Financial Services Authority

The FSA's markets regulatory agenda

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Annex 1: Glossary of terms

Please email any comments to marketsagenda@fsa.gov.uk

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1 Overview

1.1 The regulatory landscape for financial markets is undergoing a period of significant change. Various factors – some generated by the ongoing dynamics of the markets themselves; some from previous changes to the regulatory framework; and some from the need to deal with deficiencies highlighted by the financial crisis – are posing new challenges to markets regulators, particularly in Europe. It is also clear that these challenges cannot be addressed at the national level, but need an international response. This paper sets out our strategy for regulating markets in the context of these developments and highlights our key areas of focus over the coming months.[1]

1.2 Although the market context is changing, our overriding objective in regulating and supervising financial markets – derived from the Financial Services and Markets Act's (FSMA) statutory obligations – is to ensure that markets are efficient, orderly, fair, internationally attractive and sustainable. As the markets regime is refashioned, we will continue to pursue the appropriate regulatory standards and resist regulatory arbitrage. It is important to maintain market confidence; however our markets-related work also significantly contributes to our objectives of financial stability, consumer protection and reducing financial crime. High quality, transparent and open markets are important for the UK's position as a leading international market centre.

1.3 The range and scale of the UK financial markets inevitably require us to be deeply involved in all major regulatory challenges and developments currently underway. For example, as the supervisor of many organised platforms for trading equities, we have been at the forefront of dealing with the resulting greater competition and market fragmentation. Similarly, as the UK is a leading centre for the trading over-the-counter (OTC) derivatives, we have been heavily involved in the reform programme to strengthen OTC derivative markets.

1 This paper does not address wider issues relating to the economic function of traded markets, the causes and consequences of market volatility and overshoots, and the relationship between market liquidity, trading activity and volatility. These issues, which have been raised in the aftermath of the financial crisis, will be addressed in a separate FSA Discussion Paper to be issued later this year.

1.4 The main drivers for change in the current market context are:

- **Growing internationalisation of markets,** with buy and sell-side market participants developing global strategies and pressing for global regulatory standards, which are essential to prevent regulatory arbitrage. The major market infrastructure providers, for example, generally now belong to international groups.
- **The need to respond decisively to the financial crisis,** with a raft of measures to improve risk management, transparency and resilience, especially in OTC derivative markets. Market infrastructure generally performed well in the financial crisis, even in times of particular stress for the markets. But changes to market regulation are necessary to complement wider systemic reforms, such as those flowing from The Turner Review, aimed at addressing the prudential position of market participants.
- **The growth of competition in trading and clearing,** which has further impetus following the Markets in Financial Instruments Directive's (MiFID) implementation. In particular, the equities market has fragmented after the entry of several new trading platforms. Increased competition for providing market infrastructure increases the need to apply a consistent regulatory approach to different providers and ensure satisfactory standards are maintained in a more fragmented environment.
- **Technological developments** which have facilitated the growth of electronic trading and processing, and more recently the increasing use of computer-driven algorithms and very high speed/high volume trading. When dealing with such organic market developments, it is important to ensure consistently high regulatory standards and market-wide resilience when markets are becoming faster and more dynamic.
- **The need to maintain or improve market quality** to enhance efficiency and transparency in both the primary and secondary markets for all instruments, and to ensure clean markets through effective surveillance and policing.
- **Changes to the regulatory structure in Europe,** in particular the establishment of new European Supervisory Authorities from January 2011. The Committee of European Securities Regulators (CESR) will become the European Securities and Markets Authority (ESMA), with powers to set binding technical standards in specified areas, and supervisory responsibility for credit rating agencies.

1.5 The regulatory regime must evolve significantly if we are to successfully meet the challenges arising from these changes. We face a full markets-related agenda in the coming months as we, in partnership with others, develop concrete steps to strengthen the regulatory framework. This is described in more detail in chapter 4.

Our key priorities are to:

- Reform OTC derivative markets to reduce systemic risk, using more robust counterparty risk management. This includes greater use of clearing, which will build on progress to date in clearing interest rate and credit derivatives, and strengthening the risk management of non-cleared trades.
- Ensure greater transparency of OTC markets for regulators, by greater use of trade repositories for main asset classes and more comprehensive transaction reporting for these markets across Europe.
- Work with CPSS-IOSCO[2] towards strong and globally harmonised standards for clearing houses to ensure the 'single point of failure' risk is appropriately addressed, in light of the greater reliance placed on clearing houses. The European Commission is expected to look to new CPSS-IOSCO standards for legislation it will table this summer. This will introduce pan-EU regimes for clearing houses and trade repositories and promote greater use of clearing for OTC derivatives. Allied with strengthened clearing standards, we are also working to improve how the financial system deals with a market participant's default.
- Press for the forthcoming MiFID review to consolidate and strengthen the quality of post-trade transparency data in equity markets; and adjust the regulatory framework for trading venues so there is a more consistent basis for the greater competition resulting from the Directive.
- Support the MiFID review as the vehicle to introduce transparency requirements for major non-equity markets (e.g. corporate bonds, structured finance products, Credit Default Swaps (CDS) and other derivatives). Such transparency requirements will need to be carefully calibrated so they do not undermine liquidity in these markets.
- Ensure regulatory risks from evolving markets (e.g. new technology, new market participants) are understood and effectively mitigated.
- Help implement a pan-EU regime to disclose short selling positions, building on the advice prepared by CESR and on work completed to introduce disclosure in certain circumstances in the UK. We have already taken substantial steps over the past couple of years to continue to improve the quality of UK markets, through introducing a disclosure regime for contracts for difference, and clarifying the structure of the listing regime.
- Continue to vigorously pursue our credible deterrence policy of effective action against insider dealing and market manipulation. This includes surveillance of market activity; following up suspicious transactions with

2 Committee on Payment and Settlement Systems and the Technical Committee of the International Organization of Securities Commissions.

timely and thorough investigation; and actively using our civil and criminal market abuse powers.

- Continue working with international counterpart regulators, particularly the International Organisation of Securities Commissions (IOSCO) group, so we fulfil the Pittsburgh G20 meeting remit to enhance transparency in the oil derivatives markets. We will also work closely with domestic authorities responsible for physical oil markets to ensure interactions between the derivative and physical markets are understood.
- Implement the new EU oversight regime for credit rating agencies and prepare for ESMA to take on formal legal responsibility, which we believe should entail a strong continuing role for national competent authorities in overseeing rating agencies.

1.6 This agenda aims at maintaining an effective trading, transparency and risk management structure in the changed environment. It seeks to update and strengthen regulatory standards and market practice where required, ensuring markets are sound and resilient without inhibiting competition or impairing market efficiency.

1.7 We recognise that changes to the markets regime, particularly establishing regulatory standards, must be developed and agreed almost exclusively at the international level. We aim at influencing desirable outcomes at EU and wider international forums, ensuring technical considerations have primacy. The UK government leads the negotiation of European legislation, and we will continue to devote significant resources to advising and supporting HM Treasury. However, we will also continue making substantial senior level input into bodies such as CESR, and more recently-formed groups such as the OTC Derivatives Regulators' Forum. In particular, we are preparing for ESMA, CESR's successor, which is currently being established. We are working to ensure the correct balance exists between national and European regulation and supervision. We have also devoted more resources to strengthening bilateral links with key overseas counterparts and stakeholders.

1.8 We are committed to better regulation principles in the UK and in promoting these in the EU. Our definition of 'better regulation' is to introduce new regulation only where a demonstrable market failure occurs and where the cost of regulation is shown as less than the cost of allowing the market failure to persist; to integrate the economic assessment of the likely effects of legislative proposals into the policy-making process; to consult on introducing new regulation at all stages while conducting rigorous impact assessments of policy options; and subsequently reviewing measures to assess their actual impact.

1.9 This paper aims at informing market participants and others on our current thinking and the topics we will pursue over the coming year. We are not conducting a formal consultation on our regulatory agenda, as there are no

proposals for FSA rule changes at this stage. Many issues outlined are or will become the subject of separate consultation exercises by the relevant body (e.g. CESR or the Commission). Nevertheless, we welcome any comments or observations on any issues discussed.

1.10 A further paper to be published later this year will consider a wider set of issues. The focus of our markets work has been on promoting transparency and market efficiency, believing these to be important to our market confidence objective. The financial crisis suggests however that we may need to consider other issues relating to the definition and value of well-functioning markets, the determinants of volatility, and the relationship between market efficiency and financial stability. We are conducting work on this and further initiatives may emerge from this wider work.

2 The FSA's regulatory approach to markets

Scope of our markets responsibilities

2.1 Our role in market regulation is wide-ranging. It covers primary and secondary markets and involves a mixture of policy, authorisation, supervision, surveillance, policing and enforcement.

2.2 In the primary markets, we perform the UK Listing Authority (UKLA) functions, responsible for reviewing and approving prospectuses and circulars, determining eligibility for listing and maintaining the Official List. We police the ongoing compliance of issuers and major shareholders with the ad hoc and periodic disclosures required under the Disclosure and Transparency and Listing Rules. We also authorise sponsors' and monitor their performance. These are the specialist firms that assist premium issuers with drawing up listing documents, who are responsible for the content, and who act as the key interface between the UKLA and issuers.

2.3 In the secondary markets, we authorise and supervise all entities responsible for providing market infrastructure – exchanges and other trading platforms, clearing houses and securities settlement systems.[3] Box 1 lists all major market infrastructure providers we currently regulate. We supervise the UK covered bond regime and have a broad oversight of the non-exchange traded and OTC markets (e.g. bonds, CDS, Contracts for Difference, foreign exchange derivatives markets etc). We are also preparing to begin overseeing credit rating agencies (although we expect ESMA to authorise and supervise them from 2011).

2.4 We monitor UK markets for market abuse and are responsible for enforcing the market conduct regime from originally detecting cases through to investigating and prosecuting, through the civil or criminal processes. We also assist our overseas regulatory counterparts in pursuing their enquiries into

3 The Bank of England has an oversight role in relation to the embedded payment systems of LCH Clearnet, ICE Clear Europe and Euroclear UK and Ireland.

trading emanating from the UK. As part of our market monitoring function we collect and analyse reports on securities and derivative products transactions from investment firms located in the UK. We also conduct more general market surveillance, liaising with market participants to keep abreast of developments and to identify and assess new risks to our objectives.

