

# Revised note on the UK notification process for market makers and authorised primary dealers

## Overview

### Why are we issuing this document?

1. We are setting out the process for making notifications to us – the Financial Conduct Authority (FCA) – as the UK competent authority for the EU's Regulation on short selling and certain aspects of credit default swaps. It takes into account the Guidelines issued by the European Securities and Markets Authority (ESMA) on the exemption<sup>1</sup> (the ESMA Guidelines) which enters into force on 2 June 2013<sup>2</sup>. It supersedes the document published by our predecessor organisation, the Financial Services Authority (FSA) on 26 September 2012.

### Background

2. Regulation (EU) No 236/2012 of the European Parliament and the Council on short selling and certain aspects of credit default swaps<sup>3</sup> (the Regulation) has applied in the UK since 1 November 2012. The Regulation requires investors to provide notifications to competent authorities when net short positions that they hold in shares reach or fall below 0.2% of the issued share capital of the company concerned and disclose to the public any net short positions in shares once they breach a higher threshold of 0.5%<sup>4</sup>. There are also notification requirements for significant net short positions in sovereign debt and, in certain circumstances, for sovereign CDS<sup>5</sup>. It also places certain obligations on investors when entering into uncovered short positions in shares and sovereign debt regarding locating the stock in question and prohibits uncovered sovereign CDS transactions<sup>6</sup>.
3. Under Article 17 of the Regulation, there are certain exemptions for market-making activities and primary market operations from these requirements. These exemptions

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<sup>1</sup> Guidelines on the exemption for market making activities and primary market operations under Regulation (EU) 236/2012 of the European Parliament and the Council on short selling and certain aspects of Credit Default Swaps| ESMA/2013/158 of 1 February 2013

<sup>2</sup> The FCA has notified ESMA that it is complying with all of the ESMA Guidelines with the exception of paragraphs 19-22; 30; 32; 35-36; 43 (first indent); and 75.

<sup>3</sup> OJ EU No L 86/1 of 24 March 2012.

<sup>4</sup> See Articles 5 and 6 of the Regulation

<sup>5</sup> See Articles 7 and 8 of the Regulation

<sup>6</sup> See Articles 12 and 13 of the Regulation

can be used by persons that have made a legitimate notification to the relevant competent authority at least 30 days before the exemption is intended to be employed and where the competent authority has not prohibited its use.

4. The notification procedure is not an authorisation or licensing process by the competent authority.
5. We, acting as the competent authority, can prohibit the use of the exemption at any time, either during the 30 calendar days from when we receive the notification, or subsequently if the person can no longer satisfy the conditions of the exemption.
6. The exemptions apply only to the transactions carried out in performance of market-making activities and as authorised primary dealers; they do not apply to the entire scope of activities the notifying person carries out.
7. If you have already notified the FSA or FCA, you do not need to notify us again that you intend to continue using the exemption. But you must notify us if you wish to vary the financial instruments you want to use it for. Article 17(9) and 17 (10) of the Regulation require the competent authority to be notified, by a person who has previously given a notification, should any changes occur that affect their eligibility, or intention, to use the exemption. This continues to be the case. The FCA will then assess whether the relevant activities still qualify for the exemption.

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# 1 Definitions

## Market-making activities

8. Under Article 2(1)(k) of the Regulation 'market making activities' are the activities of an investment firm, a credit institution, a third-country entity, or a firm as referred to in point (l) of Article 2(1) of Directive 2004/39/EC<sup>7</sup> (MiFID), which is a member of a trading venue or of a market in a third country, the legal and supervisory framework of which has been declared equivalent by the Commission under Article 17(2) where it deals as principal in a financial instrument, whether traded on or outside a trading venue, in any of the following capacities:
- i. by posting firm, simultaneous two-way quotes of comparable size and at competitive prices, with the result of providing liquidity on a regular and ongoing basis to the market;
  - ii. as part of its usual business, by fulfilling orders initiated by clients or in response to clients' requests to trade;
  - iii. by hedging positions arising from the fulfilment of tasks under points (i) and (ii).

## Authorised primary dealers

9. An 'authorised primary dealer'<sup>8</sup> is a natural or legal person who has signed an agreement with a sovereign issuer or who has been formally recognised as a primary dealer by or on behalf of a sovereign issuer and who, in accordance with that agreement or recognition, has committed to dealing as principal in connection with primary and secondary market operations relating to debt issued by that issuer.

