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# HM Treasury publish proposals for Wholesale Financial Markets Review – what are the key points?

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HM Treasury has published its proposals for a review of the regulatory requirements applicable to wholesale financial markets. The proposals are wide-ranging and envisage (amongst other important changes) the removal of the share trading obligation and double volume cap from the UK MIFID regime, significant changes to the scope of the UK Systematic Internaliser regime (including reverting to the qualitative MiFID I SI definition and potentially disapplying non-equities pre-trade transparency obligations) and tick sizes, and the removal of regulatory commodity position limits. The consultation closes on 24 September 2021.

Key highlights from the HM Treasury consultation are set out below.

## Trading venues and perimeter issues

- The government is generally happy with the current system of having Regulated Markets (RMs), Multilateral Trading Facilities (MTFs) and Organised Trading Facilities (OTFs). However, they have identified some areas where the regime could be simplified or clarified. They are also considering changes to try to facilitate capital raising by smaller issuers and discuss non-legislative action in relation to market outages.
- Perimeter:
  - The government wants to **clarify when firms must seek authorisation as multilateral systems** and hence trading venues but are open to either (i) clarifying the definition in legislation; or (ii) clarifying through further FCA guidance.
- Operating conditions:
  - The government is considering **permitting matched principal trading by MTFs** – but is querying whether this would diminish market integrity.
  - They are also consulting on whether **SIs and OTFs should be able to be operated within the same legal entity**.
  - The government is considering **allowing OTFs to execute transactions in equities when they are part of packages**.
- SME markets:
  - The government is considering introducing a more proportionate regime for SME markets. This could be achieved via either a **new category of regulated venue, or new market segments**.

  - They are also consulting on how to calibrate disclosure requirements in a proportionate manner for SME issuers; whether assurance could be provided by venues/advisors rather than just regulation; and whether intermittent rather than continuous trading might increase liquidity.
- Outages:
  - The government has noted that the resilience of trading venues is vital for the smooth and efficient operation of capital markets. They think overall the MiFID II requirements in this space have worked, but there is some ambiguity over the role of market operators and participants when there is an outage.
  - They have identified the following actions as potential (and not mutually exclusive) options to better enable markets to resume trading:
    - For UK authorities or industry to **implement a playbook** for both trading venues and participants. This could provide guidance about clear and timely information that is expected to be communicated during an outage and could be reflective of different scenarios.
    - To **explore an alternative mechanism to a closing auction during an outage**. This could involve the primary venue establishing a secure method for the closing auction despite the outage, or an alternative venue stepping in to produce the key benchmark.
    - Linked to proposals to **amend the reference price waiver**, enabling reference price systems to match trades at mid-point to mitigate risk during an outage.
  - Overall, they **favour development of common procedures, communication standards and guidelines by the FCA rather than legislative intervention**.

## Systematic internalisers

- The government is proposing to revert to a **purely qualitative definition of SIs**, whereby an SI is determined by its market activity for a particular asset class and market participants **no longer have to undertake calculations**.
- The government notes there is often ambiguity regarding the role of SIs in reporting under the post-trade transparency reporting hierarchy, given that SI capacity is determined by instrument rather than on an entity basis. To reduce compliance costs and deliver greater clarity, the government is proposing that **SI status should be determined at entity level** (which would make it clear that **an SI is always at the top of the reporting hierarchy**).
- The government notes that the introduction of the tick size regime for SIs (with only a very limited exemption) did not achieve its intended aims. Hence, they propose to **permit SIs to execute clients orders at the mid-point within the best bid and offer for trades below LIS** (as well as above as currently), provided that the executed price is within the SI's quoted prices and the execution is in a size not larger than the quoted size. The idea is that this should provide greater flexibility to execute client orders at mid-point. This will be a welcome development as the

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application of the tick sizes regime to SIs has proved to be quite challenging for the industry and has resulted in very odd outcomes for certain types of transactions. As noted in the Equity markets section below, the government is also proposing broader changes to the UK tick sizes regime.

## Equity markets

> The government believes that there is an opportunity to simplify the MiFID II equity transparency regime, and introduce measures designed to facilitate competition and openness.

> Proposed **equity pre-trade transparency changes** include:

> > **Repealing the double volume cap (DVC)**: The government does not believe that the DVC is an effective tool in protecting price formation, and under its proposals it suggests that a more proportionate approach to ensuring market integrity is for the FCA to continue to monitor the extent of dark trading, and be able to limit (i.e. suspend) such trading where necessary. This is a helpful development, but does take away the element of predictability, unless there are clear parameters and guidance on the basis of which the FCA will exercise this power.

