KEY POINTS
- HM Treasury has published a review of the UK wholesale markets covering a wide range of adjustments to the regime, including:
  - Clarifying the regulatory perimeter for trading venues and systematic internalisers.
  - Abolishing restrictions around equities trading.
  - Recalibrating the non-equities transparency regime.
  - Facilitating access to market data.
  - Reforming the commodities regime.

Feature

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Wholesale Markets Review: an enhanced, tailor-made regime for UK markets

In this article, Elisabeth Øverland considers the principal proposals included in HM Treasury's recent consultation on wholesale markets regulation – the Wholesale Markets Review.

In July this year, HM Treasury published a review of the wholesale markets (Wholesale Markets Review: Consultation) with the aim of adjusting the applicable regulatory regime based on evidence and experience to address risks more effectively. The consultation closed on 24 September 2021 and HM Treasury is currently considering responses. Economic Secretary to HM Treasury, John Glen, noted in a speech on 23 November that they have seen broad consensus on the vast majority of the issues identified in the consultation and that a full summary of responses will be published early in 2022 together with the government's plan for taking this work forward.

Most of the rules that govern trading of financial instruments in the UK are derived from EU legislation; in particular, the EU "MiFID II framework" (ie the Markets in Financial Instruments Directive (MiFID II) and the Markets in Financial Instruments Regulation (MiFIR)). Although the UK played a significant role in developing that framework, the review considers how the UK regime can be adjusted in the post-Brexit world to ensure market participants and regulators focus on the right risks.

This is not about lowering regulatory standards, but about maintaining high standards, whilst ensuring the application of a regime that is fair and outcomes-based and that does not stifle innovation. There is renewed focus on global openness and competitiveness, as well as the ability to tailor the regime more closely to the unique circumstances of the UK.

This approach goes hand in hand with an emphasis on simplifying the approach and abandoning rules that involve costs for market participants with little or no real benefit.

Market participants have welcomed many aspects of the review, recognising that there are areas that could benefit from reform, whilst recommending caution where adjustments may cause divergence in standards that could necessitate additional work for firms seeking to comply with EU and UK rules.

The proposals are wide-ranging, but do not amount to a rewrite of the regulatory regime for wholesale markets.

Adjustments are suggested in a number of distinct areas, including:

- **Trading venues and systematic internalisers (SIs)**: Clarifying the regulatory perimeter and restrictions so the market can operate in confidence and promote innovation.
- **Equities trading restrictions**: Removing rules that limit firms' ability to access liquidity and ensure the best outcomes for their clients.
- **Fixed income and derivatives transparency**: Recalibrating the regime to ensure only liquid and standardised instruments fall within it.
- **Market data**: Enabling market participants to identify the best available prices more easily.
- **Commodities regime**: Fundamentally reforming the regime to ensure market activity is not needlessly restricted.

The Financial Conduct Authority (FCA) is expected to progress further consultations about parts of the regime falling within its rules and guidance, whilst the government intends to bring forward any primary or secondary legislation required as soon as parliamentary time allows.

Some of the main proposals are considered in further detail below.

TRADING VENUES

Clarifying the perimeter

The review includes proposals aimed at clarifying what constitutes a trading venue, noting that market change and innovation has created ambiguity in this area. There is, for example, concern that brokers arranging trades over the phone without operating a central mechanism to match client orders, and technology firms enabling firms to exchange trading interest and execute transactions with clients, "may challenge the definition of a multilateral system".

The government considers that guidance on the characteristics and functions that separate trading venues from other modes of communication may be preferable to a narrow definition in legislation.

While market participants may welcome further guidance in this area, they will be keen to avoid the introduction of additional barriers to entry or regulation that limits the ability of technology providers to assist with novel or innovative ways of providing connectivity and execution.

Reviewing restrictions on MTFs and OTFs

The government is reviewing restrictions placed on multilateral trading facilities (MTFs) and organised trading facilities (OTFs), including restrictions on matched principal trading within an MTF and the operation of an SI within the same entity as an OTF. They are questioning whether these restrictions are cost-effective methods of managing conflicts of interest or whether there are better ways of doing so, including by providing appropriate disclosure.

