

# Setting the Institutional and Regulatory Framework for Trading Platforms: Does the MiFID definition of OTF make sense?

**Diego Valiante**

## **Abstract**

As discussions around the revision of MiFID are heating up, this paper tries to set a new regulatory and institutional framework for multilateral and bilateral execution mechanisms of complex financial instruments, such as over-the-counter derivatives and fixed income products. The author argues that the current MiFID framework is equipped to capture a great deal of multilateral derivatives and fixed income trading, but the Directive fails to provide a complete definition of bilateral execution mechanisms and has narrowed it to mainly own account trading (e.g. systematic internaliser).

A key proposal of this paper is to consider own account trading, agency trades (discretionary matching) and principal trading as pure bilateral execution services to be classified under a broader definition of systematic internaliser (with revised obligations), subject then to the application of conduct of business rules (e.g. conflicts of interests management procedures) and a best execution regime. MTF would then be adapted to explicitly state that multilateral systems are not just those bringing together multiple interests from third parties, but those systems bringing together interests through 'non-discretionary' services, vis-à-vis membership, admission of products to trading, and matching of interests. Finally, despite the claim that OTF and SEF would be equivalent categories, US and EU regulators are defining diverging regulations for these venues. There are at least four important areas in which the SEF definitions do not match the proposed EU rules for OTFs.

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# Setting the Institutional and Regulatory Framework for Trading Platforms: Does the MiFID definition of OTF make sense?

## *ECMI Research Report No. 8/April 2012*

**Diego Valiante\***

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In October 2011, the European Commission released legislative proposals for the revision of the Markets in Financial Instruments Directive. It is an extensive review of MiFID I,<sup>1</sup> even though core principles such as liberalisation of investment services remain untouched. Both regulators and industry have largely recognised the success of MiFID I in opening markets and bringing down trading costs. However, regulatory gaps in MiFID I and the implications of the financial crisis and G-20 commitments have led regulators to reconsider some key aspects of the original framework Directive.

A crucial element of MiFID II is the new trading venue category called ‘organised trading facilities’ (OTFs), and claimed as the equivalent of the US swap execution facility (SEF). The introduction of a new category of trading venue would be also in line with the early G-20 commitment, stating that

*“All standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, [...] by end-2012 at the latest.”* (G-20 Toronto Summit Declaration, June 26-27 2010).

A new legal definition of trading venue in Europe aims at capturing all hybrid bespoke or manual (semi-automated) mechanisms that allow trading of derivatives and other financial instruments, typically those ‘over-the-counter’. In particular, the legal venue definition would capture all mechanisms that allow dealers and clients to get into complex and customised derivative transactions on an electronic or voice-based platform. The notional size of OTC derivatives contracts was \$708 trillion at the end of June 2011 (BIS Statistics). ISDA (2012) estimates that 30% of swap contracts (almost \$135 trillion out of \$450 trillion) would be eligible for organised electronic trading, while the remaining part will be executed through bilateral mechanisms. So far, only 10% of OTC swaps is traded on electronic platforms, and roughly 6% on multilateral venues (multi-dealer or inter-dealer platforms). The margin for additional growth of multilateral electronic trading is thus very big.

### **Setting the framework**

Before getting into the merits of key definitions, the paper puts the discussion in a more dogmatic framework. Market settings and trading financial instruments are at the core of MiFID, which attempts to capture the two broad categories that define trading of financial instruments: bilateral and multilateral market settings.

Multilateral markets are those settings whereby a market operator or an investment firm operate as riskless counterparty that brings together on a systematic basis all sorts of buying and selling

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<sup>1</sup> The MiFID II level 1 Directive and Regulation have 147 articles, while MiFID I has made incredible changes with a level 1 regulatory framework of only 73 articles based on principle. The current MiFID II will require a high number of implementing measures, in particular additional regulation will be delegated to the Commission for the definition of more technical aspects (Rec. 106, MiFID II).

interests, i.e. the operator/firm does not apply discretion on how orders are matched (so after receiving the order; ex post), as well as it does not apply discretion on whom should be allowed to access the platform and what kind of products should be admitted to trading.<sup>2</sup> A set of rules and criteria is defined ex ante to allow non-discriminatory access and fulfil the neutral role of a trading venue operator. As a result, the platform does not apply discretion ex-ante/ex-post, neither does it match against proprietary capital (as riskless counterparty). As a consequence, ‘multilateral’ does not simply mean bringing together ‘multiple’ buying and selling interests, otherwise a systematic internaliser could be considered as such, even though it does so by discretionarily matching these interests against proprietary capital.

A venue is a pure ‘multilateral’ and ‘neutral’ organised infrastructure if no discretionary rule applies in any of the three aspects below (in line with Recital 6 MiFIR, old recital 6 MiFID):

1. Matching of orders (system; manual or electronic);
2. Admission to trading (products); and
3. Access to the platform (membership).