> > **Enabling reference price systems to match orders at the mid-point**: To address issues with the current process – where venues operating under the reference price waiver must derive the price from either the venue where the instrument was first admitted to trading, or the most relevant market in terms of liquidity – the government is proposing that reference price systems be able to match orders at the mid-point within the current bid and offer of any UK (or non-UK) venue offering the best bid or offer.

> > **SI transparency**: In view of the requirement for SIs to make quotes public only where they quote up to 10% of the standard market size (and only for liquid instruments), the government is keen to improve transparency. It is therefore seeking views on, e.g., possible incentives that can be offered to SIs for them to increase the number of quotes disclosed prior to trading.

> For **post-trade transparency**, the government believes that regime is working well for equity (and equity-like) instruments. It recognises, however, that the **further standardisation** – e.g. improved flagging of trade types – could be introduced to assist with price formation. As well as future FCA work to look at the length and scope of available deferrals, the government is also looking to facilitate the **introduction of a consolidated tape** (see below).

> Proposed trading changes include:

> > **Repealing the UK share trading obligation** (STO): The government is keen that firms be able to trade shares on any venue in the UK or overseas, with any counterparty on an OTC basis. Its view is that the way in which the STO restricts trading is neither appropriate, effective or conducive to price formation or stability.

> > **Removing requirements to enter into market making agreements**: The government is proposing that the obligations on **algorithmic trading liquidity providers** to enter into binding market making agreements (i.e. setting these out in a written agreement)

"The government proposes to **repeal the double volume cap (DVC)**… and wants the FCA to monitor the extent of dark trading, and be able to limit (i.e. suspend) such trading where necessary."

"**The UK share trading obligation (STO) will be repealed.** The government believe that the STO restricts trading is neither appropriate, effective or conducive to price formation or stability."

with trading venues be removed. This follows on from industry feedback that formally-agreed market making strategies have limited positive effect, but impose disproportionate cost and administrative burdens on firms and venues.

- **Improving the tick size regime**: The government is looking at recalibrating the regime for overseas shares so that trading venues can **follow the tick sizes that apply in the relevant primary market** of a share (where it is not in the UK). This is a helpful proposal that should help resolve some of the practical issues posed by Brexit, because of which firms ended up with two different price streams for their UK vs. EU SIs for the same equity product. The government is also exploring whether to give trading venues the ability to (i) establish tick sizes for new shares (until the FCA has sufficient data available to do so); and (ii) set the value of tick sizes more generally. In relation to (ii) in particular, the government is mindful of the arbitrage risk and, if it were to take this proposal forward, it would likely require appropriate safeguards to be put in place.

## Fixed income and derivatives markets

- Derivatives trading obligation:
  - A key proposal is to grant **the FCA a permanent power (to be used only after consultation with HMT) to modify or suspend application of the UK DTO**. This will be welcome as it would allow the FCA to extend the temporary transitional relief which is currently in place and allows UK firms to trade on EU venues when their clients do not have access to venues that are mutually equivalent for the purposes of both the UK and EU DTOs.
  - The government also proposes to **realign the scope of the derivatives trading obligation (DTO) and the clearing obligation (CO)** to reflect the fact that firms that are small financial counterparties were taken out of scope of the CO by EMIR REFIT. There is currently a transitional relief in place to align the DTO and CO, but the proposal is to make this permanent.
  - The government wants to extend the exemption from the DTO which currently allows for component derivatives in portfolio compression to be replaced/terminated without needing to comply with the DTO. The **extended DTO exemption** would cover all components resulting from **non-price forming post-trade risk reduction services** (e.g. would capture cover rebalancing and optimisation services). There may be conditions attached to this exemption to avoid it being misused. HMT are also considering a similar exemption from the CO in respect of the same transactions.
- Non-equity transparency:
  - Scope: For OTC derivatives, the government recognises that the current requirements (which refer to whether instruments with the same characteristics are traded on a trading venue (TOTV)) and the way ISINs operate have meant that some standardised, liquid derivatives are out of scope. They may address this by removing the TOTV concept and, instead to bring **OTC derivatives into scope of transparency obligations if they have been centrally cleared** (either pursuant to the DTO or voluntarily). The government is also

"A key proposal is **to grant the FCA a permanent power (to be used only after consultation with HMT) to modify or suspend application of the UK derivatives trading obligation**."

consulting more broadly on how the transparency regime can be improved for fixed income and derivatives products.

