EVIA response to Consultation Paper on ESMA's Opinion on the trading venue perimeter

Answers to Questions

Q1 Do you agree with the interpretation of the definition of multilateral systems?

Yes, EVIA does broadly agree with the interpretation of the definition of multilateral systems as set out by ESMA. Whilst beyond the scope of this consultation, our members would reiterate ESMA's comments in the CP that a trading venue is legally defined under Art 4 (22) of MiFID which incorporates organisational arrangements into the assessment. Core to these proposals is the sufficiency criterion such that anyone doing multilateral activity, regardless of scale, needs to be organised as a trading venue.

Specifically in respect of the definition of multilateral systems, ESMA's proposal is based on the application of the principles within the regulation. Accordingly, we would again note our strong preference for a revised and more accurate definition at Level 1:

"Providing or making available a service, or operating or making available a system, to arrange, negotiate or match, trading interests in financial instruments constitutes an authorised activity in the Union."

It follows that we would encourage ESMA to take that scope into the harmonised interpretation when considering whether any enterprise is:

i. a system or facility;
ii. with multiple third party buying and selling interests;
iii. where those trading interests need to be able to interact; and,
iv. those trading interests include financial instruments.

We would advocate that the harmonised approach adopted by ESMA should inclusively contemplate where services are offered, especially under 'Software as a Service' or related ["SaaS," "IaaS" or "PaaS"] provisions, to be expressly included under the scope of any system or facility.

As context, we characterise two dimensions to the failure so far to establish a clear perimeter for the scope of multilateral systems:

(1) There are trading platforms operating in the Union which, on a purposive interpretation, should be operated by regulated investment firms or trading venue operators, in the same manner as MTFs or OTFs; but which, because of literal interpretations, have been able to remain outside of the perimeter of MiFID 2/R. The result is that a discriminatory two-tier system has been created: (a) regulated trading venues, which contribute trade data and transaction reporting to the overall system, and which are subject to defined governance and operating requirements in accordance with the MiFID II regime; and (b) unregulated trading systems or platforms, which operate in the dark and are not subject to any governance or

operating requirements under the MiFID 2/R regime. These evasions range from the small firms who choose not to pay the price of financial supervision to the providers of technological systems and protocols who present themselves as "FinTech" or tool suppliers while acting in a way functionally the same to an investment firm or venue operator. The same wholesale market participants make use of both tiers.

(2) The use of the "multilateral" versus "bilateral" concepts has been applied haphazardly, so that firms bringing together trading interests using the same methods and models have been subject to different requirements, depending on the Member State they are based in and the scale of their business operations. This has also resulted in a two-tier system: (a) larger firms based in certain Member States have been required to reorganise their activity as a trading venue; while (b) smaller firms in the same Member State, or firms in other Member States, have not.

The solution to the first problem is to clarify that bringing together trading interests related to financial instruments as an intermediary, whether using personnel or electronic trading systems, is a MiFID 2/R activity/investment service. This may be under the RTO as ESMA sets out [in paragraphs 12-14] or as a multilateral system, and we would further concur that a clear distinction should be made between RTO and the operation of a trading venue.

The supply of electronic trading systems fits within the perimeter when it is for the purpose of bringing together trading interests involving multiple users within that same trading system.

The solution to the second problem is to clarify that trading activity is "multilateral" when, taken as a whole and not with respect to a specific trading interest in isolation, there is the possibility for more than one person to engage with a trading interest despite there only being one buyer and one seller in the resulting transaction.

Resolving the first problem will bring more firms clearly within the MiFID 2/R perimeter. Resolving the second issue will require more firms to organise their activity on the basis of being a trading venue. These are both desirable outcomes from the standpoint of harmonisation of the MiFID 2/R rules in the Union, ensuring consistency of regulation for cross-border investors and the appropriate capture of a greater level of information about market activity within the Union.

Q2 Are there any other relevant characteristics to a multilateral system that should be taken into consideration when assessing the trading venue authorisation perimeter?

