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Annex.

This note highlights three use cases where we have identified from experience where the proposals around the provision of exemptions from the multilateral perimeter by dint of contractual arrangements between trading venues and brokers arranging transactions outside of the venues appear to be problematic or unnecessary. (for example; in Paragraph 30 of the recent ESMA consultation[1].)

These are, firstly, the arrangement of wholesale risk transfer as package transactions where each component of the transaction is contingent on the other components; and then, two examples of standard market arrangements following the MiFID II market structure requirements, wherein the arrangement of transactions takes place outside of the order book of a trading venue and is later registered and formalised under the rules of a venue.

1. Package transactions

It should be kept in mind that, in the wholesale secondary markets, package trades (also called strategy trades) are the norm, rather than the exception. When a market participant transacts in a cash security, they typically will be, at the same time, contingently selling other securities on the balance sheet, requiring funding trades, or taking out a derivatives position to hedge their exposure. The following example illustrates just one possible case.

Example 1

Fund A wishes to benefit from exposure to Security B. They purchase a large stake from Bank C. Because Security B is priced in a different currency than the base currency of the fund, and its price has been volatile over the past 12 months, Fund A seeks to hedge its FX and market risks through a derivatives contract with Bank C. Six months later, when Fund A sells its stake in Security B to another buyer, it also unwinds its derivatives position with Bank C.

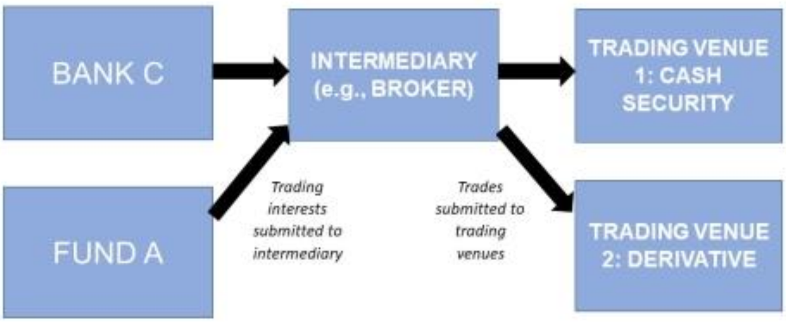
This is a typical example of a transaction in the wholesale secondary markets. The purchase and sale of cash securities on their own—i.e., on an "outright" basis—is far less common than on a package basis. This is because, due to the size of the transactions, the risks of market movements, FX volatility, and credit risks associated with issuers, there are risk management tasks linked to the purchase or sale. Conversely, when derivatives transactions are entered into, it is also common for cash securities positions to be taken to hedge against market risks. The package transaction is therefore a widely used tool for risk management.

In this example, the securities transaction between Fund A and Bank C could have been arranged by interdealer brokers ["IDBs"] outside of the order book of a trading venue, due to the size of the transaction and their ability to link buyers and sellers

[1] esma70-156-4978 consultation paper on the opinion on trading venue perimeter

efficiently. The associated derivatives contract will be tailored to the transaction, as an OTC derivative, even if includes listed derivative components. Because Fund A and Bank C were brought together by brokers operating a multilateral trading system under MiFID II, the components of the package transaction will be subject to the rules of at least one European trading venue. Depending on the model of the trading venues involved, the two components of the transaction will be deemed to have been executed at the point of agreement or at the point of acceptance by the trading venue. In either case, the parties will need to have agreed (expressly or through market convention) to which trading venue each component of the package transaction will be submitted.

The IDB will be subject to the rules of the trading venue directly (as a member/ participant/ user) or indirectly (as a user of DMA services). Each component of the package transaction will be subject to the rules of the relevant trading venue as a condition of acceptance/registration. Illustrated schematically, this could take the following form:



It is possible that one or both of Fund A and Bank C are members/participants of Trading Venue 1, so that the IDB's role is to arrange and submit the cash security component of the package transaction to Trading Venue 1 and give up the position to Fund A and Bank C or other members/participants who are responsible for the clearing of their positions.

In any event, the IDB is not acting as a co2nstituent part of the trading venue's systems, nor is it a commercial agent of that facility. It is operating its own system which is designed to source and organise trading interests that can be submitted to the trading venue's systems. If the trading venue was not involved at any stage, then the IDB could be said to be operating its own multilateral trading system that ought to be organised as a trading venue (and, indeed, it may operate its own MTFs and OTFs which are not the destination for the components of the package transaction).

However, where there is a trading venue involved in the formalisation of the transaction, the ESMA Q&As properly prevent the unnecessary proliferation of trading venues by clarifying that the IDB as intermediary does not need to organise its activity as a trading venue itself. That prevents any conflict of roles, including the application of rulebooks and reporting obligations, as between the intermediary and the trading venues, on the one hand, and as between the trading venues, on the other.

