FIA EPTA
EUROPEAN PRINCIPAL TRADERS ASSOCIATION

.

FIA EPTA response to CP 22/18 on Guidance on the trading venue perimeter

25 November 2022

FIA EPTA appreciates the opportunity to respond to the FCA's Consultation Paper 22/18 on Guidance on the trading venue perimeter.

FIA EPTA members welcome the FCA's proposed guidance and are generally in agreement with the FCA's intended approach the FCA, which we consider to be proportionate and providing for an appropriate degree of clarity to market participants regarding whether the FCA would characterise a specific system as multilateral or not.

Given our strong support for the FCA's proposals, and the consequent absence of further specific feedback on our part regarding the FCA's proposed guidance (with one exception), we limit ourselves to a response via this letter.

Our substantive comments are relation to the following:

1. The scope of the FCA's proposed guidance regarding "blocking" (Q6), which we consider should be clarified to be relating specifically to practices in the listed derivatives markets only;

Further, we have identified two areas which are not covered in the currently proposed guidance but where FIA EPTA members observe market practices that seem to be multilateral in nature while not currently being subject to trading venue authorisation. This is in relation to:

2. Retail Service Providers (RSP) systems operated by non-authorised third-party service providers (ISVs); and

3. De-facto riskless or quasi-multilateral SI activity

We reflect on these matters in our comments below:

1. Blocking onto trading venues

Q6: Do you agree with our proposed guidance relating to blocking onto trading venues?

Yes, FIA EPTA members agree with the FCA's proposed guidance. However, FIA EPTA members would encourage the FCA to be more specific regarding the specific market practices which it intends to capture, as we would have a concern that the guidance may otherwise cause a degree of confusion regarding its intended purpose.

FIA EPTA members observe that the concept of blocking trades onto a trading venue, consistent with the intentions of the parties to the underlying transactions to formalise the trade on a trading venue, is a practice which is specific to markets for listed (financial or commodity) derivatives. On such listed derivatives venues, a pre-arranged trade can only be consummated/registered when it is acknowledged and accepted by the trading venue which has listed the derivative in question.

Although the term 'blocking' is not a term discussed or defined in UK MiFID, it is seen widely used within the individual derivative trading venues rulebooks and conditions for trading. For example, ICE Futures Europe has a Block Trades and Asset Allocations Policy which provides guidance on the method of reporting Block Trades and Asset Allocations to ICE Futures Europe for registration and subsequent clearing by ICE Clear Europe, specifically for high volume trades arranged and executed by members of the exchange away from the order book in specific contracts designated by the exchange.[1]

Other listed derivatives exchanges operate blocking functionalities in a similar manner, with the aim of supporting the off-book trading of derivatives which are listed on the relevant exchange, enabling buyers and sellers to execute order information into the exchange system without execution risk.[2]

In the case of such listed derivatives blocking practices, FIA EPTA members are fully in agreement with the FCA's proposed guidance that if a firm operates a system for the purpose only of blocking such trades onto a trading venue, for example when arranging a large-in-scale trade in accordance with the rules of the venue, that these arrangements do not amount to the operation of a multilateral system.

Given the specific association of the term blocking with existing market practices in the listed derivatives space, we would suggest clarifying the FCA's proposed guidance as follows:

Q24F. Does a firm using a system to block trades <u>in respect of listed derivatives</u> on behalf of clients operate a *multilateral system*?
No, if a firm operates a system for the purpose only of blocking trades <u>**in respect of listed derivatives**</u> onto ~~a~~ <u>**the listing**</u> trading venue consistent with the intentions of the parties to the underlying transactions to trade on ~~a~~ <u>**that**</u> trading venue, for example, when arranging a large-in-scale trade in accordance with the rules of the venue, in our

[1] https://www.theice.com/publicdocs/futures/ICE_Futures_Block_Trade_Policy.pdf

[2] E.g.: Eurex (https://www.eurex.com/ex-en/trade/eurex-t7-entry-services/block-trades); CME (https://www.cmegroup.com/rulebook/files/cme-group-Rule-526.pdf)

Note the CME's definition of Block trades: "Block trades are **privately negotiated futures, options or combination transactions that meet certain quantity thresholds** which are permitted to be executed apart from the public auction market. It is not permissible to facilitate the execution of block trades in Exchange-traded products on a system or facility accessible to multiple parties that allows for the electronic matching of or the electronic acceptance of bids and offers. (…)"

view these arrangements do not amount to the operation of a *multilateral system* in the case of UK MiFIR or otherwise.

2. Multilateral characteristics contained in Retail Service Providers (RSP) systems

By way of further comment in regard to the trading venue perimeter, we note that Retail Service Provider (RSP) systems, operated by non-authorised third-party service providers (ISVs), facilitate the multilateral matching of orders in a manner very similar to RFQ MTFs, allowing brokers to poll a number of market makers for quotes to determine the best price offered.

In this context, we note that in its draft guidance that is subject to this consultation, the FCA highlights and further elaborates on the following four characteristics as being the key components of a multilateral system:

a. Having the characteristics of a trading system or facility;
b. Comprising multiple third-party buying and selling trading interests;
c. Allowing trading interests to interact in the system; and
d. Ensuring that those trading interests are in financial instruments.

