HM Treasury

Wholesale Markets Review:

Consultation

July 2021

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Ministerial Foreword

The UK is home to one of the largest financial services centres in the world and adds more than £194.2 billion of value to the UK economy. Our capital markets sit at the centre of this, providing essential services both to large and small UK companies, as well as international businesses who want to raise money and manage risk.

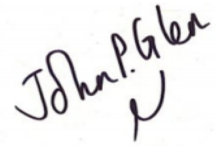
With the development of the EU's single market, much of our regulatory approach to capital markets was set in Brussels. Now that we have left the EU, we can tailor our rules more closely to the unique circumstances of the UK, improve standards and make regulation more proportionate.

This review is not about lowering standards for wholesale capital markets. Instead it is about the need for regulation to be adjusted on the basis of evidence and experience to ensure it effectively addresses risks. After the financial crisis in 2008 we were instrumental in the development of reforms to improve the stability of the global financial system. We also reformed our own regulatory regime to ensure the right regulators are focused on the right risks. That is why, in all areas we will seek to maintain the high standards that mean international firms can participate in our markets with confidence.

However, in some cases regulation does not protect market integrity or encourage competition. Rules such as the share trading obligation, which seek to restrict access to global stock markets, run exactly counter to our principles of openness and competition. The double volume cap was well-intentioned but has no basis in evidence. We need to tackle failures in market data provision to make it available to all. Many rules around transparency and disclosure serve to reduce price formation while needlessly raising costs. Removing some of these restrictions will ensure effective targeting of risk and resource by firms and regulators and bring greater competition. We also need to look to the future and ensure our regulation supports the transition to net zero, and is ready to embrace the opportunities of technological change. These are just a few areas that this consultation sets out for discussion and potential reform.

The issues raised in this document sit alongside our intention to make regulation more agile, by devolving rules to regulators and giving more space for expert judgement. Much of this is covered in the separate Future Regulatory Framework review. We are also consulting on changes to prospectuses alongside this, delivering on key recommendations from the UK Listings Review.

I look forward to leading the review of our wholesale markets regime. Your responses will be vital to shaping this important work and I look forward to reviewing them.



John Glen, Economic Secretary to the Treasury

Chapter 1

Introduction

1.1 The UK is a global centre for financial services. This is supported by many contributing factors including robust and proportionate regulation, world renowned legal expertise, access to talent, and an ongoing commitment to open, competitive and innovative markets. Deep and liquid capital markets are at the heart of the UK's prosperity as an international financial centre. They provide financing for UK and international businesses, allow businesses to hedge risks, enable institutional and private investors to access financial instruments, and provide a direct source of employment and tax revenue.

Financial services regulation in the UK for secondary markets

1.2 The Wholesale Markets Review was established to determine how the UK's approach to regulating secondary markets needs to adapt following the UK's withdrawal from the EU, and to ensure that the framework continues to cater for future challenges and opportunities.

1.3 Currently, the Financial Services and Markets Act 2000 (FSMA), which sets out the role of the financial services regulators, government and Parliament, sits at the centre of the UK's regulatory framework. Businesses that are authorised under FSMA include investment and pension advisors, stockbrokers, professional firms offering certain types of investment services, fund managers and derivatives traders. It also establishes that HM Treasury sets the 'regulatory perimeter' through secondary legislation, specifying which financial instruments and activities should be regulated, and the circumstances in which regulation should apply. However, a lot of the rules that directly govern the buying, selling and organised trading of transferable financial instruments are set out in UK legislation that transposes the second Market in Financial Instruments Directive (MiFID II) and Markets in Financial Instruments Regulation (MiFIR). These were amended to address deficiencies arising as a result of the UK's withdrawal from the EU and the end of the Transition Period, and are referred to together as the MiFID II framework.

1.4 The UK played a significant role in designing the MiFID II framework, and the government believes that the resilience and effectiveness of the UK's capital markets has been significantly strengthened by the post-crisis reforms that it implemented. However, although the transposed regime is working well in many areas, the EU approach to regulation - where the same rules apply across Member States in order to facilitate a single market in financial services - means that MiFID II requirements are not calibrated solely for UK markets.

1.5 The government sees the UK's departure from the EU as an important opportunity to ensure that we have regulation which is right for the UK. The government believes that this is best achieved by amending the regime for secondary markets to ensure that it reflects the UK's position as one of the largest capital markets globally, as well as the UK's commitment to high standards and proportionate regulation. For example, it is not surprising given the extent and complexity of the new regulation introduced by MIFID II, that some rules have not delivered their intended benefits, have led to duplication and excessive administrative burdens for firms, or have stifled innovation. The government intends to rectify this.

1.6 The government does not however intend to make changes for the sake of change. The Wholesale Markets Review is not about revolutionising the rulebook but about making it nimble and fit for purpose. This is especially relevant as the government recognises that industry has faced considerable costs in adapting to new requirements following the 2008 financial crisis.

Wholesale Markets Review: Scope, driving principles and consultation objectives

1.7 The initial reforms to the UK's wholesale markets regime that are included in this consultation have been informed by discussions that HMT and the Financial Conduct Authority (FCA) have had with market participants over the past 18 months. They have also been guided by the following objectives and principles:

> *Upholding high regulatory standards,* even in the absence of codified international standards, to ensure that the UK's regime is effectively enforced, sets an international example and allows firms and investors to operate in confidence and trust the operation of the market.
>
> *Promoting openness and competitiveness,* to allow a range of participants (i.e. domestic, international, public and private sector organisations) to access domestic and overseas markets easily, appropriately and at relatively low cost, allowing for greater competition and innovation, and to cement the UK's position as a global hub for wholesale markets.
>
> *Delivering fair and proportionate regulation*, to ensure that the UK's regime is underpinned by proportionate standards that are focused on outcomes rather than prescriptive rules, enabling firms and investors to operate in the market without unnecessary friction and costs.
>
> *Supporting economic growth,* to ensure that the UK's regime supports growth in the real economy, innovation, entrepreneurship and wealth creation across society, and facilitates investment, both in the short-term (by supporting the economic recovery from COVID-19) and in the long-term (as we transition to a low-carbon economy).

1.8 When taken together, this package of reforms seeks to create a simpler and less prescriptive regime in the most cost-effective way, for example by:

- Clarifying the regulatory perimeter and conditions governing trading venues and systematic internalisers so that the market can operate in confidence and promote innovation.
- Removing requirements that limit firms' ability to execute transactions where they can get the best outcomes for investors, for example by removing the share trading obligation and double volume cap.

- Recalibrating the transparency regime for fixed income and derivatives markets to ensure that the right instruments are subject to transparency requirements.
- Fundamentally reviewing the commodities regime to ensure that market activity is not unnecessarily restricted, while ensuring that markets function efficiently.
- Amending the market data regime to enable participants to identify the best available prices.

1.9 As well as improving the existing framework, the government wants to ensure that UK markets are ready for new challenges and opportunities. Therefore, this consultation sets out higher-level questions about longer-term priorities alongside the more detailed specific and short-term policy proposals outlined above. For example, it considers how UK authorities can help facilitate capital raising for small sized companies, and whether there is value in delegating the operation of parts of the regime to the market in the long-term. It also includes questions about broader changes to market structure and transparency.

Wholesale Markets Review: Roadmap to delivery

1.10 The regulatory framework underpinning secondary markets policy sits across primary and secondary legislation (which is the government's responsibility) and regulators' rules and guidance.

1.11 In October 2020, the government published a consultation on the Future Regulatory Framework (FRF) Review. The key purpose of the FRF review is to determine how the UK's financial services regulatory framework needs to adapt to reflect our position outside the EU and ensure it is fit for the future. It considers whether changes are required to regulators' objectives and principles; how we ensure regulators' accountability and scrutiny arrangements with the Treasury, Parliament, and stakeholders are appropriate given the regulators' new responsibilities; and how responsibility for designing and implementing rules in areas of retained EU law is transferred to the regulators. The government published a consultation on the FRF in October 2020.[1] It will publish a second consultation on the FRF Review later in 2021.

1.12 The government is consulting on specific changes to its wholesale markets regime now, alongside the FRF Review, because it is clear that there are parts of the regime that can be significantly improved and the government would like to implement these quickly where possible; some of these may be best delivered through changes to existing legislation and others through regulator rules following the implementation of the FRF. Responses to this consultation will be considered in parallel with the FRF Review.

1.13 To implement regulatory changes that will be informed by this consultation, the government intends to bring forward primary or secondary legislation as soon as parliamentary time allows. To cover the full breadth and scope of the UK's framework, the government is working closely with the regulators. The FCA has committed to take forward any further consultations about parts of the regime that fall within its rules and guidance, and that relate to these proposals, from the second half of this year onwards.

1.14 This consultation is part of the Chancellor's broader vision to enhance the competitiveness of UK capital markets, while maintaining high regulatory standards.

Other steps that the government has taken to fulfil this vision include commissioning an independent review of the UK listings regime. This reported in March 2021 and put forward a range of recommendations to boost the UK as a destination for IPOs and to optimise the capital raising process for companies to list on the main UK markets. The government's consultation on the prospectus regime, which was launched today, seeks to address three of the UK Listings Review's recommendations, and identifies a number of changes to ensure prospectus rules are not overly burdensome yet provide investors with the information they need.

Chapter 2
Trading Venues

Background

2.1 Trading venues are organised markets where tradable securities and other financial contracts are bought and sold. They differ from over-the-counter (OTC) trading, where contracts are traded directly between two parties.

2.2 Trading venues ensure fair and orderly trading as they communicate price information for all instruments that they trade. This helps investors to make well informed decisions and increases market transparency. The requirements derived from the MiFID II framework form the main part of the legal framework governing the regulation of trading venues. They are complemented by a number of implementing measures that further specify the detailed obligations trading venues are subject to.

2.3 The MiFID II framework includes three types of trading venues: regulated markets (RMs), multilateral trading facilities (MTFs) and organised trading facilities (OTFs). RMs and MTFs are multilateral systems where multiple third-party buying and selling interests in financial instruments interact in accordance with non-discretionary rules. RMs are managed and/or operated by a market operator, whereas MTFs can be operated by an investment firm or a market operator.

2.4 OTFs are also multilateral systems that facilitate the bringing together of multiple third-party buying and selling interests and can be operated by an investment firm or market operator. However, unlike RMs and MTFs, the execution of orders on an OTF is carried out on a 'discretionary basis': where the market operator takes an active role in managing trades. There are two levels of discretion for the operator of an OTF: first, deciding whether to place or withdraw an order on the OTF; and second, deciding whether to match a client order with other orders available on the OTF. The 'matched principal trading' (MPT) rule allows an OTF to interpose itself between the buyer and the seller and both sides of the trade simultaneously to eliminate market risk. The client must consent to the MPT rule being used.

2.5 In the UK there are currently 6 firms that operate an RM, 38 firms that operate an MTF and 24 firms that operate an OTF. Some firms operate multiple venues.

2.6 The government believes that the current market structure for trading venues is generally sound. The organisational requirements that they are subject to promote fair and orderly trading, and the transparency obligations help to ensure that market participants can make effective investment decisions. However, since the MiFID II regime entered into force in 2018 the market has evolved and innovated. This has created ambiguity regarding the regulatory perimeter. To ensure that the regime works effectively and to reduce risk for firms, the government has identified a number of changes to help clarify the regime. The government has also identified several areas where the regime could be simplified, or where requirements have led to unnecessary costs and burdens on firms but do not provide proven benefits in terms of market integrity.

2.7 The government is also considering changes to facilitate capital raising for smaller issuers. To try and increase the number of SMEs accessing public markets and to harmonise the standards that apply to SME markets across Member States, MiFID II introduced a new sub-category of MTFs called 'SME growth markets'. MiFID II SME growth markets have different regulatory requirements for trading than standard MTFs. For example, they allow issuers of financial instruments to produce an 'admission of trading document' instead of a more detailed prospectus. Specific provisions to encourage SME issuers to trade on SME growth markets were also included in the EU's Market Abuse Regulation (MAR) and Central Securities Depositary Regulation (CSDR), both of which the UK has brought onto its statute book. There are currently three MTFs that are registered as SME growth markets in the UK.

2.8 Although MiFID II SME growth markets in the UK are working well and have seen an increased number of IPOs over the last year, industry has suggested that they are mainly used by medium-sized SME issuers. For example, the average market capitalisation on AIM, the UK's largest SME growth market, is around £80 million and there are approximately 1,200 companies quoted on the market.

2.9 Access to risk capital should be an important source of financing for SMEs. While for many small companies funding from banks or from private equity firms might be appropriate, public capital markets can provide an important source of risk capital to support investment and growth. The government is therefore reviewing whether existing markets and associated regulation is effectively calibrated for smaller SMEs, particularly those who have a market capitalisation of less than £50 million.

2.10 Finally, market participants have raised concerns in relation to recent market outages – when technical glitches have interrupted trading – and the lack of regulatory clarity regarding action when such events occur. The government and FCA have discussed potential non-legislative action in this area, as explained below.

2.11 Taken together these changes will help firms and investors operate with confidence and trust in the operation of the market, whilst ensuring that the regime is fair and proportionate and accessible to a diverse range of participants.

Proposed Changes

The trading venue perimeter

2.12 Under MiFID I, only non-discretionary, i.e. rule-based, systems bringing about transactions in financial instruments needed to seek authorisation as a trading venue. MiFID II expanded the trading venue perimeter to any multilateral system where trading interests can interact, regardless of whether interaction is achieved through the use of the operator's discretion or according to non-discretionary rules. The MiFID II definition is also neutral as to whether transactions are finalised within the system, i.e. in accordance with the platform's rules, or bilaterally between users.

2.13 The breadth of the current definition has created ambiguity about the perimeter, especially for some technology firms. This is because as technology has evolved, some firms that are not authorised as trading venues have started to provide arrangements that permit investment firms to exchange trading interest and execute transactions with their clients in a way that challenges the definition of a multilateral system. Under the current definition, it is sometimes not clear if these technology firms, who are bringing buyers and sellers together on an informal basis, need to be authorised as an MTF.

2.14 The government is also aware that the current definition is ambiguous about whether brokers arranging transactions over the phone without operating a central mechanism to match client orders, need to be registered as a trading venue. This creates issues of fairness and uncertainty that the FCA have sought to mitigate up until now with informal guidance.

2.15 The government recognises that market participants can only compete effectively in financial markets if they have certainty about their regulatory status and the status of their competitors, and is therefore committed to clarifying the regulatory perimeter. This will help reduce risks for firms and ensure that there is confidence in how the UK regime operates.

2.16 To support innovation and remove any potential barriers to entry, the government believes that a flexible approach is preferable. Clarification in guidance may be better than embedding a narrow definition in legislation which could set out the characteristics, functions and tasks that separate trading venues from other communication arrangements. The government invites views from industry on how best to clarify the perimeter.

Box 2.A: Questions

1. Where do you think the regulatory perimeter for trading venues needs to be clarified?
2. Do you think it would be more appropriate for changes to be made to the definition of a multilateral system in legislation, or for the application of the existing definition to be clarified through FCA guidance?

Operating conditions for MTFs and OTFs

2.17 Trading venues must have transparent and non-discriminatory rules that ensure fair access to their systems and facilitate orderly trading. Given their role as part of the core infrastructure of financial markets, they must also operate in accordance with high governance standards. To mitigate the potential for conflicts of interest, the MiFID II framework introduced restrictions on the ability of an operator of a trading venue to deal on its own account. For example, an investment firm operating an MTF cannot execute clients' orders in a matched principal trading (MPT) capacity; and an investment firm cannot act as a systematic internaliser (SI) within the same legal entity operating an OTF.