In Example 1, if the ESMA Q&A did not apply, then the situation would be that:

- The IDB intermediary would need to establish itself as the operator of an OTF.
- The arrangement of trading interests would take place under the rules of the OTF.
- Two linked transactions would result from the arranging activity, which could not become effective until executed at a trading venue. If, due to the nature of the financial instruments (e.g., cash equities or ETDs), the components of the package transaction needed to be executed at Trading Venue 1 and Trading Venue 2, the IDB intermediary, as the operator of the OTF, would need to submit the pre-arranged transactions to the appropriate trading venues. Consequently, either execution would not take place at the OTF at all or there would be a second execution event at another trading venue for each component. If either Trading Venue 1 or Trading Venue 2 did not accept the relevant component of the package transaction, then there could have been execution at the OTF but not at the only trading venue that could make the component effective. That could result in a package transaction having been executed on the OTF which can never be effective, because of the contingent relationship between each of the components which rely upon other trading venues.
- In the event of an issue arising between the parties, there would be contention between the rules of the OTF and the rules of the other trading venue in respect of the same transaction.

The ESMA Q&A resolves this problem by clarifying that the intermediary is not required to establish itself as a trading venue or act as a trading venue where it is arranging trading interests for submission to another trading venue. This results in the situation that:

- There is only one trading venue for the execution of each component of the package transaction.
- The roles of the intermediary and the trading venue are clear.
- There is no risk of double-reporting by the intermediary and relevant trading venue.
- Only one rulebook applies to each leg of the package transaction.
- The point of execution depends on the model of the final trading venue.

If Trading Venue 1 and Trading Venue 2 were required to put in place some form of contractual arrangements with the intermediary, it is unclear what the purpose would be or what additional comfort it might provide. The intermediary needs to be a member/ participant/ user of each of Trading Venue 1 and Trading Venue 2 in order to submit the pre-arranged legs of the package transaction—or it needs to do so under the control of a member/ participant/ user if it is using DMA. The trading venues, therefore, have visibility of incoming transactions and trading interests, as well as the ability to protect their own markets from abusive behaviour. Ultimately, they possess the ability to discipline their members/ participants/ users, so that there is no gap between transactions submitted on an off-venue ["XOFF"] basis and those formed in the order book of a trading venue.

Further, considering the lifecycle obligations between counterparties and infrastructures, any direct contractual chain with the arranging intermediary, which treats the intermediary as part of the systems of the trading venue, would further complicate compliance with conduct obligations and reporting.[2]

2. Pre-arranging of transactions generally

The size and complexity of transactions in the wholesale markets explain the use of intermediaries. These transactions cannot be simply executed on the order books of trading venues at the best price. The trading venues require intermediaries to source and arrange liquidity in order to deal with large transactions and to source latent trading interests. The wholesale secondary markets have important risk-mitigating functions; commonly where dealers have accumulated risk positions in their trading with clients which are managed and offset by trading common risk factors.

IDBs arrange transactions between wholesale dealers by operating liquidity pools; not only in single financial instruments but in commonly traded risk-sets and pricing factors, to enable the effective management of the risks arising from the institutional markets. These require market knowledge, client contacts and engagement that is neither available to nor possible for the dealer firms on their own. Large transactions and risk offsets can be anonymously arranged through the intermediation of IDBs that could not be executed otherwise or would adversely affect pricing.

Some of the financial instruments traded through the markets operated by intermediaries will only be able to be executed through regulated markets, largely because they control access to the financial instruments, as well as the post-trade clearing and settlement processes. For example, transactions in Eurex ETDs can only be executed at Eurex, even if they are pre-arranged. Other financial instruments can be formalised on a range of possible trading venues, depending on the commercial and regulatory preferences of the trading counterparties. In the wholesale secondary markets, therefore, the identity of the execution venue will often be self-evident; i.e., it will sometimes be dictated by the financial instrument, but it may be the choice of the counterparties.

[2] The collective obligations beyond MiFID and MAR also under EMIR, CSDR, SFTR, SSR, IFR and CRR.

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Consequently, in bringing together buyers and sellers on a multilateral basis for trades that are to be sent to a trading venue once arranged, IDBs need to identify to the counterparties which trading venues are in scope. This is typically done through the provision of an execution policy document that sets out the trading venue options, at the outset of the broking relationship and periodically when it is updated. The arranging intermediary will then take instructions from the trading counterparties on the selection of trading venue, especially in those cases where there are options available to them.

Clearly, were all of the possible trading venues to treat the multilateral trading system of the IDBs as part of their own systems and require that their rules are applied to any transaction before it is ready for submission to the trading venue, then it would create a set of conflicts that would be impossible to resolve. 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?

