FIA EPTA
EUROPEAN PRINCIPAL TRADERS ASSOCIATION

29 April 2022

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

Introduction:
The FIA European Principal Traders Association (FIA EPTA) appreciates the opportunity to provide feedback to the European Securities and Markets Authority (ESMA) on the consultation on ESMA's Opinion on the trading venue perimeter

FIA EPTA represents 26 independent European Principal Trading Firms (PTFs) which deal on own account, using their own money for their own risk, to provide liquidity and immediate risk-transfer in exchange-traded and centrally-cleared markets for a wide range of financial instruments, including shares, options, futures, bonds and ETFs.

Our members are independent market makers and providers of liquidity and risk transfer on trading venues and end-investors across Europe. Market making and liquidity provision (also referred to as principal trading or dealing on own account) is a distinct activity that is undertaken by non-systemic investment firms rather than banks, in a highly dispersed and varied ecosystem of independent Principal Trading Firms. These firms operate in an innovative and competitive fashion leading to a vibrant, dynamic and diverse ecosystem which massively reduces interconnectedness and increases substitutability. This fundamentally reduces systemic risk whilst improving market quality and lowering costs for retail and institutional investors alike.

FIA EPTA members appreciate ESMA's consideration of our comments and suggested solutions and stand ready to provide any further input as required.

3.1 Multilateral Systems

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

Scope and breadth

FIA EPTA considers that ESMA's approach to defining multilateral systems is overly broad and risks creating further confusion and inconsistencies in the application of MiFID II across the Union. FIA EPTA further considers that ESMA's position risks overlooking the risk of inherently bilateral systems being

allowed to operate under the badge of a multilateral venue and risks exposing less sophisticated investors, notably retail investors, to genuine harm from the perspective of best execution.

Bilateral relationships between two investment firms involving a third-party system

At the outset, FIA EPTA would state that contrary to the position taken by ESMA in paragraphs 24 and 25 of the Consultation document, it does not make sense in our view, as a practical matter, to treat any bilateral relationship between two investment firms involving a third-party system as being multilateral without further analysis of the nature of the relationships between the parties and the specific services being provided.

As a general point, we would highlight that it is not uncommon for many large and medium-sized investment firms to have internal outsourcing arrangements within their groups, notably when it comes to technology services such as development, hosting and production support. We expect many systematic internalisers (SIs) registered in the Union to have elements of this setup in connection with technology infrastructure to operate their SIs. The internal group entity in such a setup would represent a third party under the position adopted by ESMA in this Consultation. Following the logic put forth by ESMA, as such the bilateral SI to investor relationship would need to be reclassified instead as a multilateral relationship, notwithstanding the fact that the internal group entity is operating as an outsourced technology/services provider to the entity that operates, and is ultimately responsible, for the SI. For equities, under the proposed guidance, the whole relationship would need to fundamentally change, despite this change bringing no observable benefits to the end investor:

1. Categorising the third-party as an MTF. There would now be two separate entities considering themselves the venue of execution, the SI and the MTF which is unworkable and so presumably requires the SI to cease operating as an SI;
2. Corporate restructuring to move all staff involved in the development, operation and support of the SI matching engine were housed within the regulated entity operating the SI (creating significant inefficiencies from a corporate structuring perspective);
3. Re-categorising the offering to be solely an MTF, leading to the loss of risk management controls and counterparty discretion on the part of the risk capital provider. Given that this would be significantly detrimental to their risk management practices, FIA EPTA believes it likely that such SI arrangements may have to simply cease, removing choice of execution venue and healthy competition from the end investor's trading landscape

Interactions between trading interests

FIA EPTA considers that ESMA's position and guidance on interactions between trading interests (noting that any such system must contain rules pertaining to the matching and arranging/negotiating transactions), is helpful but FIA EPTA members are concerned that this could be interpreted too broadly and would potentially capture firms that are providing pure connectivity services between investment firms and execution venues.

There are numerous technology vendors operating in the Union and elsewhere that provide such services which can range from simple technical connectivity to more involved services including the normalisation of market data and common protocols for submission of orders to multiple execution venues. These

vendors offer these services across all types of EU execution venues (including Regulated Markets, MTFs, OTFs and SIs) and can significantly reduce the cost and complexity for firms looking to trade in Europe's fragmented marketplace.

There is scope, under certain readings of the draft Guidelines, that such services could be treated as the operation of a multilateral venue. It is critical to consider in cases such as these *where* the matching of the trading interest occurs, i.e., *where* connectivity is being provided between an investment firm and a RM, MTF, OTF or SI. We consider that on the basis of such an analysis it would be clear in almost all instances that the matching of the trade occurs on the MiFID execution venue. Given that the same trade cannot occur on two different execution venues it would be illogical to treat firms and systems that provide this type of connectivity (to a third-party technology provider) as being multilateral venues.