2.18 The government supports a regulatory regime where there is a clear delineation between the different capacities in which investment firms operate. This prevents conflicts of interest that could endanger the integrity and soundness of financial markets. However, given the impact that MiFID II restrictions have on the ability of firms to enter and compete in markets and innovate, the government is considering whether the existing restrictions provide cost-effective mechanisms to manage conflicts of interest that MTFs and OTFs are exposed to. For example, the government is interested to understand if permitting matched principal trading by an MTF, where it is conducted in accordance with clear, transparent and non-discretionary rules, would diminish market integrity. Similarly, the government would like to understand if allowing an investment firm to operate an SI and an OTF within the same legal entity, would expose the investment firm to excessive conflicts of interest, even where the two activities are clearly segregated.

Box 2.B: Questions

3 Should the current restrictions on matched principal trading by an MTF be retained?

4 Should the current restrictions on the operation of an SI within the same legal entity of an OTF be retained?

5 If you answered no to question 4:

Should new rules and disclosures be introduced to address the specific conflicts that MTFs and OTFs would be exposed to when providing MPT or operating an SI?

2.19 As set out in the introduction, OTFs are limited to carrying out transactions in bonds, structured financing products, emission rights and certain derivative financial instruments. The government is not currently considering whether OTFs should be allowed to admit equities to trading in the same way that RMs and MTFs do. However, OTC derivatives such as swaps and options are frequently packaged with underlying cash equity products to meet investors risk-return objectives. When this happens, the transaction is often arranged in a way which is similar to how transactions are executed on an OTF, i.e. by facilitating price discovery and liquidity between counterparties through the exercise of discretion.

2.20 The government is not aware that restricting the ability of OTFs to execute trades relating to packages of derivatives that include cash equity products achieves any meaningful regulatory objective. Furthermore, market participants have suggested that the prohibition can complicate the way packaged transactions are executed while introducing ambiguity about their regulatory framework. This has led the government to consider allowing OTFs to execute transactions in equities when dealing in packages. The government believes that this could help mitigate uncertainty about the UK's regulatory framework and remove burdens on firms. The government welcomes industry's views on the risks and benefits of this approach.

Box 2.C: Questions

6 Do you think that OTFs should be allowed to execute transactions in packages involving derivatives and equities under their rules and systems?

7 What would be the risks and benefits of allowing this approach?

SME Markets

2.21 As outlined above, feedback from industry suggests that smaller SMEs often use crowdfunding platforms and private markets to access finance instead of using SME Growth Markets. The government understands that this is mainly because the regulatory burdens of SME Growth Markets are perceived as too onerous for smaller SMEs. Such burdens include the cost of continued compliance associated with being publicly traded under the UK legislation that transposes the Markets Abuse Regulation (MAR). The requirement to produce offer documents and ongoing disclosures has also been cited by market participants as another example of a rule that can be disproportionate. These barriers may also be compounded by a perceived lack of liquidity. The government is keen to explore how to better support small and micro-companies both on primary and secondary markets.

2.22 The UK Listings Review highlighted a number of areas where improvements could be made to encourage more companies to list in the UK. Beyond this, the government wants to explore whether a new class of trading venue with regulatory requirements tailored for smaller SMEs would increase their ability to access public markets, while preserving the high levels of investor protection that exist today. For example, a new trading venue could be targeted at SMEs with a sub-£50m market capitalisation.

2.23 A new category of venue could introduce a more proportionate framework of regulation for smaller SMEs, similar to the current MTF framework. The government envisages this would require amendments to MAR, a new offer document regime (likely formulated by market operator(s)), and the creation of eligibility criteria for a smaller subset of SMEs within the current MiFID II definition. To note, the government is also consulting on a review of public offers and offer documents more generally in its Prospectus Regime Review consultation. That consultation ties in with this proposal. The trading venue as proposed in this document would not be captured by the Prospectus Regulation.

2.24 The rationale for a new venue or an additional segment on an existing platform would be to ensure appropriate and proportionate disclosure rules. The key regulatory change needed would therefore be the reduction of the requirements around company disclosure. A different calibration of the disclosure obligations could encourage more companies to come to market earlier than planned, while ensuring that investors continue to be protected.

2.25 To facilitate demand in the shares of smaller companies the government expects that a package of measures may also be needed to compliment and support a new SME venue. Ongoing work of the Productive Finance Working Group (PFWG), particularly in relation to new fund structures such as a Long-Term Asset Fund (LTAF) may also facilitate investment in SMEs. Similarly, changes to the inducement rules that seek to incentivise the production of SME research which the FCA is currently consulting on, are intended to facilitate investment in SMEs.

2.26 As the government expects that demand for these shares is likely to come from retail investors, the government would like to explore how investor protection can be upheld while ensuring the demands made of issuers are proportionate and manageable.

2.27 The government is also keen to understand if there would be any barriers to buy-side participation in such a venue or segment.

Box 2.D: Questions

8 Do you agree that the existing regulatory requirements for disclosure at admission to trading (for MTFs and SME Growth Markets) are disproportionate for small-sized issuers?

9 What principles and/or types of information should be considered when developing requirements for disclosure at issuance to ensure requirements are proportionate?

10 How far should these be determined by the venue operator versus regulation, and what other features may provide proportionate assurances around the quality of issuers admitted to a venue (e.g. role of advisors in process)?

11 Would the creation of a new category of trading venue be an appropriate means to facilitate access to public markets for very small firms? What size of firms would be appropriate for a new trading venue?

12 If you answered no to question 11:

Would the facilitation of the creation of new market segments be a more suitable intervention?

13 If you answered yes to question 11 or 12:

What should the market cap of companies that can trade on the new trading venue and/or segment be?

14 Do you believe intermittent rather than continuous trading would increase liquidity?

15 Do you think that additional measures, such as new funds structure are needed to stimulate institutional investors to invest in SMEs?

16 What, if any, further forms of investor protection do you deem appropriate for this proposed new category of trading venue?

Outages

2.28 A market outage occurs when a trading venue temporarily ceases to process orders, execute transactions or broadcast trading interest because of technical problems with the trading platform. There have been a limited number of outages in various exchanges across the UK and Europe in the past two years. In most cases, where a primary market has experienced an outage, no significant trading activity has migrated to alternative venues despite market participants having access to those venues. This can mean that market participants are unable to reliably observe prices for instruments that they hold, and cannot see their orders. Additionally, if an outage happens at the time of a closing auction and closing prices are not produced, some funds are not able to calculate their Net Asset Values. Similarly, any derivatives and options that settle on the closing prices can be disturbed.

2.29 The resiliency of trading venues is vital for the smooth and efficient operation of global capital markets. MiFID II set out new requirements for trading venues and firms dealing on them to make financial markets more resilient and to maintain market integrity. The government is of the view that overall these have worked as intended and provide a sound framework that supports market resiliency. However, the government notes that there is ambiguity about the role of market operators and participants when there is an outage. This is preventing market participants from trading even where it would be technically possible to do so.

2.30 The failure of the market to quickly resume trading during outages is often because:

- There is not enough information about when trading in the primary venue can resume and what the status of the order book will be when that happens. Consequently, participants do not want to move to an alternative venue because they are concerned that they will have unaccounted exposure when trading in the primary venue eventually resumes.
- During an outage, some venues publish their status as "auction" or "stock suspended". However, both statuses are frequently used in situations where the venue is not experiencing an outage. This means that automated trading systems do not migrate liquidity to alternative venues, where they might otherwise do so. It has been suggested that introducing a standardised 'outage' status could help mitigate this.

2.31 The government has identified the following actions as potential, but not mutually exclusive, options to better enable markets to resume trading during and immediately after an outage:

- For UK authorities or industry to implement a playbook for both trading venues and market participants to follow when there is an outage. This could provide guidance about clear and timely information that venues are expected to communicate to the market immediately during and after an outage, and how they may do this. To account for the fact that outages can vary in length, the government believes that if this approach was taken forward it would need to be reflective of different scenarios and differentiate between actions that are needed for different types of outages. The government believes that this would help provide market participants with clarity, including on the status of orders at the venues.
- For UK authorities to explore, together with venues and other market participants, an alternative mechanism to a closing auction during an outage. This could include either establishing a secure method for the

primary venue to carry out the closing auction despite the venue being down, or arranging for alternative venues to step in to produce the key benchmark as a back-up during primary market outages. The market would need to recognise this alternative mechanism as the official closing price. The government believes this approach would ensure that the key benchmark is set and published despite a venue being down.

- Chapter 4 of this consultation (Equity Markets) includes a proposal to amend the Reference Price Waiver (RFW). It proposes enabling reference price systems to match trades at the mid-point with the current bid and offer of any UK or non-UK trading venue as long as they provide a reliable, transparent price for best execution. This would mitigate risk during an outage.

2.32 While legislative intervention is a possibility, the government believes that the development of common procedures, communication standards and guidelines by the FCA - in coordination with market participants - may allow for a quicker and more flexible approach to enhance the resiliency of UK markets. The government will ask the FCA to work with market participants to determine the most effective workplan and for appropriate procedures and guidance to be adopted and implemented, following due statutory processes.

Box 2.E: Questions

17 Do you believe that regulatory or industry guidance about how venues should operate and what they should communicate during an outage would be useful?

18 Do you have views on a fail-safe mechanism to ensure that the market has access to the key closing benchmarks during an outage in a primary exchange? What role do you see UK authorities playing to deliver this?

19 What other steps do you think UK authorities could take to ensure market resiliency in the event of an outage?

Chapter 3
Systematic Internalisers (SIs)

Background

3.1 Under MiFID II, a Systematic Internaliser (SI) is an investment firm that deals on its own account when executing clients' orders outside of a trading venue on a 'organised, frequent, systematic and substantial basis'. Unlike trading venues, SIs use proprietary capital rather than that of clients or counterparties and are therefore considered a counterparty of the trade and take on risk.

3.2 The SI regime was originally determined on a qualitative basis and limited to equity markets. Its objective was to ensure that over-the-counter (OTC) trading in the form of systematic internalisation of order flows by investment firms could contribute to price formation. It also sought to maintain a fair balance between investment firms dealing OTC and regulated venues. The regime was expanded in 2018 to cover fixed income instruments and equity-like instruments (such as depositary receipts and exchange-traded funds).

3.3 SIs are currently determined on an instrument basis. At present there are 65 firms that have notified the FCA that they are acting as an SI in at least one asset class. When acting as an SI, investment firms are - in addition to the other requirements such as best execution and trade and transaction reporting that are attached to the status of investment firms – required to make public the quotes they provide to their clients when dealing in liquid instruments and up to certain sizes.

3.4 Feedback from market participants indicates that the SI regime is by and large operating as intended. However the government has identified certain changes that could simplify the regime, reduce the cost of doing business and as a result increase the liquidity available to end clients. Alongside the proposals included in this consultation, the government welcomes views on other areas where the SI regime could be improved.

Proposed Changes

Definition of systematic internalisers

3.5 MiFID II introduced quantitative thresholds, which are calibrated at different levels for each asset class, to determine if an investment firm should be authorised as an SI. To confirm whether they exceed the thresholds, investment firms are expected to perform calculations for each financial instrument they deal in on a quarterly basis covering the previous 6-month period. When an investment firm exceeds the relevant thresholds, it must notify the FCA and be registered as an SI. To avoid having to undertake the quarterly calculations, which are costly and require a substantial amount of administrative work, the government understands that a significant number of firms who operate as an SI have opted into the regime for all financial instruments they trade in. This suggests that the current definition is not working well and could be disincentivising firms from operating as an SI.

3.6 Firms have also suggested that the thresholds for determining an SI are not effective at achieving increased transparency and aiding price formation. This is because they are inflexible and therefore unable to account for market evolution. The original reason for replacing the qualitative definition for SIs, which was included in MiFID I with a quantitative definition in MiFID II, was to address the risk of an uneven application of the regime across multiple Member States and Competent Authorities. However, now that the UK is outside of the EU, that risk is no longer relevant.

3.7 To simplify the regime and reduce costs and burdens for firms, the government is proposing to revert to a qualitative definition, whereby an SI is determined by its market activity for a particular asset class and does not have to undergo complex calculations.

3.8 In line with the government's commitment to move towards an agile framework, this would be supported by more detailed guidance that can be developed over time by the FCA. This would allow SIs to be established for appropriate reasons rather than administrative ones.

Box 3.A: Questions

20 Do you agree that the definition for SIs should be based on qualitative criteria?

21 If you answered no to question 20:

Do you think the definition should be amended in another way?

22 If you answered yes to question 20:

Do you think that regulatory guidance should be used to support the definition in legislation?

23 Do you currently opt-in to the SI regime?

Reporting

3.9 MiFID II requires firms to publish information about executed trades in real time via a trading venue or an Approved Publication Arrangement (APA). Under MiFID II, an SI, regardless of whether it is acting as a buyer or a seller, is required to take on post-trade regulatory reporting obligations on behalf of its clients. The purpose of the requirement is to clarify who has the responsibility to make the trades public. It is also to ensure that the obligation rests with firms who are well placed to connect with APAs due to the scale and nature of their business. However, because SIs are currently determined on an instrument by instrument rather than an entity basis, the government understands that for some transactions there is uncertainty about who should report the trade. This is particularly true for trades that are conducted with broker dealers. To reduce compliance costs for market participants and deliver greater clarity about how counterparties dealing with SIs can rely on them to make trading information public, the government is proposing to revert to the MIFID I approach and determine the status of an SI at an entity level.

Box 3.B: Questions

24 Should SIs be determined at entity level instead of on an instrument by instrument basis, for reporting purposes?

25 What would be the risks and benefits of adopting such an approach?

Midpoint crossing

3.10 Background on the MiFID II tick size is set out in Chapter 4 (Equity Markets).

3.11 In 2020, the tick size regime was extended to cover SIs quotes, price improvements and execution prices in an attempt to create a fair balance between SIs and trading venues. The only exemption from this extension was for large in scale (LIS) orders, which can be executed at the mid-point within the current bid and offer prices, on both SIs and TVs.

3.12 The government does not believe that the extension of the regime has benefitted price formation. In fact, some market participants have suggested that it has detracted from SIs' ability to offer best execution to their clients.

3.13 The government recognises that there is a distinct difference between SIs and trading venues, as SIs take on counterparty risk. Therefore, the government is proposing to permit SIs to execute client orders at the mid-point within the best bid and offer for trades below LIS, provided the executed price is within the SIs' quoted prices and the execution is in a size not larger than the quoted size. The flexibility to execute clients' orders at mid-point could benefit clients by providing meaningful quotes, giving greater transparency and supporting public price formation.

3.14 Additional changes to the SI regime are covered in Chapter 4 (Equity markets).

Box 3.C: Question

26 Do you agree with the government's proposal to allow SIs to execute at the midpoint for all trades, provided the executed price is within the SI's quoted price?

]

Box 3.D: Other reflections on the SI regime

27 Do you think any other changes are needed to increase the effectiveness of the SI regime?

Chapter 4
Equity Markets

4.1 MiFID I sought to increase market integrity and enhance competition by setting requirements for trading venues and market-makers to publish bids and offers before a trade has been completed (this is known as pre-trade transparency) and publicly disclose executed trades (this is known as post-trade transparency). MiFID II extended these requirements beyond equity instruments to equity-like instruments, such as depositary receipts and exchange traded funds (ETFs). It also introduced restrictions on where and how shares can be traded.