These three tasks must be in line with non-discretionary criteria to categorise the platform as a ‘multilateral’ venue. The concept of ‘neutrality’ of the platform operator, in effect, is intertwined with its inability to discretionarily influence:

- The supply of buying/selling interests (membership);
- The object of the transaction (product); and
- The interaction among these interests (matching).

Criteria for products, matching system – whether they are run through an electronic or manual (voice) matching system – and membership must be defined ex ante with transparent criteria and not on a case-by-case basis. The venue should then act as a riskless counterparty that does not deal on own account on the trading venue. The regulatory seal would then make sure that obligations (transparency, conduct and surveillance mechanisms) are uniformly applied, whether the venue is legally classified as regulated market (RM) or multilateral trading facility (MTF) under MiFID or run by a market operator or an investment firm (e.g., dealer)<sup>3</sup>. It is therefore irrelevant whether the matching is done through electronic or manual (voice) systems,<sup>4</sup> as long as the intermediary acts as a riskless counterparty and following the non-discretionary criteria.

If at least one of these three aspects that qualify a venue as multilateral/neutral infrastructure is not met, the type of execution should be then considered ‘bilateral’. Bilateral trading under MiFID is only classified through a narrow definition of systematic internaliser – which refers to systematic matching of client orders against own capital (‘own account’ trading) – and by a looser definition of over-the-counter trading – when dealing on a non-systematic basis with wholesale orders above the standard market size<sup>5</sup>. Both of them mainly apply to equity trading, which leaves MiFID

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<sup>2</sup> MiFID defines ‘multilateral’ as a ‘riskless counterparty’, which runs a ‘system’ for matching orders (not necessarily electronic) without discretion (Rec. 6, MiFID).

<sup>3</sup> As a result, the new venue categorisation (see next section) would not meet one of the three requirements above to be considered as ‘multilateral’ execution venue.

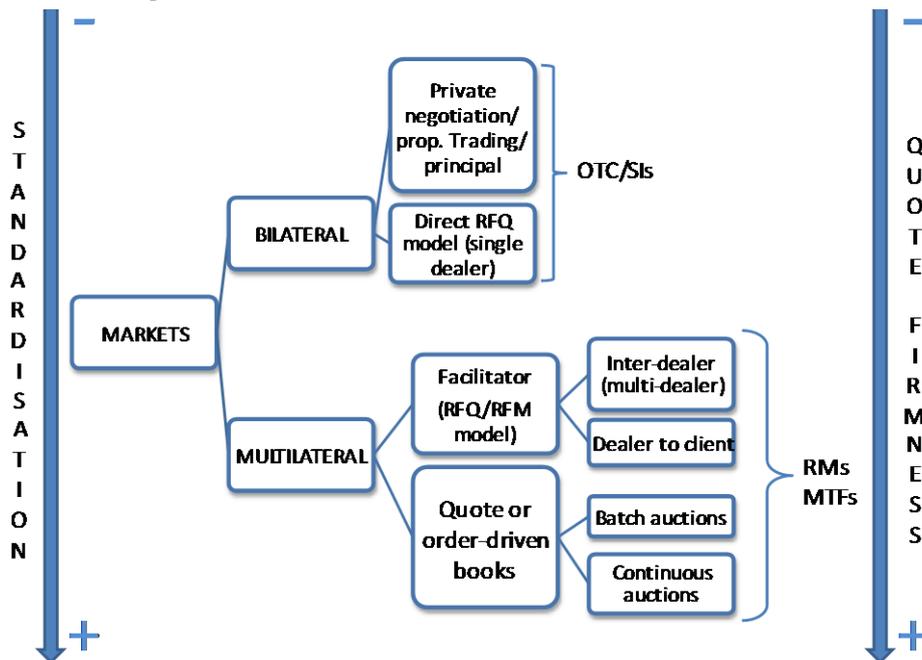
<sup>4</sup> Multilateral venues can run matching systems based on voice communication and still be able to provide non-discretionary services. It depends on the ability of the platform operator to connect multiple dealers and build a system that can provide ex ante information to clients on how the deal will be matched, rather than executing the best deal on his/her behalf. In the latter case, the nature of the transaction would then become bilateral.

<sup>5</sup> MiFID I then leaves ambiguous terminology or sets too rigid definitions for ‘systematic’, ‘wholesale’, and ‘standard market size’. Overall, its implementation has left a grey list of activities (such as those of broker-dealer crossing networks; Valiante, 2011) that are currently not classified under MiFID, which does not

unequipped to capture and classify all bilateral execution systems currently available in non-equity markets.