The review also considers whether restrictions on the ability of OTFs to execute trades relating to packages of derivatives that include cash equity products achieves any meaningful objective. A practical benefit to removing this restriction would be the ability to execute such packages on one venue, recognising that splitting execution across venues can cause operational complexity and risks if, for example, one part of the transaction fails to settle.

A new venue for small issuers

Additionally, the review floats the idea of a new type of venue which would allow more proportionate company disclosure rules for smaller issuers. The government wants to facilitate such issuers' access to capital, whilst recognising that they may find existing disclosure requirements too burdensome.

However, with demand for investment in these types of companies typically coming from retail investors, more manageable demands on issuers will need to be carefully balanced against ensuring appropriate investor protection.

Market outages

The review addresses current uncertainties around the role of market operators and participants in the event of a market outage, which could inhibit trading even where it would be technically possible. Market participants will likely appreciate more clarity in this area.

The government is considering whether procedures and guidelines developed by the FCA in co-ordination with market participants could provide a suitable approach to enhancing UK market resilience that may be preferable to legislative intervention.

Proposals for dealing with market outages include:

- A playbook for trading venues and participants to follow when an outage occurs.
- An alternative mechanism to a closing auction during an outage.
- A reference price system to match trades at the mid-point with the current bid and offer of any UK or non-UK trading venue that provides reliable and transparent pricing.

SYSTEMATIC INTERNALISERS

The government believes the regulatory regime for SIs is broadly operating as intended, but has suggested a few adjustments to simplify the regime, increase liquidity and reduce costs. An SI is a firm which on an organised, frequent, systematic and substantial basis deals with its clients as principal, "internalising" those clients' orders, rather than executing them on a trading venue.

Proposals for adjusting the SI regime include:

- Reverting to a qualitative definition of an SI and abolishing current threshold calculations.
- Determining the status of an SI at an entity-level for post-trade reporting purposes to deliver greater clarity to counterparties about who will report the trade.
- Allowing SIs to execute at the mid-point for all trades, provided the price is within the SI's quoted price.

The removal of complex threshold calculations is likely to be welcomed by firms, as well as proposals increasing the ability to determine prices. The current imposition of tick-sizes (which sets minimum increments by which prices can change) on SIs for equity and equity-like instruments is viewed by many as restricting the ability of SIs to offer price improvement to clients whilst adding significant complexity to trading.

EQUITY MARKETS

Transparency

The government considers that post-trade transparency for equities and equity-like instruments is working well and has a positive impact on price formation, although there are areas where further standardisation may be helpful.

As the post-trade deferrals regime (for deferring the publication of post-trade data) is detailed in the FCA rules, this is something the FCA will be exploring separately.

In respect of pre-trade transparency, the review includes some quite significant reforms, with the government noting that transparency can, in some cases, have a negative impact on price formation and impair liquidity.

In particular, the double volume cap, which limits the volume of trading permitted without pre-trade transparency to 4% of all trading in an instrument at a single venue and 8% across all venues, is highlighted as an inappropriate tool to protect price formation in UK markets, and the government is, therefore, proposing to abandon it. Instead, the FCA would monitor the level of dark trading and retain the power to limit it if trading is undermining price formation processes. This proposal has been well received by many market participants who view this as an unnecessary and complex requirement. In his speech on 23 November, John Glen confirmed that the double volume cap will be revoked.

Amendments are also proposed to the reference price waiver, which requires trading venues to derive the price from the venue where that instrument was first admitted to trading or from the most relevant market in terms of liquidity. The government is concerned that the restrictions on the source of the reference price has a negative market impact and that venues should be able to derive the reference price from any trading platform that offers the best execution result. This would allow reference price systems to match orders at the mid-point within the current bid and offer of any UK or non-UK venue that offers the best bid or offer.