4.2 The government believes that pre- and post-trade transparency can facilitate price formation and aid best execution. This in turn encourages competition if it is applied effectively to the correct instruments. The government believes that there is scope to simplify the MiFID II transparency regime by removing restrictions that have not aided price formation, whilst preserving a diverse market structure that balances investors' choice and market integrity. The government has also identified some amendments that could increase competition and openness, such as removing requirements that limit a firm's ability to execute transactions where it can get the best outcome for investors.

Section 1: Pre-Trade Transparency

Background

4.3 MiFID II set out pre-trade transparency requirements for MTFs, RMs and SIs, with the intention of increasing trading on lit venues. A lit venue is a market where bids and asks are posted publicly prior to any execution. Conversely, a dark venue does not make pre-trade information visible. Pre-trade transparency helps ensure an efficient price discovery process, but in some instances, it can impair liquidity. For example, market participants can use pre-trade information to increase their prices or create a shortage of shares, which can result in false indications of liquidity. This can have a negative impact on price formation. To mitigate against this, MiFID II set out four pre-trade transparency waivers for equity and equity-like instruments, which firms can use to avoid publishing offered, executable quotes before a trade has been completed. These include: the reference price waiver, for systems that determine prices by reference to a price generated by another system- typically the primary market; the negotiated waiver, for transactions that are negotiated bilaterally but are reported on venues; the large-in-scale waiver, for orders considered large-in-scale against normal market size, and; the order management facilities waiver, for orders held in an order management facility of a trading venue pending disclosure. It also introduced a mechanism to limit the amount of trading that happens under the reference price and negotiated price waivers: the Double Volume Cap (DVC).

4.4 The government believes that the MIFID II equity pre-trade transparency regime works relatively well and overall has a positive effect on price discovery. However, the government is aware that the DVC is operationally costly and does not achieve its objective of pushing equity trading onto lit venues. In addition, amendments could be made to the reference price waiver to encourage innovation and enhance best execution. The government also believes that amending the transparency regime to encourage SIs to quote in meaningful sizes could help increase transparency and therefore price formation and best execution. This is discussed further within the SI section of this chapter.

4.5 As the thresholds for the waivers are set out in the FCA rules, they are not covered in detail in this consultation. The FCA have agreed to review in due course how they are applied and the impact they have on transparency, including for ETFs.

Proposed Changes

Double Volume Cap

4.6 As outlined above, MiFID II introduced the DVC to limit the amount of trading that happens without pre-trade transparency to 4% of all trading in an instrument at a single venue, and 8% across all venues. When these levels are reached the FCA can suspend the use of the waiver by all trading venues in that instrument. A suspension lasts for 6 months and can be renewed.

4.7 Research on the impact of dark pools on the integrity and efficiency of markets suggests that the relationship between price formation, execution costs and dark trading is complex and variable. It also shows that banning dark pools can result in volume moving into hybrid, quasi-dark trading mechanisms. When this happens it is unlikely that volumes will return to transparent public markets.

4.8 The FCA's Occasional Paper No 29; *Aggregate market data quality implications on dark trading*, published in 2017, estimates that the threshold at which dark trading may start to negatively affect market quality is approximately between 11 and 17% of total trading by pound value. However, the exact amount depends on the specific market quality metric used. Evidence also shows that the use of dark pools can reduce the transaction costs of large institutional orders. This reduction in transaction costs is also observed for trading on alternative venues such as 'periodic auctions' but only following the ban on dark trading.

4.9 The government is of the view that the DVC is not an appropriate tool to protect price formation in UK markets and it is proposing to repeal it.

4.10 However, to ensure market integrity, the government is proposing that the FCA continues to monitor the level of dark trading in markets, and retains its ability to limit it if there is evidence that the volume of trading is undermining the efficiency of the price formation process. The exercise of the power to suspend by the FCA would be based on a variety of sources and market quality metrics, including views and analysis from market participants and other stakeholders. This approach will significantly reduce operational complexity in markets, lower compliance costs and increase stability and predictability in the trading of equity instruments.

4.11 This ties in with the government's commitment to competitive markets that are supported by high regulatory standards and give market participants flexibility over how and where they trade. It also aligns the UK's approach with other international financial centres, such as the US, who do not have a DVC and have seen dark trading levels plateau at around 10%.

Box 4.A: Questions

28 Do you think that the DVC should be deleted?

29 Do you think alternative incentives are needed to encourage lit trading?

Reference price waiver

4.12 As outlined in the outages section in Chapter 2 (Trading Venues), MiFIR requires trading venues operating under the reference price waiver to derive the price from the trading venue where that instrument was first admitted to trading or from the most relevant market in terms of liquidity. The concept of 'the most relevant market in terms of liquidity' is defined in technical standards as the trading venue with the highest turnover for that financial instrument. When calculating the reference price, only the mid-point within the bid and offer prices, or the opening or closing prices, can be used.

4.13 Restricting the source of the reference price to the market of first admission, or from the most relevant market, has a number of consequences. For shares that have their main pool of liquidity outside the UK, it prevents the use of a refence price derived from the most liquid market. It also limits the ability of trading venues to establish suitable reference prices based on bid and offer prices derived from a combination of trading venues. This can reduce innovation and detract from best execution. Finally, it may unnecessarily increase the dependency of the market on the price from the primary market. The government believes that these consequences can lead to suboptimal execution outcomes for investors.

4.14 To overcome this the government believes that trading venues should be able to derive a reference price from any trading platform that offers the best execution result. The government is therefore proposing to enable reference price systems to match orders at the mid-point within the current bid and offer of any UK or non-UK trading venue that offers the best bid or offer.

Box 4.B: Question

30 Should reference price systems be able to match orders at the mid-point within the current bid and offer of any UK or non-UK trading venue that offers the best bid or offer, to aid best execution?

SIs

4.15 As outlined in Chapter 2 (Trading Venues), trading venues have to make public prices and volumes in equity and equity-like instruments prior to trading. However SIs are only required to make quotes public when they are quoting up to 10% of Standard Market Size (SMS), and only for liquid instruments. This results in SIs quoting in small sizes which can impair transparency. The SMS calculation methodology is based on the average value of transactions and is backward-looking, which affects the level of transparency in the SI markets.

4.16 The government is keen to understand what incentives can be offered to SIs to increase the number of quotes that they disclose prior to trading, and would welcome views on this. As discussed above, the ability of SIs to quote at mid-point could benefit clients by providing them with meaningful quotes leading to greater transparency.

4.17 The FCA will consult on the SMS calculation methodology and its impact on transparency in due course.

Box 4.C: Questions

31 Do you consider SIs quotes useful?

32 Do you think that the ability of SIs to execute clients' orders at mid-point would incentivise SIs to provide meaningful quotes?

33 If you answered yes to question 32:

What incentives could UK authorities introduce to encourage you to report more trades, while maintaining fair competition with market operators?

Section 2: Post-Trade Transparency

4.18 MiFID II sets out a post-trade transparency regime which requires trading venues, SIs or investment firms to report basic trade data about executed trades to the market. The data must be published as close to real time as possible and offered on a reasonable commercial basis so participants can compare results and check for best execution. In certain scenarios, firms can defer the publication of their post-trade data.

4.19 The post-trade regime for equities and equity-like instruments is generally working well and has a positive impact on price formation as the data is more standardised and accessible than in other asset classes, such as fixed income. However, the government believes that there are areas where further standardisation, such as better flagging of trade types, could assist price formation (see Chapter 7 on Market Data). The length and scope of deferrals are set out in FCA rules, so the FCA will be exploring how they are applied and the impact they have on transparency, in due course.

4.20 Chapter 7 (Market Data) of this consultation explores how a consolidated tape could facilitate transparency.

Section 3: Trading

Share Trading Obligation

4.21 The Share Trading Obligation (STO) requires investment firms to ensure that the trades they undertake in shares admitted to trading on a venue, take place on an RM or MTF, an SI, or an overseas trading venue assessed as equivalent by the Treasury.

4.22 The STO is an extension of the derivatives trading obligation (DTO), which was implemented to fulfil a G20 commitment to bring more derivatives trading onto exchange or electronic platforms. However, unlike the DTO, the STO is not based on international standards or best practices. When it was implemented, policy makers believed that it would bring more trading onto lit markets and increase transparency. However, there is no evidence that either of these objectives have been met. In fact, market participants have indicated that the STO has decreased competition between trading venues globally. In some cases it has also limited firms' ability to execute trades at the venues where they can get the best price for investors. Currently, the only jurisdiction other than the UK that has an STO is the EU. The US, Hong Kong, Australia and Switzerland, who are all recognised as equivalent under the UK's STO, do not have a trading mandate in shares.

4.23 In November 2020[1] the FCA used its Temporary Transitional Power (TTP) under Part 7 of the Financial Services Act 2000 (Amendment) (EU Exit) Regulations 2019 to amend the UK's approach to the STO. The FCA's TTP allows firms to continue trading all shares on any EU trading venue or SI from the end of the implementation period in the absence of any equivalence determination, where those trading venues and SIs have been authorised by the FCA to do business in the UK. This approach has ensured that firms operating in the UK can continue to access the most liquid markets, and get the best outcomes for themselves and their clients when trading EEA shares (regardless of the currency they are seeking to trade in). Market participants have welcomed the FCA's approach.

4.24 The government does not believe that the way the STO restricts trading is appropriate, effective or conducive to price formation or stability. The government is therefore proposing to remove the STO. This will allow firms to trade shares on any trading venue in the UK or overseas with any counterparty on an OTC basis, as long as best execution is upheld. This change will ensure that investors can get the best price for their trade.

Box 4.D: Question

34 Do you think that the STO should be removed?

Market making strategy for algorithmic trading

4.25 MiFID II introduced the requirement for algorithmic trading liquidity firms that pursue a market making strategy to enter into binding market making agreements. To do so, the algorithmic trading firm must set out their market making obligations in writing and agree them with their trading venue. Both entities must also have effective systems and controls in place to fulfil their obligations under the agreement.

[1] https://www.fca.org.uk/news/statements/fca-statement-share-trading-obligation

These requirements were intended to ensure that the algorithmic market making trading firms provide liquidity to trading venues on a regular and predictable basis.

4.26 Cross-industry feedback suggests that market making strategies that are formally agreed with a trading venue have a limited impact on enhancing market quality and impose additional cost and burdens on both algorithmic trading firms and trading venues. Trading venues have indicated that market making requirements are not meaningful and that other approaches, such as non-obligatory incentive schemes, can provide outcomes that are better suited to achieve the intended objective of increasing liquidity and orderly trading.

4.27 The government therefore proposes to remove these obligations on both investment firms and trading venues. This will reduce unnecessary burdens and costs for firms and market platforms.

Box 4.E: Questions

35 Do you think that the requirements for algorithmic liquidity providers and trading venues to enter into binding market making agreements should be removed?

36 What would be the impact of such a removal for you and/ or the market you operate in?

Tick sizes

4.28 The MiFID tick size regime sets minimum increments by which prices for equity and equity-like instruments can change. This was intended to protect the quality of price formation and maintain orderly markets by ensuring that the execution process reflects an appropriate balance between price and time priority.

4.29 Overall, the government believes that it is appropriate to set a minimum price increment regime. Without it high frequency trading could gain execution priority by offering fractional price changes, which would result in disorderly markets and negatively impact price formation. The government believes that the current tick size regime is generally working well but has identified a few areas where the regime could be amended to reduce regulatory burdens, and to ensure that it is correctly calibrated for the UK market.

4.30 Firstly, the scope of the regime currently covers shares that are traded in the UK but which have their primary market outside of the UK. Because the calculation of tick sizes are based on the liquidity of the most liquid market in the UK/ EU, the current methodology delivers unnecessarily large tick sizes for overseas shares. This means that investors in the UK are subject to uncompetitive prices, compared to investors who have access on the share's primary market. While FCA amendments to the relevant implementing measures have mitigated this issue, the mechanism adopted remains unnecessarily complex as it requires an ad hoc calculation by venues for each overseas instrument. To address the problem in a more effective way, the government is considering recalibrating the regime so that trading venues can follow the tick sizes applicable in the relevant primary market of a share where that share does not have its primary market in the UK. Such an approach would be in line with the FCA's supervisory statement published in December.

Box 4.F: Question

37 Do you think the scope of the tick size regime needs to be recalibrated for overseas shares to ensure that firms can trade at the best prices in the UK?

4.31 Secondly, when a share is admitted to trading for the first time, the FCA must make an estimate of the likely liquidity – as measured by the average number of daily trades, which is the key input to determine the tick size regime - in that instrument. As it takes time for the FCA to gather this data and build up a comprehensive picture, the government believes that the trading venue admitting the instrument to trading may be better placed to establish the tick size until sufficiently robust data is available. This is because trading venues will have more insight of market demand.

4.32 Beyond this, some participants have suggested that giving trading venues discretion to set tick sizes would result in a more competitive and nimble tick size regime. However, the government recognises that delegating this function without proper controls and oversight could lead to market arbitrage. The government would therefore welcome your views on what would be the potential benefits and risks associated with the delegation of the setting of tick sizes to trading venues. At the same time, the government would like to understand if there are any other areas within the equity regime that could be operated more effectively by the market, while upholding high standards.

Box 4.G: Questions

38 Do you think trading venues are better placed to establish tick sizes for new shares until sufficiently robust data is available?

39 What are the potential benefits and risks of delegating the setting of tick sizes, in general, to trading venues? What safeguards would be needed to avoid arbitrage issues?

40 Are there any other parts of the equity regime that you think could be operated more effectively by the market, while upholding high standards?

4.33 Chapter 3 (Systematic Internalisers) sets out the government's proposal to allow SIs to cross at mid-point when trading below LIS.

Chapter 5

Fixed Income and Derivatives Markets

Background

5.1 Following the financial crisis of 2008, the G20 committed to improve the transparency and resiliency of trading in OTC derivatives and protect against market abuse. To achieve these objectives and more broadly strengthen Europe's financial markets, MiFID II significantly extended the transparency regime - which originally applied only to shares - to bonds, exchange traded notes (ETNs), exchange traded commodities (ETCs), structured finance products, emission allowances and derivatives. It also introduced the Derivatives Trading Obligation (DTO) in an attempt to bring more derivatives trading onto venues with the aim of increasing transparency. The government continues to support the G20 commitment to improve transparency, where appropriate, as it believes it plays an important role in the price formation process if it is applied to the correct instruments. However, evidence shows that the MiFID II regime has achieved little meaningful transparency, and has had limited impact on price formation at a high cost to industry. The government believes this is because the regime is not appropriately calibrated and does not account for the diverse nature of non-equity markets.

5.2 The government is therefore proposing to significantly reform the transparency regime for fixed income and derivatives markets. These reforms are aimed at making sure only standardised and liquid instruments have to comply with all transparency requirements, and are intended to support price formation and competitive markets.

Section 1: Trading

The derivatives trading obligation

Background

5.3 The DTO requires financial counterparties, and some non-financial counterparties, to trade certain classes of derivatives on UK authorised trading venues, or overseas trading venues that have been recognised as equivalent by the Treasury. The scope of the DTO was designed to align with the scope of the Clearing Obligation (CO) which is set out in the European Market Infrastructure Regulation (EMIR).