In effect, market settings for trading of financial instruments may go from pure bilateral face-to-face transactions to more sophisticated auction models based on order books or batch auctions with highly standardised financial instruments (see Figure 1). The factor that shapes the market setting and sets an efficient price formation mechanism is liquidity. As the trading of the financial instruments becomes more widespread in terms of type of buying and selling interests and frequent (so more liquid), the execution system naturally evolves from a pure bilateral setting to a multilateral one, where a more neutral infrastructure (which may not apply ‘discretion’) can cope with high volumes and buyers and sellers’ specificities through a more complex matching. By contrast, if liquidity shrinks due to the complexity of the financial instruments, the pricing of instruments relies on indications of interests rather than firm binding quotes. Therefore, the volatility of liquidity in some markets affects the structure of the market itself. As liquidity may become more volatile, multilateral (whether based on firm or indicative pricing) and bilateral market settings should thus be able to interact among each other, and so regulation should have some sort of flexibility in the interaction of legally classified trading venues and the application of rigid legal definitions. Bilateral and multilateral (with firm or indicative pricing) settings, in effect, give the possibility to find liquidity for less standardised and illiquid products such as complex fixed income products and OTC derivatives.

Figure 1. Market settings and MiFID



Source: Author.

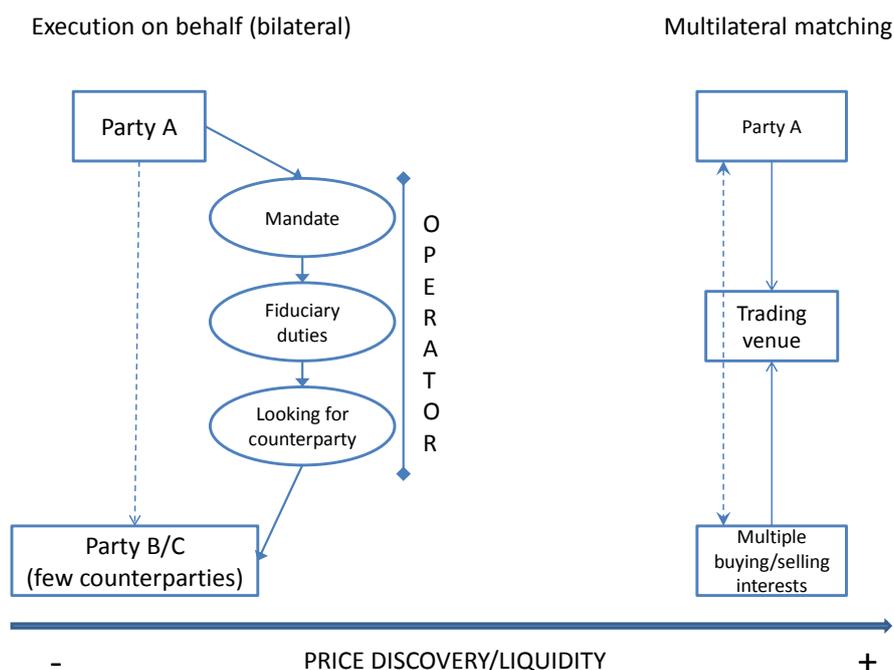
Multilateral settings are largely venues offering ‘matching’ services opposed to ‘execution on behalf’ services, which fit bilateral settings.<sup>6</sup> Liquidity in multilateral settings allows investors to

necessarily mean that they are unreported (post-trade transparency requirements typically apply to them as well).

<sup>6</sup> Under MiFID I, ‘matching services’ would fall under operation of MTF, while bilateral settings would be those related to ‘execution of orders on behalf of clients’ or ‘dealing on own account’ (Annex I, Section A, MiFID I).

‘discover’ prices themselves, as counterparties would be able to commit to a firm quote, so buying and selling interests meet in an ex-ante transparent venue<sup>7</sup> with no interference on how these interests would interact, minimising infrastructure’s conflicts between different functions. ‘Execution on behalf’ services, instead, allow a third-party, on the basis of a fiduciary relationship with the buyer or the seller to perform the transaction on his/her behalf. As a result, ‘execution on behalf’ services allow an intermediary to de facto substitute the buyer/seller in his/her decision, which legally remains his/her own (see graph below). An execution system based on execution on behalf services (such as a brokerage system) cannot be considered as a multilateral platform, as long as its matching services are discretionary (so it does not meet one of the three abovementioned factors that qualify non-discretionary services). The broker acts on the basis of a mandate that ultimately makes the transaction a bilateral agreement between two counterparties. Not all potential counterparties to the deal – that in a multilateral setting the party looking for a deal would have known and been able to reach ex ante (platform members) – will be able in a bilateral setting to interact with the other party and put those interested in the deal in competition to provide better terms. As a result, party A (see below) would get a deal that is the result of a unilateral search of the operator, rather than an interaction between party A’s interest and all potential parties that would be willing to compete for that deal by offering better terms.