BOX 1: Major infrastructure providers supervised by the FSA

Equity exchanges:

London Stock Exchange (inc AIM)
PLUS Markets

Derivatives exchanges:

EDX
ICE Futures Europe
LIFFE
London Metal Exchange (LME)

Clearing and settlement providers:

Euroclear UK and Ireland (EUI)
European Central Counterparty
ICE Clear Europe
LCH.Clearnet Ltd

Multilateral trading facilities:

Baikal
BATS Europe
BrokerTec
Chi-X Europe
Equiduct
EuroMTS
Icap Blackcross
Instinet Block Match
ITG Posit
Liquidnet Europe
NASDAQ OMX Europe
Pipeline Europe
Smartpool
Tradeweb
Turquoise

Licensed overseas entities:

Trading platforms:

CBOT (US)
CME (US)
Eurex (Swiss)
ICE Futures Inc (US)
NASDAQ (US)
NYMEX (US)
NYSE Liffe US
SIX (Swiss)
Sydney Futures (Aust)

Clearing houses:

Eurex (Germany)
SIS X-Clear (Swiss)
CME (US)
CC & G (Italy)
EMCF (Neth)
ICE Clear US
LCH.Clearnet SA (France)

2.5 We are responsible for rules and guidance for all these areas, domestically and through input into European and global processes, supporting HM Treasury in developing and negotiating legislation in Europe and internationally. We also work closely with other UK authorities such as the Bank of England, the Takeover Panel and the Financial Reporting Council. Much of the European Union Financial Services Action Plan concerns market issues with existing Directives on Prospectuses, Transparency, Markets in Financial Instruments, and Market Abuse. Similarly much of the work of IOSCO is markets-related and we also contribute to Basel Committee and the Committee on Payment and Securities Settlement Systems (CPSS) initiatives when they involve regulatory standards for market infrastructure.

2.6 We support and complement direct regulation and market supervision by our broader activity around supervising wholesale firms and asset managers; our approach to wholesale conduct of business issues; accounting and financial reporting; safeguarding client assets; and regulating products such as Undertakings for Collective Investments in Transferable Securities (UCITs), etc.

Our market regulatory objectives

2.7 Of our four statutory objectives following the passage of the Financial Services Act 2010, the most relevant concerning our markets responsibilities is maintaining market confidence. Our primary role here is to maintain confidence in the quality of UK financial markets, although our markets-related work requires us to significantly contribute to the financial stability, consumer protection and reduction of financial crime objectives. In carrying out our statutory objectives, we are also required by FSMA to consider other factors (the 'regulatory principles'). These include: the desirability of assisting innovation and competition; the international character of financial services and markets; and the desirability of maintaining the UK's competitive position. Considering these principles should not diverge from our primary objectives. Innovation, for example, cannot be at the expense of financial stability.

2.8 In our role as the UK's listing authority, we are not subject to any specific statutory objectives. Instead we pursue objectives set by HM Treasury, which has the power under FSMA to appoint the competent listing authority. These are broadly similar to our statutory ones, with our current objectives[4] as formulating and enforcing rules that:

- provide an appropriate level of protection for investors in listed securities;
- facilitate access to listed markets for a broad range of enterprises;
- seek to maintain the integrity and competitiveness of UK markets for listed securities; and
- implement the EU Prospectus Directive and associated amendments to UK primary legislation.

2.9 In summary, we see our overall aim as promoting efficient, orderly, fair, internationally attractive and sustainable markets.

4 http://www.hm-treasury.gov.uk/fin_list.htm

How we have approached market regulation

2.10 We approach market regulation by operating a risk-based system which can help competition and innovation, and which is open to new entrants who meet the required regulatory standards. We take our regulatory decisions on clear and objective criteria, in a way that respects freedom of establishment across the EU and which encourages fair and open competition. We calibrate our standards according to how we judge the regulatory outcomes we seek to achieve. For example, when supervising markets infrastructures, we aim to ensure that Multilateral Trading Facilities (MTFs) with a similar market impact or market share as Regulated Markets (i.e. exchanges) receive the same level of supervision as those markets, even though MTFs sit under a slightly different legal regulatory regime.

2.11 We aim to set the highest international standards, which go beyond EU and international minima where we consider this is justified. For example, the 'class tests' which require listed companies undertaking major transactions to obtain their shareholders' agreement through a vote have been a feature of the UK listing regime for a long time, although they are not required by EU legislation. Similarly, we have been prepared to apply EU requirements to sectors which it is not mandatory to cover. For example, we applied the civil market abuse regime to securities admitted to trading on markets such as the London Stock Exchange's Alternative Investment Market (AIM) and PLUS Markets[5] even though, as MTFs rather than Regulated Markets, they are currently not required to be covered under the EU Market Abuse Directive. We believe investors on these markets should be as protected as those trading on recognised investment exchanges.

2.12 We must emphasise that we do not see a conflict between promoting high quality, transparent and robustly regulated markets and the attractiveness of the UK as a major financial market centre. We have not sought to gain market share through lower standards or to take advantage of regulatory arbitrage. We consider that ensuring sound and fair markets which participants trust is essential to attracting issuers, investors and intermediaries.

2.13 The UK's position as a major market centre has implications for the nature of our regulatory role. The range of the exchange-traded and OTC UK markets presents us with a complex multi-faceted agenda. We need expertise in derivatives and cash markets, with a working knowledge of all OTC products. The sophisticated markets mean we are faced with continuous innovations to be analysed and our regulatory response decided. For example, the growth of dark pools of liquidity (where orders are not displayed to participants in the system in advance of trading) on organised trading platforms. We must also be closely involved in nearly all international initiatives concerning market standards, as these will affect how we regulate our entities.

5 PLUS also operates a Regulated Market.

2.14 The international character of the UK financial services means our foreign counterparts are very interested in our firms and markets. UK trading platforms and clearing entities provide services internationally. For example, around half of the members of the London International Financial Futures Exchange (LIFFE) are incorporated outside the UK; and the London Stock Exchange lists 328 non-UK companies; and a further 238 overseas companies trade on AIM. Equally, with trading mostly electronic, UK firms are major players in overseas markets by using remote access. For instance, a significant proportion of the trading conducted on the European equity market element of the New York Stock Exchange (NYSE) Euronext (Belgium, France, the Netherlands and Portugal) is conducted by firms based in the UK.

Adapting our approach to the internationalisation of markets

2.15 The growing internationalisation of markets, combined with changes to regulatory structures in the post-crisis environment mean that, in practice, most key policy and strategic supervisory issues are determined internationally. We must negotiate and use our influence to obtain desirable regulatory outcomes in the European Union and globally, working alongside HM Treasury and the Bank of England in line with their respective responsibilities. This involves dealing with several European and international entities, including policy-making, legislative and standard-setting bodies.

2.16 In the regulatory sphere we need to work with long-standing, formal, multi-lateral organisations such as CESR and IOSCO, as well as more recent groups created to deal with particular issues, for example the OTC Derivatives Regulators Forum (ORF – see footnote 11). The amount of current work streams mean we have increased resources devoted to dealing with our overseas counterparts and multi-lateral bodies. We must now produce the best regulatory outcome independent of commercial and political considerations, recognising there will also be genuine differences of approach between different regulatory authorities.

2.17 We have been active players in CESR since its inception, and we continue to engage intensively at all levels, ranging from chairing the Secondary Markets Committee, one of the committees which CESR has established in anticipation of the transition to the ESMA, to coordinating and participating in various CESR Task Forces looking at detailed aspects of markets regulation, such as the MiFID Review. Similarly, we will play a full role in ESMA and will help ensure the Authority is up and running by the proposed date of January 2011. Our objective will be to balance the promotion of harmonised and coordinated standards across Europe by effectively supervising market infrastructure providers and markets that are usually delivered best locally.

2.18 We will also continue to contribute to the global regulatory agenda for markets. We play a full role in IOSCO, participating in all relevant standing committees and task forces and in the development of the international regulatory standards. We have been particularly involved in OTC derivatives. For example we have worked with a group of OTC derivatives supervisors, coordinated by the Federal Reserve Board of New York, in overseeing industry agreed targets for operational enhancements, including clearing OTC products.

2.19 As part of our contribution to developing the international regulatory agenda we will continue to produce papers giving our analysis of and conclusions on key policy topics. For example, we published a joint paper with HM Treasury in December last year on the reform of OTC derivative markets, which was designed to help inform the debate on this topic (see footnote 9).

3 The changing market context and our approach to the resulting regulatory challenges

3.1 UK markets have a history of continuous innovation and development. But in recent years the pace of change has been particularly rapid. Increasing competition between infrastructure providers has resulted in greater fragmentation of trading and clearing. There has also been an influx of new technology, with trading becoming even faster and more dependent on computers. This has been combined with new market participants entering the market and the growth of new trading strategies, such as purely algorithmic trading.[6] Overlaying this has been the growing internationalisation of markets and, most recently, the need to respond to lessons learned from the financial crisis. This chapter explores in more detail these drivers behind the changing market environment, and our approach to the resulting regulatory challenges.

3.2 Clearly, the dynamic nature of markets means there will always be new developments which regulation needs to consider. However, the current situation is notable for the range and nature of issues that need to be addressed in addition to our existing 'business as usual' agenda of maintaining fair and efficient markets. Most significantly, the new environment has produced more than just a new set of topics for which regulatory intervention is needed; it requires change in how we regulate the market. A purely national response in is no longer feasible or appropriate, as policy in all key areas is now determined supra-nationally, particularly, though not exclusively, through the European Union. This is exemplified by the creation of the European Supervisory Authorities which will be important standards-setting bodies for the EU. If our agenda is to be achieved, we must work in partnership with others, influencing and negotiating to accomplish the outcomes we want, and deliver shared objectives.

6 These developments are of course not unique to the UK and other regulators are considering their responses. For example the SEC has published a concept release on the structure of the US equity markets (Release No. 34-61358 http://www.sec.gov/rules/concept/2010/34-61358.pdf).

Competition and fragmentation

3.3 Challenges to existing market infrastructure providers have been attempted for some time (e.g. establishing new equities exchanges such as Tradepoint and Jiway in the 1990s to compete with the London Stock Exchange (LSE)). However, competition in trading and clearing has intensified since MiFID was implemented in 2007. The abolition of the concentration rule (where some EU member states effectively required equities trading to go through national stock exchanges); the establishment of an EU-wide regulatory regime for non-exchange trading platforms ('Multilateral Trading Facilities'); and a more coherent basis for investment firms to offer themselves as trading venues, have led to an upsurge in the number of infrastructure providers fiercely competing for trading volume at the European level.

3.4 After MiFID, LSE members who trade without using the exchanges' facilities do not have to report those trades to the LSE. Investment firms can compete for more securities trading. Most strikingly, whereas the LSE used to be the only organised market where UK securities were traded, there are now six additional platforms competing for this business – Chi-X, Turquoise (now majority owned by the LSE), BATS Europe, Nasdaq OMX,[7] NYSE Arca (a Netherlands MTF) and PLUS Markets (for AIM stocks), as well as numerous investment firms. This means that from holding a previous monopoly position, today less than 60% of trading in the stocks that underlie the FTSE 100 index that takes place on Regulated Markets and MTFs is on the LSE.

Market share by venue[8]

Venue	Trades	Turnover €000's	Share
LSE	1,178,872	14,576,508	56.5%
Chi-X	1,125,491	6,836,061	26.5%
BATS	523,856	2,703,231	10.5%
Turquoise	210,019	1,042,286	4.0%
Nasdaq OMX	76,357	348,938	1.4%
NYSE Arca	55,194	286,740	1.1%

This development is not just confined to the UK. Market shares of other major European equity exchanges (excluding the Bolsa de Madrid) have also diminished in the face of competition. An estimated 30% of trading in CAC 40 index stocks now takes place outside Euronext, while over 25% of trading in DAX 30 stocks takes place outside Deutsche Borse's Xetra trading system.

