European Securities and Markets Authority

Submission Date
03/04/2017

ESMA_QA_1642

Status: Answer Published

Additional Information

Level 1 Regulation
Markets in Financial Instruments Directive II (MiFID II) Directive 2014/65/EU- Secondary Markets

Topic
Multilateral and bilateral systems

Subject Matter
Organized Trading facilities OTFs

Question
What are the characteristics of an OTF? When is the authorisation for the operation of an OTF required?

ESMA Answer

03-04-2017

Original language

[ESMA 70-872942901-38 MiFID II MiFIR market structures Q&A, Q&A 5.10]

An OTF is a multilateral system, i.e. “a system or facility in which multiple third-party buying and selling interests in financial instruments are able to interact in the system” (Article 4(1)(19) of MIFID II). The OTF definition supplements this overarching definition by further establishing that only buying and selling interests in bonds, structured finance products, emission allowances and derivatives may interact on an OTF in a way that results in a contract and that the execution of orders must be carried out on a discretionary basis.

In addition, two types of systems operated by an OTF are identified in Article 20(6) of MiFID II: (i) systems that cross client orders (without prejudice to the restrictions placed on matched principal trading) and (ii) systems that arrange transactions in non-equities where the operator of the OTF may facilitate negotiations between clients so as to bring together two or more potentially compatible trading interests in a transaction.

Under Section A(8) of Annex I of MiFID II, the operation of an OTF is an investment activity that requires prior authorisation.

ESMA is of the view that an entity should seek authorisation to operate an OTF where the three following conditions are met: a) trading is conducted on a multilateral basis, b) the trading arrangements in place have the characteristics of a system, and c) the execution of the orders takes place on a discretionary basis through the systems or under the rules of the system.

1. Trading is conducted on a multilateral basis: Interaction with a view to trading in a financial instrument is conducted in such a way that a trading interest in the system can potentially interact with other opposite trading interests. As OTFs are required to “have at least three materially active members or users, each having the opportunity to interact with all the others in respect to price formation” (Article18(7) of MiFID II), an

OTF user's trading interests can potentially interact with those of at least two other users. On OTFs, the interaction of user trading interest can take place in different ways, including through matched-principal trading or market-making, within the limits set out in Article 20(2) and 20(5).

2. The trading arrangements in place have the characteristics of a system: MiFIDII/MiFIR is technology neutral and accommodates a variety of "systems". A system would be easily identified when embedded in an automated system. This would cover a situation where, for instance, the arrangements in place consist of the automated crossing of client trading interests, subject to the exercise of discretion on an OTF. However, other non-automated systems or repeatable arrangements that achieve a similar outcome as a computerised system, including for instance where a firm would reach out to other clients to find a potential match when receiving an initial buying or selling interest, would also be characterised as a system.

Where a firm would, by coincidence and accidentally, receive matching buying and selling interests, and decide to execute those orders internally, such unpredictable circumstances would not qualify as the operation of a system.

3. The execution of the transaction is taking place on the system or under the rules of the system. The execution of the orders would be considered to be taking place under the rules of the system including where, once the trade price, volume and terms have been agreed through a firm, the counterparties' names are disclosed, the firm steps away from the transaction and the transaction is then legally formalised between the counterparties outside a trading venue.

If an investment firm arranges a transaction between two clients and the clients decide to formalise the trade on a regulated market or an MTF, the transaction would not be considered as taking place under the rules of the system because a transaction cannot be concluded on more than one venue.

ESMA notes that if an investment firm were to arrange transactions on one system and provide for the execution of the transactions on another system for avoidance purposes, the disconnection between arranging and executing would not waive the obligation for the investment firm operating those systems to seek authorisation as an OTF operator.

ESMA highlights that OTFs are only one of the three categories of multilateral trading systems foreseen by MiFID II. Market participants operating a platform that meets the characteristics of a multilateral trading facility should therefore exercise judgment to assess, based on their business model, whether they need to seek authorisation for the operation of a multilateral trading facility (MTF), an OTF or, potentially of a regulated market. See also Question 5 on the differences between an MTF and an OTF and Questions 14 and 15 on systematic internalisers (SIs) and riskless transactions.