



European Securities and  
Markets Authority

# Consultation Paper

**On the functioning of Organised Trading Facilities (OTF)**



## Responding to this paper

ESMA invites comments on all matters in this paper and in particular on the specific questions summarised in Annex 1. Comments are most helpful if they:

1. respond to the question stated;
2. indicate the specific question to which the comment relates;
3. contain a clear rationale; and
4. describe any alternatives ESMA should consider.

ESMA will consider all comments received by **25 November 2020**.

All contributions should be submitted online at [www.esma.europa.eu](http://www.esma.europa.eu) under the heading 'Your input - Consultations'.

### Publication of responses

All contributions received will be published following the close of the consultation, unless you request otherwise. Please clearly and prominently indicate in your submission any part you do not wish to be publicly disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. A confidential response may be requested from us in accordance with ESMA's rules on access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by ESMA's Board of Appeal and the European Ombudsman.

### Data protection

Information on data protection can be found at [www.esma.europa.eu](http://www.esma.europa.eu) under the heading [Legal Notice](#).

### Who should read this paper

This document will be of interest to all stakeholders involved in the securities markets. It is primarily of interest to competent authorities, investment firms and market operators that are subject to MiFID II and MiFIR. This paper is also important for trade associations and industry bodies, institutional and retail investors, their advisers, consumer groups, as well as any market participants because the MiFID II and MiFIR requirements concern the market structure of the

EU and the perimeter of trading that should be considered as multilateral and regulated as such.

## Table of Contents

1	Executive Summary .....	6
2	Introduction .....	8
3	Overview of OTF trading .....	9
3.1	OTFs current landscape .....	9
3.2	Current state of play .....	11
3.2.1	Bonds .....	12
3.2.2	Derivatives .....	16
4	OTF definition and trading venue boundaries .....	19
4.1	Legal framework and general background .....	19
4.2	Multilateral Systems .....	21
4.2.1	Multilaterality applied to non-automated systems .....	23
4.2.2	Network of SIs .....	26
4.2.3	Software providers .....	27
4.2.4	Boundaries between TV and bulletin boards .....	30
4.2.5	Operation of internal crossing systems by fund managers .....	32
4.3	Use of Discretion .....	34
5	Matched Principal Trading .....	36
5.1	Use of matched principal trading by OTFs .....	36
5.2	Restriction to matched principal trading on regulated markets and MTFs .....	38
6	Annexes .....	41
6.1	Annex I .....	41
6.2	Annex II .....	44

## Acronyms and definitions used

APA	Approved Publication Arrangement
CP	Consultation Paper
EC	European Commission
DTO	Derivatives Trading Obligation
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
EU	European Union
ESMA	European Securities and Markets Authority
FITRS	Financial Instruments Transparency System
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
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
SI	Systematic Internaliser
TOTV	Traded on a Trading Venue

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# 1 Executive Summary

## Reasons for publication

Directive 2014/65/EU<sup>1</sup> (MiFID II) and Regulation (EU) No 600/2014<sup>2</sup> (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 consultation paper (CP) 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 consultation paper contains proposals aiming at clarifying the MiFID II provisions relating to OTFs and, more generally, multilateral systems to ensure efficient EU market structures and a more 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 focusses 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 OTFs' use of discretion.

Finally, Section 5 discusses matched principal trading and presents evidence on how OTFs have been making use of matched principal trading, based on a fact-finding exercise performed by ESMA.

## Next Steps

ESMA will consider the feedback it received to this consultation and expects to publish a final report and submit it to the European Commission by March 2021.

## Disclaimer

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

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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.

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<sup>1</sup> 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)

<sup>2</sup> 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 CP concerns the report on 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 European Commission, in the context of Brexit and the Covid-19 crisis<sup>3</sup>.
3. In Section 3, this report provides an overview on 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 EU, (ii) the instruments offered for trading and (iii) the most common type of trading systems used.
4. Section 4 of the report discusses the OTF definition and analyses “trading venue boundaries”. For such purpose, the report examines in detail the definition of multilateral system and the implications of the changes introduced in MiFID II with regard to trading venue authorisation. Considering that the concept of multilateral system and the changes introduced by MiFID II are not limited to OTFs, the report analyses the implications on the overall EU microstructures, including also 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.

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<sup>3</sup> An overall planning for the MiFID II/MiFIR review reports is available on the ESMA website ([here](#)).



5. 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.
6. Based on the responses received to this consultation, ESMA will prepare its final review report for submission to the EC. Respondents to the consultation are encouraged to provide relevant information, including quantitative data, to support their views or proposals.

### **3 Overview of OTF trading**

7. One of the main objectives of MiFID II was to extend to bonds and derivatives the principles of organisation and transparency applying to equities. In this respect, the OTF concept was proposed in order to fill an existing gap, aiming to extend the definition of trading venue to those organised facilities offering trading in bonds and derivatives.
8. In order to discuss potential improvements to the current regime applying to OTFs, it is useful to provide an overview of the current landscape of the OTFs in the EU. Following that section, an analysis of the current state of play is presented which is based on data available under the Financial Instruments Transparency System (FITRS)<sup>4</sup>.

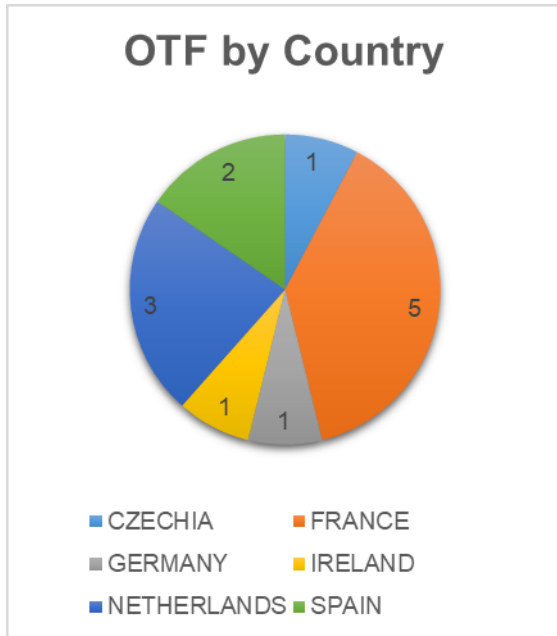
#### **3.1 OTFs current landscape**

9. ESMA has gathered information through a questionnaire submitted to NCAs, to assess the number of OTFs active in the EU, the instruments which are available for trading, the arrangements concerning matched principal trading and the use of discretion (the latter topics will be further elaborated in the coming sections of the report).
10. According to the feedback received, some OTFs authorised in the EU are currently not active, in particular those which relocated to the EU following the decision by the UK to leave. The OTFs displayed in the graphs and table below are those that are currently active within the EU. The OTFs already (or close to be) authorised which have not started their operations yet are not included.

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<sup>4</sup> Analysis has been made based on data reported to ESMA FITRS system during the period 2018-2019. It should be noted that due to data quality constraints, FX derivatives and SFPs have not been included in the analysis.