## Competent authority

10. A person wishing to use the market maker exemption must notify the FCA if the UK is their home Member State<sup>9</sup>.
11. Authorised primary dealers must notify the competent authority of the Member State of the sovereign debt concerned. So those wanting to use the exemption in relation to UK sovereign debt will be required to notify us. Those entities notifying their intention to use the exemption as an authorised primary dealer must give evidence of their agreement with the UK sovereign issuer or provide a record of their formal recognition as a primary dealer on behalf of the UK sovereign issuer.
12. Third-country entities not authorised in the EU<sup>10</sup> must notify the competent authority of the main trading venue in the EU in which they trade. The third-country entity is required to assess its activity in the course of the preceding year on the basis of the

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<sup>7</sup> Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC

<sup>8</sup> As defined in Article 2 (1)(n) of the Regulation

<sup>9</sup> As defined in Article 2(1)(i) of the Regulation

<sup>10</sup> Article 17(8) of the Regulation

turnover (as defined in Article 2(9) of Commission Regulation (EC) No 1287/2006<sup>11</sup>) on a certain venue when performing market making activities in Europe and identify on which trading venue (i.e. regulated market or MTF) it is the most active. If that venue is within the UK then they should notify us.

13. As with EU entities the relevant competent authority for third-country entities acting as authorised primary dealers is the Member State of the concerned sovereign debt. So those entities wanting to use the exemption in relation to UK sovereign debt will have to notify us.

## 2 Exemptions

14. The provisions of Article 17(1) of the Regulation exempt transactions performed due to market making activities from net short position transparency requirements (Articles 5, 6 and 7), the restrictions on uncovered short sales in shares and sovereign debt (Articles 12 and 13) and the prohibition to enter into uncovered sovereign CDS positions (Article 14) .
15. According to Article 17(3) of the Regulation, persons acting as authorised primary dealers are not required to notify net short positions in sovereign debt, are not subject to the restrictions on uncovered short sales in sovereign debt instruments and are not prohibited from entering into a sovereign CDS transaction that results in an uncovered position as referred to in Article 4.
- 16. The exemptions apply only to the transactions carried out in performance of market-making activities or as authorised primary dealers; they do not apply to the entire scope of activities the notifying person carries out.**
17. You can only use the exemptions under Articles 17(1) and 17(3) where previous notification of intent to use the exemption has been made in writing to us at least 30 calendar days before the intended first use of the exemption. We aim to process all notifications as soon as possible and, in particular, will be prepared to consider urgent notifications (e.g. in respect of shares which are being admitted to trading on a trading venue imminently) that are made less than 30 days before the intended use of the exemption.
18. We can prohibit the notifying person using the exemption if we consider that the person does not satisfy the conditions of the exemption. Notice of the prohibition together with the reasons for the prohibition will be communicated in writing within 30 calendar days from having received a fully completed notification.
19. In addition, we can, at any time, decide to prohibit use of the exemption where there have been changes in the circumstances of the notifying person so that it no longer satisfies the conditions of the exemption. This may result from our own assessment or from a subsequent notification received from the notifying person indicating a change affecting its ability to use the exemption<sup>12</sup>. The FCA Handbook (FINMAR 2.6.2G and 2.6.3G) sets out the process we will follow if we decide to prohibit someone using the

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<sup>11</sup> Commission Regulation (EC) No 1287/2006 of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards recordkeeping obligations for investment firms, transaction reporting, market transparency, admission of financial instruments to trading, and defined terms for the purposes of that Directive

<sup>12</sup> under Articles 17(9) or (10)

market maker or authorised primary dealer exemptions, including the procedure for reviews of any decisions to impose prohibitions.

### **Scope of the market making exemption**

20. To qualify for the exemption market making activities must be undertaken, whether on or outside a trading venue, by the following entities<sup>13</sup>:
- i. an investment firm which is a member of a trading venue where it deals as principal in a financial instrument in any of the two capacities and related hedging activities specified in Article 2(1)(k); or
  - ii. a credit institution which is a member of a trading venue where it deals as principal in a financial instrument in any of the two capacities and related hedging activities specified in Article 2(1)(k); or
  - iii. a third-country entity which is a member of a market in a third country, the legal and supervisory framework of which has been declared equivalent by the Commission under Article 17(2) where it deals as principal in a financial instrument in any of the two capacities and related hedging activities specified in Article 2(1)(k); or
  - iv. a firm as referred to in point (l) of Article 2(1)<sup>14</sup> of MiFID, which is a member of a trading venue where it deals as principal in a financial instrument in any of the two capacities and related hedging activities specified in Article 2(1)(k).
21. An entity as defined above can notify its intention to use the exemption if:
- i. it is a member of a trading venue<sup>15</sup> (or a market in a third country with declared equivalent regime);
  - ii. where it deals (whether on the trading venue or OTC) as principal in one of the capacities set out in paragraph 8 above;
  - iii. in a financial instrument for which it claims the exemption.
22. If these conditions are satisfied then the market making activities of the notifying entity in or related to that particular instrument may be exempted from Articles 5, 6, 7, 12, 13 and 14 (depending on the class of instrument in question) of the Regulation.
23. All persons considering use of the market making exemption should note the exemption applies with the conditions set out in paragraphs 23-25 and 27 of the ESMA Guidelines.