Figure 2. Bilateral versus multilateral execution



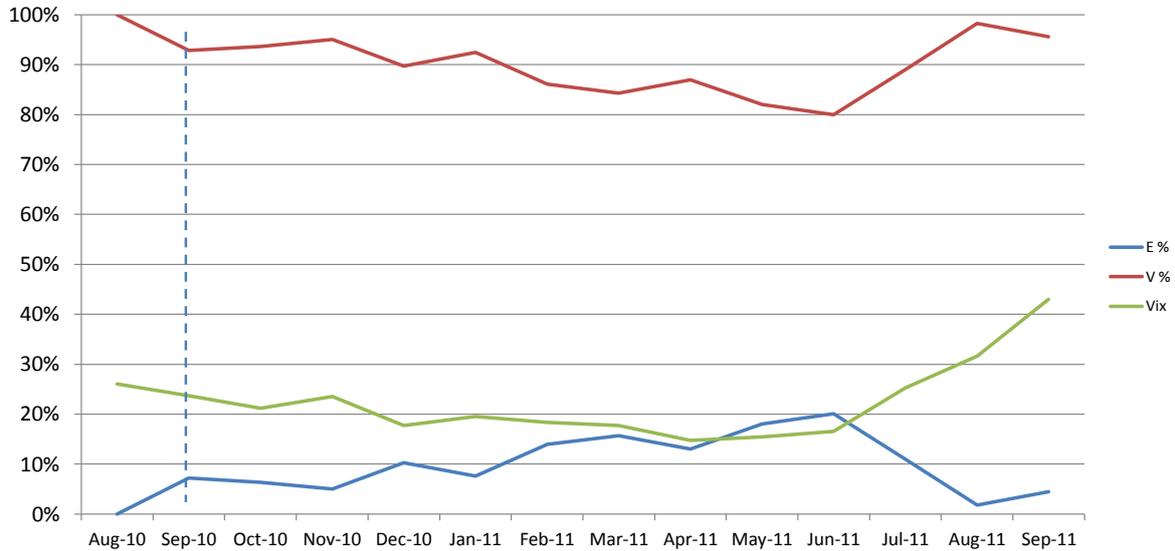
Source: Author.

Over-the-counter derivatives financial instruments are mostly traded in a bilateral fashion through private transactions, pure bilateral execution systems (voice single dealer platforms) or on sophisticated execution systems that can be a combination of bilateral (voice single dealer platforms) and multilateral execution services (such as multi-dealer or dealer-to-client trading platforms) through voice and electronic trading. In effect, some of these markets may be subject to fast-changing market liquidity conditions, therefore – when the market becomes less liquid –

<sup>7</sup> Post-trade transparency, instead, applies to all transactions done by investment firms, which involve shares admitted to trading on a regulated market or MTF (Art. 28, MiFID I).

investors may start to switch from electronic to voice, asking the broker/dealer to submit an indication of interest and match his/her interest with someone else's interest, or in other cases even to 'look for a deal' on his/her behalf (see Figure 3). Overall, as liquidity dries up, quotes naturally become less firm and more subject to oscillations.

Figure 3. Electronic vs voice execution with volatility on Euro IRS market



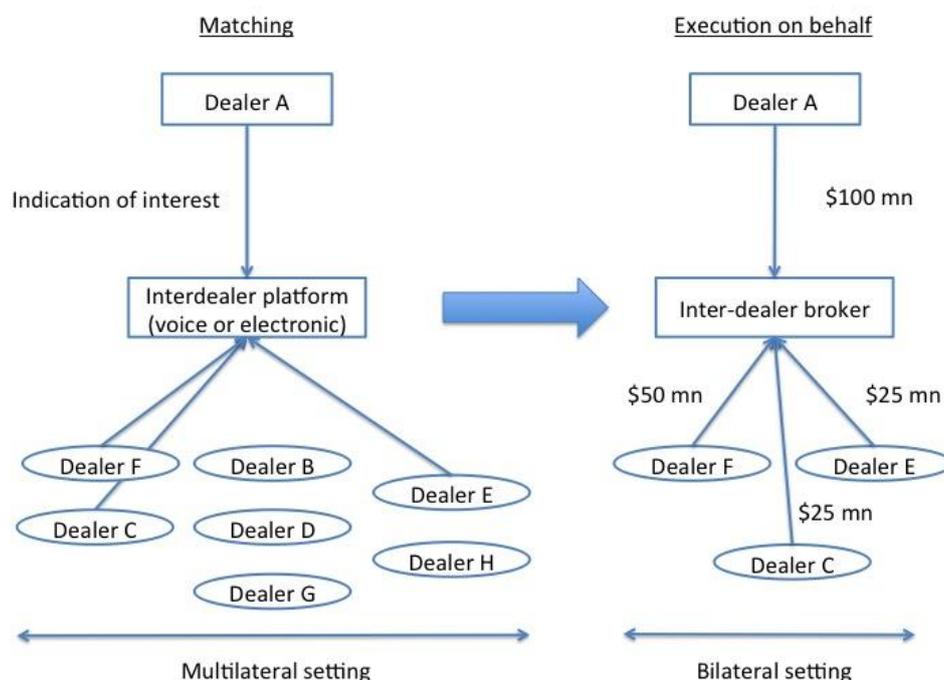
\* VIX stands for market volatility index.