As such, FIA EPTA would again stress that the simple involvement of a third-party system cannot by itself be the primary determining factor in whether such as system is a multilateral trading venue as opposed to a bilateral relationship supported by third party technology. While likely to be nuanced, FIA EPTA believes that it is essential to consider the nature of the function performed by any third-party, rather than simply their presence or absence. We note further that often clues to the nature of the service provided by third parties can be gained from the way in which services are charged for, with simple technology arrangements often incurring a fixed fees (monthly or annual), whilst venue-type services often include a transaction or order-based fee structure.

Bilateral systems posing as multilateral systems

MiFID II Article 4(19) defines a 'multilateral system' as any system or facility in which multiple third-party buying and selling trading interests in financial instruments are able to interact in the system. FIA EPTA members' interpretation of this is that more than one buying and more than one selling third-party should have the ability to access and interact in the system.[1]

Although the Opinion's aim is to clarify when certain systems and facilities qualify as multilateral, FIA EPTA believes there is also a need to review systems currently classified as multilateral and consider whether they truly operate in a multilateral manner. FIA EPTA members are aware of trading venues operating single-dealer platforms where additional dealers/liquidity providers under the venue's trading rules are not permitted to access the system i.e., are not able to become member/participants of that

[1] Noting by way of additional consideration that ESMA has confirmed in its Market Structure Q&A (in this case in the context of OTFs) that trading on a multilateral basis requires at least three materially active members or users to be able to fully interact with all the others for the system to be considered compliant with multilateral trading requirements. In other words, ESMA concludes in its Q&A that to be multilateral in this context, a user's trading interests need to potentially interact with those of at least two other users. This follows from the requirements of Article 18(7) MiFID, which also pertains to MTFs. Logically, multilateral trading on a Regulated Market should be held to at least the same standard as MTFs and OTFs in our view.
See Q&A 10 (a) here: https://www.esma.europa.eu/file/112484/download?token=Mo_twi52

segment/venue or act as liquidity providers there and our members consider that the intention of ESMA's current opinion is not to validate this type of closed market system.

Articles 18(3) and 53(1) of MiFID II require regulated markets, multilateral trading facilities and organised trading facilities have transparent and non-discriminatory rules governing access which are based on objective criteria. In this case of a venue operating a single dealer platform, the objective criteria governing access are based on a policy which limits the ability of either buyers or sellers to interact with more than one buying or selling interest. The ability to trade in a multilateral fashion is limited to one participant, namely the single dealer, while all other trading is limited to taking place on a bilateral basis. Furthermore, recital 7 of MiFR notes that the definitions of regulated markets, multilateral trading facilities and organised trading facilities should exclude bilateral systems where an investment firm enters into every trade on its own account, even as a riskless counterparty interposed between the buyer and seller.

Based on the CJEU case of 'Robeco and others vs AFM', ESMA concludes that "multiple third party buying and selling trading interests" only excludes those systems where the interaction occurs between two counterparties only, with no actual or potential third-party involvement in the system. ESMA then follows this up by stating that a single-dealer platform, even with a single counterparty, should be regarded as multilateral systems where a system operator is independent from its members or participants. This means that systems such as the single-dealer venues described above could continue to be considered as multilateral with no potential for additional liquidity provision from other dealers/liquidity providers.
The consideration of a single dealer system as multilateral merely on the basis of the system being operated by someone other than the market maker does not correspond with the MiFID II multilateral system definition, as the third party operating the system is not an additional buying or selling interest. FIA EPTA members' concern with this is that this creates a false sense of security for buy-side users/retail investors using these trading systems as they see these as a recognised multilateral trading venues/MTFs when, in fact, there is an inherent over-reliance on a single market maker. Should that single market maker elect or be forced to stop providing liquidity that venue's participants would be heavily impacted.

In this regard, we consider that there is very limited broader relevance for the Robeco et al vs. AFM CJEU case in relation to the current post-MiFID II perimeter discussion regarding multilateral trading. Most ostensibly, the Robeco et al vs. AMF case pertains to the MiFID I context, with the CJEU having had to interpret the implicit assumptions in MiFID I in relation to multilateral trading, in the absence of an explicit definition (as now contained in MiFID II). Also, we would note that the MiFID I policy context was a fundamental different one to MiFID II, given that MiFID I predated the Great Financial Crisis and the ensuing policy concerns with bilateral trading, most fundamentally expressed through the 2011 G20 commitments.