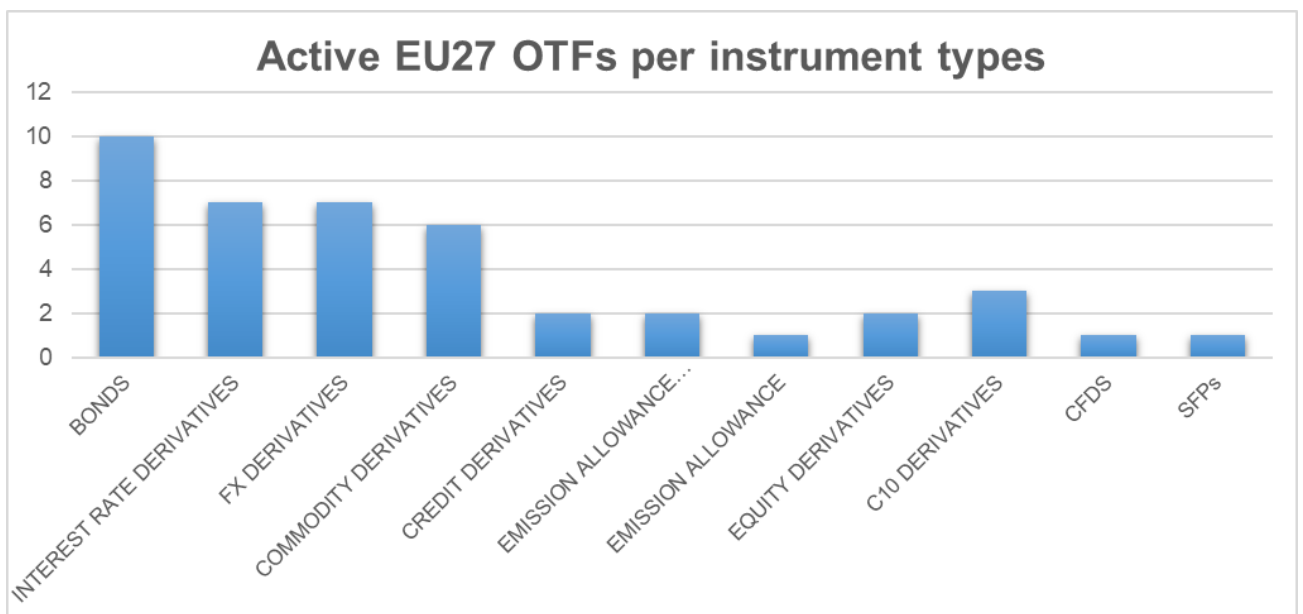
**FIGURE 1 CURRENT LANDSCAPE OF ACTIVE OTFs**



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
SPAIN	CIMD OTF
SPAIN	CAPI OTF

11. ESMA collected also information about the instruments available for trading on active OTFs. Figure 2 illustrates the number of OTFs offering for trading a particular type of instrument.

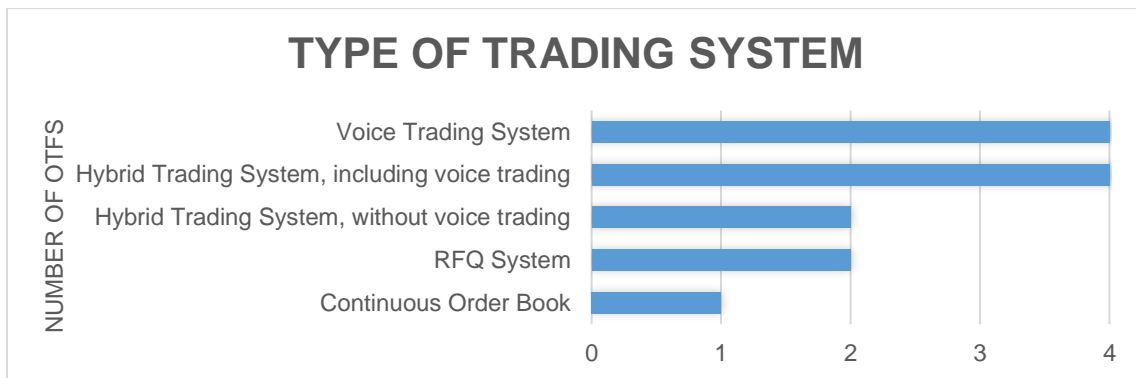
**FIGURE 2 NUMBER OF ACTIVE OTFs IN EU27 PER TYPES OF INSTRUMENTS**



12. Finally, ESMA also analysed the type of trading systems offered by such OTFs. Most of the OTFs appear to use a voice trading system or a combination of voice trading with

another type of trading system<sup>5</sup>. As displayed in Figure 3, other types of trading systems are also used, and in particular request for quote (RFQ) systems. Only one OTF uses central limit order book trading.

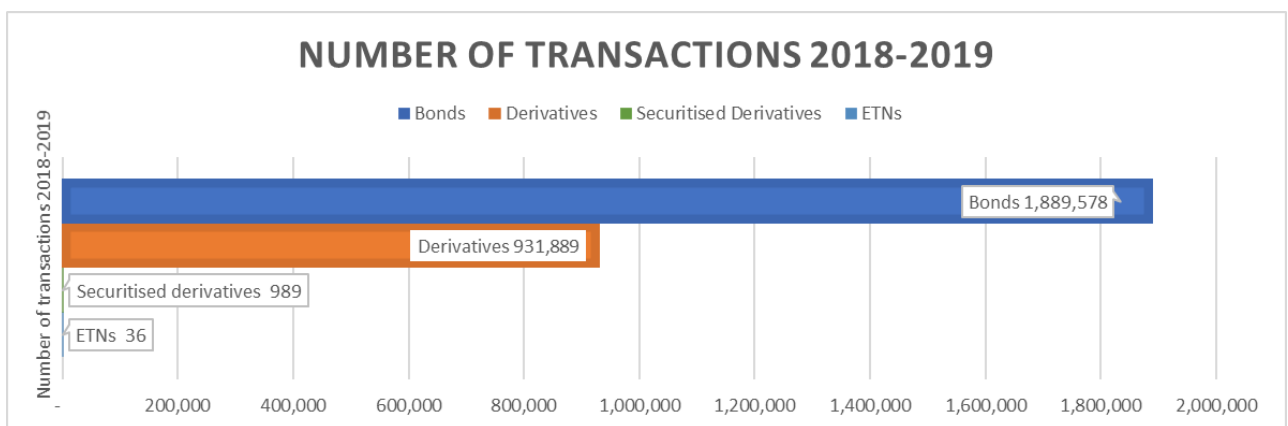
**FIGURE 3 TRADING SYSTEMS OF OTFS**



### 3.2 Current state of play

13. According to data reported to FITRS, bonds and derivatives account for the majority of OTF trading. As shown in Figure 4, those two asset classes account for virtually all trading on OTFs<sup>6</sup>. Given such evidence, ESMA has focused its analysis of the OTF trading activity on bonds and derivatives.

**FIGURE 4 TRADING ON OTFS PER INSTRUMENT TYPES**



<sup>5</sup> The ESMA review reports on the MiFIR transparency regime for equity and non-equity instruments (ref ESMA70-156-2682) have demonstrated that (i) more convergence could be found regarding the classification of trading systems in the EU and (ii) further clarification was needed regarding the delineation between hybrid systems and combination of trading systems. ESMA has made some recommendations in this respect.

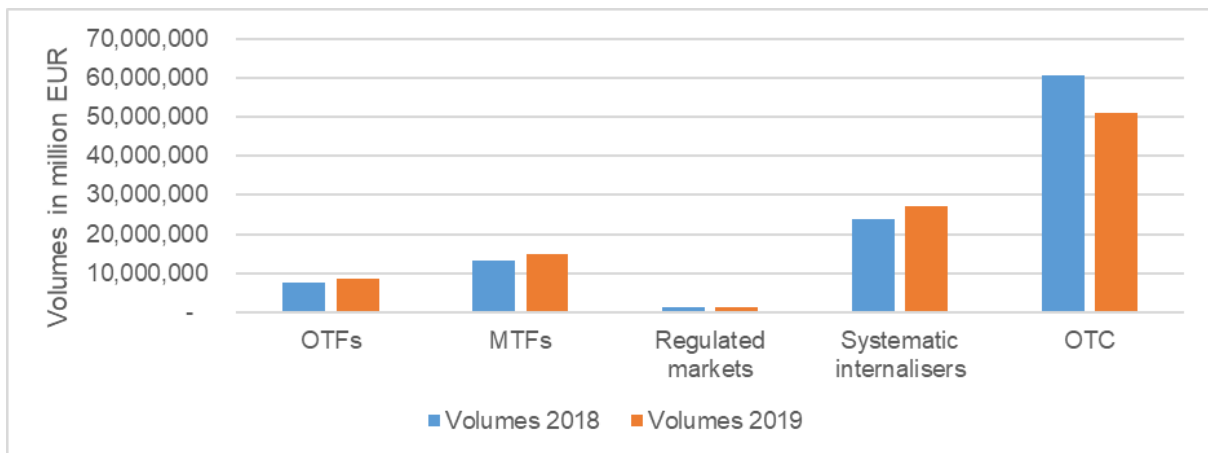
<sup>6</sup> Some trades were reported in ETNs and securitised derivatives, while no trading in emission allowances or ETCs has been reported.

