

Feature

KEY POINTS

- The regulation of market structure in the EU and UK has been a tale of constant evolution. In Europe, as elsewhere, the functions of marketplace and intermediary were historically distinct, but the boundary has become blurred. So too has the distinction between regulated and unregulated systems.
- Uncertainty over the concept of a multilateral system under the Markets in Financial Instruments Directive framework in the EU and UK has led to an unlevel playing field between regulated entities and similar systems operating outside the regulatory perimeter.
- Recent guidance seeks to provide much needed clarity on the trading venue perimeter, emphasising that the technology used and how a system classifies itself are not relevant to the issue.

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What is in a name? The regulators seek to have the final word on the meaning of trading venue under MiFID

For the EU's and UK's securities and markets regulators nothing is in the name nor in the technology used when it comes to the need for a trading venue licence. Yet, noting some uncertainty around the application of key concepts to certain facilities, each regulator has sought to provide clarity for their respective markets via recently published guidance.

BACKGROUND

The regulation of market structure in the EU and UK has been a tale of constant evolution, in reply to advances in technology and changes in trading practices.

In Europe, as elsewhere, the functions of marketplace (exchange) and intermediary were historically performed by distinct types of institution but have become more complex overtime, with the boundary between marketplaces and intermediaries becoming blurred.

The era of national-champion stock exchanges providing the sole source of liquidity for securities in their domestic market has, thanks to regulation, long ended. Technology has allowed alternative platforms to replicate the core business of exchanges – ie matching buying and selling interests in financial instruments. In addition, large volumes of client orders can be “internalised” by investment firms. In future, decentralised finance (DeFi), now a small but growing segment of cryptoasset markets, where decentralised autonomous organisations consisting of smart contracts provide trade arranging facilities that are not dissimilar to those of traditional exchanges, may see adoption in traditional securities markets.

The first Markets in Financial Instruments Directive (2004/39/EC) (MiFID I) introduced a regulatory framework for “multilateral trading facilities” (MTFs) to sit alongside the framework for exchanges (or regulated markets). Entities operating such platforms could do so on the basis of an investment firm licence (although MTFs may also be operated by regulated market operators), subject to a customised regulatory regime.

The concept of an MTF recognises systems which support the multilateral disclosure of orders or indications of interest between participants, and the execution of orders resulting from the interaction of buy/sell interests within the system. It also includes systems where orders are executed against a reference price imported from outside the system. The common, characteristic, feature of these systems is the absence of active intercession by the operator to facilitate trades, or participation itself in transactions in the system.

By the time the Commission launched its review of MiFID I and published its proposals for the eventual second Markets in Financial Instruments Directive (2014/65/EU) (MiFID II), it observed that new trading venues and market structures, such

as broker-crossing systems and derivative trading platforms, had emerged that carried out similar activities to regulated markets or MTFs, without being subject to the same regulatory requirements.

MiFID II introduced a new category of “organised trading facilities” (OTFs) with the aim of capturing organised execution systems for non-equity trading, such as “swap execution facilities”, which may have fallen outside of regulation under MiFID I.

MULTILATERAL SYSTEM

Regulated markets, MTFs and OTFs are encompassed under the umbrella concept of “trading venue”. A firm requires authorisation as (one of these types of) trading venue, if it operates what is defined as a “multilateral system” (MLS). An MLS has four elements:

- it has the characteristics of a trading system or facility;
- it comprises multiple third party buying and selling trading interests (which is to be understood in a broad sense and includes orders, quotes and indications of interest);
- it allows trading interests to interact in the system; and
- those trading interests are in MiFID II financial instruments.

However, the evolution of the definition, in addition to technological developments, has made it challenging to distinguish certain types of arrangements and systems from trading venues. This has created some uncertainty about the regulatory perimeter

for trading venues, leading to an unlevel playing field between regulated entities and certain systems operating outside the regulatory perimeter.

With the aim of providing clarity, both the UK Financial Conduct Authority (FCA) and the European Securities and Markets Authority (ESMA) have provided guidance on the concept under their respective frameworks. ESMA's final guidance was published in February 2023. The FCA's guidance was finalised in July 2023 and came into force on 9 October.¹

This article examines the regulators' efforts at articulating the characteristic elements of a trading venue and highlights the key takeaways for firms.

While neither set of guidelines is likely to settle the position once and for all, there is a striking consistency of approach between the two regulators. With an eye, undoubtedly, to future-proofing the regulatory perimeter, both emphasise technological neutrality and prioritise substance over terminology.

Fintech providers hitherto outside the paradigm of trading venue regulation will do well to carefully review the functionality of their products against the guidance, as arguments that the regulations' application to new or differently labelled technologies is unclear are likely to receive short shrift going forward.

DeFi platforms (if they come to be adopted in traditional markets in financial instruments) may yet require further regulatory intervention. The UK government and EU legislators are both taking such a wait-and-see stance in relation to cryptoasset financial markets. However, the horizon of the regulators' likely approach is already visible.

SYSTEM

In respect of the concept of a "system", the FCA's and ESMA's guidance is essentially identical.

