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Latham & Watkins Financial Regulatory Practice

7 April 2017 | Number 2112

# Significant Updates to ESMA's Q&A on MiFID II Market Structures

***ESMA's new Q&A clarify a number of key points on the MTF, OTF and SI regimes.***

On 5 April 2017, ESMA published an updated version of its Q&A document on market structures under MiFID II. The final section has been augmented substantially to include new Q&As relating to multilateral and bilateral systems. In particular, these Q&As provide much-awaited key guidance on the parameters for operating an OTF and the SI regime.

This *Client Alert* sets out some of the key points in the new Q&As.

## MTFs

Investment firms operating MTFs are not allowed to execute client orders or engage in matched principal trading. In a Q&A added at the end of January 2017, ESMA went so far as to say that, as a consequence of this prohibition, an investment firm "*could only operate on its own MTF through pure agency trading*". Therefore, even riskless principal trading cannot interact with an MTF.

This will, in effect, hinder brokers from acting both as a broker and as a broker member of their own MTF. ESMA goes onto say that it thinks the only solution to this is to operate the MTF and the broker through different legal entities, in order to manage the potential conflicts of interest. The two entities would have to operate separately from one another, with ESMA highlighting that they would need to "*prevent information sharing on each other's activities*" and have "*distinct management and operational teams and physical separation of activities*", and that "*execution systems would be expected to be segregated*".

## OTFs

ESMA's new Q&As relating to OTFs and SIs make comments that are similar to the above guidance for MTFs. Because the entity operating an OTF cannot also operate an SI, there must be two legal entities, subject to similar separation requirements relating to management and operational teams, physical separation of activities, and separate execution systems.

ESMA clarifies that, when considering whether a firm is caught by the OTF definition, the firm need not take into account occasions when "*by coincidence and accidentally*" it receives a massive buying and selling interest, as these are "*unpredictable circumstances [which] would not qualify as the operation of a system*". However, a firm cannot avoid being an OTF if it merely "*steps away from the transaction and the transaction is then legally formalised between the counterparties outside a trading venue*" — such a transaction would be considered to be concluded on the OTF. It would remain open for the firm to

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formalise the trades by submitting them to a regulated market or MTF, presumably also benefiting from the negotiated trade waiver.

ESMA states that because regulated MTFs have members or participants, whereas OTFs (and presumably SIs) have clients, "*as a consequence, transactions concluded on OTFs [and presumably SIs] have to comply with client facing rules, including best execution rules*". Therefore, the operators of OTFs or SIs cannot conclude automatically that best execution does not apply because they are a venue that the client has chosen to access for these purposes. ESMA is of the view that the best execution policy of a firm operating an OTF would cover its investment firm and OTF execution strategies separately.

ESMA also gives guidance (anticipated recently by the FCA) on the form of discretion that results in a venue being classified as an OTF. The guidance distinguishes between 'order discretion' and 'execution discretion'. Order discretion is the ability of a firm to decide how orders should interact. Execution discretion is the ability to decide whether or not orders should interact. ESMA states that "*Random placing, retracting, matching or non-matching of orders on the OTF would not be considered as the exercise of discretion*" because "*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*".

## SIs

Following communications among the European authorities in relation to SIs seeking to set up broker-crossing networks, ESMA has provided guidance regarding the extent to which an SI may engage in riskless principal trading. ESMA gives some helpful guidance in this regard when it states that the trading activity of an SI "*is characterised by risk-facing transactions that impact the Profit and Loss account of the firm*".

ESMA goes on to provide guidance on when an SI is, in fact, sufficiently "functionally similar" to a trading venue such that it must act as a trading venue, not an SI. The three criteria are:

- The SI does not in fact undertake risk-facing transactions because, for instance, it has arrangements with liquidity providers to do riskless back-to-back transactions whenever a transaction is executed with a client.
- Arrangements are used on a regular basis and qualify as a system (as opposed to being ad hoc).
- The transactions arise from bringing together multiple third party buying and selling interests OTC, outside the rules of a trading venue.

This is acknowledgment from ESMA that submitting transactions for reporting to an exchange (where the rules of the exchange apply) would mean that the trading is not considered to be executed OTC, and therefore is not part of the characteristic activities of an SI.

ESMA clarifies that, in its view, an SI is not conducting matched principal trading on an ad hoc basis if any of the following criteria are met:

- There is a system intended to match client orders.
- Non-risk facing activities account for a recurrent or significance source of revenue.
- The firm promotes its matched principal trading activities.

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