

Guidance consultation 14/9

Multilateral Trading Facilities (MTFs) - Dear CEO Letter and FCA Good Practice Observations on MTF Rulebooks

December 2014

1 Consultation on proposed guidance

Introduction and Background

- 1.1 The FCA has undertaken a thematic review of MTF operators' rulebooks. A sample of UK MTF operators responded to a questionnaire which sought to assess compliance with those areas of the FCA's Handbook (MAR 5) relating to an MTF operator's rules. In particular, MAR 5.3.1 (Trading Process Requirements) requires that "a firm operating an MTF must have transparent and non-discretionary rules and procedures for fair and orderly trading."
- 1.2 Following our thematic review, a Dear CEO Letter and FCA Good Practice Observations have been prepared to provide guidance on MAR 5 requirements relating to MTF rulebooks.
- 1.3 The Dear CEO Letter and Good Practice Observations are attached at Annex 1 below. The FCA expects all MTF operators to be able to demonstrate that they have considered the Good Practice Observations when determining their approach to compliance with MAR 5.
- 1.4 The FCA expects that an MTF operator will have a rulebook in place and the rulebook will be publicly available on the MTF's website.

Consultation and Feedback

1.5 The Dear CEO Letter and FCA Good Practice Observations constitute general guidance. The proposed guidance is therefore open for consultation and we invite your views and comments.

1.6 Please send your responses by email to MTFSupervision@fca.org.uk copying Kirstie.Boardwell@fca.org.uk and Roger.Pordes@fca.org.uk or by post to:

Kirstie Boardwell / Roger Pordes

MTF Supervision

Market Infrastructure & Policy

Markets Division

The Financial Conduct Authority

25 The North Colonnade

London E14 5HS

1.7 To take account of the forthcoming Christmas period the consultation will be open for 7 weeks until 16th January 2015.

Annex 1 - Multilateral Trading Facilities (MTFs) - Dear CEO Letter and FCA Good Practice Observations on MTF Rulebooks

1. Annex 1 sets out proposed guidance on MAR 5 requirements relating to MTF rulebooks. The guidance takes the form of a Dear CEO Letter and FCA Good Practice Observations as set out below:

From:

Edwin Schooling Latter
Head of Department / Market Infrastructure & Policy
Markets Division
FCA

To:

CEOs of all UK firms operating Multilateral Trading Facilities (MTFs)
Cc: Head of Compliance (CF10)

Dear CEO

MULTILATERAL TRADING FACILITIES (MTFs) - THEMATIC REVIEW OF MTF RULEBOOKS

The FCA has undertaken a thematic review of MTF operators' rulebooks. A sample of UK MTFs provided responses to a questionnaire which sought to assess compliance with those areas of the FCA Handbook relating to an MTF operator's rules. In particular MAR 5.3.1 (Trading Process Requirements) requires that *"a firm operating an MTF must have transparent and non-discretionary rules and procedures for fair and orderly trading."*

The attached annex sets out some of the good practice we observed at MTFs during the review, in the context of the requirements for MTFs set out in the Handbook.

We expect all MTF operators to be able to demonstrate that they have considered the good practice observations when determining their approach to compliance with Handbook requirements.

Should you require any further information in relation to the good practice observations please liaise with your usual MTF supervisor or contact the MTF Supervision team at MTFsupervision@fca.org.uk.

Yours sincerely

Edwin Schooling Latter
Head of Department / Market Infrastructure & Policy / Markets Division

ANNEX

MULTILATERAL TRADING FACILITIES (MTFs) RULEBOOKS

FCA HANDBOOK MARKET CONDUCT REQUIREMENTS (MAR 5) AND FCA GOOD PRACTICE OBSERVATIONS

Background

MAR 5 in the FCA Handbook (<http://fshandbook.info/FS/html/FCA/MAR/5>) sets out the regulatory requirements for MTF operators.

Some key MAR 5 requirements and the FCA's good practice observations relating to MTF operator rulebooks are described below.

MTF Rulebook

MAR 5.3.1(1) requires that "a firm operating an MTF must have transparent and non-discretionary rules and procedures for fair and orderly trading."

An MTF operator should have a rulebook in place. The rulebook should be clearly labelled as such and be publicly available on the MTF operator's website i.e. transparent beyond a closed participant user group.

Supporting documents such as participation agreements, terms of business, product lists, user guides, fee schedules and technical specifications are a key part of the operation of an MTF, and will in many cases be linked to the MTF's rules and procedures. The existence of such documents does not, however, suffice to meet the requirement for transparent rules and procedures.

It is good practice that supporting documents such as these should also be publicly available and transparent e.g. some MTF operators have a document library of relevant supporting information available online with the MTF rulebook.

