

Guidance on the trading venue perimeter (Consultation Paper CP22/18) September 2022

Purpose

The purpose of CP22-18 is to provide new guidance on the regulatory perimeter for trading venues. The FCA aims to ensure that firms have greater certainty about the permissions they require to carry on their business and helps protect the integrity of the United Kingdom's (UK) financial system. This consultation is part of the Wholesale Markets Review (WMR), the review of the UK wholesale financial markets the FCA has been conducting with HM Treasury. Upon recognizing that there is a need for greater clarity about the types of firms which need to be authorised as a trading venue, HM Treasury has recommended that the FCA consult on guidance in the first instance. This consultation will be of interest to trading venues, service companies, broker-dealers, portfolio managers, trade associations, law firms, and investors.

Proposed guidance covers

The FCA is proposing guidance on the different elements of the definition of a multilateral system in key areas that include investment-based crowdfunding firms operating primary market platforms, bulletin boards, tech providers, voice brokers, portfolio managers operating internal matching systems and blocking onto trading venues.

The wider context

Over time, the regulatory framework surrounding secondary markets trading has evolved largely to reflect technological developments and changes in market structure. It has also changed because of the G20 commitment to move trading from opaque and fragmented over-the-counter (OTC) markets to transparent exchanges or electronic trading platforms.

Regulated trading venues are organised markets where transferable securities and other financial contracts, like derivatives, are bought and sold. They differ from OTC trading, where contracts are traded bilaterally between firms without a market operator sitting in between. They are also distinct from unregulated trading venues which sit outside of our perimeter because the assets they trade, such as spot FX, are not financial instruments. As such, the combination of the definition of multilateral system under Article 2(1)(11) of UK

MiFIR and the rule in MAR 5AA.1.1R aims to ensure that all organised trading in financial instruments is carried out on regulated trading venues.

There are three types of regulated trading venues under UK MiFIR:

- A Regulated Market (RM) is a multilateral system operated or managed by a market operator, which brings together or facilitates the bringing together of multiple third-party buying and selling interests in financial instruments in a way that results in a contract, in respect of the financial instruments admitted to trading under its rules or systems. Some common examples of RMs are: London Stock Exchange, IPSX, The London Metal Exchange and the Cboe Europe Equities Regulated Market.
- A Multilateral Trading Facility (MTF) is a multilateral system, operated by an investment firm or a market operator (note: can be operated by either), which brings together multiple third-party buying and selling interests in financial instruments in a way which results in a contract.
- An OTF is a multilateral system which is not an RM or an MTF; and in which multiple third-party buying and selling interests in bonds, structured finance products, emission allowances or derivatives are able to interact in the system in a way that results in a contract (note: primary difference to an MTF being limitation to non-equity financial instruments).

In terms of activities outside the UK trading venue perimeter, firms which do not operate a multilateral system do not require authorisation as a trading venue. However, a firm would still need to consider how its arrangements relate to the permissions in Article 25 of the Regulated Activities Order (RAO). This might necessitate appropriate legal advice.

With reference to arranging deals in investments, the regulated activity of arranging deals in investments is described in Article 25 of the RAO. Article 25 covers two different permissions:

- arranging (bringing about deals in investments): Planning for another person (whether as principal or agent) to buy, sell, subscribe for, or underwrite a particular investment.
- making arrangements with a view to transactions in investments: Planning with a view to a person who participates in the arrangements buying, selling, subscribing for, or underwriting investments.

The harm the FCA is aiming to reduce

Since MiFID II was implemented in 2018, the FCA has continued to develop its understanding of how the trading venue perimeter operates, and of areas of potential uncertainty or where industry may lack clarity. Following the UK's withdrawal from the EU, the FCA is now able to consider approaches which are better tailored to the specificities of the UK market.

Given the ambiguity and confusion surrounding the definition of a multilateral system, the FCA is concerned that some firms may be providing arrangements which constitute a multilateral system without being authorised and regulated as a trading venue. This, in turn, could undermine the policy objectives of the trading venue regime and be detrimental to investor protection and market integrity. Additionally, the inconsistent application of the regime could potentially create an unlevel playing field and negatively impact competition in the market.

Proposals

New guidance of the definition of a multilateral system:

A multilateral system comprises the following main elements:

- it has the characteristics of a trading system or facility;
- it comprises multiple third-party buying and selling trading interests;
- it allows trading interests to interact in the system; and those trading interests are in financial instruments.

Characteristics of a system or facility

- A multilateral system needs to have the characteristics of a trading system or facility. Recital 7 of UK MiFIR clarifies that the term, "system", includes markets composed of a set of rules and a trading platform, as well as those only functioning based on a set of rules.
- Recital 7 also sets out the key functions that an operator of a system should perform for the system to be considered a trading venue: determining the conditions for members or participants to have access to the facility, setting the conditions for the admission of financial instruments to trading, establishing the rules for trading between members and reporting.
- As such, the concept of a system or facility in MiFID II systems is technology neutral for these purposes
- General purpose communications systems, such as chatroom facilities, would not as such amount to trading systems or facilities unless they are part of a facility performing the functions discussed in recital 7 where it is intended to bring about transactions.