5.4 Since the DTO was introduced in 2017, some issues with the regulatory regime have been identified and are causing ambiguity for firms. These can be addressed with simple targeted amendments, such as realigning the scope of the DTO and CO.

Proposed changes

Align the DTO and EMIR clearing obligation

5.5 As outlined above, the scope of the DTO and CO were originally designed to be aligned. However, in 2019 the EMIR REFIT reforms amended the scope of the CO to exclude small financial counterparties. Because the scope of the DTO was not updated simultaneously, this has created a misalignment. As the scope of the DTO for financial counterparties is defined with a cross-reference to the definition in EMIR, discrepancy between the two obligations has caused ambiguity for industry.

5.6 The FCA have sought to mitigate this through transitional relief. However, to ensure a consistent approach across all regulation and reduce uncertainty about the regulatory perimeter, the government is proposing to formally realign the counterparties in scope of the DTO with those in scope of the CO.

Box 5.A: Question

41 Do you agree that the scope of the DTO should be revised to bring it in line with the scope of the CO following the changes introduced by the EMIR REFIT? What risks/ benefits do you see with this approach?

Exemptions

5.7 MiFID II provides an exemption from the DTO for the termination or replacement of component derivatives in portfolio compression. The exemption intends to enable technical trades - that reduce the risk of positions that market participants have entered into - to take place in an efficient manner. However, there are other post-trade risk reduction services, including cover rebalancing and optimisation services, that do not currently benefit from the DTO exemption.

5.8 The government is not aware of any reason why the current exemption should not be extended to all post-trade risk reduction services. In fact, market participants and regulators have argued that exempting other post trade risk reduction services would help to reduce systemic risk. The government is therefore proposing to extend the exemption from the DTO to all components resulting from non-price forming post-trade risk reduction services.

5.9 To ensure that the exemption is used as intended and to maintain market integrity, the government is considering setting out conditions that need to be met for the exemption to be applicable. For example, a requirement for the same counterparties involved in the original transaction(s) to be part of the post-trade risk reduction service.

5.10 The government is also considering whether there would be benefits in providing for such an exemption to the derivatives clearing obligation.

Box 5.B: Questions

42 Do you think that all post-trade risk reduction services should be exempt from the DTO?

43 If you answered yes to question 42:

a) Do you think that there should also be an aligned exemption from the EMIR clearing obligation for trades resulting from post-trade risk reduction services?

b) What conditions do you think should be met for the exemption to be applicable?

FCA powers

5.11 In December 2020, the FCA announced that it would use its temporary transitional powers (TTP) to amend the scope of the UK DTO. The FCA has used the TTP to allow UK firms to use EU venues, irrespective of the DTO, when trading with an EU client who does not have access to a venue that both the UK and EU have granted equivalence to. The FCA's use of their TTP has limited disruption for market participants and prevented liquidity fragmentation that would have arisen from conflicting UK and EU DTOs after the end of the transition period.

5.12 The FCA's use of the TTP has demonstrated that granting the FCA the power – within certain boundaries – to suspend or modify the DTO can improve market functioning and resilience. To help protect UK markets in the event of an unexpected change in global markets or wider market disruption, the government proposes to grant the FCA a permanent power to modify or suspend the application of the DTO. However, this power could only be used after consultation with HMT.

Box 5.C: Question

44 Do you think the FCA should be given the power to modify or suspend the DTO quickly under certain circumstances, on a permanent rather than temporary basis?

Section 2: Transparency

Background

5.13 As outlined in the introduction, in 2018 the MiFID pre- and post-trade transparency regime was extended to cover bonds, ETCs, ETNs, structured finance products, emission allowances and derivatives. It was also expanded to cover trading conducted on newly defined OTFs, which previously took place OTC.

5.14 Although the MiFID II transparency regime intended to accommodate the specific characteristics of equity and non-equity markets, it does not go far enough in accounting for the fundamental differences between and within the two categories of markets. For example, it does not acknowledge that the nature and depth of liquidity is fundamentally different for fixed income and derivative instruments compared to equities. This has resulted in a number of bespoke illiquid instruments falling within scope of the regime, while some liquid and standardised contracts are not subject to any transparency requirements.

5.15 The current framework is also based on an inaccurate assumption that transparency, especially pre-trade, plays the same role in fixed income and derivatives markets as it does in equities. Unlike equity markets where transactions are typically executed on electronic order books, most fixed income and derivatives transactions occur through voice, request-for-quote (RFQ) systems, or bilateral negotiation - with the notable exceptions of some exchange-traded and OTC derivatives.

5.16 The government also believes that the vast number of exemptions from post-trade transparency requirements have made the regime overly complex and costly. It has also made it difficult for the market to view actual traded prices. The government is therefore proposing a number of significant changes that are aimed at creating a more tailored regime that supports open and competitive markets, and that seek to achieve greater transparency in a more cost-effective way.

Proposed Changes

Scope

5.17 The type of financial instruments that are in scope of pre- and post-trade transparency is determined, according to MiFIR, on the basis of whether the financial instrument or class is admitted to trading or traded on a trading venue (ToTV). The concept of ToTV is relevant for other provisions in MiFID II, such as transaction reporting, but it is not a defined term under MiFID II. This has created ambiguity in relation to the boundaries of the transparency regime for OTC derivatives.

5.18 The current regulatory guidance for investment firms dealing OTC is that they should consider any OTC derivatives to be within the scope of the regime where they share the same characteristics of derivatives already traded on trading venues (i.e., instruments that are captured in the Financial Instruments Reference Data System (FIRDS)). However, the methodology that is used to create International Securities Identification Numbers (ISINs) - which are used to identify securities - is less effective at identifying OTC derivatives within the same class but with different contractual elements than transferable securities. The reason for this is that most OTC derivatives have different ISINs that distinguish contracts within economically similar classes of derivatives. This can make it difficult for firms to assess whether comparable products exist, and has resulted in a number of OTC derivatives that are liquid and standardised inadvertently falling outside of the scope of the regime.

5.19 Past industry analysis has highlighted that as little as c.2% of OTC derivatives ISINs are included in FRDS. In addition, many OTC derivative contracts that are subject to transparency requirements use post-trade deferrals, further compounding the lack of transparency.

5.20 As transparency plays an important role in price discovery, the government is considering how it can amend the scope of the transparency regime to increase OTC derivatives transparency whilst removing contracts that do not need to be included.

5.21 One approach that the government is considering to address the issues ToTV has caused for OTC derivatives is to remove the concept of ToTV completely. Instead, the scope of the transparency regime for OTC derivatives transactions executed outside of trading venues would be determined by whether a transaction is centrally cleared- either when mandated by the clearing obligation, or cleared voluntarily. Bank for International Settlements data from 2020 shows that for some of the key OTC derivatives, clearing rates are sufficiently high to ensure that a large amount of the market would be within the scope of transparency. For example, for interest rate derivatives the clearing rate at end-June 2020 was close to 80%. The government therefore believes that requiring pre- and post-trade reporting for cleared OTC derivatives would resolve the ambiguity that exists in the concept of ToTV for OTC derivatives. It would also lower operational complexity while ensuring that all standardised and liquid derivatives, for which post-trade transparency is more valuable, continue to support price formation.

Box 5.D: Questions

45 Do you think that the current transparency requirements support price formation and open, competitive and fair markets? Please separate your answers by fixed income (please treat sovereign bonds, high-yield bonds and investment-grade bonds separately) and derivatives (please distinguish between OTC and exchange-traded derivatives (ETDs) where relevant).

46 Do you think that using ToTV is a useful criterion for determining the scope of transparency requirements for non-equity instruments, and in particular OTC derivatives? Please separate your answers by fixed income (please treat sovereign bonds, high-yield bonds and investment grade bonds separately) and derivatives (please distinguish between exchange treaded and OTC derivatives).

47 If you answered no to question 46:

Do you think the concept of ToTV should be removed for OTC derivatives, and the scope of the transparency regime determined on the basis of whether the instrument is cleared? If so, what definition of 'cleared' should be used?

48 Do you think there is another option to determine the scope of the fixed income and derivatives transparency regime? Please separate your answers by fixed income (please treat sovereign bonds, high-yield bonds and investment-grade bonds separately) and derivatives (please distinguish between exchange traded and OTC derivatives).

49 What instruments do you think should be in scope of the fixed income and derivatives transparency regime? Please consider fixed income (please treat sovereign bonds, high-yield bonds and investment-grade bonds separately) ETCs, ETNs, structured finance products, emission allowances and derivatives (please distinguish between exchange traded and OTC derivatives).

Liquid market determination

5.22 As outlined above, the MiFID II transparency regime for fixed income and derivative instruments is very broad. Similar to the regime for equities, the transparency regime for fixed income and derivative instruments requires trading interests and transactions to be made public in real time. However there are exemptions from these requirements when an instrument does not have a liquid market, or when the order/transaction is large in size (LIS). To determine whether an instrument has a liquid market or is LIS, the FCA uses trading data to complete liquidity calculations/assessments on a quarterly or annual basis, depending on the instrument.

5.23 Although liquidity calculations seem to work well for equities - that are often standardised and traded frequently - the government believes they do not work effectively for fixed income and derivative instruments. For fixed income, this is because instruments are often traded infrequently. For example, corporate bond trading is episodic and mostly concentrated around issuance and corporate action events. This means calculations based on past data are not agile enough to reflect the changing liquidity profile. For commodity derivatives, it is because the aggregation of instruments -which are not fungible- overstates the amount of liquidity in individual contracts and subjects them to transparency requirements that are not appropriate for their true liquidity profile.

5.24 Analysis conducted by the FCA, which compares the liquidity status of a random group of bonds as determined by the calculations against their "true" liquidity status, shows that bonds deemed illiquid are highly likely to be illiquid (95% – 100% accuracy rate). Between 52% and 69% of the corporate bonds that were included in the FCA's study and which were determined as liquid under the MiFID II calculations, were in fact illiquid. This suggests that despite the frequency with which calculations are performed, the results are inconsistent.

5.25 As liquidity calculations do not appear to have provided consistent results and are a burdensome approach to measuring liquidity, the government is considering replacing them with a qualitative and quantitative assessment to determine the liquid classes of financial instruments. This approach would use information in a similar way to the information that is currently used for OTC derivatives that are subject to the DTO. The government believes that this would result in a more proportionate and accurate regime, that correctly identifies liquid and illiquid instruments, and as a result aids price formation.

Box 5.E: Questions

50 What changes do you think are needed to enable liquidity calculations to work effectively? Please separate your answers by fixed income (sovereign bonds, high-yield bonds and investment-grade bonds) and derivatives (ETDs and OTC derivatives).

51 Do you think it would be preferable to move away from regular liquidity calculations towards a mix of qualitative and quantitative criteria? For example, on a sectoral basis? Please separate your answers

by fixed income (sovereign bonds, high-yield bonds and investment-grade bonds separately) and derivatives (ETDs and OTC derivatives).

Pre-trade transparency

5.26 MiFID II established a very broad pre-trade regime for fixed income and derivatives markets. It requires any bid and offer prices that are broadcast through a venue's systems to be disclosed to the public. However, a complex system of waivers – which are supported by transparency calculations – offer exemptions from pre-trade transparency requirements if: there is no liquid market for the instrument in question; if an order is large in size (with extra conditions on the trading protocol and partial transparency requirements for smaller sizes specific to the instrument); if the instrument is held in an order management facility; or if it is part of a package order or an exchange for physical (EFP) transaction.

5.27 The available evidence from the operation of the MiFID II transparency regime for bonds and derivatives is that the application of pre-trade transparency to such markets has not worked effectively. This is because, order books (which list bids and offers for all instruments), are not widely used by fixed income and derivatives traders. Instead, liquidity is usually provided on a request for quote basis, or instruments are traded of bilaterally. The reason for this is because a lot of fixed income and derivative instruments are bespoke, illiquid and complex.

5.28 To ensure that the pre-trade transparency regime is correctly calibrated, the government is proposing to limit the scope of the regime to systems such as electronic order books and periodic auctions, that currently operate under full transparency. This would mean that bespoke trades that are traded bilaterally, where pre-transparency does not play an important role, are exempt from the regime. However, more liquid instruments that tend to be traded on an order book would remain in scope. More broadly, this approach would give investors some degree of optionality as to whether they opt for pre-trade transparency and thus execute on an order book, or prefer to utilise an RFQ method and limit pre-trade transparency. This would sit alongside improvements to post trade transparency (set out later in this chapter) that would allow for price formation and competition.

5.29 More broadly, the government would like to understand how firms currently use pre-trade data - as required under MiFID II and other forms of pre-trade information, such as quotes occurring naturally in the market- and if a more fundamental review is needed.

5.30 As well as reforming the scope of the pre-trade transparency regime, the government recognises that the current regime for waivers could be simplified. However, the government is keen to understand industry's views on the pre-trade transparency regime more broadly before consulting on specific proposals to the waiver regime. If appropriate, the FCA may also consider amendments to waivers in due course.

Box 5.F: Questions

52 How do you currently use pre-trade transparency? Is pre-trade information on bonds and derivatives valuable? Please differentiate between fixed income (sovereign bonds, high-yield bonds and investment-grade bonds separately) and derivatives (ETDs and OTC derivatives), and each trading method (for example RFQ, and order book).

53 Is there a case for removing MiFID II pre-trade transparency requirements for any asset class? Please separate your answers by fixed income (sovereign bonds, high-yield bonds and investment-grade bonds separately) and derivatives (ETDs and OTC derivatives).

54 If you answered yes to question 53:

Do you think that RFQ, bilateral negotiations and indications of interest provide sufficient information for markets to function effectively? Please separate your answers by fixed income (sovereign bonds, high-yield bonds and investment-grade bonds separately) and derivatives (ETDs and OTC derivatives).

55 How do you use pre-trade quotes streamed by SIs? Please separate your answers by fixed income (sovereign bonds, high-yield bonds and investment-grade bonds separately) and derivatives (ETDs and OTC derivatives).

56 For SIs, what impact do you think removing pre-trade transparency requirements would have on your business? Please separate your answers by fixed income (sovereign bonds, high-yield bonds and investment-grade bonds separately) and derivatives (ETDs and OTC derivatives).

57 Do you have any other comments on the pre-trade transparency regime?

Post-trade transparency

5.31 MiFID II stipulates that transactions in fixed income and derivative instruments must be made public in real time (within five minutes of execution) except where post-trade deferrals apply. Currently, the publication of trades that are: (a) LIS (i.e. block trades); (b) deemed illiquid according to liquidity calculations; (c) above a size specific to the instrument (SSTI), or; (d) package orders, can be deferred for up to four weeks, or in the case of sovereign bonds, indefinitely. When a trade qualifies for a standard deferral (T+2), a number of supplementary deferrals also become available. These can take the form of aggregation of trades published weekly, to partial publication where transaction volumes are masked for the period of the deferral. This means that when and if transactions are eventually fully published, a significant amount of time will have elapsed, and the content of the publication is no longer useful to market participants.

5.32 The complex assortment and long length of deferrals have compromised transparency objectives. Feedback from industry also suggests that the number and types of deferrals are confusing and do not support best execution.

