

Submission Date

28/03/2018

ESMA_QA_1658

Status: Answer Published

Additional Information

Level 1 Regulation

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

Topic

Systematic internaliser regime

Subject Matter

Systematic internaliser

Question

Recital 19 of the Commission Delegated Regulation (EU) 2017/565 clarifies the conditions under which an SI may engage in matched principal trading to execute client orders. To what extent can SIs engage in other types of riskless back-to-back transactions?

28-03-2018

Original language

[ESMA 70-872942901-38 MiFID II MiFIR market structures Q&A, Q&A 5.26]

Recital 19 of the Commission Delegated Regulation (EU) 2017/565 is not limited to internal matching of client orders through matched principal trading but more generally prevents SIs from operating any system that would “bring together third party buying and selling interests in functionally the same way as a trading venue”. The prohibition for an SI to operate an internal matching system for matching client orders is just one example, as opposed to the unique circumstance, under which an SI would actually be operating functionally in the same way as a trading venue and would be required to seek authorisation as such.

Based on the SI definition provided in Article 4(1)(20) of MiFID II, ESMA understands that the trading activity of a SI is characterised by risk-facing transactions that impact the Profit and Loss account of the firm. By undertaking such risk-facing transactions, SIs are a valuable source of liquidity to market participants. In that regard, ESMA notes that the MiFIR pre-trade transparency provisions for SIs seek to avoid submitting SI to undue risks based on the assumption and understanding that SIs are indeed facing risks when trading.

In contrast to the above, ESMA is of the view that arrangements operated by an SI would be functionally similar to a trading venue where they meet the following criteria:

1. The arrangements would extend beyond a bilateral interaction between the SI and a client, with a view to ensuring that the SI de facto does not undertake risk-facing transactions. This would be the case, for instance, where an SI would have agreements with other liquidity providers so that the SI would do a riskless back-to back transaction with one of those liquidity providers whenever a transaction is executed with a client, or where it would only execute one transaction contingent on another one. A similar outcome would be reached from the reverse situation where one or more liquidity providers would be streaming quotes to an SI. The quotes would then be forwarded by the SI to its clients to be executed against, resulting again in no risk back-to-back

transactions which could involve multiple parties. The concept of de facto riskless back-to-back transactions is not confined to pairs of transactions in the same financial instrument. Other arrangements, for example where one leg is a securities transaction and the other is a derivative which references that security, could also be deemed as having the objective or consequence of carrying out de facto riskless back-to-back transactions.

By crossing client trading interests with other liquidity providers' quotes, via matched principal trading or another type of riskless back-to-back transaction, so that it is de facto not trading on risk, the SI would actually organise an interaction between its client orders on the one hand and the SI or other liquidity providers' quotes on the other hand. The SI would be bringing together multiple third party buying and selling trading interests in a way functionally similar to the operator of a trading venue.

2. The arrangements in place are used on a regular basis and qualify as a system or facility, as opposed to ad-hoc transactions. The existence of a system would be easily identified where, for instance, the arrangement in place would be underpinned by technological developments to increase speed and efficiency and legal agreements would be in place between the SI and liquidity providers. The operation of a system could also include circumstances where there is an understanding with third parties that trade by trade hedging will be available on a regular basis. ESMA recalls that MiFID II/MiFIR is technology neutral and applies to voice systems as well as to electronic and hybrid systems;
3. The transactions arising from bringing together multiple third party buying and selling interests are executed OTC, outside the rules of a trading venue.

ESMA highlights that the above does not prevent SIs from hedging the positions arising from the execution of client orders as long as it does not lead to the SI de facto executing non risk-facing transactions and bringing together multiple third party buying and selling interests. ESMA is of the view that an SI would not be bringing together multiple third party buying and selling interests as foreseen in Recital 19 where hedging transactions would be executed on a trading venue.