14. Trading on OTFs is currently by law limited to non-equity instruments. ESMA notes that the characteristics of trading in non-equity instruments differ from equity trading, as the latter involves more liquid instruments and different trading arrangements.
15. OTFs often rely on trading mechanisms involving voice trading elements, as those appear to be more appropriate for less liquid markets. In particular, trading in bonds and derivatives involves often negotiation to arrange for customised transactions and as such is well supported by the type of trading systems through which OTFs arrange transactions. ESMA nevertheless notes a general trend towards more electrification of trading including for non-equity instruments.

### 3.2.1 Bonds

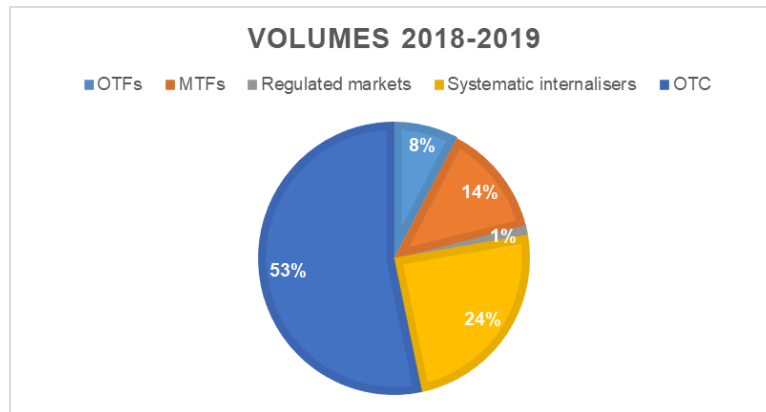
16. Trading in bonds on OTFs remains relatively low compared to other types of trading systems: during the years 2018-2019 the volume of bonds traded on OTFs represented roughly 7.6% of overall bonds' volume traded in the EU. The data further shows a slight increase in OTF bonds' volumes in 2019 compared to 2018.

**FIGURE 5 BOND VOLUMES PER TRADING SYSTEM DURING 2018-2019**



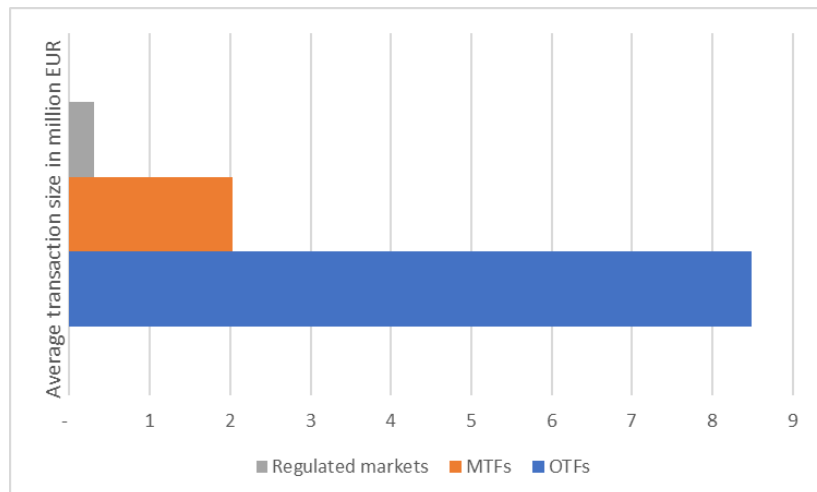
17. As presented in Figure 6, over the period 2018-2019 bonds were mainly traded OTC (53%) and on SIs (24%). Trading on MTFs accounted for 14% of total trading activity, followed by OTFs (8%) and regulated markets (1%).

**FIGURE 6 BOND VOLUMES PER TRADING SYSTEM DURING 2018-2019**



18. A similar analysis is carried out with respect to the number of transactions in bonds executed over the period 2018-2019 and presented in Figure 4 below. Such analysis shows that, despite the small increase in bond volumes on OTFs, the number of transactions has slightly decreased over the relevant period and remains lower compared to all the other execution venues (regulated markets, MTFs, SIs or OTC trading<sup>7</sup>).

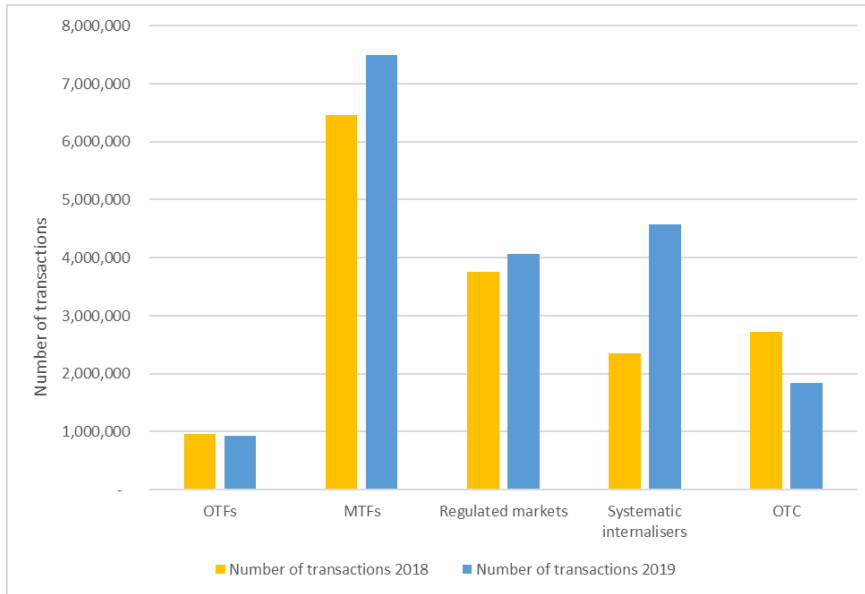
**FIGURE 7 AVERAGE TRANSACTION SIZE IN BONDS PER TYPE OF TRADING SYSTEM**



19. Furthermore, there is evidence that the average transaction size on OTFs is significantly larger than those registered on regulated markets or MTFs. As shown on Figure 7 above, during 2018-2019 the average transaction size executed on OTFs amounted to EUR 8.5 million, while on MTFs amounted to EUR 2.0 million, and EUR 0.3 million on regulated markets.

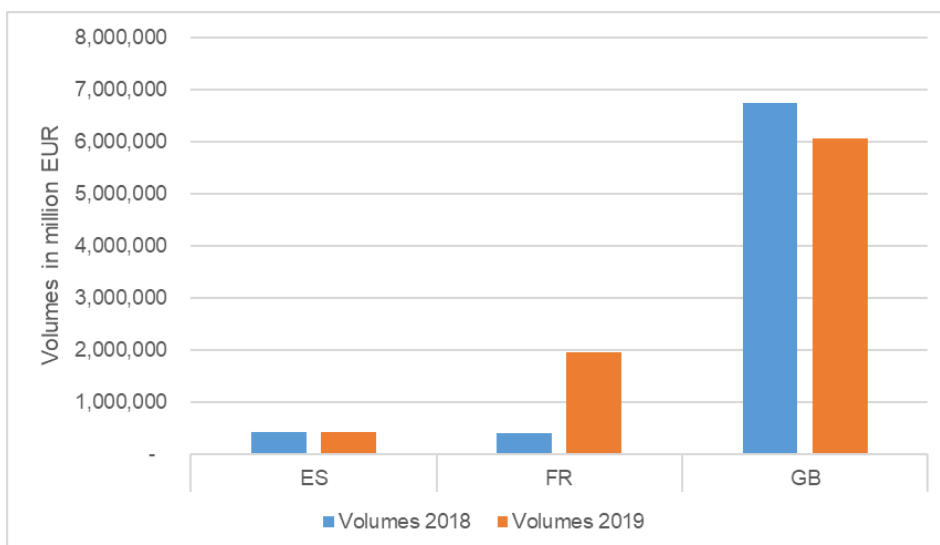
<sup>7</sup> OTC refers to transactions in TOTV instruments (i.e. instruments also traded on a trading venue in the EU, i.e. on a regulated market, MTF or an OTF) executed OTC (excluding SI trading).