More specifically, we would also argue that the concrete market structure specificities in the Robeco et al vs. AFM case are far removed from the types of trading scenarios that currently are under discussion. – The Robeco et al vs. AFM case involves both multiple takers of liquidity (the brokers and the clients) and multiple providers of liquidity (the funds and their agents), with any of the brokers being able to interact

with any of the funds (via their respective agents). On this basis it is indeed fair to classify Euronext EFS as truly multilateral.

However, in e.g., a scenario where bilateral matching takes place within a third-party system where there is only ever *one* provider of liquidity and any incoming investor order can only interact with that one liquidity source, we consider that the Robeco et al vs AFM case cannot be used to argue that this system should be considered multilateral. In our view, this setup is much more akin to an SI operating via a third-party matching engine, which (as we have argued above) should be considered a bilateral set-up depending on the specifics of the situation. In this regard, we would further argue that a more effective material test for a system to be indeed considered multilateral would be whether *multiple third-party liquidity taking interests* are factually able to interact in the system with *multiple third-party liquidity providing interests*.

In addition, FIA EPTA members consider the concept of a multilateral system being one where there is actual *or potential* third-party involvement in the system to be ambiguous. Such a non-committal approach could be interpreted differently by individual Member States, threatening the level playing field in the Union. Furthermore, leaving unanswered the question what "potential third-party involvement" should entail, creates uncertainty and risks blurring the concepts of multilateral vs. bilateral systems. -- At what point does 'potential third-party involvement' become so negligible or unlikely to materialise so as to have no material impact on the supposed multilateral nature of the system and thus translate to a system being a single-dealer or member/participant run platform? For instance, if the third-party involvement is on a very ad-hoc basis or has no direct tie to the trading conducted on the system, FIA EPTA believes such systems should not be considered multilateral in nature. FIA EPTA members would welcome therefore a further clarification by ESMA as to what constitutes "third-party involvement" and for this to be a tangible measure of where the third-party has oversight and operational control of the trading system.

By way of example: In the case of various German retail-focused exchanges, we are aware of the existence of single-dealer segments where the single-dealer operates the electronic trading system. The venue rules in these cases have a strong bias in favour of the single-dealer and there is no procedure to consider an application from other third-party firms to provide additional liquidity. This appears to be in direct conflict with the spirit of the legislation regarding the operation/organisation of a multilateral trading venue.

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

With respect to the involvement of third-party operated systems, FIA EPTA believes that considering elements surrounding the commercial terms for the use of such a system could be helpful in contributing to the determination as to whether such a system was in fact operating in a similar manner to a trading venue.

As a more general point, FIA EPTA believes regulators should focus again on the regulatory perimeter in relation to certain SI activity where the definition of multilateral and the understanding of when a trading

interest in a financial instrument is determined are currently being stretched. It is commonplace for brokers to multilaterally match client-driven swap hedge orders against either other client-driven swap hedge orders or client cash equity orders leading to de-facto riskless or quasi-multilateral trading within the SI construct. Unless it can be demonstrated that the trading interest is actually that of the broker, not the underlying client engaged in a swap transaction with the bank, then such mechanisms should be considered as providing interaction between parties with an interest in the same underlying financial instrument and hence require categorisation as an MTF.

To determine whether or not the swap-hedge order represents interest from the broker or the underlying client, brokers should have to demonstrate that they are taking material risk, justified by metrics regarding how often the requested client interest fails to transfer into a firm commitment to enter into a swap arrangement with the broker, which in effect leaves the broker riskless.

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.
FIA EPTA members consider there are several communication services that also allow trading to take place. Typically, while buying and selling interests interact within these systems, the resulting transactions are executed on another trading venue. We note that these communication services in many cases also raise non-discriminatory access and investor protection concerns.

These systems are operated by non-authorised third-party service providers (ISVs) which facilitate the multilateral matching of orders in a manner very similar to RFQ MTFs, allowing brokers to poll a number of market makers for quotes to determine best price. Such system operators offer a comprehensive handling of all elements of pre- and post-trade requirements while categorising themselves as purely a trading connectivity solution providing support for pre- and post-trading services. Retail Service Providers (RSP) are an example of this where retail orders placed are announced to the RSP network of market makers.

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.
Not specifically, however FIA EPTA remains concerned that certain EMS practices whereby commissions are charged by both parties involved in a transaction that has resulted in routing by an EMS/OMS, constitute payment for order flow and so should also be separately investigated.