Source: ICAP.<sup>8</sup>

The structure could then change from a multilateral to a bilateral execution venue, with all its implication in terms of conflicts of interest procedures and management. In effect, hybrid systems allow matching of indicative quotes on a system that can be designed as multilateral, in line with the requirements described above. However, once interests are matched, the final execution of the trade may need the intervention of a broker to get the transaction executed (see Figure 4). The broker will interpose itself to the direct negotiation of terms among parties, playing a crucial function to get the deal done. As a consequence, the nature of this relationship cannot be defined as multilateral anymore, as the broker directly or indirectly (by discretionarily asking the involved parties to offer specific terms) shapes the final terms of the deal with its intervention on how interests would interact to finalise the execution of the trade.

<sup>8</sup> ICAP i-Swap hybrid platform started operations in September 2010.

Figure 4. Hybrid systems



Source: Author.

In terms of matching mechanisms, the simple switch to voice would not necessarily mean a change in the nature of the transaction from a multilateral to a bilateral one. The switch of execution models instead happens when the operator, using an implicit or explicit mandate, takes over investor's choice and search for a deal or finalise the terms of the deal that it may consider the best available for its client on the basis of its reach and 'perception' of the market (not on the basis of the potential reach and size of the market for that financial instrument). This situation affects many complex derivatives and fixed income products, but the evolution of trading technologies are sensibly reducing the areas in which clients would need to leave the deal in the operator's hands. A regulatory framework that, on the one side, would be able to offer enough flexibility to capture bilateral execution systems (as the one illustrated in Figure 4) and make them available to investors, and, on the other side, would be able to boost market developments that will allow an ever-growing number of products to be traded in fully-transparent multilateral execution venues would be certainly beneficial for the market as a whole. Nevertheless, bilateral execution mechanisms will always be part of the market, as investors need to fulfil diverse needs with different levels of available information.

As a result, the execution system is mostly affected by the level of liquidity of the underlying instrument. For instance, with a high number of active participants and trades, standardised products<sup>9</sup> and transactions, a limit order book (LOB) would most likely be the prevailing execution system (IOSCO, 2011). The liquidity conditions that determine the prevailing execution mechanism rely on three elements: time (turnover speed, i.e. the time needed to turnover a position

<sup>9</sup> There is no formal definition of standardisation officially introduced into regulation. CESR (2010), also on the basis of my earlier paper (Valiante, 2010), has proposed a definition that relies on three key elements of standardisation: legal (contracts); process (infrastructure); product (economic terms).

in the market, which reflect the responsiveness of the counterparty in the market;<sup>10</sup> and frequency of trades); price/cost (whether the price is a binding or indicative quote, and level of spreads); size (depth of the market, i.e. the ability to absorb high size orders or indication of interests in comparison to the average size of orders); and resilience (ability to go back to original trading levels after an informational shock affecting the pricing of the product).<sup>11</sup>

Table 1. Liquidity matrix

	Execution systems		
Liquidity indicators	Pure bilateral (private negotiation)	Hybrid (RFQ/RFM)	Pure multilateral (LOB)
Turnover	Low	Medium	High
Frequency of trades	Low	Low/Medium	High
Resilience to shock	High	Medium	Medium/Low
Spread	High	Medium/High	Low
Quote firmness	Low	Low/Medium	High
Depth	High	Medium/High	Low/Medium

Source: Author.

Overall, prevailing execution models for over-the-counter derivatives and other complex fixed income markets are request-for-quote systems, whereby one party requires a known set of counterparties (dealers) a quote or two-way quotes for an instrument with specific characteristics. The counterparty would then receive all information about the party requesting the quote to price the product correctly. In effect, if a binding quote is not available, the dealer needs to know the identity of the other side to price counterparty risk in the product, especially if the dealer is committing capital to it (as for principal trades). The regulatory framework should be designed to allow the coexistence of these systems, knowing that markets cannot be always run as pure multilateral execution mechanisms.