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<sup>13</sup> Article 2(1)(k) of the Regulation

<sup>14</sup> firms which provide investment services and/or perform investment activities consisting exclusively in dealing on own account on markets in financial futures or options or other derivatives and on cash markets for the sole purpose of hedging positions on derivatives markets or which deal for the accounts of other members of those markets or make prices for them and which are guaranteed by clearing members of the same markets, where responsibility for ensuring the performance of contracts entered into by such firms is assumed by clearing members of the same markets;

<sup>15</sup> As defined in Article 2(1)(l) of the Regulation. The trading venue of which the entity must be a member does not have to be one on which it is conducting market making activities.

## The Financial Instrument Approach

24. Article 17(1) of the Regulation states that provisions of Article 5, 6, 7, 12, 13 and 14 shall not apply to transactions performed due to market making activities. Those market making activities are defined in Article 2(1)(k) as dealing as principal in a **financial instrument** (emphasis added). Consequently, the exemption under Article 17(1) applies to activities in a financial instrument, i.e. on an instrument by instrument basis and should not be considered as a global exemption for market making activities in all financial instruments.
25. Any notification submitted should therefore identify for shares, the individual instrument, and for sovereign debt and sovereign CDS, the sovereign issuer in the debt of which market making activities are notified for the purpose of the exemption.
26. However, market making activities as defined in Article 2(1)(k) of the Regulation might be carried out in financial instruments different from a share or a sovereign debt instrument e.g. (but not limited to) derivatives. To qualify for the exemption, the financial instrument must be within the scope of the Regulation as defined in Article 1.
27. When notifying the intention to use the exemption for market making activities in these other instruments, the notifying entity should also provide information regarding the category of the financial instrument under section C of Annex I of MIFID in which the market making activity is carried out.

## Trading venue membership requirements

28. Any person notifying us that they intend to use the exemption for market making activities will need to be a member of a trading venue or of an 'equivalent' market in a third country.
29. Entities domiciled outside the EEA intending to make use of the exemption will need to be a member of an EEA trading venue or of a market in a third country whose legal and supervisory framework has been declared equivalent by the Commission pursuant to Article 17(2) of the Regulation<sup>16</sup>.
30. Where an entity is a market maker for financial instruments which are admitted to trading on a trading venue the notifying person is not required to conduct its market making activities on that venue or market or to be recognised as a market maker or liquidity provider under the rules of that trading venue or market. Neither is there a requirement to have a separate contractual obligation to carry out market making activities.

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<sup>16</sup> As of 31 May 2013 no markets have been designated as equivalent by the Commission under Article 17(2) of the Regulation

### **3 General principles and criteria of market making activities**

31. A person that intends to use the exemption set out in Article 17(1) of the Regulation must:
  - i. be a member of a trading venue or of an 'equivalent' market in a third country;
  - ii. comply with the principles set out in bullet points 2 – 5 of paragraph 43 of the ESMA Guidelines; and
  - iii. be able to demonstrate at any time to the competent authority that its market making activity meets those principles and the criteria outlined below.
32. Entities notifying their intention to use the exemption under Article 2(1)(k)(i) of the Regulation ('posting firm, simultaneous two-way quotes of comparable size and at competitive prices, with the result of providing liquidity on a regular and ongoing basis to the market') must meet the principle set out in paragraph 44 of the ESMA Guidelines. Market makers in equities and in equity derivatives traded on a trading venue must meet the qualifying criteria set out in paragraphs 46 to 52 of the ESMA Guidelines.
33. Entities notifying us that they intend to use the exemption under Article 2(1)(k)(ii) of the Regulation (when dealing "as part of its usual business, by fulfilling orders initiated by clients or in response to clients' requests to trade") must comply with the principles and criteria set out in paragraphs 53 – 55 of the ESMA Guidelines.
34. An entity undertaking anticipatory hedging under Article 2(1)(k) of the Regulation must comply with the conditions set out in paragraphs 56 and 57 of the ESMA Guidelines.

### **4 Notifications**

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35. Paragraph 65 of the ESMA Guidelines sets out the information which notifying entities should provide when submitting their notifications. Notifications should be provided in electronic format in English using the forms on our website<sup>17</sup>.

#### **Timings**

36. For an exemption to be used a person must notify us at least 30 days before he or she intends to first make use of it. The 30-day period is the maximum period and in certain cases we may notify the person within a shorter timeframe either that we are minded to prohibit, or that we do not intend to prohibit, the use of the exemption.

#### **Contact**

37. You can send us your notifications by email to [SSRMarketMaker@fca.org.uk](mailto:SSRMarketMaker@fca.org.uk).

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<sup>17</sup> <http://www.fca.org.uk/firms/markets/international-markets/eu/short-selling-regulations/notifying-market-maker-exemptions>