The contents of an MTF operator's rulebook should enable them to demonstrate how they are complying with MAR 5 and their procedures are clear and seek to ensure that participant behaviour is consistent with fair and orderly trading requirements. Non-exhaustive examples of key sections of MTF rulebooks that we have observed include:

- participant eligibility criteria;
- participant obligations;
- instrument eligibility criteria;
- fair and orderly trading rules;
- market abuse prohibition rules;
- post-trade obligations;
- compliance, monitoring & sanctions;
- definitions / glossary of terms; and
- co-operation with regulators.

An MTF should require explicit written acknowledgement during the on-boarding process (e.g. via a user agreement or equivalent) that participants have read,

understood and will abide by the MTF rulebook. In circumstances where the MTF operator also offers non-MTF transactional services (e.g. broking) the firm should ensure its user agreements demonstrate clear delineations between MTF and non-MTF business so that participants have clarity as to when a transaction is conducted on the MTF and therefore that the MTF's rules apply.

MTF operators should ensure transparency to participants of changes to the MTF rulebook that are proposed or implemented. The rulebook should describe procedures for consultation, communication and implementation of rule changes.

MTFs should seek to ensure that the rulebook governance and change process is well understood by stakeholders. Whilst there will be a range of stakeholders within the MTF (e.g. legal & compliance, and business development personnel) and among the MTF participants, it is good practice for the MTF's compliance function always to be consulted, to confirm whether or not it is content with the proposed changes, for its view to be recorded, and for records of that view to be retained.

It is also good practice to undertake at least an annual review of the MTF rulebook to ensure it is consistent with relevant regulatory and legislative requirements.

As part of an MTF operator's responsibility to allow for fair and orderly trading, we consider it is good practice for an MTF to ensure that its fees and incentive schemes relating to access to and execution on the MTF should be transparent and based on objective criteria. Fees and incentive schemes should not encourage trading for improper purposes and should not distort or reduce the effectiveness of the price formation process. An MTF operator should provide a publicly available MTF fee schedule, for example as part of a document library of relevant supporting information available online with the MTF rulebook. Where this is not currently the case, MTF operators should seek to provide a publicly available MTF fee schedule within three months of the publication date of the Dear CEO letter and annex.

Instrument Eligibility Criteria

MAR 5.3.1(3) requires that "a firm operating an MTF must have transparent rules regarding the criteria for determining the financial instruments that can be traded under its systems."

An MTF's rulebook should contain transparent instrument eligibility criteria. Such criteria should offer clarity to participants as to the type and nature of financial instruments capable of admission to trading on the MTF.

In considering those instruments capable of admission to trading on the MTF, operators must also comply with MAR 5.3.1(5) which requires that an MTF operator "*must provide, or be satisfied that there is access to, sufficiently publicly available information to enable its users to form an investment judgement, taking into account both the nature of the users and the types of instruments traded.*"

In addition to instrument eligibility criteria, good practice is also to provide a full list of instruments that are admitted to trading.

Participant Eligibility & Access Criteria

MAR 5.3.1(4) requires that a firm operating an MTF must have "transparent rules, based on objective criteria, governing access to its facility, which rules must provide that its members or participants are investment firms, CRD credit institutions or other persons who: (a) are fit and proper; (b) have a sufficient level of trading ability and competence; (c) where applicable have adequate organisational arrangements; (d) have sufficient resources for the role they are to perform, taking into account the different financial arrangements that the firm operating the MTF may have established in order to guarantee the adequate settlement of transactions."

An MTF operator should ensure that its rulebook has transparent participant eligibility criteria in place that give effect to all elements of MAR 5.3.1(4) including the provisions of MAR 5.3.1(4) (a)-(d).

When enabling access to trading on the MTF, operators should be able to demonstrate that their on-boarding process incorporates an assessment of participant compliance with the MTF access requirements of MAR 5.3.1(4).

Post on-boarding, MTFs should be able to demonstrate on-going pro-active monitoring of continued participant compliance with eligibility criteria. We have previously published related guidance on expectations in this area via the "Market Operators' Oversight of Member Firm Compliance with Rules" document.

<http://www.fca.org.uk/static/documents/finalised-guidance/fq13-06.pdf>.

We expect that an MTF operator's compliance function (CF10¹ or appropriate compliance team delegate(s)) will have active oversight of participant on-boarding and on-going monitoring arrangements to ensure both initial and continued compliance with MTF participant eligibility criteria.

Finalisation of Transactions

MAR 5.4.1 requires that "a firm operating an MTF must: (1) clearly inform its users of their respective responsibilities for the settlement of transactions executed in that MTF; and (2) have in place the arrangements necessary to facilitate the efficient settlement of the transactions concluded under its systems."

Although an MTF operator will not typically be counterparty to transactions executed on the MTF, as a market operator it has a responsibility under MAR 5.4.1 to facilitate efficient settlement of transactions executed on the MTF.