5.33 To increase transparency and aid the price formation process in fixed income and derivatives markets, the government is considering refocusing the regime and reducing the number of deferrals that are available. Under this proposal, the government would remove the SSTI, package order, and EFP deferrals, which market participants have described as ineffective. The LIS deferral would remain in place for block trading in liquid instruments, and the illiquid deferral would be retained for instruments that cannot support real time transparency. This would ensure that firms can trade large blocks or illiquid instruments without undue risk and are not subject to unnecessary burdens. Alongside these reforms, to ensure that these waivers work effectively, and to limit market risk while encouraging timely price information, the government is proposing to allow comprehensive volume-masking.

5.34 The government believes that the length of the LIS and illiquid deferrals could be calibrated differently, with shorter delays for LIS transactions in liquid instruments, and longer deferrals for illiquid instruments. The calibration of the deferrals would be determined by the FCA following consultation.

5.35 Alongside these changes to the LIS deferral, the government is considering reverting to the pre-MiFID II situation, where trading venues calculated LIS thresholds for ETD post-trade reporting. Market participants have commented that the pre-MiFID II approach worked well and ensured that the right instruments were in scope of the transparency regime. Under this scenario, the FCA would set out principles that ETD trading venues would have to comply with to ensure a consistent approach. The FCA would also continue to set LIS thresholds for all other asset classes.

Box 5.G: Questions

58 How do you currently use deferrals? Please separate your answers by fixed income (sovereign bonds, high-yield bonds and investment-grade bonds separately) and derivatives (ETDs and OTC derivatives).

59 Which asset classes should deferrals apply to? Please separate your answers by fixed income (sovereign bonds, high-yield bonds and investment-grade bonds separately) and derivatives (ETDs and OTC derivatives).

60 Do you agree that the deferral regime would benefit from being simplified?

61 What do you think the optimum deferral length is? Please separate your answers by fixed income (sovereign bonds, high-yield bonds and investment-grade bonds separately) and derivatives (ETDs and OTC derivatives).

62 What are your views on the government's proposal to delete the SSTI, package order, and EFP deferrals? Do you think it would lead to more meaningful transparency? Please separate your answers by fixed

income (sovereign bonds, high-yield bonds and investment-grade bonds separately) and derivatives (ETDs and OTC derivatives).

63 Do you think volume masking and/or aggregation helps to encourage real time publication? Please separate your answers by fixed income (sovereign bonds, high-yield bonds and investment-grade bonds separately) and derivatives (ETDs and OTC derivatives).

64 What are the risks and benefits of allowing trading venues to calculate LIS thresholds for ETD post-trade reporting?

Chapter 6
Commodity Markets

Background

6.1 The UK is home to some of the largest commodity and commodity derivative markets in the world, and they play a key role in establishing prices globally. Commodities derivatives are regulated under both FSMA and the MiFID II framework, but many substantive elements of the regime are contained within MiFID II. Firms which fall within the commodities regime are required to comply with a number of requirements that are specific to commodity derivatives markets, such as position limits, as well as the transparency and trading requirements that apply to all derivative market participants. Reforms to the latter are discussed in Chapter 5 (Fixed Income and Derivatives Markets).

6.2 The specific regime for commodity derivatives was originally introduced as a response to high price volatility in the physical oil and agriculture markets in the mid-2000s. It was intended to align with the G20's 2011 commitment to give market regulators effective intervention powers to mitigate against market abuse in commodity derivatives markets.

6.3 The government remains firmly committed to the objectives of fair and efficient markets and to the G20 commitment. However, the government has always believed that the MiFID II commodity derivatives regime is poorly designed and inefficient. The government is therefore proposing to fundamentally reform the regime. The aim of these reforms is to remove requirements that are excessive and have failed to bring about their intended effect, and therefore make the regime more effective, proportionate and less burdensome.

6.4 Earlier this year, the EU legislated for a number of amendments to the commodity derivatives regime. These include limiting the scope of the overall regime as well as the position limits regime, and simplifying the ancillary activities exemption. The EU's reforms have gone some way in reducing unnecessary burdens on firms that are active within EU markets. However, because they were made after the end of the Transition Period these reforms do not form part of EU retained law. While the government understands the intention behind the EU's changes, it believes there is potential for the UK to go further to ensure that the commodity derivatives regime is capable of best serving UK and global markets in the long term.

Proposed Changes

Scope

6.5 The definition of a 'commodity derivative' in MiFID II determines which instruments are subject to position limits and position reporting requirements. It also determines which instruments are included in the calculations which firms trading in commodity derivatives have to undertake to ascertain whether they need to be authorised under the regime. The definition is currently very wide-ranging, complex and is not strongly linked to the MIFID II definition of a 'commodity'[1]. For example, it includes a number of instruments which do not relate to physical commodities, such as exotic derivatives based on climatic variables. Unlike derivatives based on physical commodities, these derivatives are intangible, which means the application of some elements of the commodity derivatives regime is often redundant or difficult to achieve. The government is therefore proposing to remove derivatives that are not based on physical commodities from the scope of the regime.

6.6 The current definition also captures other types of financial instruments which refer to commodities as a pricing element but are securities in their legal form. These securities were included in the MiFID II regime to ensure a broader application of the regime across the EU, as they are used by investors in some EU Member States as an alternative to futures or options. However, their link to the underlying market for physical commodities, and the potential for them to be used to commit market abuse, is weak. Furthermore, the government is not aware of any such instruments existing in the UK, and believes that their inclusion in the commodity derivatives regime may prevent the growth of such a market. The government therefore believes there is no need to subject them to burdensome and unnecessary requirements, and is proposing to remove them from the definition.

6.7 OTC contracts that are economically equivalent to exchange traded commodity derivatives are also captured by the MiFID II regime. The objective of including them as part of the regime was to prevent market participants from circumventing regulatory requirements that are applicable to exchange traded commodity derivatives by dealing in lookalike OTC contracts. However, in practice, identification of these contracts has proven difficult, and they have only been reported in a very small number of instances. In line with feedback from market participants, the government believes that the inclusion of these contracts and uncertainty about the scope of this requirement imposes increased legal risk and potential compliance costs for firms. To provide certainty, the government intends to remove the automatic inclusion of economically equivalent OTC commodity derivatives from the scope of the regime. However, to ensure market integrity, the government proposes that the FCA and trading venues should continue to take account of relevant OTC contracts when monitoring markets.

Box 6.A: Questions

[1] 'commodity' means any goods of a fungible nature that are capable of being delivered, including metals and their ores and alloys, agricultural products, and energy such as electricity (COMMISSION DELEGATED REGULATION (EU) 2017/565)

65 Do you think that the scope of the ‘commodity derivatives’ regime should be narrowed to derivatives that are based on physical commodities?

66 Do you think that financial instruments which refer to commodities as a pricing element but are securities in their legal form, should be removed from the regime?

67 Do you think economically equivalent OTC commodity derivative contracts should be removed from the commodity derivatives regime?

68 Are there any other instruments that you think should be deleted from the commodity derivatives regime?

Position Limits

6.8 The MIFID II position limits regime imposes limits on the maximum size of a net position that a person can hold in a commodity derivative that is traded on an exchange, or in economically equivalent OTC contracts. Position limits were introduced in MiFID II with the objectives of preventing market abuse and ensuring orderly trading and settlement of commodity derivatives. Under the MiFID II framework, the FCA is required to establish and enforce position limits for all exchange traded commodity derivative contracts. In practice, this means that they are obliged to set and monitor position limits on around 800 contracts in the UK. Additionally, UK trading venues are required to establish and operate their own position management controls (for example, to monitor positions and require a person to terminate or reduce a position if necessary, to ensure that markets function with integrity).

6.9 Prior to MiFID II, trading venues were responsible for setting controls to ensure orderly trading, settlement and delivery. These controls gave them the option to implement various forms of position limits. Feedback from market participants suggests that this approach generally worked well.

6.10 The government supports the original rationale behind the EU’s original position limits policy, which was to promote fair and effective commodities markets. However, it recognises that the current approach is overly complicated compared to the pre- MiFID II approach, and has led to position controls often being duplicated across trading venues and the FCA. The government also believes that the current scope of the regime is disproportionate and unnecessarily prevents liquidity from developing, to the detriment of all market participants. This is most pronounced in the markets for niche or illiquid commodities, where there are few users and low levels of systemic risk.

6.11 In light of this, the government is proposing to revoke the requirement for position limits to be applied to all exchange traded contracts, and to transfer the setting of position controls from the FCA to trading venues. Under this proposal, the FCA would provide a framework to set expectations on how venues should manage positions. This would include the broad objectives which venues should take into account when setting limits, such as an obligation to set minimum limits for contracts that are physically settled, or where the underlying commodity is an agricultural product. The government believes that requiring trading venues to set position limits for agricultural contracts (which have historically been subject to more market volatility), and physically settled contracts (which pose increased risk to the pricing of the underlying commodity and the settlement process), is needed to ensure that the UK upholds its G20 commitment to promote integrity in commodity markets. However, trading venues are well placed to evaluate the risks of disorderly trading in all other contracts, including cash-settled commodity derivatives, and to consider whether additional controls are necessary.

6.12 To mitigate against financial stability risks and protect market integrity, the government is proposing that the FCA retains its ability to intervene if there is evidence of market volatility. To enable the FCA to do this effectively, the government suggests that the FCA could continue to receive commodity derivative position reports on a daily basis.

6.13 The government believes that this approach will strike the right balance between achieving a base level of consistency which ensures the regime continues to apply to contracts that genuinely pose a risk to market integrity, while allowing exchanges to use their visibility of all positions to enforce limits which are appropriately tailored to market dynamics. It will mean that strict, universal limits which arbitrarily restrict market activity will be avoided.

Box 6.B: Questions

69 What would be the risks and benefits of transferring responsibility for position limits from the FCA to trading venues?

70 Under this model, what specific factors do you think should be addressed in the framework of requirements that UK authorities would provide for trading venues?

71 Do you think that the scope of contracts that are automatically subject to position limits should be limited? If yes, do you think that it should be limited to contracts that are critical or significant, which includes those that are physically settled, and agricultural?

Position Limits Exemptions

6.14 Under the MiFID II framework, non-financial market participants can obtain a position limit exemption from the FCA in order to hedge against potential commercial risk. However, regulated firms cannot obtain an exemption. This means that non-financial firms have difficulty finding a regulated counterparty that is willing and able to accept the other side of their hedging trade, because it often requires regulated firms to breach position limits.

6.15 Hedging is an important part of risk mitigation and provides liquidity to the market. In light of this, in December 2020, the FCA announced that from 1 January 2021 it would not take supervisory or enforcement action for breaches of position limits where the breach arises from a position held by a liquidity provider to fulfil its obligations to provide liquidity on a trading venue.

6.16 The government recognises that for markets to function effectively, participants must be able to both find and provide liquidity. For this reason, the government proposes that the exemptions regime should be extended to all liquidity providers. This would formalise the supervisory approach that the FCA announced in December 2020. The government believes that it is important for the regime to include a 'pass-through' hedging exemption, so that investment firms can be exempt from the regime when delivering a wider range of risk-mitigation services. Under this model, regulated firms would be allowed to facilitate hedging activity for a commercial entity, even in situations where the risk being hedged arises off-exchange or on a different trading venue. This would ensure that the regime is applied consistently and would incentivise commercial entities to more reliably invest in commodities markets, therefore contributing to growth in the real economy.

Box 6.C: Questions

72 Do you think that the UK commodity derivatives regime should allow position limits exemptions for liquidity providers?

73 Do you think that the UK commodity derivatives regime should introduce a 'pass through' hedging exemption to enable investment firms to support a wider range of hedging practices?

74 Do you think any other activities should be exempt from the regime?

Position Reporting

6.17 Under the MiFID II framework, trading venue members and participants must report their positions in all exchange traded derivatives to relevant trading venues on a daily basis. These reports must include the positions of their clients (if applicable) and any clients further down the chain, including the end client. Trading venues are required to provide these reports to the FCA at the end of each trading day.

6.18 The government believes that the position reporting regime generally works effectively and provides a valuable source of market data to trading venues, who use it as part of their position management. It is also beneficial for the FCA, who use the data for ongoing market monitoring and to inform future policy development. The government is also aware that investment firms have faced significant costs and burdens implementing reporting systems for MIFID II.

6.19 The government is therefore not considering fundamental changes to the reporting regime. However, it recognises that small amendments may help to reduce burdens on firms without compromising data quality. For example, some market participants have commented that there may be ways to improve the nature of the categories under which UK firms are obliged to report positions.

6.20 The government welcomes any specific proposals on how the effectiveness of the reporting regime can be strengthened, without restricting the valuable information that is currently provided.

Box 6.D: Question

75 Are there areas of the UK's position reporting regime which could be improved?

Ancillary Activities Test

6.21 MiFID II uses the ancillary activities test (AAT) to determine if the activities of a firm trading commodity derivatives are primarily for investment purposes or if they support the firm's commercial business, and therefore do not need to be authorised as an investment firm.

6.22 The AAT is based on quantitative criteria which requires firms to perform complex calculations and process substantial volumes of historical trading data, before notifying the FCA of the outcome of the assessment. Despite firms expending significant resources complying with the AAT, since the test was introduced in 2018 no UK firms have exceeded the threshold of speculative trading activity. Therefore, no unregulated firms have been required to obtain regulated status. The FCA has also incurred substantial costs in monitoring compliance and maintaining records from unregulated firms on the outcomes of these assessments.

6.23 Prior to MIFID II, the UK used a qualitative test to determine whether firms participating in commodity derivatives markets needed to be regulated. The FCA and industry have reported that this approach was preferable as it was more streamlined, proportionate and cost effective.

6.24 The government is therefore proposing to revert to a principles-based approach, which takes into account the nature of a firm's business more holistically. Under this proposal, the FCA would be responsible for setting out qualitative criteria for the assessment which would achieve the same intended outcome as the current test. To ensure market integrity, regulators would still be able to request evidence (including data) from any firm, if needed, to validate their status as being exempt from authorisation. The government believes that such an approach would ensure that firms can clearly understand the basis and expectations of the test, while removing the overly complicated and burdensome quantitative process.

6.25 The government also believes that the test should not be based solely on historical activities, as feedback from regulators and the market suggests that the current backward-looking approach introduces legal risk and commercial disruption. Instead, the government is proposing that the test should be based on a proactive assessment of a firm's expected activity. This would provide more clarity, enable a better and more holistic assessment, and ensure that firms which trade commodity derivatives on a scale and in a manner which represents conducting investment business, are required to be properly authorised.

6.26 Under the MiFID II framework, firms which trade commodity derivatives for commercial purposes are required to notify the FCA every twelve months to confirm that they have performed the AAT and can remain unregulated. However, the government understands that these notifications provide very limited value and constitute a significant administrative burden on both firms and the FCA. Such notifications are not required from any other type of firm which makes use of an exemption from regulation. Furthermore, the notification processes introduce compliance risks for firms that are otherwise legitimately unregulated. The government therefore intends to abolish the annual notification requirement. This will remove unnecessary burdens, without having a negative impact on the integrity of the UK's commodity derivative markets.

Box 6.E: Questions

76 Do you think that the AAT should revert to a qualitative assessment of the activities performed by a market participant?

77 Do you think that the basis of the AAT should be expected activity, rather than historic activity?

78 Do you agree that the annual notification requirement should be abolished?

The Oil Market Participant (OMP) and Energy Market Participant (EMP) regimes

6.27 The UK's regime for commodities contains separate regulatory regimes firms which are referred to as the oil market participants (OMP) and energy market participants (EMP) regimes. The OMP and EMP authorisation statuses are specific applications of the requirements contained within FSMA, for firms that undertake a limited range of activities.

