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MiFID II: Multilateral trading venues and systematic internalisers

At a Glance...

MiFID II will significantly increase the regulation of most types of secondary market trading activities and functions. It will introduce a new multilateral trading venue, known as an Organised Trading Facility (**OTF**), and extend the bilateral Systematic Internaliser (**SI**) regime for systematic own account dealing beyond equity instruments to investment firms that trade in OTC bonds, derivatives and equity-like instruments.

The OTF definition is broader than the definition of Regulated Market and Multilateral Trading Facility and was introduced to increase transparency in those bond and derivatives markets supported by inter-dealer brokers. It covers a broad range of brokerage arrangements and will capture voice brokerage deemed to constitute a multilateral system. This will apply where the third-party buying and selling interests interact via the OTF “operator’s” matched principal or agency trading activities.

What is a multilateral venue?

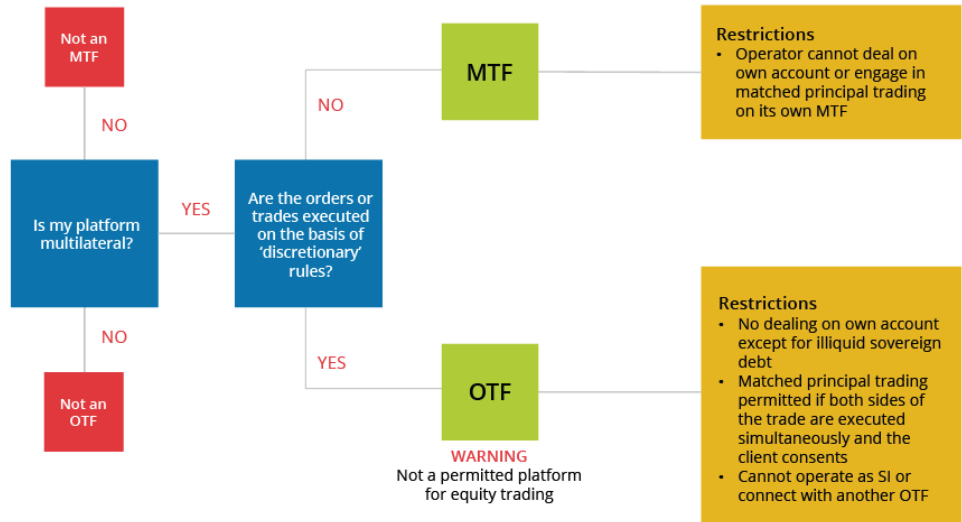
There will be three multilateral venues under MiFID II, as follows:

A Regulated Market (RM), which is a multilateral system operated by a market operator, which brings together or facilitates the bringing together of multiple third-party buying and selling interests in financial instruments – in the system and in accordance with its non-discretionary rules – in a way that results in a contract, for financial instruments admitted to trading under its rules and/or systems, and which is authorised and functions regularly and in accordance with Title III of MiFID II. The list of RMs currently includes the London Stock Exchange Main Market, BATS Europe, ICE, NYSE Euronext London and LIFFE.

A Multilateral Trading Facility (MTF), which is a multilateral system, operated by an investment firm or a market operator, which brings together multiple third-party buying and selling interests in financial instruments – in the system and in accordance with non-discretionary rules – in a way that results in a contract in accordance with the provisions in Title II of MiFID II, as outlined in the diagram below. The list of MTFs currently includes Liquidnet Europe, Currenex MTF, SIGMA X MTF, UBS MTF and ICAP Europe MTF. New electronic trading venues using matching bids and offers using an algorithmic matching engine, can choose whether to seek to become an RM or an MTF.

