

ESMA OUTLINES PERIMETER OF TRADING VENUES

ESMA, the EU's financial markets regulator and supervisor, on February 2, 2023 published its final report (the "**Report**") on the opinion on the perimeter of trading venues (the "**Opinion**") that had been put out for consultation in 2022.

The Authority's purpose is to provide guidance on the characteristics that qualify systems and facilities as "multilateral" and require them to be authorized as a "trading venue".

The amendments to Directive 2014/65/EU ("**MiFID II**") and the continuous innovation of financial markets have, in fact, led to different interpretations regarding the need to authorize a system as a trading venue, a difference that the Authority intends to harmonize.

After summarizing the different definitions of trading venues provided by MiFID II (see Article 4(1), No. 21 "regulated market," No. 22 "multilateral trading facility," No. 23 "organized trading facility," No. 24 "trading venue"), the Authority examines the elements that qualify a system as multilateral and then examines some cases that are more difficult to frame.

It is first pointed out that what is provided in Article 1(7) of MiFID II¹ means that any multilateral system shall apply for authorisation as a trading venue. This implies that, under MiFID II, in order to determine whether it is necessary to be authorized as a trading venue, it must be determined whether a system/facility is considered multilateral; operating in accordance with the multilateral system definition is a sufficient condition to be required to seek authorisation as a trading venue.

The combination of the requirement imposed by Article 1(7) of MiFID II and the definition of "multilateral system", set out in Article 4(1) No. 19 of MiFID II², aims at ensuring that trading in financial instruments is always carried out on organized venues.

The categorization of a system as a "multilateral system" depends on the occurrence of four cumulative requirements, identified from the definition provided in MiFID II:

- a) it is a system or facility;
- b) there are multiple third party buying and selling interests;

¹ **Directive 2014/65/UE, Article 1 - Scope**

"[...] 7. 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. [...]"

² **Directive 2014/65/UE, Article 4 - Definitions**

"1. For the purposes of this Directive, the following definitions apply: [...]"

19) 'multilateral system': any system or facility in which multiple third-party buying and selling trading interests in financial instruments are able to interact in the system; [...]"

- c) those trading interests need to be able to interact; and,
- d) trading interests need to be in financial instruments.

In the following are the main considerations developed by ESMA on the 4 requirements, also taking into account the views of market participants received during the consultation on the Opinion, which analyse the different aspects/criteria that should be considered in determining whether a system or facility should be classified as a multilateral system.

a) System or facility

- in the context of the definition of multilateral system, a system must be understood as a set of rules (contractual agreements or standard procedures), to which participants must adhere, that governs how third-party trading interests on financial instruments interact, and that shape and facilitate the interaction between interests. However, simply being a system does not mean that the system is multilateral;
- the type of technology used or the fact that it is an automated or non-automated system, does not determine whether it is a “system”. It is the way in which the system operates that is critical in assessing whether the activity should require authorization;
- general-purpose communication systems are out of scope of the definition of multilateral systems because, despite such systems allowing for the communication of trading interests, they are not governed by rules which facilitate such interaction of trading interests;
- the software provider and the software operator should be distinguished. If it is the investment firm that sets the rules of interaction and merely uses the software provider for example as an outsourcing of the IT capabilities, the software provider would not itself be in scope of the multilateral system definition;
- a multilateral system does not have to be one single (IT) system but can be constituted of a combination of systems, rules and/or arrangements, which together meet the four criteria of a multilateral system.

b) Multiple third-party buying and selling trading interests

ESMA takes an expansive approach in assessing the second requirement:

- the term “third-party” in this context relates to persons other than the system operator, that are not directly connected and are brought together in a transaction;
- the word ‘multiple’ refers to the system allowing various trading interests, to interact in the same system or facility;
- even systems where only two trading interests interact are in scope, provided such trading interests can interact according to the rules of a third-party operator, a single dealer system operated by someone other than the dealer could be in scope of the multilateral system definition too;

- instead, systems where the interaction occurs between two counterparties only, with no third-party involvement in the system, are excluded by the scope (for example systematic internaliser);
- however, ESMA does not provide more clarity on how to distinguish this sort of intermediation and the service of Reception and Transmission of Orders (RTO), despite the fact that this issue had been raised by multiple respondents in the consultation, and merely notes that it would reflect whether further clarification was needed to be published in the future on this point.

c) Interaction between trading interests

- if a system shall be “able to interact”, the system must not only allow the communication of the different trading interests but also allow users to react to those trading interests, i.e. it should be possible for the user to act upon those trading interests and match, arrange and/or negotiate on essential terms of the transaction with a view to dealing in those financial instruments;
- interaction requires that the system contains rules that concern the matching, the arranging and/or the negotiations of trading interests;
- a system that only displays third party trading interests which are routed to, and subject to execution under the rules of the relevant trading venue, should not be considered as a multilateral system, so bulletin boards, general advertising and/or aggregation of trading interests, considering that there is no interaction of trading interests, do not qualify as a multilateral system;
- 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(hence, systems or facilities here is confirmation of a trade or where the essential terms have been (or can be) negotiated, would still be considered as meeting this criterion, even if some further contractual details are arranged outside of the system as is the case with many derivative contracts, please see “pre-arranged transactions”.

d) Financial Instruments

- the interaction of third-party buying and selling trading interests has to relate to financial instruments which, pursuant to Article 4(1) No. 15 of MiFID II, are those specified in Section C of Annex I of MiFID II;
- where a crypto asset is considered a financial instrument within the meaning of MiFID II it would be in scope of the definition of multilateral systems.

