3 February 2023 // James Morris // Financial Regulation

MiFID II: ESMA Final Report and Opinion on the trading venue perimeter - in summary

On 2 February 2023, ESMA published its long awaited Final Report and Opinion on the Trading Venue Perimeter. This follows on from a Consultation Paper published at the beginning of 2022 (see our client note here).

The Opinion is intended to clarify the perimeter in respect to which systems should be viewed as "multilateral systems" under MiFID II, and therefore need to be authorised as a trading venue. The definition has been debated since the inception of MiFID II, particularly with respect to certain technology offerings, order management systems (**OMS**) and execution management systems (**EMS**), and certain activities such as "pre-arranging" of transactions formalised on trading venues. There have been divergent approaches to these fact patterns taken across the EU, and hence ESMA has sought to promote convergence through this Opinion.

The Opinion does not have a particular implementation date, and hence its guidance applies **immediately**. ESMA notes they will work with NCAs to ensure that firms assess their systems against the Opinion, and they expect NCAs to "require firms to take appropriate action to swiftly apply for authorisation as a trading venue where necessary". Firms should therefore consider the impact of this Opinion on their operations as soon as possible.

Concurrently, many of the same issues discussed in this ESMA Opinion have also been consulted on by the UK FCA in their own Consultation Paper proposing guidance on the trading venue perimeter (see our client note here). Once the FCA finalises its guidance there may be significant divergence between EU and UK approaches (despite both jurisdictions using an identical legislative definition).

ESMA starts the Opinion by considering the multilateral systems definition itself, before giving guidance on specific cases. We have analysed these below.

Multilateral Systems Definition

ESMA starts by running through the key aspects of the definition in Article 4(1)(19) MiFID II, being:

- it is a system or facility;
- there are multiple third party buying and selling interests;
- those trading interests are able to interact; and,
- trading interests need to be in financial instruments.

System or facility

On the concept of a "system or facility", the Opinion notes that it must be understood as "a set of rules that governs how third-party trading interests interact" ining elements concerning the matching, arranging and / or negotiation of ng interests. However, ESMA is neutral as to the form these rules could take,

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saying they could be contractual arrangements or standard procedures, but would **not** include technical standards / protocols regarding the construction and exchange of messages (seemingly therefore excluding rules that are purely technical in nature rather than actually relating to matching, arranging and/or negotiation of trading interests).

The Opinion also notes that the concept of a "system" is technology neutral, and hence could include non-automated arrangements that achieve similar outcomes to computerised systems (e.g. voice brokerage). ESMA states in the feedback on consultation responses in its Final Report that "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".

However, ESMA does also clarify that a general-purpose communication system is not a multilateral system (although it does not provide a rationale), and that a software provider providing services to an investment firm that sets the rules of interaction is not itself in scope of the multilateral system definition (since it is not the system operator). This may be helpful comfort for some technology providers.

Multiple third party buying and selling interests

ESMA takes an expansive approach to the idea of there being multiple third party buying and selling interests, given they note that "third party" refers to persons other than the system operator and the word "multiple" (in their view) refers to "various trading interests".

ESMA states that "systems where two trading interests interact, provided such trading interests are brought together under the rules of a third-party operator" are multilateral. In particular, it notes that even where there is one liquidity provider (so that one side of a transaction is always the same person), it would still be a multilateral system if the system operator "runs the system as an independent operator". In reaching this conclusion, ESMA cites the Robeco case (C-658/15). This European Court of Justice (**ECJ**) case concerned the definition of "regulated market" under MiFID I.

The distinction between this sort of intermediation by a third party between two other parties and the reception and transmission of orders (**RTO**) (which is a separate bilateral investment service under MiFID II) is not explained in the Opinion. Indeed, ESMA's commentary in the Final Report notes that this was an issue flagged by multiple respondents to their consultation, but ESMA does not provide any explanation on this point, and merely notes that they "will reflect whether further clarifications need to be published in future". However, ESMA does note that a system where "the interaction occurs between two counterparties only, with no third-party operator" are not multilateral (e.g. SI platforms).

Interaction between trading interests

ESMA explains that for there to be "interaction", a system "must not only allow the display of different trading interests but also allow users to react to those trading interests, i.e. it should be possible to exchange information concerning those trading interests and match, arrange and / or negotiate essential terms of a transactions". ESMA note that per Recital 8 MiFIR, bulletin boards are not multilateral systems for this reason, and "general advertising and / or aggregation of trading interests should not qualify as multilateral systems".

In ESMA's feedback on consultation responses in the Final Report, they note that "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. Despite displaying multiple third-party interests, a system which does not allow for its users to match, arrange and / or negotiate a transaction (i.e. there is no interaction of trading interests) does not qualify as a multilateral system." This may be useful for some order routing/management systems as it seems that ESMA is emphasising that where there is no matching/arranging/negotiation within the system itself it is not a multilateral system.

On the other hand, ESMA notes that the definition does not require the conclusion of a contract, but simply that trading interests can interact. Hence where there is


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"confirmation (or pre-arranging) of a transaction" or whether essential terms have or can be negotiated "even if further contractual details are arranged outside of the system" then the system would still require authorisation as a trading venue. However, this guidance should be read in conjunction with specific guidance on pre-arranging (discussed below).

Financial instruments

Finally, ESMA notes that the trading interests must be in financial instruments (which per earlier Q&A guidance would include security financing transactions).

