undertaken and not linked only to the technology used or how the service provider characterise itself.

Some respondents also call ESMA for cautious regarding possible supervisory actions. The possible benefits of more stringent supervision of software providers should be duly analysed together with the possible impacts this could have on innovation (which typically comes from unregulated entities and not trading venues), on the efficiency of order management and on the implementation of enhanced straight through processes. Similarly, some respondents on the importance maintain a clear distinction between the operation of a multilateral systems and the reception and transmission of orders.

Respondents suggested different possible criteria to determine whether a system is genuinely multilateral and should therefore be authorised as such.

Firstly, some raised argued that where a system supports the conclusion of transactions that are ultimately formalised on an authorised trading venue, this system should not itself be authorised for a similar service. This echoes the issue discussed earlier in the consultation paper about whether the fact that the transaction is formally executed in the system should be regarded a as a necessary condition for a system to be authorised as a trading venue under MiFID II.

Other respondents suggested to distinguish between "distributed Trading Mechanisms" vs "insourced Trading Mechanisms". The former refers to cases where a software is licensed to

each client individually allowing them to interact for trading purposes on a “peer-to-peer” or “point-to-point” basis. In the case of “insourced trading mechanisms”, the software provider does not retain interest in the trading activities. The software is operated by an investment firm, typically a broker authorised for Reception and Transmission of orders. Some respondents also noted that even authorised trading venues can used software and systems developed and commercialised by other firms.

Regarding “distributed trading mechanisms” some respondents considered that because of their “peer-to-peer” design, they should not be subject to authorisation as multilateral systems (those being bilateral by design). Other consider that this is not necessarily the case and brought the case of software that are clearly designed and serviced with the aim to bring together trading interest from multiple clients.

Another aspect many respondents insisted on is that only systems that are characterised by “many-to-many” interactions should be authorised as trading venues. There are however more diverging views regarding what precisely constitutes a “many-to-many” systems or what constitutes a genuine bilateral system. For example, respondents did not seem to agree on whether authorisation is required (i) for systems that allow market participants to send a request simultaneously to a network of liquidity providers or (ii) for systems that enable a given entity to benefit from an aggregated view to several potential counterparties’ interests. Respondents presenting aggregators as simple bilateral systems insisted on the fact that they are used to manage more efficiently pre-existing trading relationships and that they allow buy-side firms to simply operate in a more cost-effective manner (e.g. facilitating the price discovery process)

Similarly, some respondents raised questions about systems that operate under a RFQ model (i.e. systems where a client can send a request to multiple liquidity providers at the same time who can reply with quotes). Some considered that those systems are not “many to many” systems and should therefore not be authorised as multilateral systems (even though trading venues can operate such systems).

Some respondents invited ESMA and NCAs to consider whether the decision to trade is made through automation. For them, where the decision to trade is taken between individual firms (which are typically regulated entities), the system should be regarded more as a communication tool and therefore not be regulated. This is usually the case for Order Management Systems (OMS) and Execution Management Systems (EMS) which are commonly used by buy-side and sell-side firms to operate more efficiently.

Q11: Do you agree with the approach suggested by ESMA regarding software providers that pre-arranged transactions formalised on other authorised trading venues? Do you consider that this approach is sufficient to ensure a level playing field or do you think that ESMA should provide further clarifications or propose specific Level 1 amendments, and if so, which ones?

Respondents expressed split views regarding the ESMA's interpretation. Some respondents considered that where a software provider or a firm pre-arranges transactions in a multilateral fashion, it should be authorised as multilateral systems. For others, pre-arranging transactions is and should remain a separate licensable activity ('reception and transmission of orders'); whether provided by software companies or other firms.

Many respondents reiterated the points they made earlier in the paper, e.g. regarding whether execution of transactions is a key characteristic of trading venues.

Those who disagreed with ESMA's interpretation insisted on the importance of pre-arranged transactions (for non-equity instruments in particular) and raised concerns about the possible impacts a boarder authorisation regime could have on this activity and, more generally, on EU markets' competitiveness.

Some respondents considered that where pre-arranged transactions are executed on a trading venue, the pre-arranging activity should never be authorised as a trading venue itself. This might otherwise create confusion regarding the regulatory responsibilities to be complied with.

Q12: Do you agree with the principles suggested by ESMA to identify a bulletin board? If not, please elaborate. Do you agree to amend Level 1 to include a definition of bulletin board?

Most of the consultation paper participants agreed with ESMA's definition of bulletin board and that a Level 1 amend should be done to incorporate this definition.

Several respondents agreed that the definition of bulletin board should be further clarified, especially regarding the development in the crypto-asset and crowdfunding areas.

Two of the participants stated that the concept of "forming an invitation to treat" should also be helpful in this regard.

Also, several respondents considered displaying contact details in an electronic bulletin board as a security risk and it should not be allowed, justifying by stating that the indication of interest owner can be identified without displaying telephone numbers or email addresses.