As set out above, FIA EPTA members agree with the FCA's interpretation regarding the key characteristics for a multilateral system. In this regard, we note that RSP system operators offer a comprehensive handling of all elements of pre- and post-trade requirements while typically categorising themselves as purely a trading connectivity solution. However in practice, when assessed against the FCA's proposed guidance on each of the above four elements, we are of the view that RSP systems meet the definition of the multilateral system. This is because of the following considerations:

a. <u>Having the characteristics of a trading system of facility</u>: RSPs function on the basis of a set of rules that provide more than just general communication features, thereby having the characteristics of a trading system or facility (also in the light of the below criteria being equally met).

b. <u>Comprising multiple third-party buying and selling trading interests</u>: RSPs group together multiple third-party buying and selling trading interests in shares, these being retail brokers searching best bids on one side, and market makers posting bids for orders on the other.

c. <u>Allowing trading interests to interact in the system</u>: RSP are designed to allow interaction of such trading interests in shares and users to interact, by bringing together market makers (liquidity providers) and retail brokerage firms acting on behalf of the end retail investors.

d. <u>Trading interests being in financial instruments</u>: Finally, RSP systems are mainly used to allow retail customers to trade in shares, which are financial instruments.

As the FCA noted in its CP22/12, in the UK over 95% of retail orders for shares are executed through those unregulated RSP platforms. In this context, and particularly given the coverage of the RSP systems in the retail markets, we also encourage the FCA to perform a more comprehensive review of the RSP model in order to assess whether it delivers the best possible execution quality for retail investors and to determine what enhancements could be made. We believe that is important to ensure that any change to the current framework will improve the execution quality and service that retail clients receive. Therefore we suggest, that any such future review that the FCA may wish to undertake should be guided by the following principles:

- Sources of liquidity: retail brokers should thoroughly search for the best sources of liquidity and offer the highest quality of execution, whether through an RFQ system taking place on an authorised trading venue, the central limit order book of a trading venue, a dedicated segment of a trading venue, or any alternative execution venues permitted.

- Best execution: The execution prices achieved by retail customers should be at least as good as the prevailing best price on the most relevant market in term of liquidity for the so-called instrument in the UK or in another jurisdiction and one that considers the overall cost of trading including implicit and explicit costs (brokerage, trading, clearing and settlement fees).

- Resiliency: Contingency arrangements should exist to ensure systems are always available, even in the event of an outage at a trading venue or during times of high market volatility.

- Likelihood of settlement: Retail clients should be protected from counterparty risk prior to the settlement of trades.

Based on the above, FIA EPTA members firmly believe that given both the letter and the spirit of the definition and the FCA's proposed guidance of a multilateral system, that RSP systems should fall under the requirement to become authorised as trading venues. In addition to categorising the RSP platforms as multilateral systems, the FCA should also consider improving the current RSP model by making the RFQ response time more immediate (a 10 to 30 second response time to a quote should no longer be considered necessary with advances in technology). We would also suggest developing standardised execution quality metrics that should be published by the retail brokers to demonstrate that they have achieved best execution and requiring that retail brokers consider available liquidity outside of just the RSP.

Finally, we would like to reiterate that we agree with the key points made about best execution and the RSP system made by the FCA in the Investment Platforms Market Study. Specifically, we agree that firms using the RSP systems should clearly disclose that they are using this system to the clients in their order handling or best execution policies. They should also have appropriate contingency arrangements in place if the RSP system is not available at a time of market volatility. They should also undertake thorough assessments to confirm that the venue selection that is part of their execution arrangements, particularly where they rely on a small number of RSP market makers, delivers a consistently high quality of execution to their clients.

In respect of the application of pre-trade transparency requirements in the context of the RSP systems and as pointed out in FIA EPTA's response to the FCA's Consultation Paper 22/12 on Improving equity secondary markets[3], it is difficult for our members to see how the RSP system fits into the established regulatory requirements for pre-trade transparency as RSP market makers are LSE members meeting their pre-trade transparency obligation by making public two-way quotes in shares on the LSE lit orderbook which are not directly connected to the quotes provided by them via the RSP.

In order to find a constructive way forward, FIA EPTA members would like to suggest that a working group of broad industry participants be assembled by the FCA to review the RSP workflow with a view to determining how best to ensure the appropriate level of pre-trade transparency and contingent arrangements are in place and is in-line with the UK's regime for the trading venue perimeter.

3. De-facto riskless or quasi-multilateral SI activity

Finally, we would urge the FCA to review and provide guidance on the regulatory perimeter in relation to certain SI activity which is de-facto riskless or quasi-multilateral and where, consequently, the definition of multilateral trading and the understanding of when a trading interest in a financial instrument is determined are currently being stretched.

FIA EPTA members would like to draw the FCA's attention to current crossing practices within investment firms that rely on derivatives to cross client-driven equity orders away from public marketplaces. We believe that FCA guidance in this space would serve to:

- Increase total reported equity volumes in the UK, bringing clarity to the true size of the equity market in the UK;
- Redress the balance of activity between OTC and on-exchange trading as well as returning the systematic interaliser (SI) regime to a simpler, genuine risk-taking environment; and
- increase transparency and competition for order-flow, ultimately leading to better trading outcomes for end investors.