As ESMA explains, the concept of "system" is broad but not every system is multilateral and, therefore, within the scope of the MLS definition. Broadly, a "system" is a "set of rules that governs how third-party trading interests interact", meaning that they

concern the "matching, arranging and/or negotiation of trading interests". Such rules may be contractual arrangements or standard procedures. Moreover, the concept of "system" is technology neutral, meaning that non-automated arrangements (eg where firms can reach out to other clients to find a potential match when receiving a buying/selling interest) may constitute "systems" as well as automated ones. The concept of system does not include general-purpose communication systems, technical standards of message construction or protocols governing the technical exchange of messages.

The FCA's guidance, in addition to these points, includes some examples of general-purpose communication systems, namely: internet services providers, telephone networks, website providers and chatroom facilities.

MULTIPLE TRADING INTERESTS

The FCA's guidance emphasises that there needs to be multiple third-party buying and selling trading interests (ie trading interests other than those of the system operator) for a system to be an MLS. What would fall short of this criterion, and is therefore outside the scope of the MLS definition, are bilateral systems. The key question in this respect is whether, at the point of entry, a system enables one person to interact potentially with multiple others.

ESMA's guidance similarly notes that this criterion is satisfied where persons other than the system operator are brought together in a transaction or where two trading interests interact under the rules of a third-party operator. Bilateral systems, ESMA considers, are systems where interaction occurs between two counterparties only and without third-party operator involvement, such as in the case of systematic internalisers who trade on their own account on every transaction and take on market risk.

INTERACTION

In respect of the condition that trading interests must be able to interact in the system, again, the FCA's and ESMA's guidance runs along similar lines.

ESMA notes that this criterion is satisfied where the system:

- allows the display of different trading interests; and
- allows users to react to those trading interests.

This means that it should be possible, for example, to exchange information, match, arrange, and/or negotiate terms in respect of trading interests. The FCA clarifies that the information that should be possible to be exchanged comprises information relevant to the essential terms of a transaction, such as price, quantity or subject matter. Where such information can be exchanged, and terms of transactions be negotiated, there will be the requisite interaction.

On the other hand, both ESMA and the FCA concur that the interaction condition does not require the conclusion of a contract. Accordingly, as long as there is sufficient interaction between interests (eg matching and arranging), a system may require authorisation even where further contractual details would need to be arranged outside the system.

The FCA's guidance makes clear that any system that merely receives, pools, aggregates and broadcasts trading interests (eg bulletin boards), or notifies parties of general expressions of interest, but does not allow for an interaction between trading interests, should not be considered an MLS. ESMA adopts the same position.

SPECIFIC CASES

Both the FCA guidance and the ESMA guidance set out considerations on how the MLS definition applies to specific cases, albeit that the specific cases in focus differ somewhat.

Technology providers

The FCA notes that general purpose communication systems are not automatically subject to requirements to obtain authorisation as a trading venue, albeit that this will be on the basis that they do not satisfy other criteria. In other words, both providers and users of such

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systems may be deemed to operate an MLS if they satisfy the other criteria.

The FCA further considers that there are some wider factors that may impact on the assessment of whether a system is an MLS. These include:

- the system's target users and the actual use of a system by its users;
- any relevant restrictions on how the system may be used and their practical effect;
- whether the system is designed to enable trading of any kind amongst users; and
- the determinants of the remuneration of the operator and the extent to which these are linked to the interaction of trading interests in financial instruments in the system.

ESMA similarly emphasises that, in determining whether technology providers could qualify as trading venues, what is key is how a system functions, ie what it permits users to do. By contrast, the form of the arrangement (eg in-house or outsourced), the technology used, or how a system classifies itself are not relevant.

Where there is no facilitating of transactions, no genuine trade execution or arranging, a system should not be characterised as an MLS. For example, where a system consists of an interface that only aggregates and broadcasts trading interests, does not allow for communication or negotiation between advertising parties and does not allow for execution or bringing together of trading interests, such system would be identified as a bulletin board type system rather than an MLS. The same is true of execution management systems (EMS) which purely allow users to support their own order management processes, such as by offering overviews of liquidity and prices on various venues and sending orders to the preferred trading venue for execution.

However, where a system does allow for genuine interaction – for example, where an EMS allows firms to gather quotes from multiple players, allowing these trading interests to interact within the system – this may constitute an MLS.

ESMA also emphasises the importance of the role of the entity operating the

system. For example, while software vendors operating the system will not necessarily have to seek authorisation, that might be different where they embed in the system rules that govern the interaction of trading interests and investment firms would not be allowed to set their own rules.

The FCA's guidance is particularly extensive in respect of bulletin boards. In general, bulletin boards – which commonly merely notify users of general expressions of interest – will not qualify as MLS. The situation is different only where there is matching of trading interests and an ability to respond/communicate, negotiate or accept essential terms, or enter into contracts within the system.