The harmonised approach adopted by ESMA should inclusively contemplate where services are offered, especially under 'Software as a Service' or related ["SaaS," "IaaS" or "PaaS"] provisions, to be expressly included under the scope of any system or facility.

Whilst a multilateral system under MiFIR should demonstrably include financial instruments, clearly the scope of the system cannot not be limited to only those because of the nature of related arranging and trading interests. Indeed, beyond money markets, currencies, and commodities, this is also now relevant for the arrangements and trading of Cryptoassets. Financial instruments are typically included with such other instruments when arranging

packages, spreads, and portfolio's whether these be cash, commodities or now even Cryptoassets. In this way the facility, system or service coming under the perimeter will very often include a much wider gamut of instruments for which it should owe the broader set of conduct and organisational requirements.

Q3 In your experience, is there any communication tool service that goes beyond providing information and allows trading to take place? If so, please describe the systems' characteristics.

EVIA is aware of many unregulated technology offerings, together with EMS/OMS, as well as trading system operators in third countries who now all routinely provide chat or messaging facilities integrated into their services. Across many use cases, it is evident that in a number of instances such tools routinely and directly lead to sufficient arrangements and to transactions outside of any regulated perimeter. Such systems exist through the broadcast of indications of interest and the subsequent interactions of users to negotiate those core economic terms all outside of any permissions for the transmission of orders or the rules of any trading venue. Commonly across such cases, the system or facility operator who is providing the messaging service purports to enable these interactions to be undertaken with the goal of concluding the finalised trades "OTC."

We observe similar outcomes where firms that do come under the CRD/CRR bring together trading interests and risk transfer through their OMS/EMS systems. These are often characterised as ancillary to the operation of the order management protocols, but in such cases clearly fulfil the characteristics of a multilateral system. In the United States we note two enforcement actions by the CFTC and a further one by the SEC recently to take steps against unlicensed systems operated by financial firms. These models, or ones ostensibly similar are being offered and utilised in the EU and we have in the past furnished ESMA together with other NCAs with relevant details.

The relevant characteristics may take the form of several models, including the matching of trading interests through either or both decentralised and centralised tools, and therefore EVIA supports activity-based regulation which is agnostic to the technology and does not treat software providers on how they characterise themselves in relation to the regulated perimeter, but rather on what activities they undertake. As such, we advocate a categorization into two buckets, those that engage in multilateral activity (and therefore should be regulated as venues) and those that do not.

In order to determine whether a facility or service falls within the first or the second activity bucket, it is helpful to distinguish between two types of software companies: those that provide distributed trading mechanisms through their decentralised tools, and those that provide insourced or centralised trading mechanisms.

1. Distributed Trading Mechanisms

A model has been seen, whereby a technology provider makes available to its clients' technology that enables trading interests entered by each client to be made visible to and actionable by other clients.

The argument appears to be that, in this model, the technology provider is not operating a system for the purposes of MiFID II. The software is licensed to each of its clients, and their interactions are cast as bilateral because they are client-client/peer-peer.

These arguments are spurious and demonstrate a poorly conceived attempt to evade the regulatory perimeter. While there is no question that the simple provision of technology, such as an order management system, is not within the trading venue perimeter, this technology is clearly provided and serviced for the purpose of bringing together the trading interests of multiple clients in order to lead to transactions in ways prescribed by the software logic.

It should make no difference under MiFID II whether the provider or a system or facility does so on a client-server or peer-peer distributed basis. If the nature of the system is to allow the trading interests of multiple users to interact, then it must be a multilateral system. It likely also involves the regulated activities of reception and transmission of order and/or execution of orders on behalf of clients.

2. Insourced Trading Mechanisms

The second case that needs to be considered is the insourced trading mechanism. The provider of such mechanism allows multiple buyers and sellers to interact, but under the supervision and control of an investment firm which has procured the service from the provider.