3.5 The effects of competition are not only seen in equities trading, but also clearing (processing trades via a central counterparty). Several new clearers

7 It was announced on April 28, 2010 that NASDAQ OMX Europe will be closing its MTF (NEURO).

8 Source: Fidessa Fragmentation Index report for week ending 2 April 2010.

have emerged, and thus clearing is now increasingly competitive but also more fragmented. While trades carried out on the LSE and PLUS Markets are still cleared through the London Clearing House (LCH), the LSE also offers clearing though SIS X-Clear (based in Switzerland), while trades done on Chi-X, BATS and Nasdaq OMX are cleared through Netherlands-based EMCF and those on Turquoise and Smartpool through EuroCCP. In the derivatives area, ICE Futures Europe and LIFFE have established their own, separate clearing arrangements.

3.6 One of MiFID's main objectives was to encourage greater competition between market infrastructure providers in Europe, and one we fully support. Greater fragmentation of trading and clearing is a natural consequence, and is consistent with the Directive having the intended effect – enabling monopolies to be contested to promote greater efficiency and lower costs. Competition is also leading to functionalities converging – for example, there is a growing interest among entities to provide public trading and broking functionality under the same roof. However, when these developments are allied with the internationalisation of trading and clearing, these have posed new challenges. The advent of a significant number of new providers means we must ensure consistent regulation. This is not a matter of a 'one size fits all' approach as we recognise there are differences between providers as well as different regulatory regimes to be applied (e.g., between Regulated Markets and MTFs). However, we are concerned that participants in comparable positions should be treated similarly.

3.7 Given the international nature of many market players – whether overseas companies/groups setting up UK subsidiaries, or UK entities expanding through overseas ventures – it is necessary to ensure consistent oversight of cross-border groups. This requires effective cooperation and information sharing with our regulatory counterparts in Europe and more widely. We belong to formal regulatory colleges concerning LCH Clearnet, NYSE Euronext (in respect of LIFFE) and the Euroclear group (in respect of EUI). Other major UK market infrastructure providers such as LSE, ICE Futures and EuroCCP are part of larger groups and we regularly liaise with relevant overseas regulators.

3.8 Greater competition between infrastructure providers also places greater demands on us regarding our service standards and efficiency in processing regulatory requests. New market entrants obviously wish to be up and running as soon as possible. We are committed to providing an efficient licensing process while ensuring we carry out the due diligence necessary to satisfy ourselves that new entrants meet the requisite entry standards. Our need to apply high and consistent service standards extends beyond the entry process as providers may require regulatory approval or non-objection to innovations which are essential for their commercial success. This challenge has been compounded by the fact that, post-MiFID, we are, in some aspects,

administering a new regime where no existing case law or precedent exists. For example, granting of waivers from pre-trade transparency requirements on equities trading platforms.

3.9 Finally, we face the challenge of maintaining standards of market quality and integrity in a more fragmented environment. We acknowledge that greater competition has made it less simple to achieve certain regulatory goals than when there was a de facto monopoly provider of services. For example, we place great emphasis on trading platforms being effective real-time monitors of their market – a key entry criterion. But we recognise that in a fragmented environment, however good an entity's monitoring of trading on its own platform, it will not have a full picture of activity of the market as a whole.

3.10 Fragmentation inevitably impacts liquidity and market efficiency. The effect of a greater number of venues and the greater prevalence of technology-driven trading has significantly reduced average order execution size. This reduces the capacity to instantly execute large orders on a particular market.

3.11 Standards of post-trade transparency have been affected by the dispersion of trading, with particular concerns expressed about quality and timeliness of trade reporting conducted between joint market participants, rather than through an organised market. Previously such transactions were usually reported through the LSE; now they can be reported through several venues, with (on average) greater permissible delays than pre-MiFID. Therefore, the challenge is to keep the benefits of competition in terms of more competitive and innovative trading infrastructure while dealing with the consequences.

Growing internationalisation and competition between financial centres

3.12 In tandem with the increased competition between different market infrastructure providers, there are two other notable trends: intensifying competition between financial centres, while market participants and markets are becoming increasingly international in outlook. A number of countries are keen to build up their financial centres. Several Asian countries are currently focusing on developing strong domestic markets to serve domestic economies. However, globalisation means they will also begin to attract international business in the future. Similarly, in Europe some countries have a clear agenda to build up their markets.

3.13 At the same time, market participants are increasingly looking beyond national markets and seeking to internationalise their operations. In the provision of market infrastructure, what were previously stand-alone national institutions are now mostly parts of international conglomerates. For example, LIFFE is part of the NYSE-Euronext group; ICE Futures Europe is

owned by the US Intercontinental Exchange group; and LSE has merged with the Borsa Italiana and its subsidiaries. As many UK market infrastructure providers are subsidiaries of overseas corporations, we are strengthening our contacts with the parent entities to complement the relationships we have with the UK bodies.

3.14 Traders and investors are also developing global strategies, particularly in wholesale financial services. They are therefore pressing for as much harmonisation in regulatory standards as possible – preferably at the global level but certainly within Europe. There is also pressure to develop or consolidate certain specialised market infrastructure on an international basis. For example, in the context of trades in credit derivatives, the industry has developed one single international repository – the Trade Information Warehouse (now known as the Warehouse Trust) – for all relevant data.

3.15 While, in many areas, we are still able to set and impose standards which go beyond the minimum requirements laid down by European or wider norms, the internationalisation of markets and the increasing international character of market supervision and regulation inevitably limit the scope for purely national initiatives. For example, we recognise that clearing standards for OTC derivative contracts need to be set globally to benefit market participants and to avoid regulatory arbitrage given the internationally mobile nature of these markets. Similarly, supervising market infrastructure groups which operate in more than one jurisdiction has resulted in the creation of colleges of the relevant national authorities that determine the overall supervisory framework within which the group operates, and, in some cases, to take coordinated decisions on individual issues.

Technological developments

3.16 At the same time as markets have started to fragment, the rate of technological development has increased, which has enabled new types of market participant to enter. Market infrastructure providers are now essentially technology firms heavily dependent on their IT systems and competing to provide the most efficient, quick and resilient trading engines. This has been in response to, and, in turn, a driver of the growth of automated trading by market participants.

3.17 Algorithmic trading (where orders are generated according to pre-set programmes and are not dependent on manual intervention) has become an increasingly significant proportion of overall volume. High frequency traders have also become important providers of continuous two-way liquidity on electronic order books, acting in some respects as quasi-market makers. High frequency trading is now estimated to account for between a third and a half of equity trading volume within the EU.

3.18 The time taken to execute orders has become a critical factor for such trading strategies as systems seek to take advantage of arbitrage opportunities of extremely short duration or to react instantaneously to changes in trading patterns or market developments. Hence there has been a technological arms race to reduce the time between which an order is generated and when it is executed on the order book (known as 'latency'). Whereas trading times used to be measured in seconds, they have now fallen to milliseconds and are coming down to micro-seconds.

3.19 A result of this has been the steady decline in the average trade size as a premium is placed on immediate execution of orders and on not displaying large orders. In 1999 the average trade size on the LSE was £62,912. By 2009 this had fallen to £7,436. To some extent technology has compensated for the fragmentation of trading, as sophisticated trading systems connected to multiple trading venues can scan all order books in search of the most favourable prices.

3.20 It is important to note that, even in the absence of changes in the regulatory landscape, the impact of new technology and the advent of new market participants throws up new problems to address. Faster trading speeds, the growth of high frequency trading and the increase in direct market access by clients of trading platforms' members have resulted in faster, more dynamic markets. Again, the challenge is to maintain proper regulatory standards in these conditions.

3.21 We do not see it as part of our role to regulate technology in the sense of prescribing the speeds at which trading can be conducted, or to prevent participants from reaping the legitimate benefits of investment in technology. However, we do need to ensure that trading and clearing systems are sufficiently resilient to cope with the effects of high-technology high-frequency trading – so as to avoid operational problems of one participant resulting in a wider crash of systems. The necessary risk controls have to be in place to prevent 'fat finger' type errors disrupting trading and damaging market quality. Similarly, new market participants must be properly vetted and monitored to ensure they are fit to have direct access to markets. Lastly, market integrity standards need to be maintained and enforced. Gaining an edge by applying better trading technology is legitimate; using technology to manipulate markets is not (e.g. through 'algo-baiting' – i.e. entering orders so they deliberately trigger algorithms that are being used by other market participants).

Responding to the financial crisis

3.22 The UK's core market infrastructure generally performed well during the financial crisis. Trading platforms were able to cope with the volatility and volume, with automatic trading halts being triggered when there were sharp

price movements. Similarly, the clearing systems carried out their intended function in ensuring contract performance and preventing the default of any individual market participant from pulling down its counter-parties. However, it is recognised that the market infrastructure can be further strengthened to provide protection in the event of defaults (see paragraphs 4.16–4.18).

3.23 However, looking at markets more widely – in particular OTC derivative markets, e.g. CDS – it is clear that a wide-ranging programme of improvements, covering risk management, transparency and resilience[9] need to be established. The crisis revealed shortcomings in managing counterparty credit risk and a lack of confidence within the market that this risk was effectively managed. Concerns about counterparty risk had severe implications for financial markets and resulted in liquidity contracting as participants showed growing reluctance to trade with each other out of fear of potential further defaults. There is international agreement that systemic risk must be reduced by increasing central clearing of suitable contracts and better risk management of non-cleared contracts.

3.24 A second major problem was highlighted by the failure of Lehman Brothers. It was clear that positions and exposures within OTC derivative markets were not sufficiently transparent, with resulting detriment to market confidence. Therefore, it is necessary to provide greater transparency to the market of traded prices and OTC contracts volume, and to regulators of the risk positions taken by firms. The transparency agenda will also include overseeing conduct of business aspects of credit rating agencies and greater disclosures concerning short selling. Finally, there needs to be strong and globally harmonised standards for clearing houses to avoid concentrating unmitigated risk in a single point of failure. Work is under way in these areas; however much remains to be done and the reform programme amounts to a significant agenda in its own right.

Strengthening market infrastructure

3.25 Although market infrastructure as a whole performed generally well during the financial crisis, there is strong political momentum from the G20 downwards to tackle market-related areas which were shown to be defective, focusing on prudential and systemic issues. The challenge is to secure a coherent approach across the issues which need to be addressed – regulating credit rating agencies; changes to ensure OTC derivative markets operate on a sounder foundation with better transparency and risk management; strengthening central counterparty standards; and improving default handling.

