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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

Does the exercise of any form of discretion mean that a venue is an OTF?

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Original language

[ESMA 70-872942901-38 MiFID II MiFIR market structures Q&A, Q&A 5.19]

No. Article 20(6) of MiFID II sets out that “the market operator or the investment firm operating an OTF must exercise discretion only in either or both of the following circumstances:

1. When deciding to place or retract an order on the OTF they operate;
2. When deciding not to match a specific client order with other orders available in the systems at a given time, provided it is in compliance with specific instructions received from a client and with its obligations in accordance with article 27.

For the system that crosses client orders, the investment firm or the market operator operating the OTF may decide if, when, and how much of two or more orders it wants to match within the system. [...] with regards to a system that arranges transactions in non-equities, the investment firm or market operator operating the OTF may facilitate negotiations between clients so as to bring together two or more potentially compatible trading interest in a transaction”.

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.

As suggested by Article 20(6), ESMA is of the view that the exercise of discretion can usefully be split into a) order discretion and b) execution discretion.

3. Exercise of discretion at order level

When an investment firm or a market operator receives an order from a client, the “order discretion” refers to the judgement exercised by the OTF operator whether to place the order

at all on the OTF, whether to place the whole order or just a portion of it on the OTF, and when to do so. This may be the case for instance where an investment firm would receive a buy order for a 500 lots and would decide to place an order for 200 lots only on the OTF, the remaining 300 lots being executed elsewhere.

Similarly, and as opposed to the operator of an MTF which may not withdraw an order from the MTF at its own initiative unless for fair and orderly market purposes, the operator of the OTF is expected to make a judgement as to whether and when an order should be retracted from the OTF.

This may be the case where, at a given point of time, the OTF operator considers that a more favourable outcome would be obtained by executing the order on another execution venue foreseen in the best execution policy. The OTF operator may also have placed the order on the OTF, sent it to another trading venue simultaneously, subsequently decided to have the order executed on the trading venue and retracted it from the OTF.

The exercise of order discretion would always have to comply with the OTF best execution policy and with client order handling rules. Where clients would be providing a specific instruction to the operator of the OTF, the OTF operator would not be considered as exercising order discretion when complying with that specific instruction.

4. Exercise of discretion at execution level

Under Article 20(6), the exercise of discretion at execution level has to be in compliance with client specific instructions and the best execution policy. ESMA is of the view that the mere implementation of client specific instructions or of best execution obligations would not be the exercise of discretion.

The operator of the OTF is expected to exercise a judgement as to if, when, and how much of two matching orders in the system should be matched. For instance, assuming a buy side order for 500 bonds and an opposite order of 200 bonds have been placed into the OTF, the operator of the OTF would exercise discretion when deciding whether the 500 buy side order should not be matched with the sell side order.

Finally, ESMA highlights that the exercise of discretion, be it “order discretion” or “execution discretion”, should not be just a possibility foreseen in the rules of the OTF and in the best execution policy of the OTF operator. Discretion has to be actually implemented by the operator of the OTF as part of its ordinary course of business and should be a key part of its

activities. It is not expected that any quantitative threshold would be set to assess the exercise of discretion. However, as provided for under Article 20(7) of MiFID II, at the time of authorisation or on ad-hoc basis, the market operator or the investment firm operating an OTF should be able to provide to its national competent authority a detailed description of how discretion will be exercised and in particular when an order may be retracted from the OTF and when and how two or more client orders will be matched in the OTF. ESMA also highlights that the OTF operator should be able to explain to its national competent authority the rationale underpinning the exercise of discretion, such as the set of reasons and the logical basis for not matching two opposite buying and selling interests. Random placing, retracting, matching or non-matching of orders on the OTF would not be considered as the exercise of discretion.

Likewise, the exercise of pre-trade controls by the operator of the OTF to ensure fair and orderly trading would not qualify as the exercise of discretion. Post-trade decisions, for example over where transactions are settled, are not relevant either for the purposes of these provisions. Similarly, the decision to enter into a client relationship in compliance with OTF rules on non-discriminatory access does not constitute discretion under Article 20(6).