One of the better-known examples of this, but by no means singular, is Trayport, one of the leading software networks for the wholesale energy markets in Europe and provides for OTC, OTF, MTF and RM connectivity. Trayport is not a multilateral system in and of itself, it is an insourced trading mechanism. Their technology forms part of the broker's own system, which may be a combination of voice and electronic components.

The broker retains the regulatory responsibility within the perimeter and needs either a venue and/or 'reception and transmission of orders' authorization. The provider of the insourced trading mechanism does not.

Agency Broking

A broker may be engaged by a client to assist with a transaction; for example, to sell a position in a collective investment scheme or an illiquid bond. In order to find the best price for the client or ensure sufficient volumes can be traded, the broker may speak with multiple market participants. Those market participants may also be clients of the broker in other contexts.

It is possible to argue that this arrangement makes use of a system – the broker and the broker's tools – to allow multiple buying and selling interests to interact through the broker. The system can be described as a simplistic version of the systems used by brokers who

organise more sophisticated markets using voice and electronic systems to bring together wholesale market participants; generally, in the framework of OTFs.

However, in this case, the broker may approach possible buyers who are SIs. An SI cannot interact with an interest that is inside an OTF, so the engagement with the broker intermediary can only work if the approach is understood within the framework of the SI rules. In practice, this is the best understanding of the way that the transaction is being arranged: the broker is being instructed by their client to approach potential buyers on their behalf.

There are different versions of this model. For example, SIs might be willing to provide quotes to the broker on a continuous basis (i.e., streamed quotes), and the SI might be responsible to pay fees to the broker as a client. This can give rise to considerations of conflicts of interest and their management, but it should not lead to the conclusion that there is a multilateral system being organised by the broker. At the core of these models, each SI is performing its functions, and the broker is acting as "a pair of hands" for the non-SI client who is seeking quotes. The interaction between the SI and the end client is best regarded as bilateral, notwithstanding that the broker facilitates multiple bilateral engagements.

Q4 Are you aware of any EMS or OMS that, considering their functioning, should be subject to trading venue authorisation? If yes, please provide a description.

Yes, EVIA has furnished ESMA with a list of such systems or facilities and intends to update this during 2022. As set out in prior answers herein, we note that the first step should be to identify those firms' making arrangements with a view to concluding transactions or transmitting orders directly into the MiFID scope of RTO permission requirements, with the subsequent step focused on any multilateral qualification, and whether these should constitute a rules-based trading venue, even where no trade execution occurs within the system. Clearly any broader inclusion of currently entirely unregulated activities into MiFID as RTO licences would bring them under supervision, prudential and reporting requirements to constitute a major step forward from the current position.

Q5 Do you agree that Figure 4 as described illustrates the operation of a bilateral system operated by an investment firm that should not require authorisation as a trading venue?

Yes, we agree that Figure 4 illustrates the operation of a bilateral system operated by an investment firm that should not require authorisation as a trading venue. Where Bank A provides the users with access to the system, where it therefore retains oversight of the operation of the system, then it is more likely that it represents part of the bank's own system and would clearly be a bilateral system.

Furthermore, the contractual terms of any trades should include the system operator as also the generic counterparty. In this way, the system operator should also be the entity with whose balance sheet the users' contract with. Evidently this precludes any bilateral system

being an agency conduit, nor passing trades to a CCP for novation. Rather, as in the Prime Brokerage model, the bilateral system operator themselves would be the member of any onwards post trade infrastructure clearing and settlement.

Q6 Do you agree that a "single-dealer" system operator by a third party, as described in Figure 5, should be considered as a multilateral system? If not, please explain.

We agree that a single dealer system operator, as described in Figure 5, should be described as a multilateral system, and that follows from our response to the question [4] above. We would however note that this is the case only when the system operator is a third party to the legal entity operating or hosting the system (and clearly also to the various users of the system). Where the operator is expressly the agent or the outsourced operator for Bank A, so in this case Bank A should be treated as the operator of the system.