9 See also the joint FSA/HM Treasury paper “Reforming OTC Derivative Markets – A UK perspective” for more details – http://www.fsa.gov.uk/pubs/other/reform_otc_derivatives.pdf

3.26 A key objective here is to ensure regulatory outcomes deliver the necessary improvements without unintended and harmful effects. For example, in reducing the risks from OTC derivatives it would be inappropriate and counter-productive to force the clearing of OTC derivative instruments which are unsuitable for this process. In some cases it might increase risks concerning the stability of the central counterparty. As a result, it is essential that non-cleared derivative contracts are also subject to appropriate capital requirements and risk management controls if we are to reduce risks overall.

3.27 In this context it is important to recognise the proper role of market regulation and, in particular, how it complements, rather than substitutes for, a sound system of prudential regulation for relevant market participants, such as banks and other major players. Our markets agenda is aimed at improving markets' resilience and transparency as a counterpart to actions taken at firm level to discourage and prevent reckless behaviour and strengthen the financial system's ability to cope with shocks. Greater transparency of trading should provide improved early warning of the build-up and scale of developing problems, making it easier to tackle them before their impact becomes too severe. Increasing the resilience of the central market infrastructure such as clearing, cannot, by itself, prevent problems occurring in individual institutions. However, it can contain the consequences of those problems and limit harm to other participants.

4 Our markets regulatory agenda for 2010

4.1 This chapter sets out our markets-related regulatory agenda for the coming months. It covers not only our response to the issues outlined earlier in this paper, but also examines several big items of 'business as usual' work we already have in progress, such as our credible deterrence strategy for tackling market abuse and the changes we are making to the listing regime. The agenda covers all aspects of our work – policy development, supervision and operations. As already foreshadowed, a consistent theme of our work programme is that the development of new standards for markets must now be done almost exclusively at the international level.

Dealing with growing competition and fragmentation

4.2 A key objective in the post-MiFID environment is to maintain a proportionate level playing field for market infrastructure providers. In the light of the intense competition between providers, are particularly in equity markets, we have aligned our supervisory approach according to the function which entities perform, instead of according to the specific regulatory form the entity holds. Therefore, we supervise the most important MTFs to the same standards as Recognised Investment Exchanges (i.e. Regulated Market operators). We are also aligning our supervision of market infrastructure providers with the FSA's enhanced supervisory approach for high impact authorised firms, increasing our resources and the scale of contact devoted to the most significant entities. We are applying rigorous service standards when dealing with requests for approvals (whether new entities or new initiatives by existing regulated bodies) so regulation is commercially neutral and consistent with ensuring proper due diligence and satisfactory outcomes.

4.3 We have acknowledged that market fragmentation has resulted in several problems that need to be addressed. A primary issue has been dealing with the implications for post-trade transparency of spreading trading over various venues, in particular the impact on the quality of post-trade data for OTC

transactions. We have been holding discussions with market participants and venue representatives to understand the options for a more effective regulatory framework for consolidated post-trading information. We are also working to develop sensible standards to follow when reporting OTC trade data. As regards transactions settlement, we are working with market participants to introduce new technical codes in settlement processes, which will better reflect an environment where trades can be executed on multiple venues.

4.4 As most of the market framework is set by MiFID, there will be some areas where changes to the Directive are required to deal with structure and regulation issues that have emerged since 2007. We have been active in conducting research to assess the Directive's impact on equity markets and preparing for the review of the Directive which the European Commission will launch later this year.

4.5 We believe the MiFID framework is generally satisfactory and we do not wish to move back to a system which undermined competition or protected 'national champions'. However, we need to review the existing provisions for equity markets to address some inconsistencies in the competitive landscape between trading venues and to enhance post-trade transparency. Box 2 sets out the main equity markets issues which are likely to be covered in the review. We also support using the MiFID review to introduce pan-EU transparency requirements for non-equity markets (see paragraphs 4.20–4.23). However, we are opposed to imposing new obligations (e.g. a requirement for position limits in commodity derivative markets – see Box 7) unless it is clear that the benefits will outweigh the costs.

Technology and market-driven developments

4.6 Our agenda over the coming months in this area will be a mixture of intensifying supervision of regulated entities, conducting thematic work to better understand the implications of key technological changes and determining if we need to develop new rules or guidance. In this context we will be interested in responses to CESR's recent call for evidence on micro-structural issues in the European equity markets.[10] Our thematic work will particularly focus on high frequency trading, and the co-location of firms' trading systems with the infrastructure providing platforms' electronic order books. There are questions about the volume of trades' impact on platforms, in particular the rate of order entry and deletion. Platforms need to stress test their technology and surveillance systems, and ensure they can cope with the activity associated with high frequency trading. It is also essential that firms pursuing high frequency strategies have robust systems and controls, with ongoing review of the algorithms they use, and strong change management

10 CESR/10-142 published on 1 April.

procedures in place. We will therefore increase our scrutiny of trading systems' resilience to ensure crashes do not occur due to overload or problems caused by 'fat finger' errors. We are liaising closely with US regulatory authorities, as they review the causes of the severe disruption in the US markets on May 6th, to see whether there are any lessons to be learned for UK markets.

BOX 2: The MiFID review: Equity markets issues

The report by the Committee of European Securities Regulators on the 'Impact of MiFID on equity secondary markets functioning' (09-355) published in June 2009, found that MiFID has significantly changed the secondary markets landscape across Europe and recommends further work to address several issues. We are working with CESR to develop policy proposals to address these and other relevant issues for the MiFID review. CESR published proposals for consultation in April 2010 and aims to provide final advice to the Commission by the end of July 2010. Commission proposals for changes to the Directive are likely to emerge towards the end of 2010 or early 2011. The table below describes the specific equity market issues the MiFID review aims to address and our objectives.

Policy area	Our goal
Regulatory requirements and boundaries The review will examine the regulatory boundaries and obligations for Regulated Markets (RMs)and MTFs and those involving investment firms operating internal crossing systems/processes	Our position is that trading platforms – whether they are RMs or MTFs – should be subject to the same organisational requirements. We believe investment firms' crossing systems do not fall within the legal definition of MTFs and are, functionally, different from public markets. However, there is a case for introducing bespoke requirements, including greater post-trade transparency, to ensure that market participants and regulators have access to better information about the nature and scale of investment firms' crossing systems.
Systematic internaliser (SI) regime An SI is an investment firm which, on an organised, frequent and systematic basis, deals on own account by executing client orders outside a Regulated Market or MTF. There are concerns that the definition is not properly applied and the few SIs which operate may not be meeting their obligations to provide firm two-way quotes to clients	We want to clarify the definition of systematic internaliser so that it is implemented consistently. We also want to amend SIs' quoting obligations to deliver more meaningful information to firms' clients.
Pre-trade transparency waivers Exemptions from the requirement for Regulated Markets and MTFs to make public details of best bids and offers exist in the form of waivers for certain types of orders and systems. There are concerns that the waivers are not being consistently applied.	We want to ensure greater consistency when interpreting the waivers while avoiding any radical changes to the regime's structure. There is also a need to assess whether the large-in-scale waiver is calibrated properly.

Quality of equity market post-trade transparency information The obligations are aimed at promoting the overall efficiency of the price formation process, to assist the operation of the best execution obligation and to mitigate the potential adverse impact of market fragmentation. There are concerns that the quality of this information has deteriorated significantly since MiFID was implemented.	We want various amendments to MiFID which improve the quality of post-trade information.
Timing of publication of post-trade transparency information Information must be published as close to real time as possible but no later than 3 minutes after the trading time. There are concerns that the 3 minute deadline is being used routinely rather than on an exceptional basis. Information related to transactions of a certain size may be delayed to minimise adverse market impact. Again there are concerns that delays are often too long to ensure adequate transparency and that there may be inconsistencies in the way the eligibility thresholds applicable to deferred trades are expressed.	We want to improve the quality of post-trade transparency information and shorten delays for regular and deferred publication. We also want to simplify the deferred publication regime.
Regulatory framework for consolidation of transparency information Investment firms trading OTC have a choice of where to publish transparency information. We are concerned that market forces alone are not sufficient to deliver an affordable consolidated tape that is of a standard that fully satisfies market participants.	We believe that regulatory intervention is necessary to remove outstanding barriers to the consolidation of post-trade data.
Applying transparency obligations for equity-like instruments Some Member States apply pre and post-trade transparency obligations to some equity-like instruments (e.g. depositary receipts).	We support extending the MiFID transparency regime to equity-like instruments.
Best execution Investment firms must take reasonable steps to obtain the best possible result when executing client orders. There are concerns in relation to equities that firms are missing out on the best available prices because they are not connected to new trading venues.	We want to see further work by CESR so best execution rules are more consistently implemented.

4.7 We will also conduct a more general examination of the costs and benefits of high frequency trading on markets, and how it impacts other market users. This trading brings more liquidity to markets (although, as a recent study into algorithmic trading by the Australian Securities Exchange has rightly pointed out, significant order flow generated automatically should not necessarily be considered as synonymous with liquidity) but there may be the potential for adverse effects on price discovery. We will also examine when this type of

trading could be considered as abusive – i.e. when does a high order entry and deletion rate begin misleading the market?

4.8 Another area of thematic work we are pursuing is the operation of 'sponsored access' – whereby brokers give their clients direct access to trading platforms using their platform membership without the order flow going through the brokers' own systems. This will follow work we conducted in 2008 and which led to the production of informal market guidance on the conditions for providing sponsored access. Our insistence that proper pre-trade risk controls and post-trade monitoring systems must be established for sponsored access to platforms means firms cannot offer 'naked sponsored access' (where there are no controls on the client's access to the market), which has been a source of concern in the US. However, we wish to examine how sponsored access works in practice to see if further guidance or requirements are required.

BOX 3: Hedge Funds

Hedge funds continue to be a significant category of market participants. The regulatory landscape remains in a state of flux. In Europe, this is dominated by the negotiation of the Alternative Investment Fund Manager Directive (AIFMD). We have consistently said that we support the objectives of the proposed Directive, namely:

- providing regulators with the ability to identify, monitor and, where necessary, address potential systemic issues arising from Alternative Investment Fund Managers' (AIFM) activities; and
- providing investors with appropriate protection, while enhancing their access to alternative investment funds (AIFs) through the development of a pan-European marketing regime.

To enhance the access of investors to AIFs while maintaining an appropriate level of protection, we welcome the efforts to develop a "marketing" passport for AIFMs to supplement the current complex, inefficient patchwork of national regimes currently in place across Europe for AIFMs. While we welcome aspects of the Directive, we have however equally been very clear about the significant problems it would create. Given the limited consultation which was undertaken before the publication of the proposed Directive, we have worked to ensure that the Directive is in line with internationally-agreed regulatory standards and creates a regulatory framework which is consistent with the principles of good regulation.

We have expressed particular concern about the provisions relating to the marketing of non-European funds in Europe, whether these are managed within or outside the EU. The general approach agreed by the Council of Ministers on 18 May would subject such funds to a number of the Directive's requirements without any ability to obtain the European marketing passport. Depending on the precise details of the requirements that are eventually adopted, the end result could be to restrict the access of institutional investors in Europe to valid investment opportunities in third countries, while delivering little real benefit to market stability or investor protection.