General

ESMA also makes a few additional comments in passing in the Final Report (but not the Opinion), for example: (i) stating that its guidance intends to capture secondary markets trading and not primary market activities; (ii) reminding firms that it has already clarified that platforms for SFTs can be trading venues; and (iii) that crypto assets that are considered financial instruments are in scope.

Technology Providers

The Opinion largely reinforces the position in the January 2022 consultation paper regarding 'technology providers' – specifically, communication tools and OMS / EMS providers.

Such technology providers have been cited by ESMA as one of several groups where there has been particular difficulty establishing the boundary lines of the trading venue perimeter. Ultimately, as the Opinion reaffirms, it is not the technology used (nor how a system styles itself) that determines the need for authorisation, but rather the functioning of the arrangement itself.

Communication tools

Looking first the somewhat broadly defined 'communication tools', which are covered in more depth in the Final Report than the Opinion. These include platforms developed typically by technology firms that provide services such as market data and trading inventory.

Recognising the varying complexity and features of such tools, ESMA confirms that:

- As noted above, 'pure communication tools' should remain outside the perimeter scope and not require authorisation – here, ESMA has in mind bulletin board-type arrangements meeting the characteristics originally laid out in its report on the functioning of OTFs, which have been faithfully restated in the Opinion (to recap: the system is an interface aggregating and broadcasting interests; does not allow for communication or negotiation between parties; does not impose the use of affiliate company tools; and does not allow for execution or bringing together of interests in-system).

- Conversely, systems with more advanced functionality, such as facilitating 'reactions' to trading interests and providing the means to negotiate transactions, should be required to be authorised as a trading venue;

- Joining the dots between a bulletin board and an execution venue, i.e. merely providing connectivity between the two, will not fall within the perimeter so long as (1) they do not set out rules for interests to interact, and (2) do not allow participants to agree on transactions within the system in question.

OMSs and EMSs

Also falling within the scope of technology providers are OMSs and EMSs which enable firms to, respectively, internally manage orders and executions with greater efficacy (EMSs typically offer an overview of pricing and liquidity on certain venues, before passing orders across for onward execution on-venue). While the Opinion focuses more on EMSs, the Final Report takes a broader look at both OMSs and EMSs:

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- While seemingly accepting that OMS systems (as "inward looking") are unlikely to be multilateral systems, ESMA has reiterated that how a technology system names / describes itself is not determinative – the key question is how it functions.

- The starting position for EMSs, as reaffirmed in the Final Report in particular, is that where they are limited to routing orders (without any rules having been prescribed for such interactions), they are similarly not *multilateral* and do not need to be authorised. That said, ESMA says that "depending on the specifics", a system which allows firms to gather multiple quotes from multiple sources could be a multilateral system.

- The Opinion further suggests that a key determinant here will be whether the "software vendor" has set or embedded the rules that govern the interaction of trading interests, rather than letting the investment firms that use the software set their own rules. If the software vendor does set the rules, ESMA indicates the software vendor would be operating a multilateral system.

While the Opinion has not necessarily provided absolute certainty, the Final Report somewhat cryptically alludes to 'clear case-based guidance' being required by EMS / OMSs to provide further regulatory clarity. It is unclear if ESMA considers that the Opinion delivers this clarity, or if more detailed example-based guidance is required in future (and, if so, when that may arrive).

RFQ Systems

ESMA notes here that MiFID II contemplates RFQ systems as a type of multilateral system (for example in RTS 1 and RTS 2), and that even if an RFQ requests and responses are sent individually, each member could interact with multiple dealers and hence it would be multilateral. Specifically, ESMA says that even where a client can only request a quote from one dealer, the system would still be multilateral "regardless of whether it is by design or choice from the client". Given that these types of systems "allow clients to send requests to multiple dealers (either at the same time or separately), even if only using an RFQ-to-one functionality".

However, ESMA does distinguish single dealer platforms. They note that where the investment firm that operates the system is also the only liquidity provider (e.g., an SI platform), this is not multilateral. Even where, for example. they outsource certain IT capabilities to software vendors, provided the liquidity provider "keeps control of the rules and parameters", this analysis would not change.

Pre-Arranging

Another circumstance tackled by ESMA is systems which "pre-arrange" transactions that are then formalised on a trading venue.

- ESMA has maintained its position that a "pre-arranging" system does not itself need authorisation as a trading venue, provided that all the arranged transactions are formalised on a trading venue under a pre-trade transparency waiver. The Opinion says, however, that even if a small number of transactions are formalised OTC, the pre-arranging system will require trading venue authorisation.

- ESMA has maintained its stance that there must be oversight of this arrangement by the trading venue via an agreement of some sort. However, ESMA stresses that the onus for ensuring compliance rests with the operator of the pre-arranging system and has introduced some flexibility via non-exhaustive guidance on how this can be achieved. ESMA suggests that if the pre-arranger is member of trading venue on which transactions are formalised, then this obligation can be discharged by the trading venue membership agreement. However, if the pre-arranger acts as an introductory broker between two firms who subsequently formalise the transaction on a trading venue, the pre-arranger could either have an agreement with the firms themselves or with the trading venue to permit it to check that formalisation did take place on the trading venue.

- The trading venue on which transactions are formalised nevertheless needs to ensure that all transactions are carried out in accordance with its rules, with the

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Opinion saying that trading venues should “ensure they establish systems to detect any attempt to circumvent the requirements under MiFID II”.

- ESMA also confirms that the operator of a pre-arranging system would need to be authorised as an investment firm, though ESMA does not clarify exactly which investment service is views as relevant (presumably RTO or execution of orders).

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