An Organised Trading Facility (OTF), which is a multilateral system that is not an RM or an MTF, and in which multiple third-party buying and selling interests in bonds, structured finance products, emission allowances, or derivatives are able to interact in the system in a way that results in a contract in accordance with Title II of MiFID II, as outlined in the diagram below. However, ESMA has clarified that the definition of an RM and MTF is intended to only capture multilateral systems that include contract execution. An OTF can just involve price and volume discovery with the possibility of execution (although mere bulletin boards will not be OTFs). Unlike an RM or an MTF, an OTF operator is required to have discretion over the execution of transactions on its platform. The discretion may only be exercised when deciding to place or retract an order on the OTF system, or when deciding not to match a specific client order with other orders available in the system at a given time. For an OTF operator that crosses clients' orders, discretion will be deemed to be exercised if the operator decides if, when, and how much of two or more orders it wants to match within its system. For a system that arranges transactions, this may mean facilitating negotiations between clients so as to bring together two or more potentially compatible trading interests in a transaction. This may include voice broking arrangements where the third-party interests interact via the firm's matched principal or agency-dealing activities. As a consequence, OTF operators will be subject to the MiFID conduct of business requirements, including best execution, client order handling, conflicts of interest, appropriateness and inducements. Derivative transactions entered into on an OTF fall within the definition of financial instruments under MiFID II. The one exception to this is wholesale gas and power transactions within the scope of the Regulation on Energy Market Integrity and Transparency (**REMIT**) that are traded on an OTF and which "must be physically settled". Both MTFs and OTFs must have at least three materially active members or users, each having the opportunity to interact with all the others in relation to price formation. OTFs must be able to explain: (a) why the system does not correspond to and cannot operate as an RM, MTF or SI, and (b) how discretion will be exercised when it applies for authorisation and on an ongoing basis at the request of its regulator. Regulators must be provided with details regarding the OTF operator's matched principal trading activities.

Am I an MTF or an OTF?



Are there any restrictions?

Generally, operators of MTFs and OTFs will not be permitted to deal on own account or engage in matched principal trading. However, an OTF operator can deal on own account in relation to illiquid sovereign debt. In addition, an OTF operator can conduct “matched principal trading”, provided that both sides of the trade are executed simultaneously and the clients consent. However, “matched principal trading” cannot be conducted by an OTF operator specifically in relation to derivatives which are subject to mandatory clearing under EMIR. This restriction on dealing on own account also applies to any entity that is part of the OTF operator’s corporate group, which means that while market makers can access an OTF, they must not be part of the same group as the OTF operator.

It should be possible for a firm which is an operator of an OTF to deal on own account outside of the OTF (subject to the management of conflicts), provided that its own account dealing activities do not amount to the operation of an SI. This is because MiFID II states that operation of an OTF and operation of an SI cannot take place within the same legal entity. Firms will need procedures in place to ensure that they do not become an SI if conducting own account dealing within the same legal entity as the OTF. In practice, this could be quite difficult to manage, and may require some firms to reorganise their business from a legal and operational perspective to ensure that the own account dealing function and OTF activities are housed in separate legal entities.

Brokers that act as agent or as matched principal for clients, and deal exclusively with trading venues (i.e., RM, MTF or OTF) or SIs, are unlikely to be OTFs.

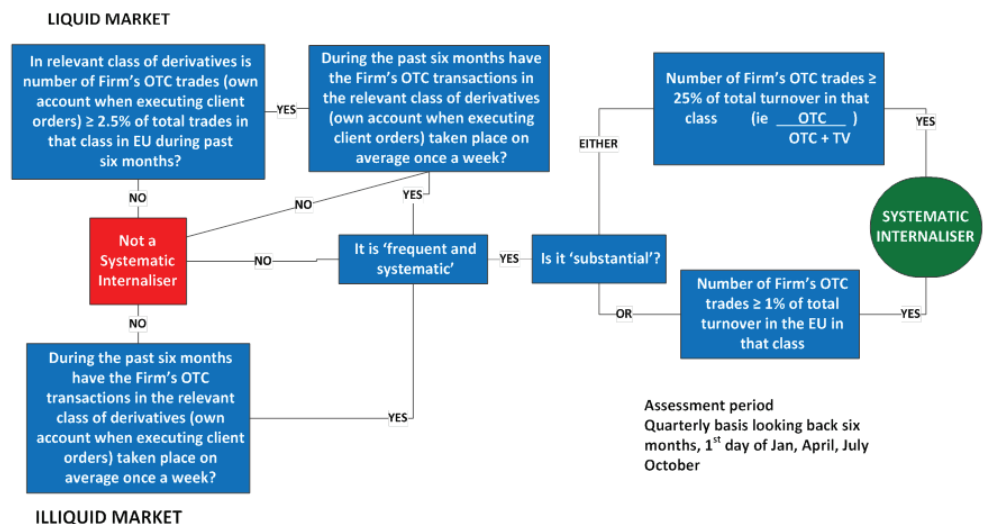
The FCA has indicated that the restriction on proprietary trading does not prevent an MTF operator from executing orders against its capital or engaging in “matched principal trading”, so long as these activities take place outside the MTF it operates.