Once ESMA has completed its examination of the requirements of multilateral systems, it analyses some specific cases in which the application of the EU regulatory framework may be difficult to determine:

1. technology providers
2. RFQ systems and

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3. pre-arranged transactions.

1. Technology providers

As technological innovation thrives in the EU, some concerns have been raised with regards to how innovative solutions are facilitating the communication with, and the access to, various sources of trading interests. The line between simple communication tools and arrangements that might *de facto* constitute multilateral systems, is sometimes blurred. In the Report, some cases are considered, with their specific technology solutions, that may affect the categorization of such systems, but a case-by-case assessment is always necessary.

As said above, facilities where there is no genuine trade execution or arranging should not be required to seek authorisation as a trading venue. If a platform simply provides pricing data or other tools used to make trading decisions, it should not require authorisation as a trading venue. *Vice versa*, if the platform allows a genuine interaction (for example by including a button, or by providing the ability for users to communicate between themselves) by which the intention to enter into a transaction can be confirmed in the system between the users of such platform, the platform shall be qualified as a multilateral system.

ESMA, taking into consideration what previously said in the Final Report on the functioning of OTFs, identify the key characteristics for the qualification as a bulletin board type system that does not need to be authorized as a trading venue:

- a. the bulletin board type system should consist of an interface that only aggregates and broadcasts buying and selling interests in financial instruments, as such pure communication tools are outside the scope of the multilateral system definition;
- b. the bulletin board type system neither allows for the communication or negotiation between advertising parties, instead systems with more advanced functionality (for example, systems that facilitate the reaction to such trading interests by providing the means to match arrange and/or negotiate a transaction between participants) meet the criteria of multilateral systems;
- c. the bulletin board type system gives no possibility of execution or the bringing together of buying and selling interests in the system. In this regard, the provision of a simple connectivity between the bulletin board and an execution venue would not bring the system into scope of the multilateral system definition as long as (i) it does not prescribe any rules for interaction of trading interests (ii) nor give its members the means to agree on a transaction within the system.

Also within the scope of technology providers are order management systems ("OMSs") and execution management systems ("EMSs") that enable firms, respectively, to manage orders and executions more effectively in-house.

In order to understand whether a system falls under the definition of multilateral systems, it is critical to understand what the system in question enables users to do, regardless of how a system classifies itself, whether it is an EMS, an RFQ or something else. ESMA's guidance on the point can be summarized as follows:

- ESMA does not intend to capture systems which provide pure connectivity services between investment firms and execution venues;

- EMS which purely supports routing orders without a third-party prescribing the rules for this interaction, should not be considered as a multilateral system. However, those systems which present additional features should be qualified as multilateral system;
- EMS which would allow for firms to gather multiple quotes from multiple sources, and where these trading interests can interact with other trading interests within the system could be, depending on the specifics, considered a multilateral system.
- if the “software vendor” has embedded a number of rules that govern the interaction of trading interests in the system and does not allow investment firms to set its own rules, it is the software vendor that is managing the multilateral system.

2. Request-for-quote trading system (RFQs)

RFQs are described in Commission Delegated Regulation (EU) No 2017/587 (RTS 1) and Commission Delegated Regulation (EU) No 2017/583 (RTS 2)³ as trading systems, that therefore require the relevant authorization. In fact, even if the requests and responses of an RFQ are sent individually by participants, each member may interact with multiple traders, i.e., those systems enable the interaction of trading interests from multiple counterparties and are hence in the scope of the definition of a multilateral system. This conclusion also encompasses systems that provide for an RFQ to one functionality.

Systems in which the operator is independent from the (buy and sell-side) participants on the system and allow multiple trading interests to interact, even with only one liquidity provider, may be considered multilateral systems, it is the third-party operator that sets the rules of the system and defines how the liquidity provider and other participants interact in the system. To the contrary, if it is the investment firm that sets the rules that govern its bilateral interaction (so that the investment firm would be considered the system operator in this case) this would not be a multilateral system. The simple use of a third-party system, for example as an outsourcing function of the IT capabilities, would not automatically result in the system meeting the criteria of a multilateral system.

3. Pre-arranged transactions

ESMA finally analyses the case of systems that pre-arrange transactions but subsequently formalised on a trading venue (it was already clarified that a transaction cannot be concluded on more than one trading venue at the same time).

The activity of pre-arranging transactions in a multilateral way is only possible without authorisation as a trading venue when:

- all transactions arranged through the investment firm’s system or facility have to be formalised on a trading venue; and,
- the transaction benefits from a pre-trade transparency waiver on the trading venue where it will be formalised.

On the contrary, should the formalisation of the transaction happen OTC, the pre-arranging activity requires authorisation as a trading venue.

³ Annex I of Delegated Regulation (EU) 2017/587 and Annex I of Delegated Regulation (EU) 2017/583: Request-for-quote trading system: “A trading system where a quote or quotes are provided in response to a request for a quote submitted by one or more other members or participants. [...]”

In any case, ESMA believes that any preorganization system should be authorized as an investment firm under MiFID II because it provides an investment service to clients. In addition, these pre-arranging firms should have an arrangement with the trading venue to ensure an appropriate oversight (in the Report, ESMA examines some practical cases and assesses how arrangements should be implemented).

ESMA maintains that the onus of ensuring that all transactions are eventually formalised on a trading venue rests with the system that pre-arranges the transaction. Nevertheless, that trading venues need to ensure that all transactions that are formalised on their venue are carried out in accordance with the rules of the trading venue and then they should ensure to establish systems to detect any attempt to circumvent the requirements under MiFID II.

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