**FIGURE 8 NUMBER OF TRANSACTIONS IN BONDS PER TRADING SYSTEM DURING 2018-2019**

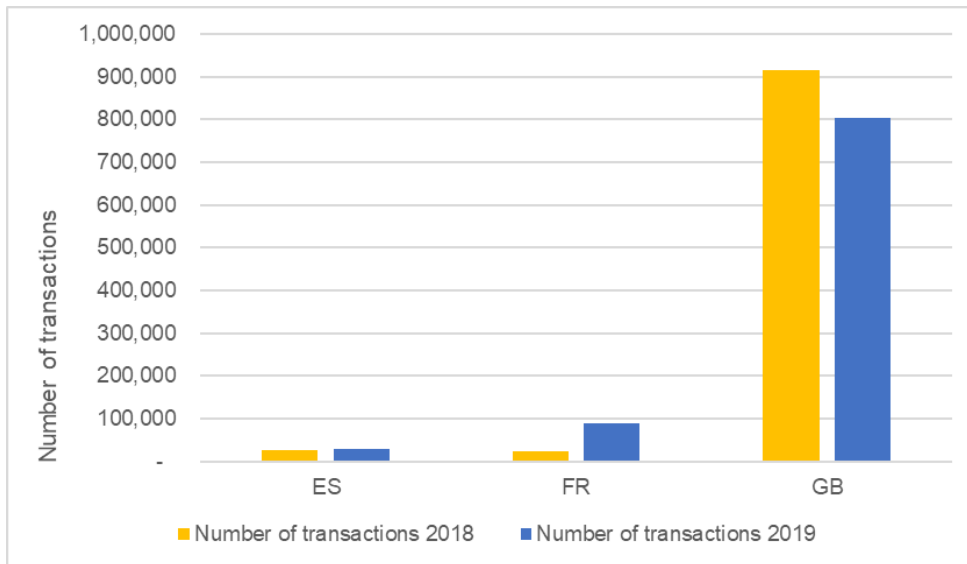


20. When observing the distribution of bonds' volumes per country, as per Figure 8, UK OTFs display the greatest turnover followed by OTFs in France and Spain. However, the market share of UK OTFs has decreased over the period 2018-2019 whereas French OTFs have gained a consistent market share. In terms of number of transactions, a similar trend is observed.

**FIGURE 9 BOND VOLUMES ON OTFs PER COUNTRY DURING 2018-2019**

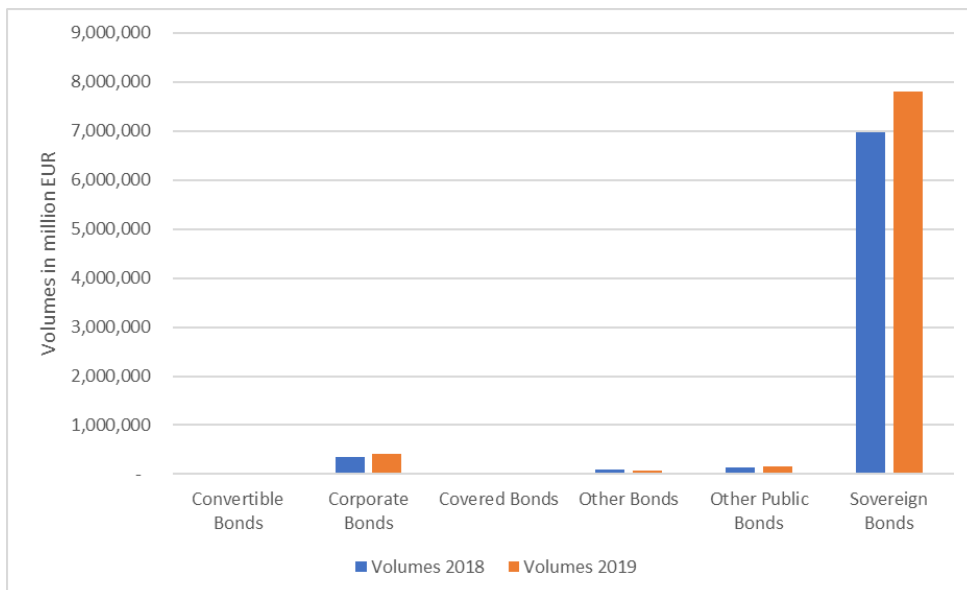


**FIGURE 10 NUMBER OF TRANSACTIONS ON OTFs IN BONDS PER COUNTRY DURING 2018-2019**

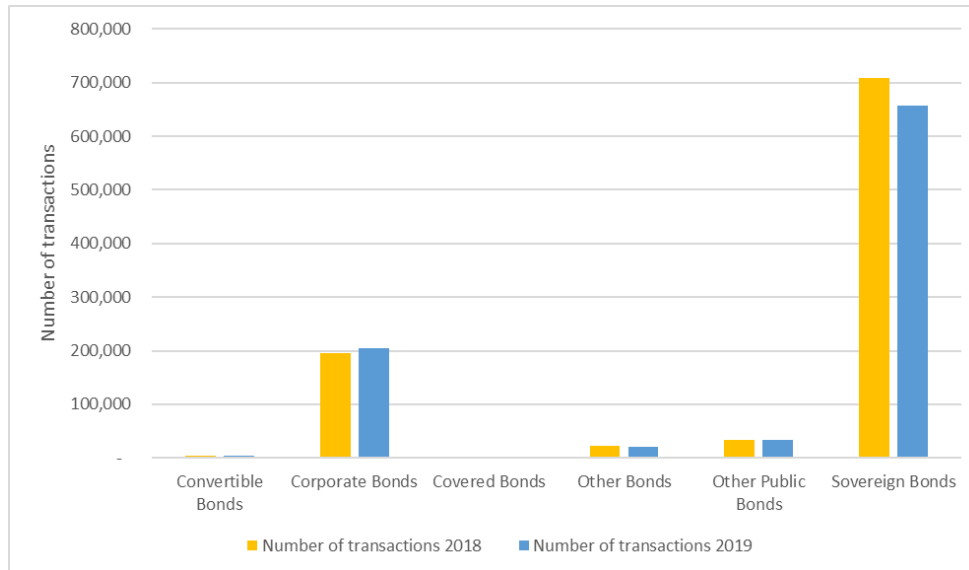


21. Statistics regarding the type of bonds traded on OTFs, show that sovereign bonds account for the largest volumes (approximately 92%), while both sovereign and corporate bonds report a significant number of transactions (73% and 20% respectively).

**FIGURE 11 BOND VOLUMES ON OTFs PER BOND TYPE DURING 2018-2019**



**FIGURE 12 NUMBER OF TRANSACTION PER BOND TYPE DURING 2018-2019**



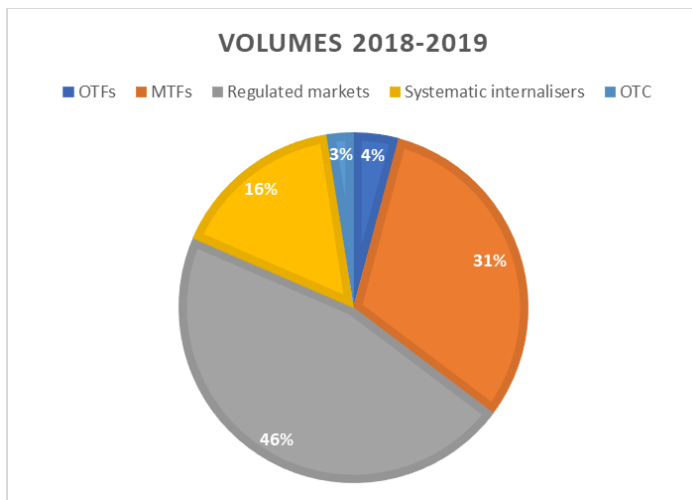
### 3.2.2 Derivatives

22. Considering the 2018-2019 period, derivatives' volumes traded on regulated markets account for 46% of the overall turnover, followed by MTFs (31%), SIs (16%) and OTFs (4%). Relatively small OTC volumes can be explained by the TOTV concept, which considers only a small percentage of OTC derivatives as traded on a trading venue and therefore subject to transparency and transaction reporting.<sup>8</sup> ESMA is aware of the quality limitations of the data reported and is constantly working on improving the accuracy of figures.