The proposed Directive's provisions in respect of leverage limits and the liability and equivalence requirements on depositaries and sub-custodians outside Europe could also materially impact asset managers' investment strategies or encourage them to consider other fund vehicles. Restrictions on the activities which can be performed by fund managers in addition to managing and administering AIFs could drive changes to business and operating models and create significant barriers to entry for smaller players.

We are therefore continuing to seek amendments to the Directive to ensure it creates a regulatory framework which enhances the financial system's stability, provides appropriate investor access and protection, and encourages sustainable economic growth and development across Europe.

The regulation of hedge funds on a global stage continues be characterised by change. Supervisory organisations and other global fora, including IOSCO, continue to enhance regulatory standards in this area including the publication of a 'Hedge Fund Oversight' report by IOSCO's Technical Committee in June of last year,

(http://www.iosco.org/library/pubdocs/pdf/IOSCOPD293.pdf) and within the Joint Forum a 'Review of the Differentiated Nature and Scope of Financial Regulation' which included a chapter on hedge fund regulation in January 2010, (http://www.iosco.org/library/pubdocs/pdf/IOSCOPD315.pdf).

Domestically, in response to the findings of The Turner Review, we continue gathering information about hedge funds which will allow us to assess the overall system-wide risks. We published the findings of our first survey of around 50 of the larger FSA-authorised hedge fund managers in February this year, (http://www.fsa.gov.uk/pubs/other/hedge_funds.pdf). While this analysis revealed no clear evidence to suggest that, from the hedge funds surveyed, any individual fund posed a significant risk to the financial system at the time, this could change and future surveys will be an important tool in identifying emerging risks. The April 2010 survey, which has been sent to participants, has been updated to improve data quality and to expand coverage of liquidity, asset and liability mismatch and leverage issues. Over time, we will be able to build a time series from the survey data, which will improve the identification of systemic risk, in particular where it might arise from the activities of hedge funds in total.

Improvements to market standards and infrastructure following the crisis

4.9 There is currently a swathe of regulatory initiatives under way to remedy defects in markets standards and/or secure the necessary strengthening of market infrastructure to cope with future risks. These are targeted at ensuring a mixture of better risk management, enhanced transparency and improved resilience. We are also examining what more we can do to re-start markets which, while inherently sound, were harmed by a loss of confidence from the financial crisis, with a focus on the distribution of securities such as covered bonds. Key work streams include: reforming OTC derivative markets; stronger global standards for clearing houses; better arrangements for handling defaults in the clearing and settlement system; greater transparency in non-equity markets; and establishing the regime for oversight of credit rating agencies.

Reforming OTC derivative markets

4.10 The financial crisis has highlighted deficiencies within OTC derivative markets, notably the shortcomings in managing counterparty credit risk and the absence of sufficient transparency (including trading and position transparency to regulators as well as post-trade transparency to the market). In response to these issues, the regulatory landscape is undergoing great change. In Europe, the Commission is working towards tabling draft legislation on market infrastructure by summer 2010, and on transparency (as part of the MiFID review) by the end of 2010. In parallel, an international group of OTC derivative supervisors and the industry are working together to

implement change in areas such as standardisation, operational risk reduction, clearing and bilateral risk management and we are closely engaged with this work. The OTC Derivatives Regulators Forum (ORF),[11] established formally in the second half of 2009, is also working on its mandate to assist information sharing and promote cooperation, consistency and assistance between regulatory authorities concerning OTC derivative Central Counterparties (CCPs) and Trade Repositories. In particular, we recognise the importance of ensuring that European standards are compatible with those being developed in the US and globally given the differing legal and regulatory regimes in distinct jurisdictions.

4.11 In our view, several measures are needed to address systemic shortcomings in OTC derivative markets.[12] These are:

- **Greater standardisation of OTC derivatives contracts:** Greater standardisation would enhance the efficiency of operational processes, assist the increased use of CCP clearing and trading on organised trading platforms, and support greater comparability of trade information. We will work with international regulators and the industry to identify and agree which products can be further standardised, in terms of underlying contract terms and operational processes, and ensure that this is implemented on a timely basis. Significant progress has been made on reducing confirmation backlogs in credit and interest rate derivatives since 2005, reflecting industry and regulators' efforts.

- **More robust counterparty risk management:** All OTC derivative trades, whether or not centrally cleared, should be subject to robust arrangements to mitigate counterparty risk. CCP clearing should be used by all financial firms for clearing eligible products. Trades that are not centrally cleared should be subject to robust bilateral collateralisation arrangements and appropriate risk capital requirements. This approach may differ for non-financial firms given the different nature of the risks they pose to the financial system. It is important that all participants bear the cost of managing the risk they pose. Significant progress has already been made on clearing CDS with several CCPs recognised for clearing such contracts, and the major dealers have successfully met their target to clear 80% of all eligible trades (calculated on a weighted average notional basis) from October 2009.

- **Consistent and high global standards for CCPs:** Increased use of CCPs will heighten their systemic importance so it is crucial they are regulated to high

11 The OTC Derivatives Regulators' Forum has been formed to provide regulators with a means to cooperate, exchange views and share information related to OTC derivatives CCPs and trade repositories. It is comprised of international financial regulators including central banks, banking supervisors, and market regulators, and other governmental authorities with direct authority over OTC derivatives market infrastructure providers or major OTC derivatives market participants, or who consider OTC derivative market matters more broadly.

12 We set out our thoughts on these issues in detail in a paper published jointly with HM Treasury in December 2009: 'Reforming OTC Derivative Markets: A UK perspective' (http://www.fsa.gov.uk/pubs/other/reform_otc_derivatives.pdf)

standards, and this is consistently applied in the major jurisdictions. We are working in the CPSS-IOSCO and the Basel committees to revise existing standards, and we anticipate that the Commission will draw on these new standards in its own proposed legislation.

- **International agreement as to which products are 'clearing eligible':** This must entail assessments by the regulators and CCPs as to which products are eligible for clearing. In addition to the degree of standardisation, they must also consider the regular availability of prices; depth of market liquidity; and whether the product contains any inherent risk attributes that the CCP cannot mitigate.
- **Capital charges to reflect appropriately the risks posed to the financial system:** These should be higher for non-centrally cleared trades, and we are working with the Basel Committee to deliver a proportionate approach. Capital charges for exposures to CCPs should also be risk-based.
- **Registration of all relevant OTC derivative trades in a trade repository:** This will help regulators to have appropriate access to the information they need to fulfil their regulatory responsibilities. We are already working through the ORF to deliver this across a number of asset classes.
- **Greater transparency of OTC trades to the market:** Access to better information around prices and volumes can help price formation and market efficiency. However, this should be calibrated to minimise scope for an adverse impact on liquidity, and consideration should be given to using existing reporting channels to minimise costs. (See paragraphs 4.20–4.23).
- **Better surveillance of OTC trading by regulators and more effective exchange of information on OTC trades especially by CESR members:** We are, for example, currently one of the very few CESR members who collects transaction reports on OTC equity and credit derivative transactions. We have a specific requirement for CDS transactions to be reported as such.
- **On-exchange trading:** Many of the steps above would, in combination, be likely to assist and promote greater electronic trading of derivatives, which we would support. However we do not believe it is necessary to mandate the trading of standardised derivatives on organised trading platforms at this stage. Regulatory objectives of reducing counterparty risk and improving transparency can be achieved by other means and we will review how initiatives in this area are progressing. Moreover, mandating the use of organised platforms will imply a regulatory imposition of trading structure, which we do not believe is necessary.

BOX 4: Sovereign CDS

Sovereign CDS have been scrutinised significantly in the first half of 2010, particularly concerning their perceived role in the Greek government debt crisis. Discussion has centred on whether excessive speculation resulted in an overshoot of pricing in CDS, pushing spreads wider in Greek government debt.[13]

The European Commission has established an inquiry into the role and impact of speculative practices connected with CDS referencing government bonds of European countries and consideration of the appropriate regulatory or legislative response. We expect this work to analyse whether there is any clear evidence of CDS trading being used for manipulative purposes to directly drive bond spreads wider and, more broadly, whether there is any evidence of market failure. If the Commission concludes that legislative steps were necessary, such steps could be expected to be incorporated within the short selling legislation due later in 2010.

With respect to 'naked' sovereign CDS, the International Monetary Fund's (IMF) latest 'Global Financial Stability Report'[14] concluded: 'Even though sovereign CDS may at times influence underlying bond markets, particularly during periods of distress, banning "naked shorts" would be ineffective and difficult to enforce. In addition, "naked shorts" may be hard to define and such bans may hamper legitimate financial activity. Instead, transparency and collateral practices in CDS markets could be substantially improved to reduce risks.'

We agree that the definition of 'naked' is complex. This is because sovereign CDS are typically used to hedge a variety of credit exposures, (e.g. government debt, risk to the government as a counterparty and country risk for a portfolio of credit exposure to corporates located in the country in question). Such complexities add to the challenges for how restrictions on 'naked' CDS could be defined and implemented effectively.

We will continue to keep these issues under review, and consider any necessary regulatory interventions if we believe they are warranted. We are liaising closely with our CESR counterparts. Given the global nature of these markets, any regulatory interventions would need to be co-ordinated globally to be fully effective, most probably through the fora of the G20 or Financial Stability Board.

Stronger standards for clearing houses

4.12 As more transactions are cleared, it becomes ever more important to ensure that there are robust standards for clearing houses to address the risk of a 'single point of failure'. It is also essential that these standards are developed and applied on a globally harmonised basis. This is necessary to promote competition between clearers without the danger of regulatory arbitrage threatening sound standards. Work is under way to revise the CPSS/IOSCO standards for clearing houses, securities settlements systems and systemically important payment systems and we are fully inputting into this. A consultation has been published in May with respect to specific recommendations around the clearing of OTC derivatives, and further consultation on the new standards is expected in early Q1 2011.

13 A distinction should be drawn between market manipulation and the effect of speculation on the market. Manipulation is market abuse and if found, should clearly be dealt with. However, speculation is not illegal and some view it as an important contributor to market liquidity.

14 http://www.imf.org/external/pubs/ft/gfsr/2010/01/pdf/text.pdf

4.13 At the European level where we expect a legislative proposal from the Commission in mid-2010, we are seeking better cross-border access for clearing houses to promote a more competitive market and offer the prospect of reduced transaction charges for investors. In setting European standards, which in our view should be consistent with the CPSS/IOSCO standards referenced above, we also wish to ensure a level playing field exists between clearing houses, regardless of their location or the currency in which the contract is denominated. Experience has confirmed that there is no prudential risk in having instruments cleared by CCPs outside of the jurisdiction of the currency in which the contract is denominated. Moreover, many clearing houses have become global infrastructures, operating across borders in several different currencies, and it will be important to avoid policies which segment trading, hinder competition and increase costs.

4.14 More widely, CCPs have the ability to clear products denominated in non-local currencies due to their diverse links to trading platforms in multiple jurisdictions as well as their OTC clearing services offered to participants located in multiple currency areas. To settle such trades CCPs will access local Central Securities Depositaries (CSDs) or use settlement agents to settle cleared trades in either central or commercial bank money. Where commercial bank money is used, a CCP will limit its risk to ensure the failure of such a commercial bank does not threaten its ongoing viability. In some instances, access to central bank accounts can provide an alternative to commercial bank money for a CCP as a means of effectively addressing this issue.

