SPECIAL REPORT SERIES: MARKET INFRASTRUCTURE UNDER MIFID II

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This Special Report is the fourth in FIA and FIA Europe's series covering specific areas of the European Securities and Markets Authority's consultation process for the implementation of the recast Markets in Financial Instruments Directive ("MiFID II") and the new Markets in Financial Instruments Regulation ("MiFIR").

Specifically, this Special Report provides an overview of ESMA's proposals relating to (i) the new obligation to trade derivatives on trading venues and (ii) certain organizational requirements for trading venues, as set out in the recently published Consultation Paper[1] and Discussion Paper[2] with draft technical advice measures and proposed draft Regulatory Technical Standards ("RTS") and Implementing Technical Standards ("ITS").

TRADING VENUES: NEW PROVISIONS

The new legislation introduces three major innovations that impact trading venues:

i. Organised Trading Facility ("OTF"): a new category of trading venue broadly akin to a U.S. swap execution facility, which permits discretionary execution and limited matched principal trading[3];

ii. Trading obligation for derivative contracts: a new obligation that will require Financial Counterparties and certain Non-Financial Counterparties, as defined in the European Markets Infrastructure Regulation ("EMIR"),[4] to trade specified derivative contracts on Regulated Markets ("RM"), Multilateral Trading Facilities ("MTF"), or OTFs;

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[1] ESMA Consultation Paper (ESMA/2014/549).
[2] ESMA Discussion Paper (ESMA/2014/548).
[3] Recital 24 clarifies that "dealing on own account" includes when a firm executes client orders from different clients by matching them on a matched principal basis (*i.e.*, back to back trading).
[4] Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories, OJ L 201, 27.7.2012, p.1.

iii. New organisational requirements for trading venues: these requirements are designed to enhance resilience of the trading venues' systems and address specific risks associated with electronic, algorithmic, and high-frequency trading.

Because there are few MiFID II or MiFIR implementing measures specific to OTFs, the Consultation Paper and the Discussion Paper contain little analysis of the OTF category. Consequently, this Special Report focuses on the Trading Obligation and the new organisational requirements for trading venues.

Organised Trading Facility

As previously mentioned, the legislation creates a new category of trading venue—the OTF—which has been designed to include much of the inter-dealer market, such as voice broking systems. The new rules include some restrictions on the ownership and operation of OTFs by legal entities owning and operating systematic internalisers.

OTFs differ from RMs and MTFs in three material ways. First, OTF rules permit execution of orders on an OTF on a discretionary basis. Second, only bonds, structured finance products, emission allowances, and derivatives may be traded on an OTF (equities cannot be traded on an OTF). Third, investment firms operating OTFs may engage in limited matched principal trading in bonds, structured finance products, emission allowances, and derivatives that are not subject to the Clearing Obligation set out in EMIR.

Trading Obligation

Article 28 of MiFIR sets out a Trading Obligation for Financial Counterparties and certain Non-Financial Counterparties that engage in trading certain over-the-counter ("OTC") derivative contracts. Specifically, OTC derivative contracts declared subject to the Trading Obligation may not be traded bilaterally; instead, they must be traded on RMs, MTFs, OTFs, or equivalent third-country trading venues.

The Trading Obligation is broadly similar to the "trading mandate" for swaps under Title VII of the Dodd-Frank Act, with intragroup transactions being exempted from the Trading Obligation.

Generally, there are three conditions for application of the Trading Obligation:

i. The contract in question pertains to a class of derivative contracts that ESMA has deemed subject to the Clearing Obligation under EMIR; and

ii. The class of derivative or "a relevant subset thereof" must be admitted to trading on at least one trading venue (or third-country equivalent trading venue); and

iii. The class of derivatives is considered sufficiently liquid.