<sup>8</sup> Please see ESMA Opinion on TOTV: [https://www.esma.europa.eu/sites/default/files/library/esma70-156-117\\_mifir\\_opinion\\_on\\_totv.pdf](https://www.esma.europa.eu/sites/default/files/library/esma70-156-117_mifir_opinion_on_totv.pdf)

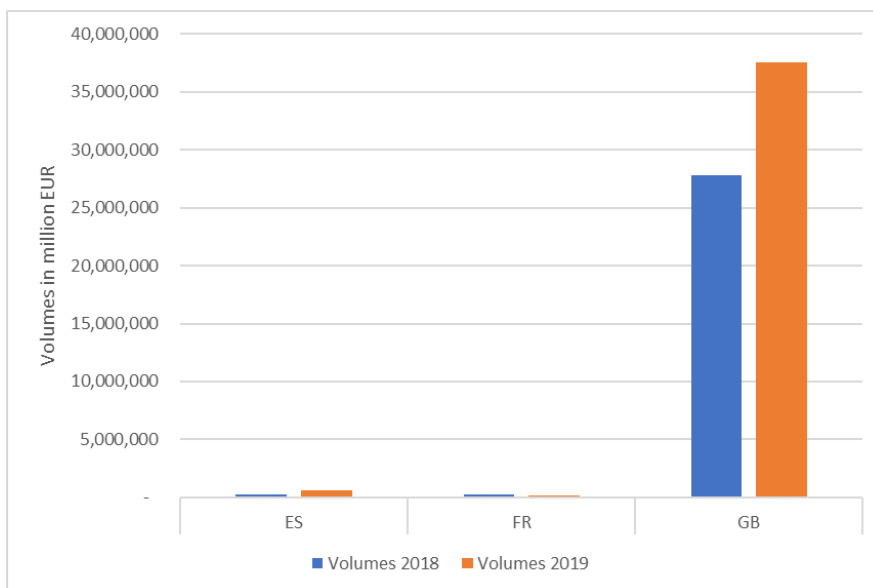


**FIGURE 13 DERIVATIVES VOLUMES PER TRADING SYSTEM DURING 2018-2019**



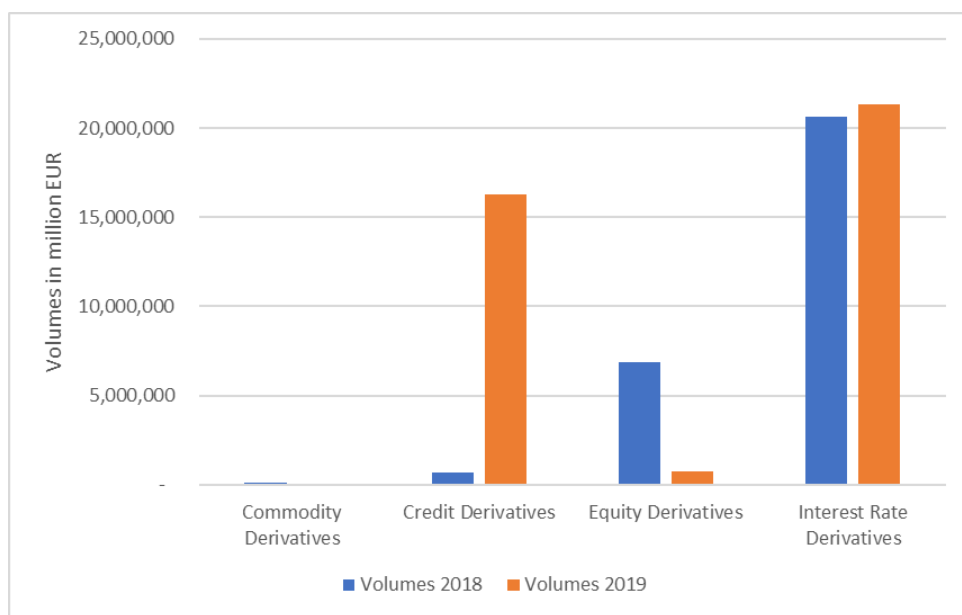
23. Looking at the distribution of volumes per country, the UK shows the greatest volumes of derivatives traded on OTFs, followed by Spain and France. However, Spain shows the greatest yearly increase, with a growth of turnover of approximately 115%.

**FIGURE 14 DERIVATIVES VOLUMES ON OTFs PER COUNTRY DURING 2018-2019**



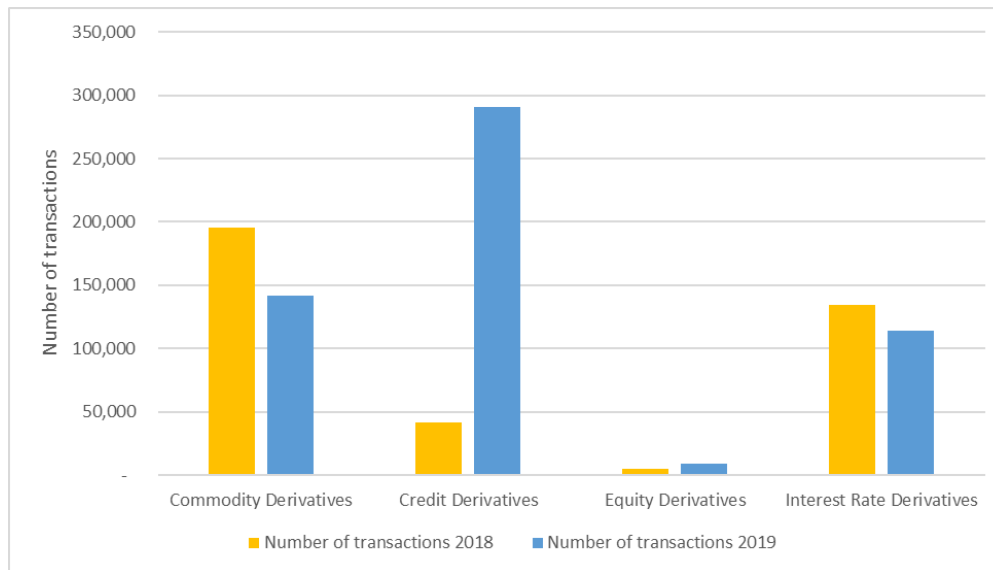
24. ESMA has also carried out an analysis detailing the derivatives asset classes traded. As shown in Figure 14, the highest volumes in 2019 are registered in interest rate derivatives and credit derivatives, followed by equity derivatives and commodity derivatives. The derivatives trading obligation (DTO), contributes to this result.

**FIGURE 15 DERIVATIVES VOLUMES ON OTFs PER TYPE OF DERIVATIVE DURING 2018-2019**



25. Results appear different when observing number of OTFs transactions in derivatives. As shown in Figure 15 below, despite the decrease in the number of transactions in commodity derivatives executed on OTFs, this asset class remains one of the most frequently traded. In parallel, transactions in credit derivatives have greatly increased from 2018 to 2019.

**FIGURE 16 NUMBER OF TRANSACTIONS ON OTFs IN DERIVATIVES PER TYPE DURING 2018-2019**



**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?**

**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?**

## 4 OTF definition and trading venue boundaries

### 4.1 Legal framework and general background

26. Over the years market infrastructures have evolved from traditional exchanges to include other types of organised systems also supported by detailed rules where members could interact and deal in financial instruments. In order to promote fair and orderly trading, market integrity and a level playing field, the co-legislators have extended the regulatory perimeter defining a trading venue, from traditional exchanges to other trading facilities.

27. MiFID I provided for a new type of alternative multilateral trading systems that operate in a similar way to exchanges (or regulated markets in MiFID terminology). These are the MTFs<sup>9</sup> and their definition was similar to that of regulated markets<sup>10</sup>, characterised by being

<sup>9</sup> 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”.

<sup>10</sup> 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”.

systems that operate in accordance with non-discretionary rules bringing together 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 to operate outside the trading venue regulatory perimeter (e.g. certain Broker Crossing Networks or BCNs).

28. 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 venue 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.
29. 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.
30. 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”.
31. A common feature between regulated markets, MTFs and OTFs is that they are multilateral systems where trading interests are able to interact in the systems 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.<sup>11</sup> This section of the report provides an analysis of the concept of multilateral system (which is not limited to OTFs but expands to all types of trading venues) and the use of discretion by OTFs.

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<sup>11</sup> 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.