Where a subsidiary, an investment firm or market operator is the system operator, the case is more likely to be one in which some facility has been created with the aim of providing liquidity to a number of participants or members or users in direct collaboration with Bank A. That is more clearly a multilateral system, in which prices are provided by a liquidity provider to multiple liquidity takers using the trading systems of a third party, as described in the ESMA paper.

Q7 Do you agree that systems pre-arranging transactions that are formalised on a trading venue, even when arranged in a multilateral way, should not be required to be authorised as trading venues? Do you agree with the justification for such approach?

Yes, EVIA does agree with ESMA that systems pre-arranging transactions that are formalised on a trading venue, even when arranged in a multilateral way, should not be required to be authorised as trading venues provided that the waiver thresholds are observed.

We agree substantively and in most aspects with the justification for such an approach as set out across paragraphs 73 - 83.

We do not however agree with the subsidiary statements in paragraph 48 and paragraph 80 that the pre-arranging facility or service needs to be closely in contractual delegation with the final formalising trading venue. Clearly these act against the principles of MiFID wherein choice and shopping around are fostered, whilst also imposing insurmountable obstacles for the commercial and cross-border operation of wholesale liquidity.

We set out three different use-case examples in the attached supporting annex, but specifically

Para 48

"… ESMA considers however that systems that pre-arrange transactions which are negotiated as multilateral should be considered as an extension of the trading venue where the transaction is ultimately formalised. That is to say that the pre-arranging system itself does not require authorisation as a trading venue as it delegates the process of formalisation of the transaction to an authorised trading venue."

Our concern with this part of the explanatory material is that systems which pre-arrange transactions, which are then submitted to a trading venue for formalisation, generally are not extensions of the trading venue; nor is the pre-arranging system delegating formalisation of the transaction to the trading venue. The pre-arranging system is commercially independent of any trading venue and may in some aspects of its activities anyway be already organised as a trading venue in its own right. In this way almost all of our member firms arrange and execution multilateral trading under entirely under their own rules which does not go to finalising trading venue for formalisation; but alongside this their facilities also arrange wholesale packages involving the submission of pre-arranged trade legs to exchanges.

Organisationally, we note that these roles are separate and distinct. As the operator of the pre-arranging system which is a member/ registering broker on the tertiary trading venue, trading interests will be brought together on an "XOFF" basis; such that they are matched outside of any order book [if any] pertaining to the trading venue but subject to its acceptance and registration under its rules. Indeed, most exchanges as RMs are set up to accept pre-arranged transactions from members and on this basis, and the member is subject to the rules and discipline of the trading venue when they submit the transaction. The trading venue does not need to treat the member as being part of its own systems, or act as if there is a delegation of functions, any more than it does when members submit single trading interests to be matched in its own order book.

Para 80

For the same reasons, we also fundamentally disagree with the statement in paragraph 80 that:

> "*If the conditions above [i.e., in para 79] are met, the system that pre-arranges transactions should be considered as an extension of the trading venue where the transaction is ultimately formalised. Hence, as stated in the Final Report on OTF the trading venue should ensure, through contractual arrangements, that all relevant MiFID II provisions are complied with, including rules relating to non-discriminatory access and fees*."

This statement creates a number of particular challenges and obstacles which would frustrate the effective operation of market structure:

Firstly, because the conditions set out in the preceding paragraph 79[1] do not describe the circumstances in which there is a delegation or extension of trading systems. Rather, they describe the conditions for the pre-arranging system not needing to be authorised and organised as a trading venue in its own right. There is no formal link between these conditions being met and any requirement to treat the pre-arranging system as, "*an extension of the trading venue where the transaction is ultimately formalised*."

Secondly the implication of compliance with, "*all rules relating to non-discriminatory access and fees*," carries the implication that both systems are inside the EU and that they are commercially acting as a single entity. Whilst both conditions are unlikely and not in alignment with the broader CMU objectives, we consider that the commercial ties would contravene TFEU 101/102 as the right to carry out business.