For these reasons, the only effective legal framework is to follow the provisions of the ESMA Q&As. They note that the intermediary will be operating a multilateral trading system but do not attempt to impose the trading venue framework on the system precisely because of the conflicts that would arise. The counterparties or the arranging intermediary must submit the transaction or its relevant components in accordance with the rules of the relevant trading venues and subject to their supervision. This ensures certainty of the rules and sanctions which apply and the process that needs to be followed for the trade or its relevant components to be accepted.

In the case of transactions in OTC derivatives, there is another complication. A pre-arranged transaction might never be formally concluded following the IDB or platform passing each of the trading counterparties the names of the other party. Such "*name give-up*" transactions are arranged as to their essential terms, but the trading counterparties have the ability to walk away from the transaction if they do not agree to proceed. That could be the case if, for example, they do not agree on other specific terms that are relevant to the transaction. In that event, the arranging intermediary might have submitted the required information to trade affirmation middleware operators such as MarkitSERV, in the expectation that the transaction ultimately will be sent to a CCP for novation or a CSD for settlement, but the execution of the transaction will be formalised at a trading venue. Under this use case, the counterparties may have agreed on the execution venue but one or both of them might resile from the alleged trade before it is subject to settlement finality. In such cases, it would be unhelpful to treat the multilateral trading system of the intermediary as a trading venue, in its own right, and to treat the initial agreement to essential terms as the execution of a transaction.

The salient question to ask with respect to the MiFIR framework is, "At what point does the executing trading venue have any jurisdiction over the transaction?" Can it ever be said that the IDB or platform acting as the arranging intermediary is operating as part of the systems of any trading venue? In order to fit with market practice and to prevent conflicts arising, the best solution is to treat the submission of a pre-arranged transaction as non-addressable liquidity (i.e., an XOFF transaction) at the point it is submitted for formalisation. Where the intermediary arranging the transaction is a member/ participant/ user of the trading venue, there should be no formal distinction from their role as a submitter of trading interests to the order book of the trading venue. There is no benefit to treating the intermediary as if they are either part of the trading systems of the trading venue or playing a different role that ought to be contractually formalised in a different way.

3. Pre-arranging with "captive" venues

A related case arises from the common market practice where the arranging intermediary operates its own OTFs or MTFs which offer the service of formalising eligible transactions. This is the typical IDB structure under MiFID II, where the majority of pre-arranged transactions are submitted to trading venues operated by the intermediary or its affiliates. This is a consequence of both MiFIR structures and also the adverse impact to wholesale clients of standardised fee structures [3]for transactions arranged and executed inside an OTF—the latter a consequence of the transposition of the retail model for equities trading onto wholesale secondary markets for non-equities.[4] There is a strong market preference for transactions in the dealer risk offset markets to be pre-arranged and submitted to trading venues for registration/formalisation so that each counterparty only pays those fees which it has negotiated with the intermediary.

While operating OTFs and MTFs, on the one hand, and acting as arranging intermediaries on the other, IDBs are at all times subject to MiFID II rules and applying the rules of the relevant trading venues. Should IDBs be required to go further and act as part of the trading venues they submit pre-arranged transactions to, then the risk is that they would be required to apply trading venue fee structures which have nothing to do with the business activity of the IDBs nor the expectations of their clients. That would have adverse consequences for the objectives of both CMU and the original G20 aspirations for MiFID II.

[3] Article 4 of RTS 10 concerns the 'Transparency of fee structures' and requires trading venues (regulated markets, MTFs and OTFs) to publish the objective criteria for the establishment of their fees and fee structures and other conditions provided for in Article 3, together with execution fees, ancillary fees, rebates, incentives and disincentives in one comprehensive and publicly accessible document on their website. ESMA has added FAQ guidance to this in Question 6 (28/03/2018) and in Question 9 (04/10/2018).

[4] Few clients are willing to pay standardised fees, and those who are do not constitute sufficient liquidity to make OTFs effective on their own.

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The case for a wide regulatory perimeter, with a portfolio approach to intermediary firms holding permissions and licenses within a flexible and proportionate FSMA regime.

Clearly the first and most relevant criteria should consider the permissions held, and both the supervisory classification together with the prudential categorisation of the firm.

Other scalable proportionality could consider the asset classes enabled, or the associated obligations within those assets classes such as clearing or trading mandates.

Permissions / Licenses	Dealing as principal
	Dealing as agent
	Arranging and bringing about
	MTF
	OTF
	Crypto Assets
Supervisory Classification	Fixed Portfolio
	Flexible Portfolio
Prudential Categorisation	SNI
	Non-SNI; Cat 1
	Non-SNI; Cat 2
	Non-SNI; Cat 3
Asset Classes Admitted	Shares
	Bonds
	Derivatives
	Commodities
	FX
	Money Markets and SFTs
	Crypto Assets
Derivative Obligations	CO Instruments
	TO Instruments

Ends.