## 4.2 Multilateral Systems

### A. Analysis

32. Over the past months, ESMA received many concerns from market participants about firms that are operating systems which are functioning in a similar way as multilateral systems but without being authorised as a trading venue. The information received in this respect comes primarily from authorised trading venues who are stressing what they deem to be an unlevel playing field and who are asking ESMA to take remedial actions.
33. ESMA first notes that in addition to the introduction of a new type of trading system, 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”.
34. Furthermore, MiFID II complemented the definition 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 regulated market, MTF or OTF (depending on the asset class). Such requirement is spelled out in Article 1(7) of MiFID II<sup>12</sup>.
35. 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 definition 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.
36. Furthermore, the definition of multilateral systems does not require the conclusion of a contract as a condition but simply that trading interests can interact within the system. It results from such definition, read in conjunction with Article 1(7) of MiFID II, that the conclusion of a contract is not a prerequisite for an investment firm or a market operator to be required to request authorisation as a trading venue for the system it operates. In other words, systems where trading interests can interact but where the execution of transactions

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<sup>12</sup> 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. (...)”

is formally undertaken outside the system would still qualify as multilateral systems and be required to seek authorisation as trading venues.

37. In practice, under the new legislation, the key concept for establishing the regulatory perimeter for authorisation as a trading venue is whether a system is considered to be multilateral. Should that be the case, such system should seek authorisation as a trading venue, being a regulated market, MTF or OTF.

## B. Conclusions and Proposals

38. The combination of the changes introduced in MiFID II in Article 1(7) and the definition of multilateral system under Article 4(19) is intended to ensure that any multilateral system is required to seek authorisation as a trading venue. That means that any multilateral system would have to operate in accordance with the definition of regulated market, MTF or OTF, regardless of the changes needed to comply with such definitions. Therefore, even if a facility does not comply with all aspects of the definitions of trading venues, this should not be interpreted as this system not being required to seek authorisation as a trading venue. The compliance with the multilateral system definition is sufficient for the facility to be required to be authorised as a trading venue.
39. Despite the fact that the clear language introduced in MiFID II regarding the conditions under which a facility has to seek an authorisation as a trading venue, ESMA is of the view that, there is still a need to further clarify some aspects of the practical application of the conditions where such authorisation is required. In order to provide for further clarification, ESMA is putting forward 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.
40. Regarding the amendments to Level 1 texts, ESMA does not consider that significant changes need to be implemented. However, while the relevant definitions are already clear, the disadvantage of having such framework in a Directive rather than a Regulation is that it may cause issues with transposition into national law. ESMA has been made aware that transpositions may have caused issues of convergence within the EU framework and has, in certain jurisdictions, raised questions regarding possible contradictions with other parts of domestic legislation.
41. 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 of transposition, ESMA proposes that 1) the restriction set out in MiFID II in Article 1(7) is moved into MiFIR, and 2) this restriction is worded as a prohibition so as to make it suitable for direct applicability in Member states. For instance, it could be stipulated in MiFIR that:
- 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.

42. Beyond those Level 1 changes, ESMA does not foresee at this stage any other immediate need for amendments in MiFID II or MiFIR.

**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?**

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.

44. ESMA would also like to stress that further details regarding this general guidance has been provided through Q&As (see in particular Q&A 7 and 10 of the section of Q&As on MiFID II and MiFIR market structures topics, ref. ESMA70-872942901-38) and invites NCAs to take remedial actions should some firms within their jurisdiction not operate in compliance with the MiFID II authorisation framework.

45. Beyond the issue about the execution of transactions within the system, there are other issues and circumstances where the conditions of authorisation as a trading venue might need to be further specified. Therefore, ESMA also intends to further clarify the conditions under which a facility should request authorisation as a trading venue via an ESMA Opinion. Some topics that could be tackled within this Opinion are addressed in the following sections.

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

#### **4.2.1 Multilaterality applied to non-automated systems**

##### A. Analysis

46. 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.

47. An authorisation as an OTF obliges the concerned firm to comply with a dedicated set of MiFID II/MiFIR rules. This includes amongst others the following obligations: capital requirements, organisational requirements for trading venues, transparency obligations, transaction reporting, submission of reference data, and obligations to maintain records. While some of those rules are subject to a proportionality principle, most of them apply indiscriminately to small and large firms and without taking into account the scale and complexity of the business they operate.
48. Questions can therefore be raised about whether smaller entities should be exempted from authorisation and, if yes, which firms should specifically benefit from this exemption. The challenge posed by the new definition of multilateral system in MiFID II is indeed to delineate the boundary between well-established interdealer brokers that operate systems that are well-organised and other less sophisticated arrangements that exist in the broker space.
49. The concept and the circumstances of authorisation of OTFs have been further clarified under an ESMA Q&A<sup>13</sup>. The guidance, while clarifying that the trading arrangements in place need to have the characteristics of a system for those to be considered a trading venue, also states that the characterisation of a system is technology neutral and includes both automated as well as non-automated systems. Whilst it seems clear that sufficiently organised systems which operate facilities such as an order book or an RFQ should be within the OTF perimeter, for voice trading systems operating on a standalone basis the delineation of the perimeter remains more challenging.
50. It should also be noted that the Q&A does not establish any type of threshold below which the activity would be exempted from authorisation. The Q&A simply clarifies that “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”. The Q&A indicates that, based on the current Level 1 text, in all other circumstances a broker who meets the criteria of an OTF needs to seek authorisation, regardless of the scale and complexity of its business.

## B. Conclusions and Proposals

51. Regarding first the fact that MiFID II does not take into account the scale and complexity with respect to authorisation of OTFs, ESMA remains sceptical about the real burdens that would justify that small entities are exempted from the OTF regime. On the contrary, ESMA considers the current authorisation regime which is not construed on a proportionality principle ensures a more level playing field between the different stakeholders and a better level of protection of EU investors and EU markets in general.

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<sup>13</sup> Q&A 10 of Section 5.2 of the ESMA Questions and Answers on MiFID II and MiFIR market structures topics, ref. ESMA70-872942901-38 ([here](#)).



52. Introducing more proportionality regarding the OTF authorisation regime would also 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 activity that is within the OTF regime and activity that is excluded. Such a regime, which is for instance used for the regulation of systematic internalisers, also entails disadvantages. It creates in particular more uncertainty and instability regarding the application of the MiFID II and MiFIR rules and introduces complexity for both, supervisors and stakeholders, if the proportionality criteria are not clearly stated.
53. Therefore, ESMA would not propose to establish such a threshold-based regime for OTFs and remains of the view that authorisation of OTFs should be independent of the scale and complexity of the concerned entities. However, even if ESMA considers that the OTF regime should apply broadly and capture indistinctively small and more sophisticated brokers, it is important that such regime does not put smaller brokerage businesses at risk.
54. Therefore, ESMA is 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 invites input from market participants 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.

**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?**

**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?**

**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?**

## 4.2.2 Network of SIs

### A. Analysis

55. As flagged in the MiFIR report on systematic internalisers in non-equity instruments<sup>14</sup> ESMA has been made aware of concerns about the blurring distinction between multilateral and bilateral trading and the development of other types of arrangements that facilitate the execution of transactions between multiple buyers and sellers without being authorised as a regulated market, an MTF or an OTF.
56. 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.
57. The issues expressed by respondents in the context of the review report on SIs is 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<sup>15</sup>. Third, trading venues claimed that Broker Crossing Network (BCN) trading volumes under MiFID I have shifted to SIs instead of moving to multilateral trading venues. In their view, this demonstrates the failure of MiFID II to move more trading to lit venues.
58. 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:
- a. 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;
  - b. 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,

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<sup>14</sup> [https://www.esma.europa.eu/sites/default/files/library/esma70-156-2756\\_mifidii\\_mifir\\_report\\_on\\_systematic\\_internalisers.pdf](https://www.esma.europa.eu/sites/default/files/library/esma70-156-2756_mifidii_mifir_report_on_systematic_internalisers.pdf) paragraph 109, page 37.

<sup>15</sup> '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."

as provided for by Recital (19) of the Commission Delegated Regulation (EU) 2017/565;

- c. 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.

## B. Conclusions and Proposals

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

60. ESMA is also seeking participants' views as to whether such clarifications are sufficiently clear or whether a Level 1 amendment should be proposed in order to give market participants more legal certainty.

**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.**

**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?**

### **4.2.3 Software providers**

#### A. Analysis

61. Another source of concerns received by ESMA over the past months relates to the regulatory treatment of so-called software or middleware providers. Those technology firms typically work as aggregators providing enhanced access to various sources of trading interests: MTFs, dealers, single banks platforms, etc... The software provider concept however encompasses a multitude of different types of providers and business models making their regulatory analysis more challenging.