One of the respondents agreed that setting a more descriptive definition of bulletin boards is necessary, but not using the same characteristics used by ESMA on the consultation paper. For this respondent the issues rely with paragraphs (b) and (c) of ESMA's proposal. The participant states that the paragraph (b) removes the possibility of communication between advertising parties, which is too restrictive, and paragraph (c) suggests that the bringing together of a buying and selling interest is enough to bring a platform into scope of a multilateral system. The respondent proposes the following as characteristics of bulletin boards:

a. an interface that only receives, pools, aggregates and broadcasts buying and selling interests in financial instruments, (including financial securities registered in a distributed ledger);

b. the system does not impose the mandatory use of tools of affiliated companies; and,

c. there is no possibility of execution in the system.

Another participant also considered to be the upmost importance that ESMA were proceeds with the Level 1 amendment to encapsulate its definition of bulletin boards, but it should make explicitly clear that the lack of categorisation of a software solution as a bulletin board is not sufficient to conclude that such software provider falls within the definition of multi-lateral system or the regulatory perimeter. The respondent further suggests that bilateral communication tools (one to one communication) should be explicitly stated to fall outside the regulatory perimeter.

The few respondents that did not agreed with ESMA's view considered either bulletin boards as multilateral trading, or that such new category is not necessary.

One of the respondents also declared that a bulletin board should be allowed to be integrated in the system architecture of a market end-user, without (because of this integration) being deemed a multilateral system under MiFID II.

Q13: Are you aware of any facility operating as a bulletin board that would not comply with the principles identified above?

Most of the participants did not reply to this question and the ones that did stated that are not aware of any facility operating as a bulletin board that would not comply with the principles identified by ESMA.

One of the participants suggested that given the clarity of the existing regime, if concerns exist with individual participants the existing rules should be enforced rather than pursuing further legislative change.

Q14: Market participants that currently operate such systems are invited to share more detailed information on their crossing systems (scale of the activity, geographical coverage, instruments concerned, etc…), providing examples of such platforms and describing how much costs & fees are saved this way as opposed to executing the relevant transactions via brokers or trading venues.

Most respondents did not provide any opinion nor comment to this question. Also., few that did provide a response did not deliver any details on scale of the activity, geographical coverage, instruments concerned, etc.

Respondents reinforced the positive points on having internal crossing systems, such as:

- Execution/transaction cost savings/optimisation (depending on the volume)
- Better pricing as execution is generally at mid of the Bid-Offer spread
- Facilitates delivery of Best-execution remit on the part of the investment manager
- No or limited external market exposure/impact (depends on the size and ability to match blocks and asset types)
- Ultimately, can also facilitate an improvement in the net investment performance of the investment manager for his/her managed funds.

Several respondents also explained that the crossing price is typically based on an externally provided mid-price with zero commission to ensure a fair treatment of both selling and buying, and that these practises are normally explained to investors prior to the commencement of the investment mandate to ensure that they understand the controls that are in place to achieve consistency and fairness across funds and accounts.

One of the respondents recommended that any operator of a system (whether SI, MTF, crossing network) should run through an authorisation procedure which must include a description of the business activities, fees, instruments, etc. Furthermore, the respondent added that it could also be helpful to regularly assess the compliance with the authorisation requirements and to grant competent authorities the possibility to request further information, if necessary.

Q15: Do you consider that internal crossing systems allowing different fund managers within the same group to transact between themselves should be in scope of MiFID II or regarded as an investment management function covered under the AIFMD and UCITS? Please explain. In your view, should the regulatory treatment of these internal crossing system be clarified via a Level 1 change?

Most of the respondents of the overall consultation paper did not reply to this question.

One respondent agreed that the that internal crossing systems allowing different fund managers within the same group to transact between themselves should be in the scope of MiFID II, and another one disagreed.

The respondent that agreed stated that trading volumes conducted on international crossing networks should be subject to the same strict MiFIR/MiFiD requirements as those conducted on regulated trading venues.

The respondent that disagreed justified its view stating that the internal crossing systems are part of the workflow management of the investment manager, which has definite benefits, but since these internal crossing systems do not constitute any form of multilateral trading and imposing OTF obligations would increase costs, diminish efficiencies, and ultimately potentially impact investment performance, there is no further clarification required, nor a Level 1 amend is needed.

Q16: Do you agree with the interpretation provided by ESMA regarding how discretion should be applied and do you think the concept of discretion should be further clarified?

The large majority of respondents stated that they were in agreement with ESMA's view on how discretion should be applied and supported the view that the Q&A published by ESMA offers sufficient guidance and there is no need for further clarification.

One respondent believed that the interaction between discretion and the rulebook of an OTF is very difficult to comprehend and considers that it would benefit from clarification.

Two respondents did not comment.

Q17: For OTF operators: Do you apply discretion predominantly in placement of orders or in execution of orders? Does this depend on the type of trading system you operate? Please explain.