The first two conditions are reasonably well-known. However, the third condition has proven difficult to define. Of note, MiFID II and MiFIR contain different definitions of "liquid market" and apply the concept differently for equities and non-equities. Specifically, ESMA states that liquidity tests and assessments in other pieces of European legislation serve different regulatory purposes and are, therefore, independent of the liquidity assessments for MiFIR.

ESMA outlines its analysis and preliminary approach on liquidity in Section 3.6 of the Discussion Paper. Section 3.6 includes ESMA's discussion of the criteria below, which are set forth in MiFIR and are aimed at determining whether a financial instrument or a class of financial instruments is liquid. The criteria are trade-based, order-based, and market-structure-based measures of liquidity and are as follows:

i. Average frequency of transactions (ESMA's preference is to require both a minimum number of transactions as well as a minimum number of trading days on which at least one transaction occurred);

ii. Average size of transactions (ESMA's preference is to take into account the total turnover over a specified period divided by the number of trading days);

iii. Number and type of market participants (ESMA's preference is to define a "market participant" as any member or participant of a trading venue involved in at least one transaction in a given market; ESMA suggests that the necessary data could be computed by assessing the transaction reporting data, as required under EMIR);

iv. Average size of spreads (ESMA's preference is to use the end-of-day relative bid-ask spreads, as published by the most relevant market in terms of liquidity, irrespective of the size and type of the quotes).

While the role of liquidity under MiFIR drives certain transparency obligations, MiFIR does not prescribe how to (i) combine these criteria or (ii) assess, in practice, whether a financial instrument or a class of financial instruments is liquid or not. ESMA is seeking the input of market participants on those two questions.

Organisational Requirements for Trading Venues

Algorithmic and high-frequency trading together have proven one of the most contentious issues in the policy making process to date. MiFID II includes new organisational requirements both for (i) investment firms engaging in algorithmic and high-frequency trading and (ii) trading venues that permit algorithmic and high-frequency trading on and through their trading systems (which, in effect, are almost all trading venues in the EU).

The key provision for trading venues is Article 48 of MiFID II, which sets out a wide range of organisational requirements related to orderly trading conditions, such as systems resilience standards and prescribed fee structures. Although

Article 48 only speaks of RMs, Article 18(5) of MiFID II extends this provision to all trading venues (*i.e.*, to MTFs and OTFs).

In practice, most trading venues that permit trading in derivatives contracts have already implemented many requirements imposed by Article 48.

Organisational Requirements for Investment Firms and Trading Venues: Common Elements

Section 4.1 of the Discussion Paper addresses certain microstructural issues that are applicable to both investment firms engaging in algorithmic trading and trading venues. In particular, Section 4.1 of the Discussion Paper provides ESMA's preliminary view on the definition of "trading systems" used by trading venues and the concept of "real time" market monitoring of algorithmic trading activity. The same section also clarifies the parameters that should be considered by trading venues in relation to the concepts of "severe market stress" and "disorderly trading conditions" when determining whether their systems and controls are sufficient.

To a large extent, ESMA's approach follows its 2012 Guidelines on Systems and Controls in an Automated Trading Environment.

Organisational Requirements for Trading Venues under Section 4.3 of the Discussion Paper

Section 4.3 of the Discussion Paper analyses certain organisational requirements for trading venues that are imposed by Article 48 of MiFID II. In particular, it outlines criteria that should enable real time monitoring of performance and capacity of trading venues' systems. Trading venues should analyse those criteria taking into account the nature, scale, and complexity of their business and may need to establish more stringent organisational requirements where appropriate.

The Discussion Paper further outlines ESMA's view that trading venue systems should have sufficient capacity to accommodate at least twice the highest number of messages per second ever recorded on any given day managed by the trading system (*i.e.*, messages received, sent, or rejected). Trading venues should assess that capacity on an ongoing basis and should be able to scale the performance of its systems in order to respond to rising message flow that might threaten its proper operation. ESMA considers capacity not to be "overwhelmed" provided that the elements of that trading system perform their functions without system failures or outages, errors in matching transactions (no order lost), or missing or incorrect data (no transaction lost, no display of blank or incorrect prices, no wrong trading volumes).