62. Concerns raised revolve around 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. The clients are also exempted from the MiFID II/MiFIR provisions applicable to trading venues which also contributes to making trading on those

platforms attractive. In practice, ESMA notes that while some of those software 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.

63. Stakeholders also stress that those firms, on their website, use a terminology that is very close to the business of a trading venue and which is deemed to give an indication about their real business. They indeed advertise themselves as providing “electronic trading solutions”, “execution management systems”, “e-trading solutions” or even “trading systems”.
64. Another aspect of relevance commonly mentioned is the type of fee charged by those software providers. While some are based on a software license pricing model, other are charging clients based on brokerage fees (i.e. fee per trade or based on volume traded).

## B. Conclusions and Proposals

65. ESMA first acknowledges that the recent development of those new types of stakeholders raises supervisory convergence issues. It is important that new business models 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 between all firms operating in the EU.
66. Despite the variety of co-existing business models, it nevertheless appears that there are good reasons to question whether those software providers or at least certain of them are providing or performing an investment service or activity and should be authorised as such.
67. As explained in the section above, ESMA has not identified any major shortcomings in MiFID II/MiFIR that would justify an immediate significant amendment of the Level 1 text and the current regulatory framework appears suitable to ensure, where necessary, appropriate supervision of those new stakeholders. ESMA however would like to collect more input on those new stakeholders (e.g. regarding their possible categorisation).
68. Regarding the current regulatory framework, the general approach explained in the sections above regarding the concept of multilateral systems should also apply to software providers. This includes notably the fact that execution of transactions within the system is not a prerequisite to be required to seek authorisation as a trading venue. In other words, the fact that the ultimate execution of transactions is concluded outside the system cannot be used to demonstrate that the system is not multilateral and should not seek authorisation as trading venue.
69. ESMA does not consider that the fee structure can be used to demonstrate that a software provider does not operate a multilateral system. Similarly, the technology used is not a relevant criterion to exempt those providers from the MiFID II regulatory framework. It is the core business of a trading venue to bring together interests and the mere fact that this activity is conducted through new protocols (e.g. acting as an Application Programming

Interface or API) should not lead to the conclusion that those systems are outside the boundaries of MiFID II.

70. Regarding the MiFID II investment services and activities, a clear distinction should also be made between RTO and the operation of an OTF or MTF. More specifically, multilateral systems should not be authorised as RTO but authorised as trading venues. In particular, systems broadcasting trading interest to multiple clients with those clients being able to interact, within the system or through the software, with those trading interests, is likely to constitute a multilateral system in the MiFID II sense.
71. Similarly, in ESMA's view, the fact that the finalisation of transactions negotiated through the software does not formally take place in the system but on an authorised trading venue (or OTC) should not exempt the software provider to seek authorisation as a multilateral system under MiFID II.
72. ESMA has clarified in a Q&A<sup>16</sup> 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.
73. This guidance, clarifying that only one trading venue at a time could officially be involved in a transaction, was meant to allow for an adequate allocation of responsibilities and therefore application of relevant obligations. It should however not be interpreted as automatically exempting from the MiFID II authorisation regime all software providers that pre-arrange transactions that are only formalised on authorised trading venues.
74. In ESMA's view, a software provider that operates a multilateral system but without executing trades (the transaction being formalised on another authorised venue) may still require authorisation as a trading venue. For ESMA, in this case, it could be considered that the software provider operates an OTF or MTF but with an execution system outsourced to another trading venue (acting here not as trading venue but as a simple service provider).
75. Consistently with the clarifications explained in the above sections, ESMA considers that it is the design of the system operated and the type of interactions it allows that determine whether it should be authorised as a multilateral system regardless of whether transactions are formalised on this system or outside the system. In addition, it is important to stress that outsourcing all or part of their operational functions should not exempt trading venues from complying with all relevant MiFID II/MiFIR provisions, the outsourced functions remaining subject to all relevant obligations as if they were directly by the trading venue.

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<sup>16</sup> 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](#)).

**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?**

**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?**

#### **4.2.4 Boundaries between TV and bulletin boards**

##### A. Analysis

76. There have been a number of projects in the EU, mainly related to crowdfunding and crypto assets platforms, where the boundaries between bulletin boards and trading venues, in particular OTFs, seem to 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.

77. In contrast to a trading venue, a bulletin board exclusively performs advertising of buying and selling interests, possibly including prices and the quantities available, and therefore cannot organise the bringing together of these interests nor use a centralised order book or any other kind of trading system. A bulletin board should not facilitate the bringing together of buying and selling interests in any form whatsoever, in particular by proposing means of communication or contact between potential buyers and sellers which might enable them to interact via the system.

78. However, ESMA considers that a bulletin board can display the contact details of potential buyers and sellers so that they may establish bilateral contact with one another outside of the system. The trading and conclusion of transactions should therefore be performed bilaterally, outside of the system.

##### B. Conclusions and Proposals

79. MiFID II recognises that systems, such as bulletin boards, which aim only at advertising trading interests without facilitating in any way the interaction of those interests should not be required to be authorised as a trading venue<sup>17</sup>. ESMA believes that there should be a principle-based approach on what should be considered a bulletin board to ensure that

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<sup>17</sup> 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 (...)".

those systems where it is not possible for users to act upon advertised interests are not to be subject to authorisation as a trading venue. Such interpretation is supported by the reading of Recital 8 of MiFIR as “(...) [OTF] should not include facilities where there is no genuine trade execution or arranging taking place in the system”.

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

- 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.

81. In light of the increase in the number of crowdfunding or crypto assets platforms seeking to offer a platform for secondary market trading, ESMA is of the view that the concept of bulletin board should be further clarified. As such, in order to provide for more legal certainty to market participants, ESMA proposes to amend the MiFID II Level 1 text to include a definition of bulletin boards, taking into account the characteristics listed above.

82. Despite ESMA’s understanding that the MiFID II regime as it currently stands may not appear appropriate to cater for the specificity of crowdfunding and crypto asset facilities, ESMA does not consider it appropriate to broaden further the concept of the bulletin board category. If there could be legitimate reasons to discuss about what would constitute an appropriate regulatory framework for crypto-asset and crowdfunding platforms, this discussion should be held independently from this proposal to include a definition of bulletin board in MiFID II.

**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?**

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



## 4.2.5 Operation of internal crossing systems by fund managers

### A. Analysis

83. It was brought to ESMA's attention that there is another issue relating to the multilateral system boundaries. The issue relates 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. Relevant fund management companies include UCITS management companies (UCITS ManCos) and alternative investment fund managers (AIFMs).
84. 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 market.
85. For example, a fund manager may want to buy a certain amount X of units of an instrument (for example shares) to the benefit of fund A and, at the same time, sell Y of the same instrument from fund B. Their systems would identify these trading opportunities and transfer the shares from fund B to fund A (in most circumstances at mid-market price) while any imbalance would be satisfied by buying or selling the remaining shares from a broker or on a trading venue.
86. The concern arising is that because such transactions are taking place internally, the funds may be exposed to risks and practices that would be subject to regulation and supervision if the transaction were carried out on a trading venue. However, proponents of the practice may argue that it reduces trading costs and as such may be deemed of benefit to investors.
87. In the context of ESMA's considerations to date, it appears 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.
88. ESMA is seeking to clarify the extent to which that matching of trades may meet the definition of multilateral systems under MiFID II.
89. The definition of multilateral system is instructive in this regard. Article 1(19) defines a multilateral system as (emphasis added): "*any system or facility in which **multiple third-party buying and selling trading interests in financial instruments are able to interact in the system.***"



90. Where a fund manager acts on behalf of funds it manages, 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.
91. 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.
92. 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 AIFMD and UCITS Directive and, as such, be excluded from the scope of MiFID II.

## B. Conclusions and Proposals

93. The question about the regulatory framework applicable to internal crossing systems is not straightforward. Therefore, ESMA would like 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.
94. More generally, ESMA is interested in market participants' views on the regulatory framework applicable to internal crossing systems (MiFID II or UCITS Directive / AIFMD) and whether it would be useful to clarify this through targeted Level 1 changes.

**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.**

**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?**

## 4.3 Use of Discretion

### A. Background

95. 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<sup>18</sup>. Such discretion can be exercised in the following circumstances:

- when placing or retracting an order; or
- when deciding not to match a specific client order with 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 its best execution obligations.