## The Commission's proposal and current MiFID text

For trading of OTC derivatives and some fixed income products bilateral execution systems are complementary to multilateral ones and cannot be outlawed. There is no way to assess perspective liquidity with precision, but execution can be ex ante classified as bilateral or multilateral. There is therefore a need to modify the current MiFID text to deal with market developments. Non-equity markets have a more complex market structure and to deal with the peculiar market structure of products that will fall under the trading obligation (Rec. 22-23, and art. 26-27, MiFIR), the Commission's proposal does not amend MiFID current venues for bilateral and multilateral execution but it introduces a new venue that would only capture part of the bilateral execution systems currently available (pure execution on behalf services, which does not include trading on own account and principal trading). It then elevates this definition to the level of regulated markets and multilateral trading facilities, which are pure multilateral execution systems, so functionally different (on a paradoxical claim to level the playing field, even if they are not playing the same

<sup>10</sup> For complex OTC derivative products this time is sensibly lower as they need to price the counterparty and offer a quote.

<sup>11</sup> The proposed definition takes some elements from the proposed definition of liquidity for order books by Kyle (1985).

game). More precisely, the explanatory memorandum clarifies that “while both the rules on access and execution methodology of an OTF have to be transparent and clear, they allow the operator to perform a service to clients which is qualitatively if not functionally different from the services provided by regulated markets and MTFs to their members and participants” (p. 6, MiFID II).

More specifically, the Commission proposes:

‘Organised trading facility (OTF)’ means any system or facility, which is not a regulated market or MTF, operated by an investment firm or a market operator, in which multiple third-party buying and selling interests in financial instruments are able to interact in the system in a way that results in a contract in accordance with the provisions of Title II of Directive [new MiFID] (Art.2.7, MiFIR).

Once again, the new MiFID does not try to capture all bilateral trading systems, but it suggests a residual category (in addition to the OTC residual category, Rec. 18, MiFIR<sup>12</sup>) that takes into account only one tiny form of bilateral trading (discretionary matching). In effect, OTF will not be able to match orders against own capital. The text clarifies that only SIs would be able to match against own capital. It does not consider principal trading either. Nevertheless, the proposal does not allow an SI to interact with an OTF, which further reduces the range of action of the OTF. In the end, the effectiveness of this categorisation becomes very minimal, but at the same time its boundaries are so blurred that could become a mean to categorise business models that resemble a pure bilateral transaction, but that for marketing purposes gets a better advertisement as a platform that would be elevated by regulation as similar to neutral infrastructures, such as multilateral trading facilities and regulated markets. The current definition adds confusion to an already complex venue classification under MiFID. The recent draft report of the European Parliament (so called, ‘Ferber Report’; EP, 2012) does not address the missed classification of bilateral execution systems and confirms the content of the old MiFID definition of bilateral trading as ‘own account trading’. ‘Multilateral’, instead, only refers to a system that brings together multiple buying and selling interests.

## An alternative view of the topic

Current multilateral trading facilities (MTF) under MiFID can cope with most of derivatives organised trading. In effect, the current MTF definition defines non-discretionary matching of ‘buying and selling interests’ “to be understood in a broad sense [...]” including “[...] orders, quotes and indications of interest” (Rec. 6, MiFID). As a result, the definition suits most of the request-for-quote (RFQ) or request-for-market (RFM) models currently available on the market to deal with ‘episodic market’. The operator in these markets is a sort of ‘facilitator’, which allow matching of complex buying and selling interests, keeping its neutrality by providing non-discretionary services (see Figure 1). RFQ and RFM models help to solve strong asymmetries of sizes and economic terms among counterparties and can be modelled as multilateral execution mechanisms, as long as the market can interact with bilateral mechanisms if needed. This paper thus formulates two options that would best suit the structure of MiFID and the nature of European markets.

### Option 1

Instead of introducing a new category designed on a rather partial view of the market, an alternative would be to amend current definitions under MiFID to qualify better multilateral and bilateral execution systems. RFQ and RFM models can be run through multilateral/non-discretionary platforms (as defined above) whether matching is done electronically or manually

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<sup>12</sup> Current Recital 53, MiFID.