- Pre-trade transparency:
  - The government considers the current calculations which determine whether bonds or derivatives have a "liquid market" to be flawed. For bonds, they say that liquidity is episodic (around issuance or corporate events), and indications are that 52-69% of bonds determined to be liquid under the calculations are in fact illiquid. The government want to replace current liquidity calculations with a **"qualitative and quantitative assessment" to determine liquid classes of instruments** (similarly to the way information in respect of OTC instruments is currently assessed for DTO purposes)
  - They propose **limiting the non-equity pre-trade transparency regime to systems such as electronic order books and periodic auctions**, thereby completely taking out of scope bespoke trades traded bilaterally. More broadly, the government is interested in how firms use non-equity pre-trade data to determine whether a wider review is needed. The waiver regime may be simplified at a later stage. This is quite a significant proposal, that should effectively switch off pre-trade transparency obligations for non-equities SIs.
- Post-trade transparency: The government envisages an **overhaul of the non-equity post-trade transparency regime**, as follows:
  - There would be **no size specific to the instrument (SSTI), package order and exchange for physical (EFP) deferrals**.
  - Deferrals for large in scale (LIS) and illiquid trades would continue to apply, but the government envisages **shorter deferral periods for LIS trade, and longer deferrals for illiquid trades (which the FCA would consult on)**.
  - As was the case pre-MiFID II, HMT propose that **trading venues calculate LIS threshold for ETD post-trade reporting** (following principles to be set by the FCA). The FCA would set LIS thresholds for other asset classes.
  - The government proposes to allow "**comprehensive volume masking**".

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## Commodity markets

- The government believes the MiFID II commodity derivatives regime is poorly designed and inefficient, and so are proposing to fundamentally reform the regime. In this regard, the UK intends to go further than the EU's MiFID quick fix.
- Scope:
  - The government is proposing to **remove derivatives that are not based on physical commodities** from the scope of the commodities regime.
  - The government is proposing to **remove securitised derivatives from the definition of commodity derivatives**.

"The government proposes **fundamental reforms to the commodity derivatives regime**... which go further than the EU's MiFID quick fix."

- > The government will **remove** the concept of **"economically equivalent OTC commodity derivatives"** from the regime.
- > The government intends to **revoke the requirement for position limits to be applied to all ETDs**.

> Operation of position limits and reporting:

- > The government proposes to **transfer the setting of position controls from the FCA to trading venues** themselves. The FCA would then provide a framework and set expectations on how venues should manage positions. In this regard, they think **requiring trading venues to set position limits for agricultural contracts and physically settled contracts** is needed to promote market integrity.
- > The consider that the FCA should **continue to receive daily commodity derivative position reports** to monitor the market.
- > The government intends to provide **exemptions to the position limits regime for all liquidity providers**.
- > They also propose a **"pass-through" hedging exemption**, so that investment firms can be exempt when delivering a wider range of risk-mitigation services (e.g. facilitating hedging for a commercial entity).
- > The government generally wishes to **retain position reporting** but is considering **small amendments** to help reduce burdens on firms.

> Regulatory perimeter and classification:

- > The government intends to modify the "ancillary activities test" in relation to the dealing on own account exemption in commodities, so that it will be based on **qualitative criteria only**. **Annual notification requirements for use of the exemption would be abolished**. The FCA would still be able to request evidence from firms using the exemption. The test should also be based on a **pro-active assessment of the firm's expected activity** (rather than a backward-looking approach as currently).
- > The government proposes to **abolish the oil market participants and energy market participants regimes** (firms would be either authorised under MiFID or be able to use the ancillary activities test based exemption above).

## Market data

> The government believes MiFID II has not achieved its aim of making standardised data easily accessible to market participants. The government is keen to improve the quality and usability of market data and progress the emergence of a consolidated tape (CT).

> The government is considering two potential options for encouraging a CT:

- > Changes to legislation to enable a private sector tape:
  - > Make it **mandatory** for trading venues and authorised publication arrangements to **submit their data** to a CT.
  - > **Remove the requirement for CTs to provide 100% coverage of equity activity or 80% coverage of fixed income activity**.

"The government is keen to improve the quality and usability of market data and progress the emergence of a consolidated tape…"

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    - **Remove the requirement for CTs to provide their data for free after 15 minutes**.
    - **Simplify and standardise fixed income deferrals** to facilitate consolidation.
    - Require a private sector CT to have a **balanced governance structure** that represents providers and consumers.
  - Alternatively, the public sector could work to develop a CT. The government notes, however, that this would not create a competitive environment, and they would need to ensure the sector contributes to the cost of such a service.
- The government notes that the FCA's call for input on market data will result in a feedback statement later this year. The government will take note of this in developing policy but feel that issues around the quality of data reporting could be dealt with through changes to FCA rules.