Three respondents stated that they apply discretion to order placement and execution in equal measure. One respondent specified that this is due to their hybrid system. Another respondent stated that the entities represented apply discretion both to order placement and execution, as they have diverse trading models.

One respondent answered discretion is applied more often to execution of orders. One respondent stated discretion is applied more often to placement of orders, and such discretion substantiates in imposing limits to the maximum volume that might be placed in a single order on their platform.

One respondent stated that in the FX market discretion often consists in offering diverse pricing for similar trades depending on some factors including the nature of the transaction, the relationship between the counterparty and the institution, and the market conditions prevailing at the time pricing is determined.

Five respondents did not provide any comment.

Q18: For OTF clients: Do you face any issue in the way OTF operators exercise discretion for order placement and order execution? If so, please explain. Does it appear to be used regularly in practice by OTF operators?

Three respondents did not comment on this matter.

The majority of respondents stated that there has been no issue arising on the way OTFs apply discretion. One respondent noted that there can be an appearance of less transparency, however this is misleading as the rules are in the Rulebook of the OTF or on its website. Other respondents also noted that OTF have a rulebook on their websites and the use of discretion is explained in a transparent manner. Some respondents further stressed that discretion is exercised keeping in mind the client best interest and best execution policies. One respondent highlighted that discretion is used widely and regularly.

One respondent discussing discretion in FX markets stated that the OTF rulebook and other relevant documentation should clearly inform the client/counterparty on how the OTF operates concerning discretion and discretionary orders and its approach to providing Best Execution under MiFID II. All such policies should be freely available to client and counterparties.

Q19: Do you think ESMA should clarify any aspect in relation to MPT or that any specific measure in relation to MPT shall be recommended?

Of the stakeholders that replied to this question, the majority did not see any need for further clarification. Only a few respondents supported the proposal.

One of the respondents favouring a clarification mentioned that the current rule regarding the MPT restriction of SIs is only specified in Level 2 and Level 3 text. The respondent noted that this should be clarified in Level 1 regulation in order to create a level playing field, as it is mentioned in Level 1 for OTFs, RMs and MTFs. Another respondent supporting a clarification outlined two scenarios. (1) No matter the definition of MPT, SIs can act as brokers. Otherwise, (2) it shall be clear that MPT does not include the situation where the investment firm (the SI) enter into separate trades with separate clients even though the buy price and the sell price is the same.

The respondents opposing the proposal mentioned that they have a good understanding of MPT and that there is no need for further clarifications. Two of these respondents also considered the risk that further clarifications might increase complexity and reduce competition and diversity in financial markets. One respondent also stressed the importance of supervisory convergence.

Q20: In your view what is the difference between MPT and riskless principal trading and should this difference be clarified in Level 1? In addition, what, in your view, incentivizes a firm to engage in MPT rather than in agency cross trades (i.e. trades where a broker arranges transactions between two of its clients but without interposing itself)?

A few respondents supported a clarification between MPT and riskless principal trading, though not necessarily in the Level 1 text. Respondents noted that there are subtle differences between MPT and riskless principal trading. Some respondents acknowledged that at times

these terms may not differ much in practice and are used interchangeably. However, some also explicitly noted that MPT should be seen as a subset of riskless principal trading.

In terms of differences and incentives, respondents noted that an MPT transaction will provide for a higher level of anonymity as the counterparties remain unknown to each other. Additionally, there will be one single point of settlement and only the need to assess the credit risk of the intermediary firm and not of all possible counterparties (uniformity of credit risk). Another characteristic of MPT that was named is that it would be more suitable for complex transactions that can be arranged involving multiple trade legs.

An incentive that was named for carrying out agency cross trades was that these may come with a higher degree of operational efficiency compared to MPT.

Two specific issues for clarification that were mentioned were cost transparency requirements in relation to MPT and whether MPT is possible for spread-based trading.

Q21: Do you agree with ESMA's proposal to clarify that the prohibition of investment firms or market operators operating an MTF to execute client orders against proprietary capital or to engage in matched principal trading only applies to the MTF they operate, in line with the same wording as applicable to regulated markets?

Most respondents supported the proposal, mostly without further comments. One of the respondents supporting the proposal suggested that this could be addressed with a Q&A.

The respondents not supporting the proposal notes this is already sufficiently explained in Level 1 text. One of these respondents argued that the potential creation of an unlevel playing field is better addressed through supervisory convergence measures. This respondent also highlighted the importance of direct relationships in financial markets.

6.2 Annex II

Commission mandate to provide technical advice / Legislative mandate to [develop technical standards]

Article 90 (1) of MiFID II:

Before 3 March 2019 the Commission shall, after consulting ESMA, present a report to the European Parliament and the Council on:

(a) the functioning of OTFs, including their specific use of matched principal trading, taking into account supervisory experience acquired by competent authorities, the number of OTFs authorised in the Union and their market share and in particular examining whether any adjustments are needed to the definition of an OTF and whether the range of financial instruments covered by the OTF category remains appropriate;

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