6.28 In 2001, the FCA's predecessor, the Financial Services Authority (FSA), inherited the regulation of these firms from the Securities and Futures Authority (SFA), which had overseen their authorisation since the implementation of the Financial Services Act 1986. When the regimes were introduced, the government's intention was that they would only apply for a limited period of time. However, both regimes are still applicable, and currently a small number of firms hold the relevant permissions and are subject to a limited set of FCA rules.

6.29 The government believes that the regulatory costs placed on the firms that use these regimes are disproportionate to the risks that they pose to commodity derivatives markets. As the regime is established within the FCA Handbook, changes to FSMA are not necessary to abolish the OMP and EMP regimes. However, the government intends for these firms to become authorised under MiFID II, unless the reformed AAT deems this unnecessary. The benefit of this would be to ensure consistency and simplicity in the UK's approach to regulation of market participants.

Box 6.F: Questions

79 Does the continued existence of the separate OMP and EMP regimes for commodity derivative market participants serve any meaningful purpose?

80 Do you think that the OMP and EMP regimes should be removed as particular regulatory statuses from the UK's regulatory perimeter?

81 Do you think any changes would need to be made to the MiFID II regime, if the OMP and EMP regimes are removed as particular regulatory statuses?

Chapter 7

Market Data

Background

7.1 Market data is fundamental in helping participants identify investment opportunities and evaluate positions, and is essential for price formation and best execution.

7.2 In an attempt to make data more accessible and easier to use, MiFID II requires trading venues and approved publication arrangements (APAs) to make data available on a 'reasonable commercial basis' (RCB). The RCB provision stipulates that data must be provided to the market at a reasonable fee, and made free 15 minutes after its initial publication. In an effort to improve data standards, MiFID II also set up a framework for a consolidated tape (CT), to collect unified post-trade reports for financial instruments from trading venues and APAs, and to then consolidate them into a continuous electronic live data stream.

7.3 However, the government believes that MiFID II has not achieved its aim of making standardised data easily accessible to market participants. This is because obligations such as RCB have not succeeded in facilitating data access, and there is inconsistency between the comparability, usability and quality of information that is published by different venues and APAs. A CT has also failed to emerge, which means firms have to go to each data source separately to access market data. This is costly, time consuming and burdensome, particularly because there is no standardisation of data across trading venues and APAs.

7.4 Given the important role that market data plays in helping markets to function efficiently, the government is keen to improve the quality and usability of market data to enhance the effectiveness and attractiveness of UK markets, and is committed to help progress the emergence of a consolidated tape.

Proposed Changes

Consolidated tape (CT)

7.5 Although a tape has not materialised the government believes that a CT is one of the best ways of increasing data standardisation and accessibility. Feedback from market participants suggests that a CT would help to:

- Improve data quality, particularly for fixed income markets where trading is relatively infrequent compared to equities, and for derivatives markets which suffer from poor standardisation and a lack of meaningful transparency.

- Facilitate data access, for example by addressing the high cost of data. Evidence suggests that when data is more widely available it is easier for market participants to meet best execution requirements and manage risk.

- Provide the market with a reference price if the primary market is down.

7.6 Engagement that the government has had with industry has demonstrated that there is support for an equity tape that covers both pre-trade and post-trade data, as well as a fixed income tape that covers post-trade data. The government is of the view that there is more urgency to develop a CT for fixed income data. This is because fixed income trading is less concentrated than equity trading, and a greater proportion is executed over the counter rather than on venues. This means that standardisation, or a lack thereof, is a more significant issue for fixed income markets. Additionally, because of flaws in the current transparency regime for fixed income and derivatives markets, there is less visibility on liquidity.

7.7 Despite there being widespread calls for a CT, opinions vary and differ among market participants on the optimal scope and model of a CT. The government would therefore like to understand industry's views on two potential options for a fixed income consolidated tape in the UK.

A. Changes to legislation to enable a private sector tape

7.8 Under MiFID II, an equity CT is required to obtain data and provide 100% coverage of equity trading activity, whereas a fixed income CT is only required to cover 80% of fixed income trading activity. For both asset classes, the CT provider must meet a number of governance provisions, such as an obligation to maintain effective administrative arrangements to prevent conflicts of interest. The CT also has to comply with the RCB provision. Feedback from industry has suggested that these requirements, together with lack of a viable commercial model, are the primary reasons why a private sector tape has not emerged.

7.9 When MiFID II was being negotiated, the government supported the creation of a private sector CT. The government continues to believe that a market-led solution is preferable as it would help drive competition and efficiency, and lower prices. To enable a private CT to emerge, the government is proposing to:

- <u>Make it mandatory for trading venues and APAs to submit their data to a CT.</u> This would overcome current issues that potential CT providers have faced in trying to access data at a price that allows them to consolidate it, without charging overly high fees to end users of the CT. The government would need to consider whether any fees or charges would be appropriate as part of this change.

- <u>Remove the requirement for CTs to provide 100% coverage of equity trading activity or 80% coverage of fixed income trading activity,</u> as analysis shows that 100/80% coverage is not needed to effectively support price formation and best execution. The government would need to consider if the requirement should be deleted in full or replaced with a lower limit.

- <u>Remove the requirement for CT providers to provide their data streams for free after 15 minutes</u>. As outlined above, the RCB provision (which currently applies to CTs) stipulates that data must be made free 15 minutes after its initial publication. This has played a significant role in preventing potential CT providers from developing a tape, because the volume of users who would likely wait to access the data after 15 minutes means that there would not be enough demand from paying users to recover the cost of running the CT.

- Simplify and standardise fixed income deferrals to allow effective consolidation. These proposals are outlined in chapter 5 (Fixed Income and Derivatives Markets).
- Require any private sector tape to have a balanced governance structure that represents providers and consumers, and to operate in a transparent and accountable way. This would help to ensure that the CT(s) is balanced and makes decisions in a fair manner.

7.10 The government welcomes industry's views on these suggested changes and whether other changes would be needed to enable a private sector tape to emerge. The government also welcomes views from industry on whether a single tape for each class, or multiple competing tapes per asset class would be preferable.

B. Public sector involvement in creating and running a tape

7.11 Alternatively, the government is aware that some industry participants would like the public sector to play a more active role in the creation and ongoing governance of a CT. It has been suggested that alongside making the legislative changes outlined above, UK authorities could work with a cross section of industry representatives to develop a CT, and play an ongoing role in its governance to ensure neutrality. The government is conscious that whilst this model would probably ensure the development of a CT, it would not promote a competitive environment for CTs. The government would also have to ensure that the sector appropriately contributed to the cost of such a service. However, it welcomes views from industry on public sector involvement in running a tape.

Box 7.A: Questions

82 Do you agree that the government should take action to encourage the development of a CT?

If you answered yes to question 82:

83 Do you think a fixed income tape should be prioritised?

84 Do you think that it would be beneficial for a fixed income CT to include post-trade data only, or would there be value in a tape covering pre-trade data too?

85 Is there any value in a delayed data CT for fixed income markets?

86 Is it valuable for an equity CT to include pre- and post-trade data?

87 Is there any value in a delayed data CT for equity markets?

88 Should the government amend legislation to enable a market-led private sector CT to develop, or do you think UK authorities should be actively involved in creating a CT?

89 What are the legislative barriers for a private sector-led CT to emerge? Do you agree with the legislative changes identified above? Are there additional changes that UK authorities should be considering?

90 Do you see any risks with removing the obligation for CTs to provide data for free after 15 minutes?

91 What are the potential advantages and disadvantages of multiple private-sector CTs for each asset class?

Other changes to data

7.12 The FCA's Call for Input (CfI) on market data which closed on 21 January, sought to explore how market data is accessed, used and priced. The scope of the CfI included both regulated and non-regulated activities. The FCA is planning to publish a Feedback Statement in response to the CfI later this year, which will set out the findings and any next steps. The government will take note of this review when developing policy. However, as the quality of data reporting can largely be dealt with through changes to the FCA rulebook, the government is not considering any changes at this moment in time.

Box 7.B: Question

92 Do you have any suggestions on further areas that UK authorities should be considering when making changes to market data, especially in relation to requirements that are set out in legislation?

Chapter 8
Reporting

Trade and transaction reporting – MiFID II

8.1 The MiFID II framework has two reporting regimes: one for trades and one for transactions. Trade reporting requires trading venues and investment firms to publish basic information (for example about volume and price) within one minute of an equity transaction, and within 5 minutes of the execution of a non-equity transaction. Investment firms submit their trade reporting data to an Approved Publication Arrangement (APA), which makes the information public. The data that is collected from this reporting helps to aid price formation and best execution, and promotes the efficient functioning of UK markets.

8.2 Transaction reports are more detailed and include information about the instrument, the buyer and seller. They are required to be reported to the FCA no than the following working day after a transaction is executed. Transaction reports are not made public and are primarily used to detect and mitigate market abuse.

8.3 Feedback from industry suggests that transaction reporting is generally working well. However, the government is aware that there is some confusion over who is responsible for reporting information about trading. To mitigate this, Chapter 3 (Systematic Internalisers) includes a proposal to clarify that SIs can fulfil the trade reporting obligation at an entity, rather than instrument level. This should remove any confusion about whether the buy-side should be reporting trades themselves.

8.4 The government is not currently proposing to make any further amendments to the reporting regime. However, the government would like to gather views on whether there is scope to make requirements more efficient in the long-term. Separately, the FCA intends to consult on potential amendments to the transaction reporting regime later this year.

Overlap in Reporting requirements

8.5 A number of firms have commented on the overlap between reporting requirements in MiFID II, and EMIR. The government is keen to understand where the overlaps lie, and invites feedback from industry on this point. The government is also aware of concerns that industry have raised about MiFID II and EMIR using different reporting formats. These regimes are important for UK authorities who use them to monitor market abuse as well as systemic and financial stability risks. The government is not proposing any changes to the regime at this moment in time, but would like to understand exactly where the overlaps lie. The government invites feedback from industry on how the regimes could be aligned in a way that would not negatively impact the information that UK authorities need to fulfil their statutory objectives, or result in significant operational and compliance costs for firms.

8.6 The FCA and Bank of England are currently using the Temporary Transitional Power (TTP), under Part 7 of the Financial Services Act 2000 (Amendment) (EU Exit) Regulations 2019 which it was granted under the EU Withdrawal Act. This has had the effect limiting the overlap in reporting under MIFID II and the Securities Financing Transactions Regulation (SFTR) for firms undertaking securities financing transactions (SFTs) with a member of the European System of Central Banks. However, the TTP expires on 31 March 2022. The government welcome industry views on how to mitigate duplicative reporting in this area when the TTP expires.

Box 8.A: Questions

93 Where do the current regulatory reporting regimes for wholesale markets contain duplicative reporting requirements?

94 Is intervention needed to mitigate against duplicative reporting for firms undertaking SFTs with members of the European System of Central Banks?

Investor protection reports

8.7 As well as trade and transaction reporting, MiFID II includes a number of reporting obligations that are designed to protect investors. These include:

- The cost and charges report, which requires firms to give clients information on all costs and associated charges in good time before they conclude a trade.
- Best execution reporting, which requires firms to provide reports on execution quality.
- Client execution reports, which require investment firms to provide clients with client execution reports the day after executing a trade.

8.8 Investor protection was one of the key objectives of MiFID II and remains a priority for the government. However, evidence shows that many of the reporting obligations in MiFID II are not necessary for wholesale clients, and have introduced significant and administrative burdens and costs. To ensure that the reporting regime protects investors but is proportionate for wholesale clients, the FCA is consulting on removing requirements on market operators and participants to produce best execution reports. This is because although the reports were intended to help investors make better trading decisions, industry engagement has revealed that investors do not use them.

8.9 On 30 June, the government brought forward secondary legislation to make various changes to the MiFID conduct rules, in particular in respect to the information that firms have to report to clients. One of the requirements that the statutory instrument amends is provisions on providing costs and charges where agreements are concluded by distance communication. The result being that where agreements to buy or sell financial securities are concluded via distance communication, the instrument allows investment firms, where the client consents and the investment firm has given the client the option of delaying the conclusion of the transaction until the client has received the information, to provide costs and charges information to clients after the transaction has been concluded. However, the firm still has to provide the client with the option of receiving the information by telephone before the conclusion of the transaction.

8.10 The statutory instrument also removed the requirement for firms to report portfolio losses of 10% or more, to professional clients. The government would like to understand views on how this rule applies in relation to retail clients and whether there are more effective ways of protecting retail clients in this area.

8.11 The government is also interested in the format of the information that firms send to their clients. Currently, where MiFID II requires firms to provide information to retail investors in a durable format, the default is for communications to be paper based. To reduce burdens on firms and clients, the government is minded to make electronic communication the default for communication with retail clients. However, the government would like to seek feedback on this, particularly in relation to any protections that would be needed to ensure that clients who want to continue to receive paper communications are able to do so.

Box 8.B: Questions

95 Do you think the 10% loss reporting rules for portfolios and contingent liability transactions offer effective investor protection? If not, how do you think the rules in this area should be revised?

96 Do you think electronic communication should become the default means of communication for disclosures and reporting to retail clients, and, if so, what protections are needed for retail clients around such a change?

97 Are there any other changes to the conduct rules in the MiFID delegated regulation that you think could be made to reduce costs whilst continuing to offer meaningful investor protection?

98 Do you think other changes are needed to ensure that the reporting regime correctly balances investor protection and transparency?

Financial instrument identifiers

8.12 MiFID II requires firms to use International Securities Identification Numbers (ISINs) for reporting purposes. The government believes that ISINs work well for most instruments, but understands that it can be difficult to use them for over-the-counter (OTC) and derivatives reporting. This is because for derivatives the current system of absolute tenors creates, for example, a new ISIN every day for a 10 year swap. Not only has this produced a multitude of ISINs which are practically the same, but it has proved costly for market participants who are sourcing ISINs. It also negatively impacts transparency. The government is aware of the development of Unique Product Identifiers (UPIs) which may improve the issues firms are facing with ISINs. The government would welcome industry feedback on the use of ISINs, the potential use of UPIs, and whether there may be alternative identifiers that could be made available to better identify derivatives, particularly swaps.

Box 8.C: Questions

99 Have you experienced any issues with the utilisation of ISINs as identifiers?

100 Do you have any suggestions on how the use of identifiers could be improved?

Chapter 9

Cross Cutting Issues

Background

9.1 In addition to enhancing the effectiveness of our current regulatory framework, the government is actively considering its longer-term vision for capital markets in order to ensure that the UK's approach enables firms and regulators to address the challenges and opportunities of the future, as well as the present.