Para 81

We also disagree with the statement in paragraph 81 that:

> "*ESMA considers that under these circumstances the main objective of MiFID II of ensuring on-venue trading, which provides for increased transparency and investor protection, has been achieved. On the contrary, should the formalisation of the transaction happen OTC, the pre-arranging activity requires authorisation as a trading venue. That is because in such a case there would be no delegation of the formalisation process to an authorised multilateral trading system and hence the pre-arranging activity itself should not be possible without the appropriate authorisation. Furthermore, where a pre-arranging system is also capable of formalising transactions, including where this occurs only for few cases, it should still require authorisation as a trading venue*."

There is a common possibility of a pre-arranging system supporting transactions that are not concluded on a trading venue, or ultimately are concluded on a different trading venue than it might have expected or ultimately need to be formalised in a third country or bilaterally. These situations may arise where the trading counterparties do not proceed with a transaction or agree between themselves to submit a transaction to a different trading venue or if it is rejected[2].

These are all perennial features of the wholesale derivatives markets, in which transactions are arranged via the "core economic terms," often on a "name give up" basis where substantive legal details are negotiated on at the point of formalisation. Indeed, despite a preponderance of standardised credit annex agreements, in some cases, one or both counterparties resiles from the transaction before it is formalised; whilst in others, the counterparties agree later to submit the transaction to a nominated trading venue. In general,

[1] 79. Therefore, ESMA is of the view that the activity of pre-arranging transaction on a multilateral way is only possible without authorisation as a trading venue when:
a) All transactions arranged through the investment firm's system or facility must be formalised on a trading venue; and,
b) The transaction benefits from a pre-trade transparency waiver on the trading venue where it will be formalised.

[2] Noting the debate in the US rulemaking around the concept of "Void ab Initio"

once the counterparties have agreed and affirmed the detailed terms with the arranging facility, only then does that intermediary submit the required and complete details to the final and formalising trading venue and only then could the alleged match be compliant to the end rulebook.

As mentioned above, please refer to the attached annex for use-case details.

Q8 Are there any other conditions that should apply to these pre-arranged systems?

As arrangers and where seeking to offer, '*invitations to treat*' any trading interests in ways that may bring about a transaction, the other conditions that should apply to these pre-arranged systems are the general licencing and authorisations under each MiFID/R, MAD/R and the IFD/R that would normally apply to the RTO activities.

Q9 Are there in your views any circumstances where it would not be possible for an executing trading venue to sign contractual arrangements with the pre-arranging platforms? If yes, please elaborate

As set out and discussed in answers 7 and 8 above, EVIA strongly disagrees with this condition which would pose challenges and obstacles to the currently licenced market structure arrangements. It is neither necessary nor practical for finalising trading venues carrying out trade execution to sign contractual arrangements with pre-arranging systems. Nor would it be beneficial, especially when considering current CMU objectives, for wider competition policy. Furthermore, for cleared derivatives and other transactions where execution legally occurs within the post-trade infrastructure such as the CCP novation, the interposition of a registering trading venue only serves to charge gatekeeper and IPR fees.

Firstly, in considering the pre-arranging service, it follows from our preferred description of a multilateral system in answer (1) above that the use of the term, "*service, system or facility*" is preferred over purely, "*platforms*", because the relevant systems might involve staff, electronic systems, SOAS, cloud, or combinations of these. Of course, the two-part model envisaged in the consultation likely only represents the simplest model of real-life interconnected chains and systems, especially when the cross-border nature of wholesale markets and liquidity is taken into consideration.

Secondly, when considering any, "executing trading venue," the most appropriate location of its perimeter is that point at which any submitted trading interest is formally accepted under its rules. Prior to that point, there is every possibility that the relevant matched allege of trading interests could be rejected, submitted to another trading venue or to none at all. For example, it may be resubmitted elsewhere, in different constructions or with different legal entity counterparties. Once a trading venue member or participant gains confirmation that the submission of its matched or alleged pre-arranged trade has been accepted then the perimeter jurisdiction is clear.