Trading restrictions

The share trading obligation currently requires investment firms to ensure trades in shares admitted to trading on a trading venue take place on a regulated market, an MTF, through an SI or on an "equivalent" overseas trading venue. The government believes this restriction is inappropriate and should be abolished as it is not conducive to price formation or stability.

The aim is to ensure investors get the best price for their trade, with firms being free to trade shares on any trading venue, whether in the UK or overseas, and with any counterparty, provided best execution is achieved.

Whilst this proposal has been appreciated by broad sections of the market as a move to support open UK capital markets, there may be concern in some quarters about whether it will negatively impact price transparency. However, in his speech on 23 November, John Glen confirmed that the share trading obligation will be revoked.

Another broadly welcomed proposal is the removal of the requirement for algorithmic liquidity providers and trading venues to enter into binding market making agreements. The government has considered industry feedback suggesting that the impact on markets of agreeing strategies in this way is limited, whilst needless costs and administrative burdens are imposed on both market makers and trading venues.

The review also suggests recalibrating the tick-size regime to enable trading venues to follow tick sizes in the relevant primary market of a share where it does not have its primary market in the UK. In addition, the government is considering any potential benefits and risks associated with delegating the setting of tick sizes to trading venues.

FIXED INCOME AND DERIVATIVES MARKETS

Transparency

To support price formation and competition in fixed income and derivatives markets, the government plans to reform the transparency regime to ensure only standardised and liquid instruments fall within scope.

Proposals include changes to:

- Remove the concept of "traded on a trading venue" (TOTV) from the determination of instruments to which transparency applies.
- Determine scope for OTC derivatives by whether a transaction is centrally cleared.
- Replace liquidity calculations with qualitative assessments to determine liquid classes of instruments to which transparency applies.

The scope of the regime has been particularly difficult to define for OTC derivatives (as the ISIN used to identify derivatives that are TOTV can relate to different products), but it seems unlikely there will be any meaningful change to this position until product identifiers allow for better identification of in-scope instruments. Using central clearing to determine scope may not necessarily capture only standardised and liquid derivatives; particularly if voluntarily cleared contracts are in scope.

In respect of post-trade transparency, proposals include simplifying the deferrals regime by removing several categories, leaving just the large in scale (block trades) and illiquid instruments deferrals in place.

The review notes that the pre-trade transparency regime has not worked effectively due to a significant proportion of instruments being bespoke, illiquid and complex. The government proposes to limit the regime to systems such as electronic order books and periodic auctions that currently operate under full transparency. This would mean bespoke bilateral trades (including via SIs and RFQ (request for quote) systems) would be outside the regime. This has been broadly welcomed by the industry.

Any changes to waivers from the transparency requirements will be considered under specific proposals at a later stage.

Derivatives trading obligation

The derivatives trading obligation (DTO) requires financial counterparties, and some non-financial counterparties, to trade certain classes of derivatives on UK trading venues or overseas venues recognised as "equivalent". Suggestions in this space have generally been well received by market participants.

Proposals include:

- Revising the scope of the DTO to bring it in line with the clearing obligation under the European Market Infrastructure Regulation (EMIR).
- Exempting additional post-trade risk reduction services, including cover rebalancing and optimisation services.
- Granting power to the FCA to modify or suspend the DTO quickly in certain circumstances on a permanent basis, rather than pursuant to current temporary transitional powers.

The market will be keen to ensure the FCA's new powers cannot be used to introduce a DTO in respect of additional classes of derivatives. Market participants will also want proper notice of modifications or suspensions wherever possible, combined with forbearance measures to allow time for compliance as appropriate.

MARKET DATA

The review recognises the important role market data plays in price formation and best execution, as well as in identifying new opportunities and evaluating existing positions.

The government is critical of the MiFID II approach to achieve easy access to data. A consolidated tape has failed to emerge, which means market participants may incur significant costs when obtaining data from several sources.

The government considers that a consolidated tape – an electronic system that collates real-time market data – may be the best way to increase data standardisation and accessibility, stating that it 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".

Proposals include legislation to enable a private sector tape to emerge or alternatively public sector involvement to create and run the tape.