9.2 The Chancellor has been clear in setting his vision for financial services that he is committed to a sector that is regulated to the highest standards. On 1 July 2021, he published 'A new chapter for financial services', which sets out our four themes to guide the UK's vision for financial services:

- **Open and Global financial centre**: The UK will use its strengths as a global financial hub to establish and enhance strong relationships with jurisdictions all around the world, attracting investment and increasing opportunities for cross-border trade. The government will promote international standard setting to encourage the global financial system to support openness through consistently high standards
- **At the forefront of technology and innovation**: The UK will support innovation and the adoption of cutting-edge technologies through nimble policy making and agile regulation, for the benefit of businesses, consumers and the economy, while ensuring appropriate protections and promoting financial stability
- **A world-leader in Green Finance**: The UK will ensure the financial system plays a major role in the delivery of the UK's net zero target and ambition for a 'nature positive' future. The government will press for global action and build international standards, including through COP26, using leading commercial and policy expertise to reaffirm the UK as the best place in the world for green and sustainable investment.
- **A competitive marketplace promoting effective use of capital**: The government will maintain and build on the UK's attractive and internationally respected ecosystem for financial services across both regulation and tax. The government will tailor it to reflect our new position outside the European Union, while supporting and promoting the interests of UK markets and maintaining high regulatory standards in the face of new and evolving risks

Proposed Changes

Technology

9.3 In January, the government conducted a Call for Evidence on the use of distributed ledger technology (DLT) in financial market infrastructures (FMIs), in order to understand the impact DLT could have on markets. It explored whether current legislation or regulation is able to accommodate DLT, and what the government could do to support the use of new technology across markets. Since the Call for Evidence closed the government has announced a number of measures in this area, including a new HMT and Bank of England taskforce to explore a possible UK central bank digital currency (CBDC). The government has also announced a new FMI Sandbox to support firms wanting to use new technology in the provision of market infrastructure services. The government is keen to continue looking ahead and to work with industry to explore what further steps can be taken to encourage new technologies that have the capacity to increase efficiencies and reduce costs for firms operating in capital markets.

Box 9.A: Question

101 What further steps can UK authorities take to enable firms to take advantage of technological innovation in capital markets?

Green Finance

9.4 The government remains dedicated to leading the way for tackling climate change and environmental degradation globally, for example, through its target to reach net zero emissions by 2050. It sees financial services as a key part of the plan to work towards a greener, more sustainable future, underpinned by a clean and resilient economy.

9.5 The government intends the UK to become the first G20 country to make TCFD-aligned disclosures mandatory across the economy, as set out in its 2020 Roadmap and Interim Report. This is part of a wider programme of work aimed at greening the financial system and financing the green economy, while capturing the opportunities of the transition to net-zero. Important initiatives in this area include the launch of a UK taxonomy of sustainable activities and the Chancellor's announcement last year that, subject to market conditions, the UK will issue Green Gilts to support the transition. Since then, the UK Debt Management Office has committed to offer at least £15bn in Green Gilts to the market.

9.6 Given the role that capital markets play in underpinning the economy, the government believes that the sector has the scope to play an important role in supporting the UK's transition to a low carbon economy.

9.7 The government welcomes any insights on how we can support the opportunities the sector faces as we strive to meet our climate objectives, and what steps we could take to ensure that wholesale markets are sustainable and ethical well into the future. It also welcomes reflections on how to mitigate any risks that may arise.

Box 9.B: Question

102 What further steps can UK authorities take to support the wholesale markets sector as we move towards a low carbon economy?

Retail investors

9.8 The government recognises that the pace and creativity of innovation in UK financial services creates new opportunities for businesses and consumers to participate in markets through technologies such as app-based platforms. In recent years, investors with access to social media and online investing have become bigger players within the retail space. New technology has also meant that retail investors from outside of the UK can access UK markets easily, providing UK companies with global reach.

9.9 The government is keen to understand the current barriers to retail participation in capital markets across all asset classes. For example, market participants have highlighted that there is insufficient access to research. Industry have also highlighted that there is higher retail participation in equity markets than fixed income markets.

9.10 The government would also like to understand whether the balance between investor protection and retail access is correct.

9.11 Through understanding these issues, this consultation will complement the UK's consultation on prospectuses as well the FCA's discussion paper on high risk investments which among other things considers the balance between retail access and investor protection[1]. One of the key aims of the government in relation to prospectuses in future will be to facilitate wider participation in the ownership of public companies, by reducing barriers to issuance that exist for wider groups of investors – including retail investors. This will also complement further work the government will undertake as part of its commitment to review the retail disclosure regime under the PRIIPs Regulation.

Box 9.C: Questions

103 How do companies harness retail investment whilst ensuring investor protection?

104 How do companies take advantage of the globalisation of information to reach investors?

105 Is there a role for UK authorities to play to facilitate retail access to capital markets, while continuing to offer high standards of investor protection?

[1] See this discussion paper here.

Chapter 10
Responding to the Consultation

Submitting a response

10.1 This consultation will remain open for 12 weeks, closing on 24 September 2021.

10.2 Please submit your responses to:

WholesaleMarkets.Review@hmtreasury.gov.uk, or post to:

Wholesale Markets Review

Securities and Markets, Financial Services Group

HM Treasury

Horse Guards Road

SW1A 2HQ

Who should respond?

10.3 A wide range of stakeholders will be interested in the important issues presented in this document. Responses are welcome from all stakeholders, including:

- Financial services institutions and firms
- Other businesses impacted by financial services regulation
- Trade associations and representative bodies
- Consumer groups

Annex A
Glossary

Term	Definition
Algorithmic trading	A form of trading in financial instruments which is executed via computer programs that utilise algorithms (a set of defined instructions) to automatically determine individual parameters of orders such as timing, price or quantity with almost no or limited human intervention.
Ancillary Activities Test (AAT)	The test which determines whether a firm trading in commodity derivatives needs to be authorised as an investment firm.
Approved Publication Arrangement (APA)	A person authorised under MiFID II to publish trade reports on behalf of investment firms.
Best execution	The requirement for an investment firm to take all sufficient steps to obtain the best possible result for their clients when executing orders.
Block trades	Trade that is larger in size than the normal transaction in an instrument and that is generally privately negotiated and executed between two counterparties outside of the public market for that instrument.
Central Limit Order Book	An electronic trading protocol where bids and offers are matched according to pre-defined rules, generally according to price and time priority, instead of being intermediated by a dealer.
Client	Any natural or legal person to whom an investment firm provides investment or ancillary services.
Commodity derivative	Derivatives with a commodity identified as their underlying asset.
Consolidated tape (CT)	A continuous electronic live data stream providing price and volume data of bids and offers, and/or executed trades in financial instruments taking place on trading venues and bilaterally.
Consolidated tape provider (CTP)	A person authorised to operate a CT.
Dark venues	A trading venue that matches orders with no pre-trade disclosure, to other users or the public, of bid and offer prices prior to execution.
Deferral	The delay by an investment firm or trading venue of the publication of executed trades so as not to expose counterparties to the trade to undue risk.
Derivatives	A financial contract that derives its value from the price of an underlying asset(s), indices or other measures.

Derivatives Trading Obligation (DTO)	The requirement for certain persons to trade in-scope derivatives on UK trading venues or third country venues that have been deemed equivalent by HM Treasury.
EMIR REFIT	Legislation updating the European Markets Infrastructure Regulation (EMIR) with a view to making it simpler and less costly for firms to comply with.
Emission allowances	Units recognised for compliance with the UK or EU Emissions Trading Schemes.
Energy Market Participant (EMP)	A firm authorised by the FCA which is restricted to carrying out activities related to investments linked to energy.
European Market Infrastructure Regulation (EMIR)	Legislation establishing requirements in relation to OTC derivatives, CCPs and trade repositories. It aims to improve transparency and reduce the risks associated with the derivatives market.
Exchange traded commodities	A form of exchange traded product which invest in underlying commodities or follow commodity indices.
Exchange Traded Derivatives (ETDs)	A derivative such as a future that is traded on an Exchange and cleared by a CCP.
Exchange Traded Funds (ETFs)	A collective investment scheme traded on a trading venue with at least one market maker which takes action to ensure that the price of its units or shares on the trading venue does not vary significantly from its net asset value and, where applicable, from its indicative net asset value.
Exchange traded notes	An exchange traded product in the form of a debt security issued by an institution that tracks an underlying index of securities.
FCA Handbook	The rule book that sets out the rules and guidance made by the Financial Conduct Authority (FCA)
Financial Conduct Authority (FCA)	The conduct regulator for financial services firms and financial markets in the UK.
Financial Instruments Reference Data System (FIRDS)	Data infrastructure operated by the FCA that collects and publishes financial instrument reference data for the purposes of transaction reporting.
Fixed income	Securities that pay investors fixed payments until maturity date.
FSMA	Financial Services and Markets Act 2000
Hedging	The practice of using a financial instrument such as a derivative to mitigate against risks inherent to other assets.
High-yield bonds	Bonds rated BB, B, CCC, CC or C
Illiquid	A situation where, for a financial instrument or a class of financial instruments, there are not ready and willing buyers and sellers on a continuous basis.
Indications of interest	An indication of a desire but not a commitment to buy or sell a financial instrument.
International Securities Identification Number (ISIN)	A 12-character, alphanumeric code which uniquely identifies a financial instrument and provides for the uniform identification of instruments for trading or settlement purposes.
Investment-grade bonds	Bonds rated AAA, AA, A or BBB
Large-in-scale (LIS)	A MiFID transparency threshold above which an order or trade is deemed sufficiently large to benefit from a pre-trade transparency waiver or post-trade deferral.

Liquid	A situation where, for a financial instrument or a class of financial instruments, there are ready and willing buyers and sellers on a continuous basis.
Liquidity	Concept that reflects how easy it is to buy or sell a financial instrument, usually without affecting the prevailing price.
Lit venue	A trading venue where bids and offers prices are publicly disclosed prior to execution.
Market outage	A market situation where a trading venue's technical system fails to operate.
Market-maker or liquidity provider	A firm that holds itself out on the financial markets on a continuous basis as being willing to deal on its own account by buying and selling financial instruments against its own proprietary capital at prices.
Matched Principal Trade (MPT)	A transaction where the facilitator interposes itself between the buyer and the seller to the transaction in such a way that it is never itself exposed to market risk throughout the transaction, with both sides executed simultaneously, and where the transaction is concluded at a price where the facilitator makes no profit or loss, other than a previously disclosed commission, fee or charge for the transaction.
MiFID	Markets in Financial Instruments Directive.
Multilateral Trading Facility (MTF)	A multilateral system operated by an investment firm, a qualifying credit institution or a market operator that brings together multiple third party buying and selling interests in financial instruments in accordance with non-discretionary rules.
Net Asset Value	The value of a fund's assets, minus the value of its liabilities.
Non-price forming trade	A trade that does not contribute to price formation.
Oil Market Participant (OMP)	A firm authorised by the FCA that is restricted to carrying out activities related to investments that are linked to oil.
Organised Trading Facility (OTF)	A multilateral trading system operated by an investment firm, a qualifying credit institution or a market operator in which multiple third-party buying and selling interests in bonds, structured finance products, emissions allowances or derivatives can interact in the system.
OTC	Over the counter – trading of financial instruments outside the systems and rules of a trading venue.
Package	A transaction composed of multiple financial instruments that are interlinked and where the execution of each component is simultaneous and contingent upon the execution of all the others.
Position limits	Restrictions on the maximum size of a net position that a person can hold.
Post-trade transparency	The obligation to publish the details of a trade report after execution.
Pre-trade transparency	The obligation to publish in real time bids and offers for financial instruments.
Price formation	The process whereby the price of a financial instrument reflects all the available information based on supply and demand.
Primary venue	Market where a security was first listed or admitted to trading.

Prospectus	Document to be published when securities are offered to the public or admitted to trading on a regulated market.
Reasonable commercial basis (RCB)	The requirement to make market data available under charges which are based on the cost of such data and in a fair, and non-discriminatory manner.
Regulated Market (RM)	A multilateral system operated by a Recognised Investment Exchange that brings together multiple third party buying and selling interests in financial instruments in accordance with non-discretionary rules.
Regulatory perimeter	The determination of which activities or instruments require FCA authorisation or are subject to FCA oversight.
Request-for-quote	A method of trading whereby a quote or quotes by a member or participant are provided in response to an inquiry.
Risk capital	Funds invested speculatively in a business.
Riskless principal basis	A form of trading where a firm interposes itself between the buyer and the seller without being exposed to market risk.
Secondary venue	Where a share trades on a venue other than its primary venue and without a request of admission by the issuer.
Share Trading Obligation	The obligation for shares to be traded on UK trading venues and systematic internalisers, or third country trading venues that have been deemed equivalent by HM Treasury.
Size specific to the instrument (SSTI)	An order or trade size threshold that forms part of the transparency regime for bonds and other non-equity instruments to determine whether waivers/deferrals can be utilised.
SME	Small and medium sized enterprise.
Sovereign bonds	A debt instrument issued by a sovereign issuer.
Structured finance products	Securities created to securitise and transfer credit risk associated with a pool of financial assets entitling the security holder to receive regular payments that depend on the cash flow from the underlying assets.
Systematic Internaliser (SI)	An investment firm which on an organised, frequent, systematic and substantial basis deals on its own account when executing client orders outside of a regulated market, UK MTF or UK OTF, without operating a multilateral system. Or an investment firm that has chosen to opt-in to the systematic internaliser regime.
Temporary Transitional Powers (TTP)	The powers which HM Treasury gave UK financial regulators under the EU Withdrawal Act, to make transitional provisions to financial services legislation for a temporary period to help firms adapt to their new requirements following the onshoring process.
Tick size	The minimum increment by which the price of a financial instrument can move up or down.
Traded on a Trading Venue (ToTV)	A concept which brings OTC instruments that equivalent to instruments traded on a trading venue into the scope of various requirements that apply to venue traded instruments. ToTV is used to impose specific transparency reporting requirements on instruments that are traded on trading venues.
Trading Venue (TV)	A regulated market, a multilateral trading facility or an organised trading facility.

Transaction reporting	Reports of executed trades that must be made to the FCA under MiFID II.
Transparency	The disclosure of trading interests and executed trades to market participants.
Volatility	The fluctuation in the market price of a financial instrument.
Waiver	Regime under which pre-trade transparency requirements can be modified.

Annex B
Privacy Statement

This notice sets out how HM Treasury will use your personal data for the purposes of the Wholesale Markets Review and explains your rights under the General Data Protection Regulation (GDPR) and the Data Protection Act 2018 (DPA).

Your data (Data Subject Categories)

The personal information relates to you as either a member of the public, parliamentarians, and representatives of organisations or companies.

The data we collect (Data Categories)

Information may include your name, address, email address, job title, organisation and employer of the correspondent, as well as your opinions. It is possible that you will volunteer additional identifying information about yourself or third parties.

Legal basis of processing

The processing is necessary for the performance of a task carried out in the public interest or in the exercise of official authority vested in HM Treasury. For the purpose of this consultation the task is consulting on departmental policies or proposals or obtaining opinion data in order to develop good effective government policies.

Special categories data

Any of the categories of special category data may be processed if such data is volunteered by the respondent.

Legal basis for processing special category data

Where special category data is volunteered by you (the data subject), the legal basis relied upon for processing it is: the processing is necessary for reasons of substantial public interest for the exercise of a function of the Crown, a Minister of the Crown, or a government department.

This function is consulting on departmental policies or proposals, or obtaining opinion data, to develop good effective policies.

Purpose

The personal information is processed for the purpose of obtaining the opinions of members of the public and representatives of organisations and companies, about departmental policies, proposals, or generally to obtain public opinion data on an issue of public interest.

Who we share your responses with

Information provided in response to a consultation may be published or disclosed in accordance with the access to information regimes. These are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 2018 (DPA) and the Environmental Information Regulations 2004 (EIR).

If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals with, amongst other things, obligations of confidence.

In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information, we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on HM Treasury.

Where someone submits special category personal data or personal data about third parties, we will endeavour to delete that data before publication takes place.