What about the new SI regime?

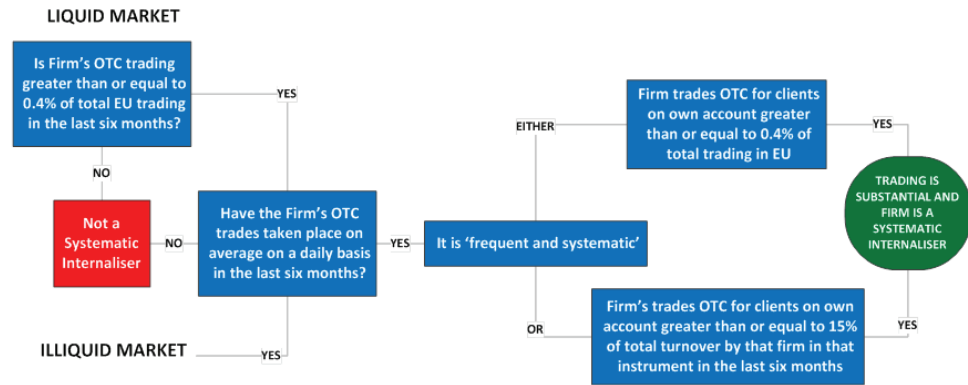
The SI regime which currently applies only to trading in equities will be extended to a wider range of instruments. The instruments that will become subject to the SI regime for the first time are non-equity instruments such as bonds and derivatives, and also equity-like instruments such as ADRs and ETFs. The regime applies to investment firms that execute client orders on own account on an “organised, frequent, systematic and substantial basis” outside an RM, MTF or OTF. In this context, the term own account means commitment of proprietary capital and does not include riskless principal trading. ESMA in its Q&As has indicated that certain interconnected networks of SIs are likely to be treated as multilateral arrangements rather than bilateral arrangements, and this may mean that the investment firms in question will have to be authorised as MTFs.

MiFID II introduces new quantitative criteria for determining an investment firm’s status as an SI on a specific financial instrument basis. SI status will apply where the pre-set limits for the frequent/systematic test and for the substantial basis test are both crossed, or where the firm chooses to opt-in to the SI regime. The diagram below contains a summary of the SI threshold test for equities and derivatives only. Different criteria will apply to other types of instruments, including bonds and structured finance products.

Am I an SI in Derivatives?



Am I an SI in Equities?



What does this mean for me?

Operators of RMs, MTFs and OTFs will be required to be authorised by a Member State Regulator and, once authorised, will be subject to certain organisational, market surveillance and conduct requirements.

Trades executed on an RM, MTF, OTF or an “equivalent third-country venue” (i.e., a non-EU venue that has been deemed equivalent by the European Commission) will enable counterparties to comply with the new mandatory “on-exchange” trading requirement for derivatives in MiFID II. An SI is not a relevant venue for these purposes. Non-EU investment firms and market operators will have to take steps to ensure that equivalence is granted, in addition to considering how to access and thus retain EU business post-MiFID II.

Trades executed on an RM, MTF, SI or an equivalent third-country venue will enable counterparties to comply with the new mandatory “on-exchange” trading requirement for shares and equity-like instruments in MiFID II. An OTF is not a relevant venue for these purposes.

Trades executed on an OTF and an MTF or with an SI will still be treated as OTC for the purposes of EMIR, and so counterparties that execute trades on such venues will still have to comply with the reporting, risk mitigation and clearing obligations under EMIR (where applicable).

Next steps

MiFID II will apply from 3 January 2018. It is important that investment firms and market operators understand their regulated status under MiFID II. Certain restrictions and mandatory trading requirements, both in relation to equities and derivatives instruments under MiFID II, will affect the existing business of these operators and firms, including non-EU investment firms and market operators that currently access the European market under an exemption (e.g., on the basis of the UK’s overseas persons exemption).

The FCA has opened the authorisation application gateway for new regulated

activities under MiFID II, and has published an applications and notifications guide. The FCA has said that they cannot guarantee that any authorisation or variation of permission applications submitted will be determined in time for 3 January 2018.

Please do get in touch with a member of the Financial Regulation team to discuss how we can assist you with MiFID II implementation.

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