(voice). Current MiFID text could be amended to define non-discretionary rules (Rec. 6, MiFID) as above, i.e. if they meet the three requirements (membership, product and matching). Additionally, the systematic internaliser definition, a legal trading venue (art. 2.8 Reg 1287/2006), should be expanded (art. 4.1(7), MiFID) to include systematic and material (as defined by Reg. 1287/2006) own account trading, pure discretionary matching (agency trades) and principal trading (pure brokerage services) done by the operator, which would then qualify as bilateral execution system. This concept of ‘discretionary’ does not clash with the non-discretionary requirement of art. 21.1(a) Reg. 1287/2006, as CESR clarified that “a firm should always use discretion when deciding whether or not to execute a client order against its own account as the firm has to meet best execution obligations; [...] the non-discretionary element of a SI is a relevant component of the definition to avoid including ad hoc transactions that would not be systematic” (CESR, 2010; p. 13-14). Perhaps, regulators would need to directly clarify what would not be considered as ‘systematic’, by first saying that non-discretionary rules for SI do not refer to the execution mechanism but to the commercial policy and access to the venue (as set by art.27(5), MiFID). The article (art. 21.1(a), Reg. 1287/2006) could then be amended as ‘non-discretionary access rule’, clearly referring to the access rather than the execution system. The text would then need to state that SI would apply conduct of business rules (CoB; e.g. conflicts of interest rules) and best execution (if execution on behalf). Additional surveillance requirements may be designed for the platform. The application of CoB rules does not make up for the use of discretionary services, but it reduces the conflicts between different functions of the operator. Therefore, even if an OTF applies CoB and best execution rules, these would not be enough to consider this platform as ‘multilateral’ and ‘neutral. And vice versa, if a platform deals only with eligible counterparties (ECP), so it does not apply best execution requirements, this does not change the bilateral nature of the service provided. The ECP regime is an exception to the application of fiduciary duties (which do not apply) that does not change the fact that the service is based on a fiduciary relationship, with all related implications for price formation mechanisms.

In relation to the provision of quotes by the operator, the obligation to provide firm quotes (art. 27, MiFID) should only apply to equities, while for non-equities the obligation could entail the provision of indicative quotes or to provide firm quotes when the transaction would fall under the pre-trade transparency obligation, under the new transparency regime based on the nature of the instruments. To avoid risks of market manipulations with indicative pricing mechanisms, an obligation to execute trades in the matched spread (interest) should be added to the legislative text.

Furthermore, it should be clearly stated that a SI could interact with a MTF run by the same or a different operator. Ownership restrictions to the SI operator over the MTF platform could be introduced. If the SI brings together third-party orders<sup>13</sup> it must be classified as MTF. As a result, this would define clear boundaries of bilateral execution systems, which are now missing in MiFID. Non-systematic wholesale transactions will remain exempted under the OTC conditions set by the Directive (Rec. 53, MiFID; now Rec. 18, MiFIR).

## Option 2

An alternative but still incomplete option would be to amend the current OTF definition by allowing interaction with SI and allowing principal trade of the operator, as long as a viable classification and separation of principal trading from own account trading would be possible. In effect, principal trading positions may be rolled over and become own account trading, so violating a key requirement of this platform. Therefore, if the operator decides to roll over a principal

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<sup>13</sup> Principal trades done by the SI operator should be classified as client orders, while principal trades in which the operator is not involved should not be allowed on a SI. If it happens, they would need to register a MTF and direct that specific business on that platform.

trading position as ‘own account’, it would need to disclose it and complete it outside of the platform. It could be done on a SI if interaction between OTF and SI would be permitted. In any case, the exclusion of principal trading from the OTF definition hampers the possibility for this platform to become execution venue for a vast range of OTC derivatives transactions. More precisely, a narrow definition would potentially outlaw systematic principal trading, as it would not be captured by any of the definition proposed by the MiFID review.

This option however would not help to clarify the distinction between bilateral and multilateral by keeping the original confusion, and whether the OTF would be able to run both execution systems. Even if it would not be allowed to run both systems, the separation of functions between an OTF and an SI would still be difficult to be drawn, in particular if OTFs would be allowed to interact with a SI or to trade on own account or run principle matching.

### **Differences with the US Swap Execution Facility (SEF)**

Important differences emerge among the new OTF category and the current competing proposals formulated in the United States by the Securities and Exchange Commission (SEC) and the Commodity Future Trading Commission (CFTC). It should be clarified beforehand that the US have a limited regulatory framework for trading of over-the-counter derivatives and in particular for the operation of multilateral versus bilateral execution systems, which are usually regulated by asset class. As a consequence, the alternative trading system (ATS) definition, which captures alternative multilateral execution systems, only applies to equities. In Europe, instead, the MTF definition applies to all financial instruments and several platforms trading fixed income and standardised derivatives are currently registered as MTF. Therefore, the discussion in the US is much more focused on creating a new category able to capture multilateral execution systems and own account trading for standardised fixed income products (and in particular, derivatives<sup>14</sup>). Therefore, a list of divergences between the SEF and OTF definitions emerges (see table below).

First, the US regulators propose to put a cap on a swap dealer’s ownership of the infrastructure (whether the operator or not). The CFTC proposes a 10% stake maximum, while the SEC sticks to the original Dodd-Frank proposal of 20% threshold (CFTC, 2011, p. 1217; SEC, 2011, p. 132). MiFID proposals do not put a cap on the ownership of the infrastructure.

Second, the SEF definitions allow own account trading of the operator to interact with the operation of the infrastructure. The Commission’s proposal, instead, explicitly prohibits the OTF operator to have own account activities or even interact with systematic internalisers (Rec. 8, MiFIR).