Where information about respondents is not published, it may be shared with officials within other public bodies involved in this consultation process to assist us in developing the policies to which it relates. Examples of these public bodies appear at: https://www.gov.uk/government/organisations

As the personal information is stored on our IT infrastructure, it will be accessible to our IT contractor, NTT. NTT will only process this data for our purposes and in fulfilment with the contractual obligations they have with us.

How long we will hold your data (Retention)

Personal information in responses to consultations will generally be published and therefore retained indefinitely as a historic record under the Public Records Act 1958.

Personal information in responses that is not published will be retained for three calendar years after the consultation has concluded.

Your Rights

- You have the right to request information about how your personal data are processed and to request a copy of that personal data.
- You have the right to request that any inaccuracies in your personal data are rectified without delay.
- You have the right to request that your personal data are erased if there is no longer a justification for them to be processed.
- You have the right, in certain circumstances (for example, where accuracy is contested), to request that the processing of your personal data is restricted.
- You have the right to object to the processing of your personal data where it is processed for direct marketing purposes.

- You have the right to data portability, which allows your data to be copied or transferred from one IT environment to another.

How to submit a Data Subject Access Request (DSAR)

To request access to personal data that HM Treasury holds about you, contact:

HM Treasury Data Protection Unit
G11 Orange
1 Horse Guards Road
London
SW1A 2HQ

dsar@hmtreasury.gov.uk

COMPLAINTS

If you have any concerns about the use of your personal data, please contact us via this mailbox: privacy@hmtreasury.gov.uk.

If we are unable to address your concerns to your satisfaction, you can make a complaint to the Information Commissioner, the UK's independent regulator for data protection. The Information Commissioner can be contacted at:

Information Commissioner's Office
Wycliffe House
Water Lane
Wilmslow
Cheshire
SK9 5AF

0303 123 1113

casework@ico.org.uk

Any complaint to the Information Commissioner is without prejudice to your right to seek redress through the courts.

Annex C
Consultation Questions

Chapter 2: Trading Venues

1 Where do you think the regulatory perimeter for trading venues needs to be clarified?

2 Do you think it would be more appropriate for changes to be made to the definition of a multilateral system in legislation, or for the application of the existing definition to be clarified through FCA guidance?

3 Should the current restrictions on matched principal trading by a multilateral trading facility (MTF) be retained?

4 Should the current restrictions on the operation of an SI within the same legal entity of an organised trading facility (OTF) be retained?

5 If you answered no to question 4:

Should new rules and disclosures be introduced to address the specific conflicts that MTFs and OTFs would be exposed to when providing matched principle trading (MPT) or operating a systematic internaliser (SI)?

6 Do you think that OTFs should be allowed to execute transactions in packages involving derivatives and equities under their rules and systems?

7 What would be the risks and benefits of allowing this approach?

8 Do you agree that the existing regulatory requirements for disclosure at admission to trading (for MTFs and SME Growth Markets) are disproportionate for small-sized issuers?

9 What principles and/or types of information should be considered when developing requirements for disclosure at issuance to ensure requirements are proportionate?

10 How far should these be determined by the venue operator versus regulation, and what other features may provide proportionate assurances around the quality of issuers admitted to a venue (e.g. role of advisors in process)?

11 Would the creation of a new category of trading venue be an appropriate means to facilitate access to public markets for very small firms? What size of firms would be appropriate for a new trading venue?

12 If you answered no to question 11:

Would the facilitation of the creation of new market segments be a more suitable intervention?

13 If you answered yes to question 11 or 12:

What should the market cap of companies that can trade on the new trading venue and/or segment be?

14 Do you believe intermittent rather than continuous trading would increase liquidity?

15 Do you think that additional measures, such as new funds structure are needed to stimulate institutional investors to invest in SMEs?

16 What, if any, further forms of investor protection do you deem appropriate for this proposed new category of trading venue?

17 Do you believe that regulatory or industry guidance about how venues should operate and what they should communicate during an outage would be useful?

18 Do you have views on a fail-safe mechanism to ensure that the market has access to the key closing benchmarks during an outage in a primary exchange? What role do you see UK authorities playing to deliver this?

19 What other steps do you think UK authorities could take to ensure market resiliency in the event of an outage?

Chapter 3: Systematic Internalisers

20 Do you agree that the definition for SIs should be based on qualitative criteria?

21 If you answered no to question 20:

Do you think the definition should be amended in another way?

22 If you answered yes to question 20:

Do you think that regulatory guidance should be used to support the definition in legislation?

23 Do you currently opt-in to the SI regime?

24 Should SIs be determined at entity level instead of on an instrument by instrument basis, for reporting purposes?

25 What would be the risks and benefits of adopting such an approach?

26 Do you agree with the government’s proposal to allow SIs to execute at the midpoint for all trades, provided the executed price is within the SI’s quoted price?

27 Do you think any other changes are needed to increase the effectiveness of the SI regime?

28 Do you think that the double volume cap (DVC) should be deleted?

29 Do you think alternative incentives are needed to encourage lit trading?

30 Should reference price systems be able to match orders at the mid-point within the current bid and offer of any UK or non-UK trading venue that offers the best bid or offer, to aid best execution?

31 Do you consider SIs quotes useful?

32 Do you think that the ability of SIs to execute clients' orders at mid-point would incentivise SIs to provide meaningful quotes?

33 If you answered yes to question 32:

What incentives could UK authorities introduce to encourage you to report more trades, while maintaining fair competition with market operators?

Chapter 4: Equity Markets

34 Do you think that the share trading obligation (STO) should be removed?

35 Do you think that the requirements for algorithmic liquidity providers and trading venues to enter into binding market making agreements should be removed?

36 What would be the impact of such a removal for you and/ or the market you operate in?

37 Do you think the scope of the tick size regime needs to be recalibrated for overseas shares to ensure that firms can trade at the best prices in the UK?

38 Do you think trading venues are better placed to establish tick sizes for new shares until sufficiently robust data is available?

39 What are the potential benefits and risks of delegating the setting of tick sizes, in general, to trading venues? What safeguards would be needed to avoid arbitrage issues?

40 Are there any other parts of the equity regime that you think could be operated more effectively by the market, while upholding high standards?

Chapter 5: Fixed Income and Derivatives Markets

41 Do you agree that the scope of the derivative trading obligation (DTO) should be revised to bring it in line with the scope of the clearing obligation following the changes introduced by the European Market Infrastructure Regulation (EMIR) REFIT? What risks/ benefits do you see with this approach?

42 Do you think that all post-trade risk reduction services should be exempt from the DTO?

43 If you answered yes to question 42:

a) Do you think that there should also be an aligned exemption from the EMIR clearing obligation for trades resulting from post-trade risk reduction services?

b) What conditions do you think should be met for the exemption to be applicable?

44 Do you think the FCA should be given the power to modify or suspend the DTO quickly under certain circumstances, on a permanent rather than temporary basis?

45 Do you think that the current transparency requirements support price formation and open, competitive and fair markets? Please separate your answers by fixed income (please treat sovereign bonds, high-yield bonds and investment-grade bonds separately) and derivatives (please distinguish between OTC and exchange-traded derivatives (ETDs) where relevant).

46 Do you think that using traded on a trading venue (ToTV) is a useful criterion for determining the scope of transparency requirements for non-equity instruments, and in particular OTC derivatives? Please separate your answers by fixed income (please treat sovereign bonds, high-yield bonds and investment grade bonds separately) and derivatives (please distinguish between exchange treaded and OTC derivatives).

47 If you answered no to question 46:

Do you think the concept of ToTV should be removed for OTC derivatives, and the scope of the transparency regime determined on the basis of whether the instrument is cleared? If so, what definition of 'cleared' should be used?

48 Do you think there is another option to determine the scope of the fixed income and derivatives transparency regime? Please separate your answers by fixed income (please treat sovereign bonds, high-yield bonds and investment-grade bonds separately) and derivatives (please distinguish between exchange traded and OTC derivatives).

49 What instruments do you think should be in scope of the fixed income and derivatives transparency regime? Please consider fixed income (please treat sovereign bonds, high-yield bonds and investment-grade bonds separately) ETCs, ETNs, structured finance products, emission allowances and derivatives (please distinguish between exchange traded and OTC derivatives).

50 What changes do you think are needed to enable liquidity calculations to work effectively? Please separate your answers by fixed income (sovereign bonds, high-yield bonds and investment-grade bonds) and derivatives (ETDs and OTC derivatives).

51 Do you think it would be preferable to move away from regular liquidity calculations towards a mix of qualitative and quantitative criteria? For example, on a sectoral basis? Please separate your answers by fixed income (sovereign bonds, high-yield bonds and investment-grade bonds separately) and derivatives (ETDs and OTC derivatives).

52 How do you currently use pre-trade transparency? Is pre-trade information on bonds and derivatives valuable? Please differentiate between fixed income (sovereign bonds, high-yield bonds and investment-grade bonds separately) and derivatives (ETDs and OTC derivatives), and each trading method (for example RFQ, and order book).

53 Is there a case for removing MiFID II pre-trade transparency requirements for any asset class? Please separate your answers by fixed income (sovereign bonds, high-yield bonds and investment-grade bonds separately) and derivatives (ETDs and OTC derivatives).

54 If you answered yes to question 53:

Do you think that RFQ, bilateral negotiations and indications of interest provide sufficient information for markets to function effectively? Please separate your answers by fixed income (sovereign bonds, high-yield bonds and investment-grade bonds separately) and derivatives (ETDs and OTC derivatives).

55 How do you use pre-trade quotes streamed by SIs? Please separate your answers by fixed income (sovereign bonds, high-yield bonds and investment-grade bonds separately) and derivatives (ETDs and OTC derivatives).

56 For SIs, what impact do you think removing pre-trade transparency requirements would have on your business? Please separate your answers by fixed income (sovereign bonds, high-yield bonds and investment-grade bonds separately) and derivatives (ETDs and OTC derivatives).

57 Do you have any other comments on the pre-trade transparency regime?

58 How do you currently use deferrals? Please separate your answers by fixed income (sovereign bonds, high-yield bonds and investment-grade bonds separately) and derivatives (ETDs and OTC derivatives).

59 Which asset classes should deferrals apply to? Please separate your answers by fixed income (sovereign bonds, high-yield bonds and investment-grade bonds separately) and derivatives (ETDs and OTC derivatives).

60 Do you agree that the deferral regime would benefit from being simplified?

61 What do you think the optimum deferral length is? Please separate your answers by fixed income (sovereign bonds, high-yield bonds and investment-grade bonds separately) and derivatives (ETDs and OTC derivatives).

62 What are your views on the government's proposal to delete the size specific to the instrument (SSTI), package order, and EFP deferrals? Do you think it would lead to more meaningful transparency? Please separate your answers by fixed income (sovereign bonds, high-yield bonds and investment-grade bonds separately) and derivatives (ETDs and OTC derivatives).

63 Do you think volume masking and/or aggregation helps to encourage real time publication? Please separate your answers by fixed income (sovereign bonds, high-yield bonds and investment-grade bonds separately) and derivatives (ETDs and OTC derivatives).

64 What are the risks and benefits of allowing trading venues to calculate LIS thresholds for ETD post-trade reporting?

Chapter 6: Commodity Markets

65 Do you think that the scope of the 'commodity derivatives' regime should be narrowed to derivatives that are based on physical commodities?

66 Do you think that financial instruments which refer to commodities as a pricing element but are securities in their legal form, should be removed from the regime?

67 Do you think economically equivalent OTC commodity derivative contracts should be removed from the commodity derivatives regime?

68 Are there any other instruments that you think should be deleted from the commodity derivatives regime?

69 What would be the risks and benefits of transferring responsibility for position limits from the FCA to trading venues?

70 What specific factors do you think should be addressed in the framework of requirements that UK authorities would provide for trading venues?

71 Do you think that the scope of contracts that are automatically subject to position limits should be limited? If yes, do you think that it should be limited to contracts that are critical or significant, which includes those that are physically settled, and agricultural?

72 Do you think that the UK commodity derivatives regime should allow position limits exemptions for liquidity providers?

73 Do you think that the UK commodity derivatives regime should introduce a 'pass through' hedging exemption to enable investment firms to support a wider range of hedging practices?

74 Do you think any other activities should be exempt from the regime?

75 Are there areas of the UK's position reporting regime which could be improved?

76 Do you think that the ancillary activities test (AAT) should revert to a qualitative assessment of the activities performed by a market participant?

77 Do you think that the basis of the AAT should be expected activity, rather than historic activity?

78 Do you agree that the annual notification requirement should be abolished?

79 Does the continued existence of the separate Oil Market Participant (OMP) and Energy Market Participant (EMP) regimes for commodity derivative market participants serve any meaningful purpose?

80 Do you think that the OMP and EMP regimes should be removed as particular regulatory statuses from the UK's regulatory perimeter?

81 Do you think any changes would need to be made to the MiFID II regime, if the OMP and EMP regimes are removed as particular regulatory statuses?

Chapter 7: Market Data

82 Do you agree that the government should take action to encourage the development of a CT?

If you answered yes to question 82:

83 Do you think a fixed income tape should be prioritised?

84 Do you think that it would be beneficial for a fixed income CT to include post-trade data only, or would there be value in a tape covering pre-trade data too?

85 Is there any value in a delayed data CT for fixed income markets?

86 Is it valuable for an equity CT to include pre- and post-trade data?

87 Is there any value in a delayed data CT for equity markets?

88 Should the government amend legislation to enable a market-led private sector CT to develop, or do you think UK authorities should be actively involved in creating a CT?

89 What are the legislative barriers for a private sector-led CT to emerge? Do you agree with the legislative changes identified above? Are there additional changes that UK authorities should be considering?

90 Do you see any risks with removing the obligation for CTs to provide data for free after 15 minutes?

91 What are the potential advantages and disadvantages of multiple private-sector CTs for each asset class?

92 Do you have any suggestions on further areas that UK authorities should be considering when making changes to market data, especially in relation to requirements that are set out in legislation?

Chapter 8: Reporting

93 Where do the current regulatory reporting regimes for wholesale markets contain duplicative reporting requirements?

94 Is intervention needed to mitigate against duplicative reporting for firms undertaking securities financing transactions (SFTs) with members of the European System of Central Banks?

95 Do you think the 10% loss reporting rules for portfolios and contingent liability transactions offer effective investor protection? If not, how do you think the rules in this area should be revised?

96 Do you think electronic communication should become the default means of communication for disclosures and reporting to retail clients, and, if so, what protections are needed for retail clients around such a change?

97 Are there any other changes to the conduct rules in the MiFID delegated regulation that you think could be made to reduce costs whilst continuing to offer meaningful investor protection?

98 Do you think other changes are needed to ensure that the reporting regime correctly balances investor protection and transparency?

99 Have you experienced any issues with the utilisation of International Securities Identification Number (ISINs) as identifiers?

100 Do you have any suggestions on how the use of identifiers could be improved?

Chapter 9: Cross Cutting Issues

101 What further steps can UK authorities take to enable firms to take advantage of technological innovation in capital markets?

102 What further steps can UK authorities take to support the wholesale markets sector as we move towards a low carbon economy?

103 How do companies harness retail investment whilst ensuring investor protection?

104 How do companies take advantage of the globalisation of information to reach investors?

105 Is there a role for UK authorities to play to facilitate retail access to capital markets, while continuing to offer high standards of investor protection?

HM Treasury contacts

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