4.15 Finally, we consider it is essential that authorising and supervising CCPs within the European Union remains a matter for national authorities and should not be allocated to ESMA. Supervision of these entities is and needs to remain a national competence. This is because of the need to align regulatory responsibility with fiscal responsibility – it is the Member State in which the CCP is located which needs to support it in case of financial difficulty – and because supervision needs to be close to firms if it is to be effective. In this context, we welcome the European Council's decision that CCPs should be supervised at national level.

Better default handling

4.16 Allied with strengthened clearing standards, we are working to improve how the financial system deals with a market participant's default. We believe default arrangements should allow transactions with a defaulting market participant to be handled in a timely and efficient manner, and the outcome of their application should be consistent with the contracting parties' reasonable expectations. Their operation should be robust and command market participants' confidence, even in the face of financial innovation. They should not create additional market uncertainty and ideally should seek to reduce the market disruption which the default of a market participant often entails.

4.17 We have been working closely with HM Treasury and market participants to develop a package of measures which will achieve those objectives, as described in HM Treasury's December 2009 paper 'Establishing resolution arrangements for investment banks' (together with an earlier related paper it published in May 2009). The key elements are:

- information about how transactions were traded, e.g. on a particular trading venue, should be available and sufficiently clear for the application of default procedures;
- OTC transactions should have contractual default terms so they can be closed out within a reasonable time;
- clearing houses should be required to offer members the option of segregating client business, and to make clear to members and their clients in their offerings what the implications of segregation are, all of which will dovetail with reforms we are making to investment firms' client asset requirements;
- consideration should be given as to whether protection from insolvency challenge (now existing for default rules of recognised exchanges and clearing houses) should be extended in a similar way to cover any default rules used by MTFs;
- consideration should also be given as to whether protection from insolvency challenge should be developed in light of recent proposals from clearing houses made to help transfers of transactions and related collateral, and in some cases related back-to-back transactions, from a defaulting clearing member to another clearing member, and to avoid closing out those transactions; and
- the procedures of CREST, the UK's dematerialised securities settlement system, should be revised so that a defaulting participant's pending settlement instructions are 'frozen'.

4.18 These measures will be introduced, subject to responses from the consultation which closed in mid-March and any other developments, in a mixture of legislative, regulatory and market-led changes.

BOX 5: Securities Law Directive

In 2004, the European Commission set out a roadmap for future action with a view to enhancing the safety and efficiency of post-trading arrangements across Europe. It advocated, among other proposals, addressing legal barriers to establish a safe and efficient post-trading landscape. It mandated a group of legal experts, the Legal Certainty Group, to advise the Commission on whether securities holding and dispositions legislation should be improved, and if so, how to carry this out. The group presented its advice to the Commission in August 2008. On this basis, the Commission is planning a Securities Law Directive for a harmonised legal framework for intermediated securities. This will provide better protection for investors by clarifying securities holders' legal position at all transaction stages.

The UK will want to ensure the draft directive's scope does not disproportionately impose legislative requirements on firms where these requirements are unjustified. It also believes that conflicts of laws can best be dealt with by a Hague Securities Convention rule – the applicable law should be determined by reference to the securities account agreement's governing law, chosen by the parties to that agreement (as opposed to where the securities accounts are maintained). This is consistent with the benefits of maintaining global compatibility, and an integrated solution for cross-border holdings of intermediated securities that extend within and outside the EU.

Greater transparency to the market and to regulators

4.19 Reducing counterparty risk is not the sole focus of regulatory reforms. The financial crisis has also brought to light many weaknesses concerning market opacity. Measures designed to improve transparency – in terms of the information provided to market participants and that provided to regulators – can deliver a range of efficiency and risk benefits and should be a key objective of proposed reforms.

4.20 In relation to trading transparency, MiFID imposes transparency obligations for equities, which aim at ensuring a level playing field between trading venues. This is so the price discovery mechanism regarding particular shares is not impaired by the fragmentation of liquidity, and investors are not penalised as a result. Box 2 sets out the issues concerning the existing transparency regime for equities that are addressed in the MiFID review.

4.21 Unlike equity markets, other asset classes are not subject to formal pre and post-trade transparency requirements under MiFID. As a result, some market participants have better access to information on prices and volumes, which can lead to an unfair advantage regarding the price formation process. We consider a well calibrated post-trade transparency regime can play an important role in the efficient functioning of markets. The need for greater pre-trade information for non-equity markets is less clear as market participants generally agree that post-trade information is more useful. But, as is the case with the equity markets regime, it is important that regimes for non-equity markets are structured so the scope for an adverse impact on liquidity is minimised, and markets' specific characteristics are considered.

4.22 Given the discrete differences of the variety of markets in question, we think it is essential that several factors are considered when designing a post-trade transparency regime particularly for OTC markets. These are:

- the particular market participants in each asset class;
- the degree of market liquidity;
- the degree of product standardisation;
- the level of post-trade information already available; and
- the existing market infrastructure: the costs of any proposals for greater transparency will be lower if they enable use of existing channels for collection and dissemination of information.

4.23 We are actively engaged in this issue and support the work being undertaken by CESR, which is currently consulting on proposals for calibrating transparency requirements for corporate bonds, structured finance products and CDS.[15] The conclusion of this work will feed into the Commission's consideration of this issue as part of the wider MiFID review.

4.24 Another important way of increasing transparency in OTC markets is by using trade repositories. We believe they are best placed to provide transparency in relation to firms' position data, which can assist regulators in monitoring exposures on their regulated entities' books. The data can also serve the market as a whole to identify aggregated risks for specific asset classes. We do not support transaction reporting to trade repositories for market monitoring purposes as this information is already gathered by regulators using other systems, and would be overly burdensome to achieve on a global scale.

4.25 We welcome the industry's efforts to date to establish and use trade repositories for CDS, interest rate and equity derivatives. We see much benefit in regulatory efficiency terms in one single global location for data for any asset class, subject to information being easily accessible to the relevant regulators. We therefore support internationally agreed information sharing arrangements that respect data privacy rules as well as regulators' access rights over data relating to their supervised entities. Such arrangements are already being discussed by the OTC Derivatives Regulators' Forum. With appropriate information sharing, we do not see a case for establishing specific repositories in Europe, if there are already adequate repositories elsewhere.

4.26 Any regulatory framework for trade repositories needs to be reasonably high-level in approach to account for asset class specific requirements. We are engaged in and supportive of the efforts by CPSS-IOSCO to draw up recommendations which are likely to be finalised in the second half of 2010.

15 CESR/10-510, 'CESR technical advice to the European Commission in the context o the MiFID review: non-equity markets transparency'.

In the UK, we believe we already have the necessary flexibility to provide a regulatory umbrella for trade repositories.

4.27 Short selling is a further area where we seek greater transparency. We have given our views that the best way forward is a comprehensive system of public disclosure of significant short positions.[16] Again, we have closely cooperated with our CESR colleagues in drawing up detailed proposals for a European equities short selling disclosure regime. We have been particularly mindful of market participants' express wish for harmonised requirements in this area. This has resulted in a proposed model, which is based on the short seller making a private disclosure to the regulator of net short positions of 0.2% and above of the issuer's share capital, with public disclosures of positions above a 0.5% threshold. CESR submitted its recommended disclosure model to the European Commission in March.[17] We now await the Commission's proposals for European legislation in this area and will continue participating in developing the disclosure regime as well as responding to any other initiatives on short selling that may emerge.[18]

4.28 The Bank of England has recently consulted on its initiatives to require greater transparency in relation to structured products as part of the eligibility criteria for instruments accepted in its operations in the sterling money markets.

4.29 At the operational level we are pursuing initiatives with our CESR colleagues to enable the exchange between European regulators of transaction reports in OTC equity derivative products. We are also pursuing discussions on harmonising the basis on which transaction reports are required to be generated. These initiatives will give CESR members a better picture of OTC or remote activity on their markets.

BOX 6: Commodity markets

The last two years have seen considerable political attention focusing on the functioning of the worldwide commodities trading markets. These are highly significant as they provide the mechanism to deliver the world's key consumables including oil, power, metals and agricultural products. Significant price movements have led to debate about the functioning and efficiency of these markets. Our direct interest is in the financial derivative commodity markets that we supervise, rather than the physical markets. In relation to derivatives markets, the regulatory debate has focused on two discrete issues:

- combating market manipulation; and
- controlling or limiting price movements.

Combating market manipulation is one of our regulatory objectives. We support all policy measures that aim at preventing manipulative behaviour in derivative markets, particularly those with an element of physical delivery, such as commodities. One concern about manipulation is the effects of holding and abusing a large position. Rather than adopting rigid position and using accountability limits as a means to deal with such circumstances, the UK regime has a more encompassing set of

16 Short selling – Feedback on DP09/1 http://fsa.gov.uk/pubs/discussion/fs09_04.pdf.

17 CESR/10-088, 'Model for a Pan-European Short Selling Disclosure Regime'.

18 Events over the last few weeks have obviously brought short selling into heightened focus.

tools with an emphasis on a broad position management approach. In addition to the overarching framework for managing positions –e.g., the London Metal Exchange's (LME) lending guidance – exchanges have the authority to manage positions at any point throughout a contract's cycle, taking account of contract liquidity as well as the scale and nature of participants involved at any time. While we are not opposed to regulators having the option to set limits as one tool to help combat market manipulation, we do not believe rigidly applying limits would necessarily be the best means of combating manipulation. Nor do we consider, more specifically, that precluding or limiting financial participants as a group in UK commodity, or broader derivative, markets will necessarily reduce the potential for manipulation.

In relation to controlling or limiting price movements, while we are not a pricing regulator, we have nevertheless carefully considered the various analyses of recent price movements. We have seen no evidence to suggest that one particular type of market participant has been solely responsible for driving derivative market prices. Furthermore, it is not clear that commodity prices or other financial derivatives can be effectively controlled by the mandatory operation of regulatory tools such as position limits, whether on-exchange or OTC. Analysis of market data suggests that contracts where position limits are already in use have not reduced in volatility or absolute price movements compared with contracts where they are not.

In line with the Pittsburgh G20 meeting's conclusions, IOSCO is reviewing the workings of commodity derivatives markets, and pursuing ways to enhance their transparency to regulators and market participants. We are co-chairing the relevant IOSCO Task Force with the Commodity Futures Trading Commission (CFTC) and the Task Force will report back to the next G20 Heads of Government meeting. We are also actively engaged in the commodities related aspects of the review of markets legislation underway in Europe.

Overseeing credit rating agencies

4.30 Due to their role in rating structured finance products – particularly those linked to US sub-prime mortgage assets – credit rating agencies (CRAs) have come under increasing political and regulatory scrutiny. Several concerns have been at the forefront of analysing CRA activities, in particular:

- conflicts of interest created by the 'issuer pays' business model;
- the potential for rating shopping (where an issuer or arranger commissions several preliminary ratings and only proceeds with the one most likely to give the highest rating);
- the adequacy of monitoring of outstanding ratings; and
- the transparency of the rating process.

