FINANCIAL CONDUCT AUTHORITY

Consultation Paper
CP24/14**

Consultation on the derivatives trading obligation and post-trade risk reduction services

July 2024

How to respond

We are asking for comments on this Consultation Paper (CP) by **30 September 2024**.

You can send them to us using the form on our website.

Or in writing to:

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Chapter 1

Summary

Why we are consulting

1.1 This consultation is part of the Wholesale Markets Review (WMR), the review of UK wholesale financial markets we have been conducting with the Treasury since 2021. It supports the FCA's commitment to strengthen the UK's position in wholesale markets, as outlined in our Business Plan.

1.2 The Financial Services and Markets Act 2023 (FSMA 2023) amended parts of UK MiFIR (onshored Regulation (EU) No 600/2014 on Markets in Financial Instruments Regulation, hereinafter referred to as UK MiFIR) to give us the necessary powers to deliver the reforms set out in the WMR.

1.3 This consultation includes proposals on three distinct but interconnected aspects of the derivatives trading obligation (DTO). We shared our proposals with the Markets Practitioners Panel and discussed them with our Secondary Markets Advisory Committee, where they received strong support.

1.4 We are consulting on: (1) including certain overnight index swaps (OIS) based on the US Secured Overnight Financing Rate (SOFR) within the classes of derivatives subject to the DTO; (2) expanding the list of post-trade risk reduction (PTRR) services exempted from the DTO and from other obligations; and (3) how we intend to use our power to suspend or modify the DTO once our transitional powers under Part 7 of the Financial Services and Markets Act 2000 (Amendment) (EU Exit) Regulations 2019 expire at the end of this year.

1.5 Our proposals aim to improve the UK's regulation of secondary markets, reduce systemic risk in derivatives markets and avoid fragmentation and disruption for firms trading over-the-counter (OTC) derivatives subject to the DTO.

Who this applies to

1.6 This consultation will primarily be of interest to:

- Providers of PTRR services
- Trading venues which admit to trading or trade derivatives
- Investment firms and banks dealing in derivatives
- UK branches of overseas firms undertaking investment services and activities

1.7 Our proposals will also interest Approved Publication Arrangements (APAs), central counterparties (CCPs), law firms, consultancies and their related trade associations.

What we want to change

List of derivatives subject to the DTO (Chapter 3)

1.8 At the Pittsburgh Summit in September 2009, the G20 committed to improve OTC derivatives markets, with a view to increasing transparency, mitigating systemic risk and protecting against market abuse. The G20 stated that all standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms and cleared through CCPs by end-2012, where appropriate. OTC derivative contracts should be reported to trade repositories, and non-centrally cleared contracts should be subject to higher capital requirements. The DTO was the implementation of this G20 commitment, in the EU, and subsequently the UK.

1.9 The DTO is implemented through Article 28 of UK MiFIR, which requires certain financial and non-financial counterparties to conclude transactions in standardised and liquid OTC derivatives only on regulated trading venues or on equivalent third country venues. The obligation applies to classes of derivatives that we bring under the trading mandate. Before bringing classes of derivatives under the DTO, we are required to consider whether the derivatives are: a) subject to the derivatives clearing obligation (CO); b) admitted to trading on at least one regulated trading venue; and c) sufficiently liquid to trade only on those venues.

1.10 The Bank of England brought SOFR OIS under their CO since 24 August 2022. These instruments are also already subject to the US trading mandate, the equivalent of our DTO, as required by the CFTC since 5 August 2023.

1.11 The available evidence about the liquidity of certain SOFR OIS, also supported by feedback from market participants, suggests that they are sufficiently liquid to be brought in scope of the UK DTO.

1.12 We propose to modify our DTO register to bring in scope certain SOFR OIS instruments, thereby increasing transparency in the OTC derivatives market in the UK and supporting our G20 commitment.