Third, SEF definitions would not allow discretionary matching, but voice intermediation will be allowed only if used as a mean of communication for the electronic matching (CFTC 2011, p. 1221) or for trading of block trades. As explained above, at the core of the Commission’s proposal discretionary matching would be the key feature of an OTF, which would partially capture hybrid systems based on voice brokerage services.

Fourth, SEF definitions call for an obligation to have a minimum number of active participants that will be dealing with a request for quote or other buying/selling interest. The OTF category does not contemplate so and it actually leaves full discretion to the operator/broker, under its mandate and under a loosen definition of best execution, the decision to survey the whole or a tiny part of the market to get an interest that would provide the ‘best’ available deal for the client.

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<sup>14</sup> Dodd-Frank bill classifies different types of derivatives under the sole definition of ‘swap’, while the European definition of swap only includes those financial instruments that allow an exchange of payments between two parties if specific conditions are met.

Table 2. Key differences US-EU proposals

		US		MiFID I		Commission's proposal			Option 1	
		SEF (SEC)	SEF (CFTC)	MTF	SI (own account only)	MTF	OTF	SI (own account only)	MTF	SI (brokerage services)
<b>Discretion</b>	Membership	NO	NO	NO	YES	NO	NO	YES	NO	YES
	Products	NO	NO	NO	YES (equities only)	NO	NO	YES (equities only)	NO	YES
	Matching (e.g. bilateral voice)	NO	NO	NO	YES	NO	YES	YES	NO	YES
<b>Pre-trade transparency</b>		YES	YES	Depends on instrument	Depends on instrument	Depends on instrument	Depends on instrument	Depends on instrument	Depends on instrument	Depends on instrument
<b>Binding quotes only</b>		NO (one type or both)	NO (both)	NO	YES (for liquid shares)	NO	NO	YES (for liquid shares)	NO	NO
<b>Ownership restrictions</b>		YES (20%)	YES (10%)	NO	NO	NO	NO	NO	NO	NO
<b>Own account trading</b>		NO	YES	NO	YES (equities)	NO	NO	YES (equities)	NO	YES
<b>Limit on number of participants</b>		YES (at least one)	YES (min. 5)	NO	NO	NO	NO	NO	NO	NO

Source: Author.

Such strong divergences reflect somehow a different regulatory background and supervisory culture, the US one typically more focused on prescriptive regulation and the European one that was used to be, at least before the crisis, much more focused on regulating different functions rather than how the service or product should be ultimately delivered. The MiFID framework for market (infra)structure, despite all its pitfalls, has proved once again to be ahead of what even its drafter had originally thought. In effect, with some adjustments (option 1), it can set a framework that would provide a clear and sound venue classification. However, divergences of approach between Europe and the US will still remain. For instance, the limit to the ownership of the infrastructure may somehow reflect the different approach on how to deal with conflicts of interest, which in Europe has been historically focused on how to get the management of conflicts right rather than trying to avoid that the conflict would emerge *ex ante*.

## Conclusions

Discussions around the revision of MiFID are heating up and one of the key topics on the desk of regulators is the current trading venue classification and its flexibility to catch up with complex market developments in the trading of ‘standardised’ over-the-counter derivatives.

Current MiFID framework is currently equipped to capture a great deal of derivatives trading (at least the one based on multilateral execution systems).<sup>15</sup> However, the Directive did fail in understanding correctly how bilateral execution systems work and the implications of limiting its legal classification to a narrow definition of systematic internalisation. As a result, the attention of regulators should be more on ensuring a proper regulatory framework for bilateral execution systems, rather than pretending that a system based on discretionary matching could be considered multilateral and put on the same level than a MTF or a regulated market. This risks creating additional confusion in an already complex set of market infrastructures and execution mechanisms.

The key proposal of this paper is to consider own account trading, discretionary matching and principal trading as parts of the same set of core brokerage services to be classified as bilateral execution systems under a broader definition of systematic internaliser (with revised obligations), subject then to the application of conduct of business rules (e.g. conflicts of interests management procedures) and a best execution regime. MTF would then be adapted to explicitly state that multilateral systems are not just those bringing together multiple interests from third parties, but those bringing together these interests through ‘non-discretionary’ services, as described above, whether or not the actual matching system is electronic or manual (voice).

Finally, despite convergence on high-level objectives, US and EU regulators are following diverging paths in defining the regulatory framework respectively for SEF and OTF. There are at least four important areas in which the SEF definitions do not match up with the proposed rules for OTFs. Most importantly, proposed SEF definitions would not allow discretionary matching services and so single dealer voice brokerage services, which are a core part of the parent OTF definition. Big differences with US counterparty can lead to regulatory arbitrages, as long as regulation adds up confusion to an already complex market structure.

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<sup>15</sup> Different discussion apply for the transparency regime, which fits perfectly under MiFID for equities, while a regime for non-equities is still missing.

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