This has led to a number of regulatory developments, of which the most important for us is the introduction of the new EU CRA Regulation.

4.31 The Regulation requires all CRAs operating within the EU to register with the relevant national authorities between 7 June and 7 September 2010. Only ratings produced by registered CRAs will be acceptable for regulatory purposes within the EU from 7 December 2010. Registered CRAs will need to meet a wide range of requirements designed to mitigate or eradicate conflicts of interest, improve corporate governance, increase levels of monitoring of

ratings and enhance the levels of disclosure on rating decisions and processes. Under the terms of the Regulation, CRAs will be registered as a legal entity, rather than on a group basis. This means the majority of the requirements will need to be met at a subsidiary level. We fully support the Regulation's objectives and are working closely within CESR to ensure the regime is consistently and effectively implemented.

4.32 Two mechanisms – endorsement and equivalence – have been created which allow the ratings from CRAs operating outside the EU to be used for regulatory purposes within the EU. Systemically important CRAs will need to have their ratings endorsed by an EU-registered CRA. We therefore expect all major CRAs to ask their EU-registered subsidiaries to endorse ratings originating outside the EU. CRAs that are not deemed systemically important will not necessarily be required to establish an EU subsidiary for their ratings to be eligible for regulatory use within the EU. This is provided that, among other requirements, the European Commission has deemed the regulatory regime within the relevant third country to be 'equivalent' to that of the EU. The successful implementation of this element of the regime will be vital, to avoid potentially negative market disruptions that could arise if non-EU ratings are not treated appropriately.

4.33 In December 2009 it was agreed that ESMA will be responsible for supervising CRAs, instead of colleges of national authorities. The Commission needs to introduce legislation to deliver this change. We expect the proposals will transfer supervision to ESMA from January 2011. An important element of our work on CRAs will now be ensuring that the transition to ESMA supervision is successful and leads to effective and proportionate regulation of CRAs. We see a strong continuing role for national authorities in overseeing CRAs and consider that efficient regulatory colleges can play a valuable role, under overall ESMA responsibility. In our view, this will produce a better outcome than centralising all supervisory activity within ESMA as it would allow CRA regulation to remain local, while effectively coordinated across the EU. We will continue to actively engage with our CESR partners and other relevant authorities to ensure that CRA supervision does not negatively impact the markets.

BOX 7: Credit Rating Agency Regulation Timeline

The existing EU Regulation on Credit Rating Agencies (CRAs) requires all CRAs wishing to continue to do business within the EU and have their ratings used in EU directive-based financial services regulations (e.g. the CRD) to register with EU authorities. The key implementation dates are:

7 June 2010: Earliest date for CRAs to apply for registration.

7 September 2010: Latest possible date for application for registration and date of compulsory compliance with the Regulation by all CRAs.

7 December 2010: Date at which only ratings issued by CRAs which are registered or in the process of being registered can be used in specified financial services regulation.

Strengthening the markets for securitised products

4.34 The new regime for CRAs is supplemented by other initiatives underway to improve confidence in the market for securitised products, such as asset backed securities, through improved regulation. A healthy securitisation market benefits consumers, investors, issuers and banks. It helps to support economic growth through aiding credit intermediation and diversifying risk. However, as seen in the period leading up to the recent financial crisis, wrong incentives, inadequate risk management practices and other problems led to significant deterioration in asset quality for various securitised products, affecting market confidence.

4.35 We are considering responses to our consultation on rules to implement the amended Capital Requirements Directive (Directive 2009/111/EC).[19] The rules will restrict regulated credit institutions from taking on an exposure to a securitised product unless the originators, sponsors or the original lender have explicitly disclosed to the entity that it will retain, on an ongoing basis, a material net economic interest of no less than 5%. Thus the latter parties will continue to have exposure to the long-term viability of the securitised product, aligning their interests with those of the investors.

4.36 New qualitative due diligence and disclosure requirements will affect investors and originators/sponsors. Investors will be required to perform adequate due diligence before investing to ensure that risks arising from the securitisation are properly assessed; originator and sponsor credit institutions are required to provide adequate information to enable investors to meet those requirements. This covers all materially relevant data on the credit quality and performance of the individual underlying exposures, cash flows and collateral supporting a securitisation, as well as the information necessary to conduct comprehensive and well-informed stress tests on the cash flows and collateral values supporting the underlying exposures. Sponsor and originator credit institutions are also required to apply the same sound and well-defined criteria for credit-granting to exposures to be securitised as they apply to exposures held on their book. These rules will come into effect on 1 January 2011.

4.37 We are also looking at the UK Regulated Covered Bond (RCB) regime. This came into force in March 2008, and 9 issuers are currently admitted to the RCB Register. The RCB regime qualifies as 'special public supervision', as defined in the Undertakings for Collective Investments in Transferable Securities (UCITS) Directive and RCB Registered Bonds benefit from:

- higher prudential investment limits under UCITS (concentration limits increased from 5% to 25%);

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- higher investment thresholds for insurers (up to 40% for RCBs compared with 5% in unregulated covered bonds); and
- a lower risk weighting under the Banking Consolidation Directive.

4.38 We have been analysing with HM Treasury what further enhancements can be made to the RCB Regulations to reinforce the high quality nature of the regime, and to promote investor understanding of the regulatory framework. Any changes to the regime will be subject to consultation. Box 8 shows the amount of registered covered bonds issued to date.

BOX 8: Covered bond issuance		
Firm	**Programme Size (€bn)**	**Issuance (€bn)**
Abbey National	25.0	11.1
Barclays	35.0	3.7
HBOS	60.0	37.6
HSBC	25.0	17.9.
Leeds Building Society	7.0	1.4
Lloyds TSB	15.0	9.2
RBS	15.0	0.0
Nationwide	45.0	27.4
Yorkshire Building Society	7.5	3.5
Total	234.5	111.8

4.39 We are also exploring how to encourage more sustainable, transparent and standardised UK mortgage-backed securities markets, by working with the Bank and HM Treasury through the Council for Financial Stability, and holding discussions with issuers and investors, to establish a broader investor base and lay foundations for stronger markets in the future.

Improving market quality

4.40 We have taken substantial steps over the past couple of years to continue improving the quality of UK markets. We have given particular emphasis to pursuing an approach of credible deterrence against insider dealing and market manipulation. We have also introduced a disclosure regime for contracts for difference, and for significant short positions in financial firms and companies undertaking rights issues. We have also reviewed and clarified the structure of the listing regime – strengthening the requirements applied to non-UK issuers to align them more closely with those for UK issuers – as well as streamlined the rights issue process. We will build on these steps over the coming period.

Market conduct

4.41 Combating insider dealing and market manipulation remains at the top of our agenda. We continue to pursue vigorously our policy of credible deterrence, which entails:

- devoting substantial resources to the surveillance of market activity;
- following up suspicious transactions with timely and thorough investigation, so that those acting inappropriately have a high prospect of being caught; and
- applying the full range of civil and criminal prosecution tools, so that those that are caught are punished.

We usually have about 100 preliminary enquiries into unusual/suspicious trading under way at any one time and around a further 40 investigations into cases involving suspected market abuse.

4.42 Market abuse is difficult to detect, investigate and prosecute. Tackling it is a long-term challenge and our strategy involves making full use of all the tools we have available. Market participants also have a key role to play, and we are committed to working in partnership with the industry. Our approach to achieving 'credible deterrence' recognises that market abuse may range from premeditated, one-off or repeated instances of trading by market professionals to opportunistic and ill-considered activity. Tackling the former is especially challenging and requires considerable work, not least because participants may have taken active steps to try to avoid detection.

4.43 **Prevention and education:** We want to ensure that market participants are aware of their obligations and take all reasonable steps to mitigate the risk of market abuse. We therefore promote the need for effective anti-market abuse systems and controls, and conflicts management, with a particular focus on training and education. We undertake thematic and supervisory visits to firms to assess their systems and controls and publish details of weaknesses and good practice points in our 'MarketWatch' newsletter.[20] We may also consider spot checks to ensure controls are robust.

4.44 Examples include reviews of the following:

- the quality of Suspicious Transaction Reports (STRs);
- the strength of controls over inside information relating to public takeovers;
- the strength of controls at hedge fund managers and commodities firms; and
- the market abuse risks in the credit markets.

20 http://www.fsa.gov.uk/pages/About/What/financial_crime/market_abuse/library/newsletters/index.shtml

Each review has increased firms' awareness of issues and of good practice, enabled us to provide training to firms and feeds into our risk-based approach to supervising market participants. This work complements firm-specific risk assessment visits from our supervisory teams, which also review market conduct controls where appropriate. A particular area of current focus is the need for a change in culture to stop the practice of leaks to the market ahead of price sensitive announcements where a party may consider that they, or the transaction itself, will gain from early media positioning. This practice is unacceptable.

4.45 **Detection:** Identifying potential market abuse quickly is key to successful investigation and enforcement action. We expect market participants to proactively report to us suspected wrongdoing or unusual activity, whether by clients, their own employees or other market participants. STRs from authorised firms have proved to be a valuable source of leads about possible market abuse.

4.46 Transaction reports are another important component of our toolkit for investigating instances of market abuse, including insider trading. We receive approximately 30 million transaction reports per week from over 1000 firms. Strengthening our surveillance capabilities, by improving our systems is a core part of our strategy. When fully operational, our new systems will enable us to undertake more sophisticated analysis of all the data we receive, set alerts and progress our enquiries in greater depth and more efficiently than we can at present.

4.47 Errors in firms' transaction reporting can impact our ability to effectively monitor and take action against market abuse. We therefore take breaches seriously. Whilst there is still work to be done to reduce the level of transaction reporting failures, recent enforcement action (for example, the £2.45m fine imposed on Barclays in September 2009), a number of further enforcement investigations and our strategy of continued engagement with the industry, all mean that firms' awareness of the importance of transaction reporting is increasing.

4.48 **Investigation:** One of the challenges of combating market abuse is establishing to the necessary degree all the many and varied elements of the offence. Direct evidence of misconduct is rare. For example, people carrying out insider dealing will often have taken care to try to cover their tracks. Therefore, we typically have to infer from the circumstances of suspected misconduct, e.g. from the timing of the relevant trades. Obtaining evidence of such misconduct is especially challenging with complex insider dealing rings involving multiple participants.

4.49 However, we have a wide range of tools available to help us investigate potential offences. In addition to interviews and document requests, we can obtain confidential banking information and execute search warrants. We can also obtain telecommunications data using our powers under the Regulation

of Investigatory Powers Act 2000 (RIPA). We can also use civil powers to restrain the proceeds of suspected market abuse. We can, and do, use all of these powers in our investigations.