"The government is taking this opportunity to canvas views on possible longer-term measures to ensure the reporting regime is as efficient as possible."

## Reporting

- The government is not – at this time – proposing to make any changes to the reporting regime (although note the proposal in relation to SIs fulfilling the trade reporting obligation at an entity level, described above).
- However, the government is taking this opportunity to canvas views on possible longer-term measures to ensure the reporting regime is as efficient as possible. In particular, the review is seeking input on:
  - **Overlap between MiFID II and EMIR (and SFTR) reporting**: The government is keen to understand more about any overlaps that exist and issues in relation to different reporting formats between the regimes. The government is also welcoming views on the extent to which duplicative reporting requirements may become an issue in future between MiFID II and the SFTR – particularly from 31 March 2022 when the temporary transitional powers (which have mitigated this issue to date) expire.
  - **Investor protection reports**: In addition to the "Quick Fix" package of changes recently announced, and variously being implemented by the FCA (as to which see this client note) and HM Treasury (as to which see this client note), the government is also keen to explore the potential for further fine-tuning of reporting requirements designed to protect investments. Areas under consideration include (i) in relation to the requirement for firms to report on portfolio losses of 10% or more (which is being removed for professional clients), whether this requirement remains an effective protection for retail clients; and (ii) with a view to reducing burdens on firms and clients, whether electronic communication should become the default method for all clients, including retail.
  - **Financial instrument identifiers (ISINs)**: The government recognises that there are some difficulties using ISINs for derivatives reporting (in particular), and is keen to understand the extent of such issues and possible improvements that could be made (e.g. through the development of unique product identifiers (UPIs).

## Next steps

HM Treasury's consultation on the UK Wholesale Markets Review closes on 24 September 2021.

The government intends to bring primary and secondary legislation to implement the legislative changes resulting from the Wholesale Markets Review "as soon as parliamentary time allows".

The FCA will start consulting in the second half of 2021 on changes to its rules and guidance which are affected by the proposals in the Wholesale Markets Review.

The Wholesale Markets Review is being run in parallel with the wider policy work on the UK Future Regulatory Framework (FRF). This is because the government want to implement some changes to the rules applicable to wholesale financial markets swiftly. Outcomes from this consultation will be taken into account in the wider FRF review, on which a further consultation is due later in 2021.

## Documents and related publications

Click here for the HM Treasury Wholesale Markets Review consultation document, published on 1 July 2021.

The consultation was published following Chancellor Rishi Sunak's Mansion House speech.

The speech was also accompanied by:

- a document setting out a vision of the future of financial services;
- a consultation on the UK Prospectus Regime Review following Lord Hill's recommendations in the UK Listings Review;
- a response to the call for evidence of the UK Solvency II review; and
- a consultation on access to cash.

If you would like to discuss any of the above proposals, please do not hesitate to contact any of those listed below.

## Contacts

**Sebastian Barling**
Financial Regulation Group, Partner
Tel: (+44) 20 7456 5352
sebastian.barling@linklaters.com

**Raza Naeem**
Financial Regulation Group, Counsel
Tel: (+44) 20 7456 5272
raza.naeem@linklaters.com

**Peter Bevan**
Financial Regulation Group, Partner
Tel: (+44) 20 7456 3776
peter.bevan@linklaters.com

**Karen Cooper**
Financial Regulation Group, Senior PSL
Tel: (+44) 20 7456 5693
karen.cooper@linklaters.com

**Harry Eddis**
Financial Regulation Group, Partner
Tel: (+44) 20 7456 3724
harry.eddis@linklaters.com

**Benjamin Maconick**
Financial Regulation Group, Managing Associate
Tel: (+44) 20 7456 4940
benjamin.maconick@linklaters.com

**Alastair Holt**
Financial Regulation Group, Partner
Tel: (+44) 20 7456 2760
alastair.holt@linklaters.com

**James Morris**
Financial Regulation Group, Managing Associate
Tel: (+44) 20 7456 5948
james.morris@linklaters.com

**Michael Kent**
Financial Regulation Group, Partner
Tel: (+44) 20 7456 3772
michael.kent@linklaters.com

**James Piggott**
Financial Regulation Group, Associate
Tel: (+44) 20 7456 4847
james.piggott@linklaters.com

**Pansy Wong**
Financial Regulation Group, Partner
Tel: (+44) 20 7456 5018
pansy.wong@linklaters.com

For general enquiries please contact

Linklaters LLP
One Silk Street
London EC2Y 8HQ

Tel: (+44) 20 7456 2000
Fax: (+44) 20 7456 2222

linklaters.com

Authors: Karen Cooper, Raza Naeem, Benjamin Maconick, James Piggott

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