Although this has been welcomed by many market participants in respect of both equities and bonds, it would be unlikely to work in derivatives markets unless and until a better way of categorising and identifying contracts is introduced. A consolidated tape may, however, not provide the data required by sophisticated market users, for whom latency issues and data analysis may necessitate more complex arrangements.

Biog box
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REPORTING

Whilst the FCA is expected to consult separately on possible amendments to transaction reporting, the government is seeking views on whether reporting could be made more efficient in the long-term. Feedback is sought on overlaps in reporting under MiFIR, the Securities Financing Transactions Regulation and EMIR.

Whilst simplification may well be helpful, firms have invested heavily in systems enabling compliance with current requirements and many are unlikely to be keen on changes that would involve further divergence between UK and EU regimes.

The government is also seeking views on the use of ISINs and the potential use of Unique Product Identifiers (UPIs) or alternative identifiers to identify derivatives for reporting purposes more easily. In turn, this will have an impact on the usefulness of transparency and market data in derivatives markets.

COMMODITY MARKETS

The review includes fundamental changes to the commodity markets regime to remove excessive regulation and make the regime more proportionate.

The government notes that it "has always believed that the MiFID II commodity derivatives regime is poorly designed and inefficient" and should be reformed to ensure it can serve UK and global markets in the long term more effectively.

Proposals include removing the following types of instruments from scope:

- Derivatives that are not based on physical commodities.
- Financial instruments that refer to commodities as a pricing element but are securities in their legal form.
- "Economically equivalent" OTC commodity derivatives (whilst retaining an obligation for the FCA and trading venues to consider such contracts as part of their market monitoring).

Position limits

The government views the current approach to position limits as too complex and needlessly duplicating controls across trading venues and the FCA.

To avoid preventing liquidity from developing (to the detriment of market participants), the government wants to revoke the requirement for position limits to be applied to *all* exchange traded contracts.

It proposes transferring the setting of position controls from the FCA to trading venues, an approach which was confirmed by John Glen in his speech on 23 November, whilst enabling the FCA to set a framework for venues, including an obligation to set minimum limits for physically settled contracts or where the underlying commodity is an agricultural product. This is intended to strike a balance between applying the regime to contracts that pose a risk to market integrity and allowing venues to use their oversight to enforce appropriate limits.

In a move that is likely to be welcomed by end-users, the government is suggesting that position limit exemptions are extended to liquidity providers to facilitate hedging activity for commercial counterparties via a "pass-through" hedging exemption.

Ancillary activities test

The current regime employs an "ancillary activities test" to determine if an entity's trading in commodity derivatives is primarily for investment purposes or in support of the entity's commercial business (in which case it would not require investment firm authorisation).

In a move broadly welcomed by the market, the government wants to abolish this test and revert to a principles-based approach based on qualitative criteria that take account of the entity's business more holistically.

Oil and energy markets

The government proposes to abolish the separate UK regimes for oil market and energy market participants, bringing them within the MiFID II framework instead.

CROSS-CUTTING ISSUES

In addition to enhancing the effectiveness of the current regulatory framework, the government is considering its longer-term vision for capital markets.

The review identifies several issues that guide the UK's vision for financial services. Areas being explored include:

- What additional steps can be taken to encourage new technologies to increase efficiencies and reduce costs?
- How can opportunities in the financial sector to meet climate objectives, and ensure sustainable and ethical markets, be supported?
- What are the barriers to retail participation and is the balance between investor protection and retail access correct?

The issues raised in the review are wide-ranging and sit alongside the government's intention to make regulation more agile, by devolving rules to regulators and giving more space for expert judgement. Overall, this is an approach that is likely to be well received by the industry. ■

Further Reading:

- What's in a name? "Systematic internalisation" and the regulation of trading under MiFID II (2015) 7 JIBFL 421.
- Regulatory divergence after Brexit: laying the foundations for a new UK regime (2021) 2 JIBFL 129.
- LexisPSL: Financial Services: News: The Wholesale Markets Review: fine-tuning the MiFID II regime?