Post-trade risk reduction services (Chapter 4)

1.13 Transactions resulting from portfolio compression, a type of risk reduction service, are currently exempted from the DTO and from other obligations. The WMR concluded that those exemptions should also be available to trades that arise in relation to other PTRR services. Making those exemptions available to a wider set of risk reduction services would support firms' risk management practices and contribute to reducing systemic risk in financial markets.

1.14 FSMA 2023 amended Article 31 of UK MiFIR to allow us to make rules to exempt trades conducted as part of PTRR services if we consider it necessary or expedient for the purpose of advancing one or more of our operational objectives referred to in section 1B(3) of FSMA. We also have the power to impose conditions or exceptions where appropriate.

1.15 We propose to maintain the existing exemptions for trades conducted as part of portfolio compression. We also propose to expand the exemptions to trades conducted as part of portfolio rebalancing and basis risk optimisation, which are widely used risk reduction services.

1.16 In this consultation we set out the characteristics that risk reduction services would need to satisfy for trades used to conduct them to be eligible for exemption. We also propose to require providers of PTRR services to comply with disclosure and notifications obligations.

1.17 Our proposal aims to advance our market integrity objective by strengthening risk management practices, improving transparency and enhancing the overall stability and efficiency of the financial markets. We are of the view that our changes would improve the OTC derivatives market by removing information about transactions that are part of those risk reduction services and are currently reported to the public but do not support price formation.

Power to amend or suspend the DTO (Chapter 5)

1.18 Following the UK's departure from the EU, we have been using our temporary transitional powers (TTP) to modify the application of the DTO.

1.19 We used the TTP to grant relief to firms subject to our DTO in order to prevent disruption in derivatives trading arising from our departure from the EU. However, the TTP will expire on 31 December 2024.

1.20 FSMA 2023 inserted Article 28a in UK MiFIR, which gives us a new power of direction to suspend or modify the DTO if we consider this necessary for the purpose of preventing or mitigating disruption to financial markets and advancing one or more of our operational objectives.

1.21 In this consultation we set out how we intend to use our power to suspend or modify the DTO. We propose to exercise this power in a similar way we used the TTP, as we believe the conditions that supported the use of the TTP continue to be relevant.

Summary of the cost and benefit analysis of our proposals

1.22 We have carefully considered the potential costs and benefits of our proposals. These are set out in Table 4 of the CBA on bringing SOFR OIS in scope of our trading obligation on page 54 of this document and in Table 7 of the CBA on exemptions for PTRR services on page 68 of this document.

1.23 We expect that moving SOFR OIS into the scope of the DTO and the resulting movement of trades subject to the DTO to have a positive impact on liquidity and trading costs. We consider that there will be net benefits in this proposal.

1.24 Particularly, we anticipate that shifting trading on to trading venues for standardised and liquid derivatives reduces fragmentation, increases pre-trade price transparency and thereby increases the liquidity and reduces execution costs due to market participants having better information about prices and addressable liquidity.

1.25 We also expect that expanding the list of PTRR services exempted from the DTO and other relevant obligations will be net beneficial. Our proposals will increase the use of PTRR services. Increasing the use of PTRR services will reduce risk in swap markets and the risk that shocks are amplified. This makes the system more resilient and therefore reduces systemic risk in financial markets and the wider economy.

1.26 Particularly, we anticipate that disapplying the DTO to a wider range of PTRR services would reduce the complexity of the amended positions resulting from using such services. This in turn will remove the disincentive to firms unwilling to use PTRR services (other than compression) due to the complexity of instruments that PTRR services currently require them to hold. We therefore expect that the disapplication of the DTO to PTRR services will increase uptake, particularly among smaller firms.

1.27 Overall, we consider that our proposals may have significant potential for long-term benefits due to their effectiveness in reducing systemic risk and enhancing integrity of the market.

Measuring success

1.28 We will use a variety of metrics to assess whether our changes achieve their intended objectives and strengthen the UK's position in global wholesale markets. We will monitor how our actions improve the UK market including measuring success against our relevant objective, as well as that of the original G20 mandate.