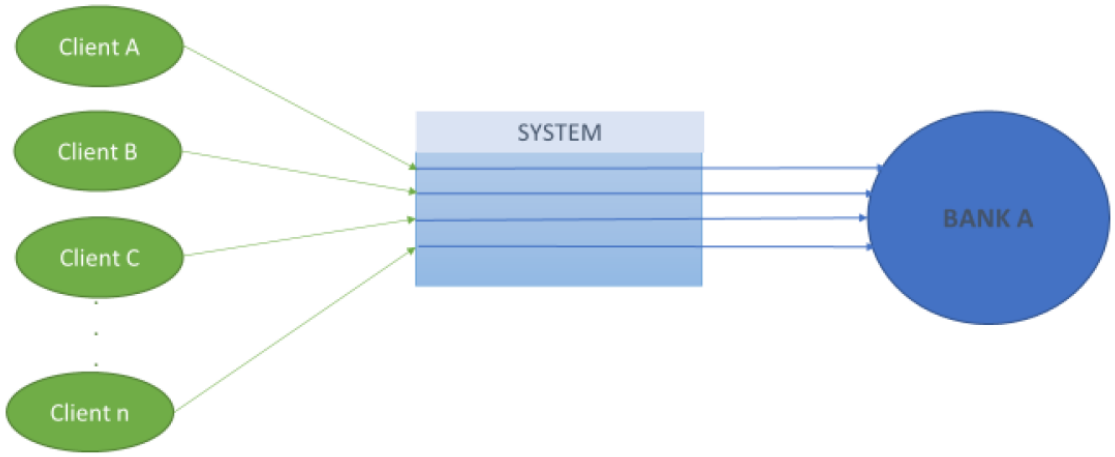
We also note certain investment firms which appear to facilitate the interaction of client orders under the guise of providing execution services. Such arrangements are structured with an investment firm acting as an execution service provider (an international bank that also runs an affiliated bank SI) that facilitates the interaction of client orders with other client orders. Client orders are reviewed upon receipt (in parallel with routing orders to its own SI) to determine if there is a match and if a cross can be achieved. This would be executed by submitting the trade to a trading venue under a pre-trade transparency waiver (negotiated trade / LIS) or as a non-price forming trade where applicable, or by submitting both sides to

a periodic auction system for execution. However, the functionality to determine matches and crosses could be considered as a trading venue in its own right. Not regulating it as such limits competition for order flow and leads to less competitive pricing.

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?
N/a

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.
FIA EPTA believes it is important to look at the specific role performed by the third-party, not simply the presence or absence of a third-party, as described in our response to Question 1. Furthermore, FIA EPTA believes it would be helpful to clarify that in the case where the system and its operation remains the responsibility of BANK A (in this example), then the entire arrangement remains bilateral (such as an SI), even where the "SYSTEM" constitutes third-party technology managed under a technology outsourcing arrangement, controlled by BANK A.

Figure 5: Single dealer, multilateral system



4.3 Pre-arranged transactions

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, FIA EPTA agrees 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.

Further, FIA EPTA believes that the use of negotiated trade waivers should remain available for manual off-book interactions. However, we believe that the practice of operating automated, systematic multilateral crossing engines within broker crossing networks and then simply systematically bringing trades on exchange under a negotiated trade waiver does not fit within the spirit of the intended regulation and should be addressed.

Q8: Are there any other conditions that should apply to these pre-arranged systems?
We note that ESMA's opinion states the onus of ensuring that all transactions are eventually formalised on a trading venue sits with the system that pre-arranges the transaction and ESMA is of the view that the activity of pre-arranging transactions in 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 have to 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.

However, FIA EPTA observes there is currently a common practice of formalising pre-arranged ETD transactions on a trading venue (regulated market) that are not eligible to benefit from a pre-trade transparency waiver. In this case, where the conditions to qualify for such a waiver are not present, any order placed into the orderbook of a trading venue should be capable of being traded by multiple third party buying or selling interests i.e., in accordance with the MiFID II definition of multilateral trading. An order entered on the orderbook which is intended to be crossed by that same participant before any interaction with other buying or selling interests is possible lacks the intention of multilateral trading and should not be permitted on a trading venue.

That said, these pre-arranged systems should not be permitted to enter such orders of a pre-arranged trades directly into the order book for immediate execution. There should be a requirement, enforced by the trading venue who is formalising the trades, to make these orders pre-trade transparent and offered for execution for a sufficient amount of time to multiple buying/selling interests as envisaged by MiFID II i.e., other market participants should have time to respond such that they have the opportunity to execute on the order book at the most favourable price.

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.
N/a