96. Furthermore, where the trading system 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.

97. As clarified in a Q&A<sup>19</sup>, 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.

98. 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, or to withdraw the order 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. Order discretion should not be necessarily exercised order by order but can consist of criteria applied to type of orders that have similar characteristics (e.g. the OTF operator may consider, at a given point in time, that some or all orders of a specific size in a specific instrument should be handled in a pre-determined way).

99. The exercise of discretion at execution level has to be in compliance with client specific instructions and the best execution policy. 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. Such type of discretion is only meaningful when exercised at order level. ESMA is further of the view that the exercise of discretion should not be just a possibility foreseen

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<sup>18</sup> 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.

<sup>19</sup> 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](https://www.esma.europa.eu/sites/default/files/library/esma70-872942901-38_qas_markets_structures_issues.pdf)

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. The OTF shall further be able to provide to its NCA a description of how discretion is applied and the rationale underpinning the exercise of discretion.

100. ESMA has further clarified that the use of fully automated systems does not preclude the exercise of discretion. In fact, the use of discretion when to place or retreat an order could possibly be automated through artificial intelligence and algorithms, without necessarily the exercise of human judgement on a case-by-case basis. This would, for instance, be the case where the algorithms supporting automated matching anticipate the circumstances under which the orders would not be matched or when, in compliance with the best execution policy or a client specific instructions, to match (or not to match) two opposite trading interests. As a consequence, the algorithms operated by the OTF would be expected to take into account external market factors or other external source of information to demonstrate the exercise of discretion.

## B. Analysis

101. ESMA has 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.
102. Those that operate voice trading systems apply discretion to the orders received by clients regularly. Brokers are in control of the orders both in terms of how they are processed and which counterparties to target. In addition, brokers in voice trading systems also have an impact in the negotiation of the price of the orders providing their market knowledge to the benefit of the client.
103. 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.
104. 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 is not satisfied by an electronic RFQ. In those circumstances, the OTF brokers will fulfil the order by exercising discretion on which counterparties to contact, when to make that contact and how to design or change the order in order to achieve execution. The order will always ultimately be executed by sending another RFQ request.

## C. Conclusions and Proposals

105. 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 that it has been sufficiently clarified in ESMA Q&As. Hence ESMA currently does not deem it necessary to propose further clarifications. Furthermore, ESMA understands that the application of discretion might vary depending on the type of trading system used by the OTF operator and might be less intuitive for those OTFs that operate automated systems.

106. In light of the above ESMA seeks views of market participants regarding the interpretation provided by ESMA on how discretion should be applied and a possible need for further clarifications, and further information on which type of discretion is applied more often, i.e. discretion in order placement or discretion in order execution.

**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?**

**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.**

**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?**

## **5 Matched Principal Trading**

### **5.1 Use of matched principal trading by OTFs**

#### A. Background

107. Article 4(1)(38) of MiFID II defines matched principal trading (MPT) as “a transaction where the facilitator interposes itself between the buyer and the seller to the transaction in such a way that it is never exposed to market risk throughout the execution of the transaction, with both sides executed simultaneously, and where the transaction is concluded at a price where the facilitator makes no profit or loss, other than a previously disclosed commission, fee or charge for the transaction”.

108. Hence, three conditions should be fulfilled for a transaction to qualify as MPT: (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.

109. 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.
110. 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 (EMIR).
111. 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.
112. NCAs are required to, in accordance with Article 20(7) of MiFID II, monitor the engagement of OTFs in MPT to ensure that it complies with the definition and to ensure that it does not give rise to conflicts of interest between the investment firm or market operator and its clients.

## B. Analysis

113. Based upon the current responses, there are six OTFs which do not use MPT and seven OTFs that allow for MPT<sup>20</sup>. All of the OTFs which allow for MPT do so in bonds (excluding ETNs and ETCs). One of those OTFs allows for MPT in structured finance products and one in C10 derivatives. There is currently no MPT offered in the remaining instruments that can be traded on an OTF and for which MPT is allowed, i.e. emission allowances and derivatives not subject to the clearing obligation.
114. In order for an OTF to engage in MPT, its clients need to provide agreement as part of the OTF membership agreement. From the evidence gathered it appears that in some cases clients are requested to sign an explicit consent to MPT, while in others information on MPT is disclosed in the OTFs’ rulebooks (including fees), to which the client consents before trading activity takes place. Overall, the use of MPT appears limited to few instruments and, from the feedback received, does not raise any supervisory concerns with NCAs, as clients provide their agreement and there is transparency with respect to the commission fee and terms and conditions applied by the OTF operator.

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<sup>20</sup> One OTF in Spain, two in the Netherlands and four in France.

### C. Conclusions and Proposals

115. ESMA 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 a detail of the fees applied, to which the client agrees.

116. In light of the above ESMA does not deem it necessary to undertake any specific review or recommend any specific measure regarding the use of MPT, unless markets participants deem it relevant.

**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?**

**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)?**

## **5.2 Restriction to matched principal trading on regulated markets and MTFs**

### A. Background

117. MiFID II explicitly prohibits operators of MTFs and regulated markets from engaging 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.

118. ESMA understands, as a result of conversations with NCAs and market participants, that there may be different interpretations in relation to the prohibition of engaging in MPT for regulated markets and MTFs. In fact, ESMA has been made aware that Article 19(5) of MiFID II could be interpreted as restricting any activity of dealing on own account by an investment firm operating an MTF or, alternatively, as prohibiting solely proprietary trading carried out under the systems or the rules of the MTF operated by the investment firm. ESMA is of the view that a divergent interpretation of the aforementioned provisions could potentially result in an unlevel playing field in the EU.

### B. Analysis

119. The diverging interpretations arise since the wording used in MiFID II to apply the restriction on proprietary trading activities to different types of trading venues differs. In fact, while for regulated markets MiFID II specifies that “Member States shall not allow

market operators to execute client orders against proprietary capital, or to engage in matched principal trading on any of the regulated markets they operate”, for MTFs, MiFID II specifies 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”.

120. Because of 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. Such interpretation would not seem to be supported by the policy intent of MiFID II. In fact, such interpretation would create an unlevel playing field between MTFs and regulated markets 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.
121. Given the overarching principle of MiFID II to align the requirements between MTFs and regulated markets, it would not appear logical to subject market operators of regulated markets to less stringent requirements than those investment firms operating an MTF. Such reading is further supported by Recital 7<sup>21</sup> of MiFIR, which refers to MTFs and regulated markets stating that “Regulated markets and MTFs should not be allowed to execute client orders against proprietary capital”, possibly implying that the same obligations apply to both type of trading venue.
122. In light of the above and given the similarities between MTFs and regulated markets and the MiFID II intent to further align requirements among the two, ESMA believes that Article 19(5) should be interpreted as applying the restriction on dealing on own account only to the MTF operated by the investment firm. Such reading is further supported as, from a legal standpoint, any restriction or prohibition under MiFID II should be interpreted narrowly.

### C. Conclusions and Proposals

123. ESMA believes 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 deems such clarification relevant as diverging interpretations could contribute to the creation of an unlevel playing field in the EU.
124. In light of the above, ESMA seeks views of market participants on the proposal to align the wording in Articles 19(5) and Article 47(2) of MiFID II in order to clarify that for MTFs,

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<sup>21</sup> “The definitions of regulated market and multilateral trading facility (MTF) should be clarified and remain closely aligned with each other to reflect the fact that they represent effectively the same organised trading functionality. The definitions should exclude bilateral systems where an investment firm enters into every trade on own account, even as a riskless counterparty interposed between the buyer and seller. Regulated markets and MTFs should not be allowed to execute client orders against proprietary capital (...)”.

as for regulated markets, the restriction on dealing on own account holds only in relation to the MTF operated by the investment firm and does not imply that an investment firm operating an MTF could not act in a principal capacity

**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?**



## **6 Annexes**

### **6.1 Annex I**

#### **Summary of questions**

**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?**

**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?**

**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?**

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

**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?**

**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?**

**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?**

**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.**

**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?**

**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?**

**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?**

**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?**

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

**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.**

**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?**

**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?**

**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.**

**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?**

**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?**

**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)?**

**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?**

## 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;

[...]