Such a clear and bright-line boundary negates any need for contractual arrangements to be in place between executing trading venues and pre-arranging systems on a trade-by-trade basis and opens the ecosystem for innovation and growth. The undertakings of those pre-arranging services and systems should be carried out under their own permissions and licences rather then, as ESMA appears to contemplate, none whatsoever.

Thirdly, the case of cross-border liquidity. Where the pre-arranging system is located in a third country, it should still submit pre-arranged matched trades and alleges that are compliant to the trading venue rules, and it should be recognised on the ESMA TCTV register such that all broader conduct requirements are deemed to have been met[3]. Where the finalising TV is located in a third country, it should recognise the permissions and licences of the prearranging system under the appropriate EU conduct, integrity, and prudential rules. These may well also include SFTR, SFDR and REMIT.

Fourthly, whilst pre-determined contractual arrangements may be suitable for retail and cash equity markets, the size and complexity of arrangements leading to risk transfer in the wholesale markets requires the use of intermediaries, the availability of choice and the cross-border operations.

Risk transfer is usually based upon balance sheet risk factors, portfolios and capital raising. Such transactions hold several contingent variables and could not be constrained to single order books or auction systems. When wholesale intermediaries ["IDBs"], who operate such liquidity pools, arrange large in scale transactions in commonly traded risk-sets and pricing factors, then these require market knowledge, credit considerations, client suitability and engagement that is neither available to, nor appropriate for the dealer firms on their own.

In transferring and standardising risks, several the financial instruments within packages will be executed through RMs by dint of the liquidity and the IPR restrictions for access to the post-trade clearing and settlement processes. For example, transactions in Eurex ETDs can only be executed at Eurex, and iTraxx can only be traded at IFE, even if they are pre-arranged. Away from equities and credit, other financial instruments may be formalised across a range of possible trading venues, which will likely depend upon the commercial and regulatory preferences of the wholesale trading counterparties. In short, the identity of the execution venue will often be self-evident and tied to the vertical silo available; it will sometimes be dictated by the financial instrument, but it may be the choice of the counterparties.

Consequent to these four points, it follows that the prescriptive proposals identified are inappropriate and that both principles and flexibility in regulation are important and should facilitate supervisory proportionality. Pre-arrangements between wholesale counterparties are typically made through the provision of an execution policy document that sets out terms of business such as the trading venue options and the instructions from the trading counterparties at the outset of any client or market participant relationship. Such policy provision is the ambit of licensing and supervision. It therefore becomes the basis for cross-border recognition, equivalence, and deference.

[3] In much this same way the US have an overseas requirement for NFA membership.

Clearly, any superposition and iteration across all the rules of possible final formalising trading venues into all the possibly pre-arranging systems would create a set of conflicts and complexities that would be impossible to resolve and ill serve the public policy objectives. For example, which rules would apply in the case of a large bond trade, where there are multiple trading venue options? How would different requirements in the rules of the possible trading venues be reconciled? Which trading venue would have the jurisdiction to assert its discipline over the transaction, and from what point? How could this be applied where trade legs within the contingent transaction package are to be executed in third countries?

It follows that the ESMA opinion and guidance should still follow the provisions within the relevant Q&As. These denote that the arranging intermediary will be separate to the trading venue framework precisely because of the conflicts that would arise, but notwithstanding that any trade submissions must be in accordance with the rules of the relevant trading venues and subject to their acceptance. These hurdles include the matter of commercial fee structures as set out in the annex use case examples. For their part, trading venues require certainty of where their rules, supervision and sanctions apply, and do not have cross jurisdictional reach.

In terms of the policy objective of a meaningful consolidated tape, clearly a removal of prescriptive hurdles and barriers such as those identified in paragraphs 48,80,81 will serve to encourage more trades to be finalised under the MEFFROC perimeter and included into that information. Conversely, arrangements which are subject to terms reconstruction or fail to be settled would only be applied when appropriate.

Finally, it follows there remains the significant case for removing the prescriptive equity CLOB template and for ESMA to consider its opinion somewhat differently for those markets in scope of RTS1 transparency requirements as contrasted against those non-equity markets in scope or RTS2.