The Discussion Paper also details which minimum arrangements trading venues should have in place to ensure resilience of trading systems; requires the trading venues to test the capacity of members or participants to access trading systems; and requires the trading venues to facilitate the testing of algorithms to avoid disorderly trading conditions. The Discussion Paper further outlines the pre-trade controls that a trading venue must have in place (*i.e.*, the systems that members or participants of trading venues should have to check their orders before their submission to the trading system).

Finally, the Discussion Paper outlines controls that have to be implemented by trading venues to allow members or participants to provide direct electronic access ("DEA"). DEA is defined in MiFID II to include both Direct Market Access and Sponsored Access ("SA") (MiFID II prohibits unfiltered SA). The Discussion Paper also discusses the degree of intervention that trading venues should be able to exercise with respect to members or participants seeking to provide DEA.

The DEA-related controls are based on the requirements implemented pursuant to MiFID I, evidence gathered by ESMA in relation to current market practice, and the IOSCO Principles for Direct Access to Markets. Accordingly, ESMA is considering two options regarding the power of trading venues to permit their members or participants to provide DEA to their clients:

i. Trading venues should set out a general framework that should be met by its members or participants if the members or participants want to offer DEA. If the trading venue detects that this framework is not met by a member or a participant, it should ban the provision of DEA by that member or participant.

ii. Trading venues should authorise the provision of DEA by each of its members or participants before those members or participants may offer that service to their clients.

The latter option is likely to prove unpalatable for most trading venues.

Other Organisational Requirements for Trading Venues
In addition to the organisational requirements included in Section 4.3 of the Discussion Paper, Section 4.4 of the Discussion Paper contains requirements for trading venues that have a market making scheme in place and outlines conditions under which having a market making scheme is not appropriate.

There are separate but arguably conflicting requirements applicable to (a) investment firms using an algorithmic trading strategy to make markets and (b) trading venues. The former must enter into a market making agreement if they make markets while the latter are obliged to offer market making schemes subject to market making agreements and ensure sufficient participation in same. Draft RTS will further specify key provisions of the market making agreements.

Separately, Section 4.5 of the Discussion Paper contains details on the Order-to-Transaction Ratio ("OTR"). ESMA has interpreted this requirement narrowly—according to the Discussion Paper, draft RTS would require OTRs only for cash instruments. This interpretation may be seen as divergent from the primary legislation, but trading venues and market participants are not likely to oppose it.

Section 4.6 of the Discussion Paper addresses co-location services, although ESMA avoids prescriptive requirements regarding trading venue charges for co-location and related services.

Section 4.7 discusses fee structures applicable to trading venues. These provisions proved very contentious in the policy making process and ESMA has

been careful to avoid controversy and restrict its proposals on fee structures to those incentivising disorderly trading as well as opaque and discriminatory fee structures.

Finally, Section 4.8 of the Discussion Paper outlines proposals for the tick size regime, which ESMA has interpreted as being limited to equities and equity-like instruments.

Upcoming Special Reports

In the coming days, FIA and FIA Europe will issue will issue special reports on the remaining topics addressed in the two papers:

1. **Investor Protection**
2. **Algorithmic and High-Frequency Trading** (defining terms and regulating activities)
3. **Third Country Access** (treatment of third country firms accessing EU customers)
4. **Reporting of Instruments**
5. **Transparency Requirements for Instruments**

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Additional MiFID II/MiFIR documents are available here.

Disclaimer: This report was drafted by the London office of Covington & Burling LLP on behalf of FIA and FIA Europe. The report is part of a series of reports intended to provide factual summaries of MiFID/MiFIR on certain topics of interest to the members of FIA and FIA Europe. The reports are provided for general informational purposes only. They do not constitute legal or regulatory advice and should not be relied upon for this purpose.

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