The FCA further provides clarification as to activities a bulletin board could provide while remaining outside the scope of the MLS definition. Bulletin boards can, for example, enable the publication of users' contact details so that users can contact each other bilaterally outside the system. Bulletin boards can also make available, and even require the use of, template documentation for negotiating and executing transactions bilaterally outside the system (although they should not complete such template documentation in relation to the essential terms of the transactions). Lastly, a bulletin board can provide post-trade services such as assisting with the transfer of funds or registering the transfer of financial instruments. Depending on the circumstances, however, this may require authorisation for providing payment services or electronic money issuance.

Request-for-quote systems

ESMA's guidance explains that RFQ systems can be described as trading systems where:

- a quote or quotes are provided in response to a request for quote submitted by one or more members or participants;
- the quote is executable exclusively by the requesting member or participant; and
- the requesting member or participant may conclude a transaction by accepting the quote or quotes provided to it on request.²

In general, ESMA considers that many RFQ protocols fall within the definition of MLS.

Where RFQ systems allow clients to request a quote from multiple dealers/liquidity providers, such request (and, therefore, the system) is multilateral in nature even where the multiple quotes are provided in response to a single request. A system that functions so as to allow requesting a quote from only one dealer at a time (RFQ-to-one) could still be considered multilateral to the extent that it allows clients to send multiple requests to dealers (eg separately) despite the RFQ-to-one functionality.

However, where a system envisages only one liquidity provider, such as a systematic internaliser operating its own single-dealer system, it would usually be considered to be a bilateral system and, hence, not an MLS, provided that the system is operated by the single liquidity provider. By contrast, where a third-party operator that sets the rules of the system and defines how the liquidity provider and other participants interact in the system, ESMA considers this to be multilateral. In this case, a software vendor operating the system as a consequence of outsourcing arrangements would also not be characterised as an MLS provided that the investment firm keeps operating the system.

The FCA would seem to take a similar approach, explaining its position in the following terms:

“[t]he fact that when any two persons negotiate within the system they do so between themselves does not mean that the system is bilateral rather than multilateral. Instead, what matters is whether the system, at the point of entry, enables one person to interact potentially with multiple others (other than the operator).”

Systems that pre-arrange transactions

The ESMA guidance explains that systems that pre-arrange transactions may fall outside the scope of the MLS definition where both:

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

Such pre-arranging system would not require authorisation as a trading venue, albeit that it would require authorisation as an investment firm.

To ensure appropriate oversight and compliance, a pre-arranging system should have an arrangement with the trading venue where pre-arranged transactions are formalised, such as a membership agreement with the trading venue where the firm will be a member (eg where it acts as agent vis-à-vis the trading venue) or an arrangement that allows the firm to confirm whether transactions it pre-arranged are always formalised on a trading venue (eg where it acts as introductory broker between different parties). The burden of ensuring that all transactions are eventually formalised on a trading venue is on the pre-arranging system.

Where formalisation of a pre-arranged transaction occurs over-the-counter, or where the pre-arranging system is capable of formalising transactions, such system would qualify as an MLS and require authorisation as a trading venue, even if this occurs only in respect of a small number of transactions.

The FCA's guidance is less detailed on this point, but it too confirms that a firm using a system for the purpose only of executing these trades on a trading venue, in accordance with the intentions of the parties to the underlying transactions to trade under the venue's rules, does not operate an MLS.

Other cases

Lastly, the FCA discusses a small number of minor additional cases, which may be of particular relevance to UK markets but could also be useful to firms considering the scope of EU MiFID II.

Illustrating the point that the MLS definition depends not on technology or arrangements employed but on the functionality of a system, the FCA notes that voice broking may, but need not, comprise the

operation of an MLS. Whilst merely arranging or executing client orders over the telephone does not constitute an MLS, voice broking may enable negotiation between parties or be used in conjunction with other execution modes, such as electronic order books, in which case it would form part of an MLS.

Portfolio management firms that use an internal matching system to execute trading interests relating to one client's portfolio against trading interests relating to the portfolio of another of its clients are generally not within the scope of the MLS definition. This is because it is the portfolio manager's discretion that is at the heart of such trading, such that the portfolio manager would be considered the only user of the system.

A crowdfunding platform would not be considered an MLS when an issuer's business funding interests are matched with the interests of investors, but it would be so considered in cases where it allows multiple third-party buying and selling trading interests to interact within a system, such as in a secondary market. ■

- 1 See *Final Report On ESMA's Opinion on the Trading Venue Perimeter*, available at <https://www.esma.europa.eu/sites/default/files/library/ESMA70-156-6383%20Final%20Report%20on%20ESMA%27s%20Opinion%20on%20the%20trading%20venue%20perimeter.pdf>; and FCA, PS23/11: Guidance on the trading venue perimeter, available at <https://www.fca.org.uk/publications/policy-statements/ps23-11-guidance-trading-venue-perimeter>
- 2 See, eg Commission Delegated Regulation (EU) 2017/583, Art 1(2); Commission Delegated Regulation (EU) 2017/587, Annex I, Table 1.

Further Reading:

- Digitised trading and settlement: Exchange 4.0 (2022) 3 JIBFL 176.
- What's in a name? "Systematic internalisation" and the regulation of trading under MiFID II (2015) 7 JIBFL 421.
- Lexis+® UK: Banking & Finance: Overviews: Regulation of derivatives trading venues – overview.