Current Practices

It is commonplace for brokers to multilaterally match client-driven swap hedge orders against either other client-driven swap hedge orders or client cash equity orders, leading to de-facto riskless or quasi-multilateral trading within the SI construct. Unless it can be demonstrated that the trading interest is actually that of the broker, and not the underlying client engaged in a swap transaction with the bank, then such mechanisms should be considered as providing interaction between parties with an interest in the same underlying financial instrument and hence should require categorisation as an MTF.

To determine whether or not a swap-hedge order represents interest from the broker or the underlying client, an important test will be that brokers should be able to demonstrate that they are taking material risk, justified by metrics regarding how often the requested client interest fails to transfer into a firm commitment to enter into a swap arrangement with the broker, which in effect leaves the broker riskless.

[3] https://www.fia.org/epta/resources/fia-epta-response-fcas-cp2212-improving-equity-secondary-markets

Within the OTC/SI regimes, brokers can continue to operate internal systematic central limit orderbooks, provided that at least one side of each trade is flagged as the broker's synthetic hedge order (e.g., a swap) rather than a client cash equity order. A broker's principal hedge is systematically created (subject to broker risk checks) upon receipt of a client instruction indicating client desire to enter into a swap arrangement.

The behaviour and handling of that hedge order, whilst in a legal sense nominally independent of client activity, is in practice typically driven entirely by the client's preferences and specific instructions, and so it is functionally not different from the execution of a genuine client cash equity order. Given that the client-driven hedge is legally the broker's principal hedge, it can represent the broker's principal liquidity within the SI regime, despite the broker taking no market risk as a result of such principal hedge order being filled against another client cash equity order within the broker's SI.

Transparency Concerns

Where a synthetic hedge order crosses against a client cash equity order, such a trade can be undertaken within a broker's SI. Therefore, in addition to misrepresenting riskless activity as internalisation, crosses involving client-driven hedge orders also lead to dramatically reduced pre- and post-trade transparency relative to multilateral activity undertaken on a trading venue. Such broker crossing SI activity is:

- Pre-trade transparent only to the extent of the broker's pre-trade SI quoting (which itself is limited to only liquid instruments);
- Is often undertaken at the prevailing mid-price, though without the need for a reference price waiver (albeit needing to adhere to the tick size regime); and
- Enjoys post-trade transparency delays for larger trades and for less liquid instruments.

Of far greater concern, however, where a client-driven synthetic hedging order crosses against another client-driven synthetic hedging order, there is no pre-trade transparency, nor any requirement to issue a post-trade report, given no change in beneficial owner.

The widespread de-facto riskless crossing activities disguised within the OTC and SI regime are therefore both grossly inflating reported SI and OTC volume as well as preventing significant volume from achieving any pre- or post-trade transparency, understating the true size of the equity capital market in the UK. By way of illustration: Calculations from Rosenblatt put SI notional activity in Europe at €7bn in September 2022, with bank SI activity making up €6.78bn or 97% of SI reported volume. It is not possible to know from public data what proportion of this €6.78bn would constitute genuine risk activity.

Potential Areas for Change and FCA Guidance

Minor changes to the trade reporting regime could, as a simple first step, bring greater transparency to this activity. For example, following the same principles that currently ensure that one and only one trade report occurs throughout a chain of execution could be extended to cover the derivatives activity where equal and offsetting equity hedging has occurred. Requiring an equity trade report (perhaps flagged with a derivative identifier) on the back of the client derivatives executions in the event that no other equity trade report occurred throughout an execution chain, would provide valuable transparency into true activity levels in UK equities.

Specifically in regard to the trading venue perimeter, further principles-based guidance requiring brokers to attest to taking genuine risk within mechanisms designed to systematically cross equity orders against each other would exclude this quasi-multilateral client-driven activity from the OTC/SI regimes, leading to greater liquidity and more efficient price formation on public markets. Such a change would facilitate a greater level of open competition and interaction between trading interests, as well as increase both pre- and post-trade transparency, leading to better outcomes for end-investors. The resulting additional on-venue liquidity with increased visibility could help create a virtuous cycle, increasing the size and quality of public equity markets, thereby helping to achieve the objectives of strengthening UK capital markets and attracting more investor and listing activity.

FIA EPTA members appreciate the FCA's consideration of our comments above and we will be happy to provide any further input as required.

FIA EPTA represents 24 independent Principal Trading Firms (PTFs) which deal on own account, using their own money for their own risk, to provide liquidity and immediate risk-transfer in exchange-traded and centrally-cleared markets for a wide range of financial instruments, including shares, options, futures, bonds and ETFs. Our members are independent market makers and providers of liquidity and risk transfer for exchanges and end-investors across the European trading region, including the UK. FIA EPTA's members are based in the Czech Republic, Germany, Ireland, The Netherlands and the UK (two-thirds of our members having been authorised by the FCA).

fia.org/epta
wearemarketmakers.com