4.50 We can deal with some offenders by way of a sanction under FSMA in order to secure their evidence against others. We took this approach in the recent prosecution of Malcolm Calvert for insider dealing. From 6 April 2010 we have also been able to exercise powers under the Serious Organised Crime and Police Act 2005 in relation to offenders who are willing to assist in the investigation or prosecution of others.

4.51 Records of telephone conversations and electronic communications can play an important role in investigations of market abuse by giving context and helping to establish the facts. From March 2009, firms have to record all telephone conversations and electronic communications relating to client orders and the conclusion of transactions in the equity, bond and derivatives markets. Firms have to keep recorded calls and communications for six months. We are currently consulting on requiring firms to tape relevant communications on mobile phones issued by the firms for business use. We are also proposing to introduce a rule requiring firms to take reasonable steps to prevent employees or contractors from using any private communications equipment for such purposes.[21]

4.52 **Prosecution:** We recognise that one of the most significant components of credible deterrence is ensuring there is a genuine fear that wrong doing will be identified and the punishment received will be meaningful. So our enforcement approach involves sending tough messages about wrongful behaviour and imposing sanctions that are severe enough to be a deterrent, as well as ensuring we undertake enough cases to have a 'demonstration effect'.

4.53 Our approach uses the criminal prosecution powers available to us and our civil powers under the market abuse regime (which enable us to impose unlimited financial penalties). On the criminal side, each of the five individuals we have prosecuted for insider dealing had dealt ahead of public takeovers and each trial resulted in convictions of all defendants with custodial sentences handed down. On the civil – market abuse – side our recent new penalties policy has emphasised we expect to increase the financial penalties we impose in market abuse cases. We have just levied our largest fine on an individual – £2.8 million on Simon Eagle for deliberate market abuse relating to a share ramping scheme. In parallel, we are taking action against FSA-authorised firms for breaching our Principles for Business and against FSA-approved persons for breaching our Statements of Principle and Code of Practice for Approved Persons. The Principles relating to acting with integrity, with due skill, care and diligence and observing proper standards of market conduct are particularly relevant.

21 CP10/7 Taping: removing the mobile phone exemption

4.54 **Cooperation with other law enforcement agencies:** The nature of market abuse, as explained above, means bringing wrongdoers to book through our tools and powers is not always possible. We work closely with other law enforcement agencies both in the UK (including the Serious Organised Crime Agency for example) and overseas to ensure that we can obtain (or indeed provide) specialist assistance on investigations into market misconduct.

4.55 We will regard our strategy as successful if the opportunities to commit abuse are minimised through: better controls within the industry; if we can detect incidents of abuse quickly; and if potential wrongdoers have a real fear of being caught and of facing a meaningful sanction. We believe our recent achievements mean we are progressing towards our goal of achieving credible deterrence.

BOX 9: Enforcement cases since January 2009		
Criminal actions – insider dealing		
Date	**Persons we have taken action against**	**Outcome**
May 2010	Anjam Ahmad	Pleaded guilty to one count of conspiracy to insider deal. Sentencing due in June 2010.
March 2010	Malcolm Calvert	Found guilty on five counts of insider dealing and sentenced to 21 months in prison.
December 2009	Matthew Uberoi Neel Uberoi	Found guilty on twelve counts of insider dealing and sentenced to 12 months and 24 months in prison respectively.
March 2009	Christopher McQuoid James William Melbourne	Each found guilty on twelve counts of insider dealing and sentenced to 8 months in prison (the latter suspended for 12 months due to age).
Civil actions – market abuse		
Date	**Persons we have taken action against**	**Outcome**
April/May 2010	Winterflood Securities Limited Simon Eagle Jason Robins Stephen Sotiriou	Fined £4 million, £2.8 million, £50,000 and £200,000 respectively for market abuse relating to share ramping scheme in an AIM-listed company. Eagle was also banned from working in the financial services industry.
April 2010	Robin Chhabra Sameer Patel	Fined £95,000 and £180,541 respectively for insider dealing in Ebookers and Eidos shares and banned from working in the financial services industry.
March 2010	Bertie Hatcher	Fined £56,098 for market abuse relating to 6 LSE companies (in connection to Malcolm Calvert criminal case).
January 2010	Mehmet Sepil Murat Ozgul Levant Akca	Fined £967,005, £105,240 and £94,062 respectively for insider dealing in Heritage Oil plc
November 2009	Alexei Krilov-Harrison	Fined £24,000 for using inside information to encourage his clients to buy shares in Provexis.

October 2009	Darren Morton Christopher Parry	A public censure for committing market abuse in relation to a new issue of Barclays' bonds.
February 2009	Darwin Clifton OBE Byron Holdings Ltd	Fined £59,500 and £86,030 respectively for insider dealing in the shares of Desire Petroleum plc.
January 2009	Erik Boyen	Fined £176,254 for insider dealing in the shares of Monterrico Metals plc. This followed on from fines issued against two other individuals in the same case in November 2008.
Civil actions – market misconduct		
Date	**Persons we have taken action against**	**Outcome**
September 2009	Mark Lockwood	Fined £20,000 for failing to act on and report to the FSA, a suspicious client order that allowed the firm to be used to facilitate insider dealing.
May 2009	Nilesh Shrof	Fined £140,000 and prohibited from performing any regulated function for 'pre-hedging' client programme trades.
Civil actions – transaction reporting		
Date	**Persons we have taken action against**	**Outcome**
April 2010	Commerzbank AG	Fined £595,000 for breaches of SUP17
April 2010	Instinet Europe Ltd	Fined £1.05 million for breaches of SUP17, Principles 2 and 3
April 2010	Getco Europe Ltd	Fined £1.4 million for breaches of SUP17
April 2010	Credit Suisse Securities (Europe) Ltd Credit Suisse (UK) Ltd Credit Suisse International Credit Suisse AG	Fined £1.75 million for breaches of SUP17
September 2009	Barclays Capital Ltd Barclays Capital Division	Fined £2.45 million for breaches of SUP17, Principles 2 and 3.

Restructuring the listing regime

4.56 As Listing Authority we handle a high volume of prospectuses and other shareholder documents for vetting. In 2009 we approved over 1,700 documents and handled around 8,000 helpdesk calls. We also interact with numerous issuers and their advisers in our company monitoring role, checking that accurate and timely disclosures are being made to the market and follow up suspected breaches of the regime.

4.57 In the policy area our agenda over the last three years has been focused on modernising the listing regime structure. The review's objective has been to provide greater clarity and choice about the regime's structure, and the rights

and obligations it creates. The regime's restructuring came into effect in April 2010, and we will monitor how the standard and premium listings are implemented in the future. As part of this, we are engaging with relevant markets and data providers to identify how best the new structure and labelling can be incorporated into the information they give to end-users.

BOX 10: Review of the listing regime's structure

We conducted this review to ensure that, following market and regulatory change in recent years, the UK's listing regime remains effective and relevant. The regime has grown organically over the last 10-15 years and one particular consequence of this was an increasing concern, shared by market participants, that the regime lacked the clarity necessary to give investors appropriate protection while maintaining the UK's international competitive position.

In conducting the review, we focused on three key objectives:

- we sought to ensure investors can take more informed decisions on the basis of enhanced clarity and common standards;
- we sought to position the UK regime appropriately in a very competitive global market, while protecting the 'badge of quality' represented by super-equivalent Premium listing requirements – this remains highly valued by all market participants; and
- we took steps to enhance the flexibility that issuers need concerning options open to them in raising capital.

We have therefore restructured the regime so that it has two clearly labelled segments. 'Premium' represents the UK's more stringent super-equivalent requirements and 'Standard' represents the EU minimum standards underpinned by the key Directives (Prospectus, Transparency and Market Abuse Directives). As part of this we have clarified that the Premium segment is only available to equity shares that meet all super-equivalent requirements. This will ensure that investors can be confident that any Premium listed equity meets in full a clearly defined and more rigorous set of standards.

We have also sought to provide as far as possible a level-playing field between UK and overseas issuers. So, we have introduced changes to increase corporate governance standards for Premium overseas companies by requiring them to comply with the UK Combined Code in the same way as UK Premium issuers and to offer pre-emption rights, and we have extended our implementation of the Company Reporting and Statutory Audit Directives to overseas issuers (this had previously been implemented on a UK incorporated basis only.) At the same time, and following the principle of providing a level playing field where possible, we introduced changes in October 2009 to open up the Standard segment to UK companies. This had previously only been available for overseas companies. However, we decided the Standard segment should be open to UK issuers who wanted the option of an EU Directive minimum listing in the UK. This is consistent with our objective of enhancing the flexibility available to issuers in deciding which route they can use in raising capital.

Taken together these changes mean, broadly, that all listed companies are subject to the same requirements, depending on their Listing Segment, and irrespective of their country of incorporation. Investors can make better informed decisions with greater clarity about the obligations attached to specific securities within each segment. At the same time the UK badge of quality represented by the Premium segment will be fully protected, while allowing issuers flexibility in the route they follow in raising capital. These measures will continue to position the UK as an attractive place for domestic and international companies to raise capital, and for investors to participate in.

Conclusion

4.58 This represents a demanding regulatory agenda for the months ahead. We will become more involved in areas where our engagement has previously been limited – such as the oversight of Credit Rating Agencies. Our regulatory agenda recognises that new standards will now almost exclusively be set either at the EU or wider international level. We have correspondingly moved away from developing UK standards in isolation and are refocusing our resources to engage more deeply and continuously with key multilateral and bilateral partners.

4.59 However, it is important to emphasise that our regulatory approach in promoting efficient, orderly, fair, internationally attractive and sustainable markets remains unchanged. In developing new standards and frameworks we will continue working towards clear and justifiable regulatory outcomes which are consistent with market efficiency, competition and innovation.

Annex 1

Glossary of terms

Alternative Investment Fund (AIF)
Alternative Investment Fund Managers (AIFM)
Alternative Investment Fund Manager Directive (AIFMD).
Alternative Investment Market (AIM)
Central Counterparty (CCP)
Central Securities Depositary (CSD)
Committee of European Securities Regulators (CESR)
Committee on Payment and Securities Settlement Systems (CPSS)
Committee on Payment and Settlement Systems and the Technical Committee of the International Organization of Securities Commissions (CPSS-IOSCO)
Commodity Futures Trading Commission (CFTC)
Credit Default Swap (CDS)
European Securities and Markets Authority (ESMA)
Financial Services and Markets Act (FSMA)
International Monetary Fund (IMF)
London Clearing House (LCH)
London International Financial Futures Exchange (LIFFE)
London Metal Exchange (LME)
London Stock Exchange (LSE))
Markets in Financial Instruments Directive (MiFID)
Multilateral Trading Facility (MTF)
New York Stock Exchange (NYSE)
Over-the-Counter (OTC)
OTC Derivatives Regulators Forum (ORF)
Regulated Covered Bond (RCB)
Regulation of Investigatory Powers Act 2000 (RIPA)
Serious Organised Crime Agency (SOCA)
Suspicious Transaction Reports (STRs)
UK Listing Authority (UKLA)
Undertakings for Collective Investments in Transferable Securities (UCITS)

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