An MTF operator should therefore ensure that its rulebook gives effect to MAR 5.4.1(1) and (2) i.e. requiring that transactions concluded on the MTF should be settled; clarifying the respective settlement responsibilities of participants and the MTF; and detailing the appropriate arrangements to facilitate settlement e.g. post-trade confirmations, and established links to post-trade infrastructure providers.

Good practice is for the MTF pro-actively to monitor settlement performance of

¹ The compliance oversight function as described in SUP10A.7.8R of the FCA Handbook.

transactions executed on the MTF.

Monitoring Compliance with MTF Rules

MAR 5.5.1(1) and (2) require that "a firm operating an MTF must: (1) have effective arrangements and procedures, relevant to the MTF, for the regular monitoring of the compliance by its users with its rules; and (2) monitor the transactions undertaken by its users under its systems in order to identify breaches of those rules, disorderly trading conditions or conduct that may involve market abuse."

MAR 5.5.1(1) requires that an MTF operator regularly monitors compliance with all its rules. This requirement is wider in scope than monitoring only for potential market abuse or disorderly trading conditions as required by MAR 5.5.1(2).

An MTF operator must therefore ensure it is able to monitor for and ensure compliance with all aspects of its rulebook e.g. participant eligibility criteria, trading and settlement rules and anti-market abuse rules.

An MTF compliance function should be able to demonstrate how, and by whom, these rules are monitored.

In determining who at the MTF will monitor for specific rules compliance, it is good practice for the MTF to give consideration to the experience and background of the relevant personnel and the extent to which those personnel may have conflicts between their compliance objectives and commercial objectives, for example, as a result of a wider client-servicing role.

In our review, we noted good practice where some MTFs had appropriate sanctions in place to ensure compliance with its rules. These sanctions were clearly outlined in the MTF's rulebook. We observed a range of sanctions in place including written warnings, suspension or termination of participant access and public or private censure. Operators should consider the appropriate range of sanctions to ensure participants' compliance with the MTF's rules.

MAR 5.3.1 requires an MTF to have transparent rules and procedures for "fair and orderly trading." MAR 5.5.1(2) above requires that the MTF "monitor the transactions undertaken by its users under its systems in order to identify breaches of those rules, disorderly trading conditions or conduct that may involve market abuse."

An MTF operator should have rules and market control arrangements which enable it to provide for and maintain fair and orderly trading. As part of this, an MTF operator should identify the range of potential disorderly market conditions that could occur on the MTF e.g. stale market data, system outages or other business interruption events, erroneous orders or trades etc.

An MTF's rules and market control arrangements should seek to address the identified potential disorderly conditions through both preventative provisions, such as system security or erroneous order entry rejection, and re-active market control provisions, such as suspension of trading (e.g. at instrument or participant level) or trade

cancellation, where appropriate.

An MTF operator's rulebook should contain a clear reference to the prohibition on market abuse.

An MTF operator should undertake regular assessments as to the types of market abuse that could occur on the MTF. An MTF should ensure it has appropriate monitoring and surveillance arrangements in place (systems, procedures and personnel) to monitor transactions undertaken by participants on the MTF and report to the FCA the activity of the types set out in MAR 5.6.1 in accordance with MAR 5.6.1 reporting requirements (see below).

Reporting Requirements

MAR 5.6.1 requires that "an MTF must:(1) report to the FCA: (a) significant breaches of the firm's rules; (b) disorderly trading conditions; and (c) conduct that may involve market abuse; (2) supply the information required under this rule without delay to the FCA and any other authority competent for the investigation and prosecution of market abuse; and (3) provide full assistance to the FCA, and any other authority competent for the investigation and prosecution of market abuse, in its investigation and prosecution of market abuse occurring on or through the firm's systems."

MTF operators will note that the reporting requirements of MAR 5.6.1(1) are threefold i.e. significant rule breaches, disorderly trading conditions and potential market abuse.

Reports made under MAR 5.6.1(1) (a) and (b) should be made to the MTF Supervision team in the first instance via MTFsupervision@fca.org.uk. MTF operators reporting conduct which may involve market abuse (MAR 5.6.1(1)(c)) should report via the Suspicious Transaction Reporting process full details of which can be found at: <http://www.fca.org.uk/firms/markets/market-abuse/suspicious-transaction-reporting>.

We expect the internal identification, escalation and reporting process to be well understood by MTF staff. Consideration should be given to the extent to which personnel involved in the reporting process, for example management team members with client-servicing and business development responsibilities, may face conflicts between their reporting obligations and commercial objectives. The MTF should ensure that its policies and procedures do not dis-incentivise fulfilment of reporting obligations where they may conflict with commercial objectives.