- Even if the operator of a general-purpose communications system is not operating a multilateral system, a person using that system to operate a trading system or facility will operate a multilateral system if the other elements of the definition of a multilateral system are met.
- The FCA would have regard to whether a system has features specifically designed to enable the interaction of trading interests in financial instruments. They would consider the role of the operator in relation to determining who can access the system and under what conditions the monitoring of the performance of the system and of the behaviour of users, the types of financial instruments that can be traded and the reporting of information to members.
- However, the FCA's assessment of whether there is a system or facility would also take into consideration a wider range of factors.
- It is possible that a firm operates more than one piece of technology which, when taken together, have the characteristics of a trading system or facility operated by a person.

Multiple third-party buying and selling trading interests

- There needs to be multiple third-party buying and selling trading interests in the system for the system to be a multilateral system.
- The fact that when any two persons negotiate within the system, they do so between themselves, does not mean that the system is bilateral rather than multilateral. Instead, what matters is whether the system, at the point of entry, is designed to enable one person to interact with others. This is the service a person receives as a user of the system.

Interaction within the system

- There needs to be multiple third-party buying and selling trading interests in the system for the system to be a multilateral system.
- Interaction takes the form of an exchange of information relevant to the essential terms of a transaction in financial instruments and other actions signalling intent to conclude a trade. Accordingly, the FCA views that a system which enables this information to be inputted and then responded to in the system would allow trading interests to interact in the system.
- Interaction between trading interests can arise in a system because the system either matches trading interests within the system or allows users to respond within the system to other users' trading interests, including by communicating in relation to, negotiating or accepting essential terms of a transaction.
- The concept of interaction between trading interests in the system does not require execution and the settlement of a transaction to be entered into within the system if it is with a view to the counterparties agreeing the contractual terms of a trade.

Financial Instruments

- The interaction of multiple third-party buying and selling trading interests in the system must be in financial instruments for the system to be a multilateral system. As such it does not include, for example, systems to trade foreign exchange spot contracts.
- A financial instrument is an instrument specified in Part 1 of Schedule 2 to the RAO. Further guidance on financial instruments is available in PERG 13.4.

Voice Broking

In the FCA's view, arranging trades over the telephone is not a sufficient condition for a firm to seek authorisation as a trading venue. When considering whether a voice broking system constitutes a multilateral system, firms should look at the characteristics of a trading system or facility and the functions performed by the operator as discussed above.

Internal crossing by portfolio managers

- The FCA has sought to set out the circumstances where a portfolio manager does not operate a multilateral system when it executes trading interests relating to funds it manages. A firm engaged in portfolio management, in whatever capacity, must exercise discretion in relation to the financial instruments it manages. The FCA does not consider that a portfolio manager operates a multilateral system when, in the exercise of this discretion, it executes trading interests relating to the portfolio of one of its clients against the trading interests relating to the portfolio of another of its clients in an internal matching system.

Blocking onto trading venues

This occurs where an investment firm arranges a transaction between two clients, and that transaction is then executed between the counterparties on a regulated trading venue.

- The FCA views that where a firm operates a system for the purpose only of blocking trades onto a regulated trading venue, where those instruments are admitted to trading and consistent with the intentions of the parties to the underlying transactions, these arrangements do not amount to the operation of a multilateral system

Crowdfunding platforms operating in primary markets

- The FCA views that there is a distinction between the matching of funding interests and the interaction of trading interests referred to in the definition of a multilateral system. Thus, a crowdfunding platform in which the business funding interests of an issuer of shares, debentures or alternative debentures are matched with those of investors does not amount to a multilateral system.

Bulletin boards

- Recital 8 of MiFIR implies that a bulletin board should not be considered a multilateral system. This is because, unlike a trading venue, a bulletin board merely advertises trading interests without enabling the interaction of those interests

The definition of a service company

- A service company is a firm that is authorised only to plan with a view to transactions in investments. A service company is typically authorised by the FCA to carry on investment business only with specified types of clients, as set out in their permissions, which operates as a limitation on the firm's investment activities.
- The FCA is proposing to add to the limitation "professional clients" and "eligible counterparties" client types, whilst also preserving the references to "market counterparties" and "intermediate customers." This will avoid the need for existing authorised firms which are service companies to apply to vary their Part 4A permissions and enable any future applicants to apply for a permission with a limitation comprising the current client types.
- The client type limitation will read as follows:
"Incorporates a limitation substantially to the effect that the firm carry on regulated activities only with one or more of market counterparties, intermediate customers, professional clients or eligible counterparties."

Potential areas for future change

While the FCA are not currently proposing to make any changes to the requirements applicable to firms operating an MTF or an OTF, they have opted to seek views from firms and other interested stakeholders on specific aspects of the MTF and OTF regimes through this CP.

How Pillar 4 can help

Pillar 4 has extensive knowledge in helping trading venues get FCA authorisation and meet their on-going compliance, regulatory, risk, and market surveillance aspects.

Speak to us for guidance on how to carefully navigate the requirements of setting up or operating a trading venue in a compliant manner.