1.29 To measure our success,

- We will continue to review relevant market data on liquidity to assess the success of our proposal to include SOFR OIS under the DTO. We will consider our policy to be successful where amending the DTO maintains or improves liquidity and transparency in the relevant SOFR OIS derivatives.
- We will monitor whether our proposed changes to risk reduction services support the use of those services by market participants and the extent to which they reduce operational and counterparty risk and enhance the overall operation of markets. We will also consider whether the exemptions improve the content of post-trade information for OTC derivatives.
- We will continue to monitor market and regulatory developments through feedback from market participants and trade associations, and consider use of our power to amend or modify the DTO on an ongoing basis. We will consider our policy to be successful where use of our power to modify the DTO provides a continuity in trading and access to liquidity for UK firms.

Next steps

1.30 We are seeking views on our proposals by 30 September 2024.

1.31 Please send your comments to us using the options in the 'How to respond' section above. Unless you have indicated that your response and/or the fact that you have responded are confidential, we will not treat them as such.

1.32 Based on the responses we receive, we will finalise the draft rules, guidance, technical standards and policy statement. We will publish our direction on the modification of the DTO in Q4 2024.

Chapter 2

The wider context and the relationship to our objectives

2.1 The UK Markets in Financial Instruments Directive (UK MiFID) is the collection of laws that regulate the buying, selling and organised trading of financial instruments. The rules are derived from European Union (EU) legislation that took effect in November 2007 and were revised in January 2018 (MiFID II).

2.2 One of the objectives of MiFID II was to bring more trading to regulated trading venues, thereby improving the resiliency of trading in OTC derivatives, increasing market transparency, investor protection and access to liquidity.

2.3 MiFID II delivered against that objective by introducing the DTO. This requirement, see Article 28 of UK MiFIR, brought more derivatives trading onto regulated trading venues.

The harm we are trying to reduce

2.4 Our proposal to expand the DTO to certain SOFR OIS reflects the global transition from London Inter-bank Offered Rate (LIBOR) to risk-free rates (RFR). Liquidity in SOFR OIS is sufficiently high and comparable to other classes of derivatives which are already in scope of the DTO to be subject to the trading mandate. Keeping SOFR OIS outside the DTO would reduce the benefits from platform trading and run counter our G20 commitment.

2.5 When we consulted in CP23/32 on improving transparency for bond and derivatives markets, we proposed a new regime of post-trade transparency requirements for OTC derivatives. We did not address the reporting of transactions resulting from risk reduction services under that consultation. We also did not address the issue of mandating execution on trading venues of transactions resulting from PTRR services.

2.6 Given the nature of the transactions resulting from PTRR services, including them in the scope of post-trade transparency creates unnecessary noise and complicates the use of market data. Our proposals aim to address this and also facilitate the use of PTRR services, which supports reducing systemic risk in the market.

2.7 Our proposal on the use of our power to modify or suspend the DTO deals with the forthcoming expiry of the TTP. Failure to provide continuity in the outcomes achieved through the TTP could lead to market fragmentation and disrupt trading for UK firms dealing with EU clients.

How it links to our objectives

Market integrity

2.8 Our proposed changes are primarily aimed at promoting the stability and resilience of the UK's OTC derivatives market. Overall, we believe our proposals advance market integrity by improving market transparency, mitigating systemic risk and protecting against market abuse.

2.9 Mandating the trading of sufficiently liquid SOFR OIS on regulated venues should increase transparency and enhance the orderly operation of the financial market. We expect this to improve the quality of information available to firms participating in secondary markets, thereby reducing the risk of market abuse and disorderly trading.

2.10 We also propose changes which will remove non-price forming transactions that result from risk reduction services from inclusion to post-trade transparency. We believe this will improve the quality of the information available to market participants who will be better able to identify addressable liquidity.

Secondary international competitiveness and growth objective

2.11 We expect our proposed changes to promote international competitiveness and growth by enabling UK-based firms to offer and participate in innovative and efficient PTRR services without the need to incur disproportionate regulatory costs. A more proportionate regulatory regime will enhance the attractiveness of the UK for international businesses and investors, thereby facilitating long-term and sustainable growth.

2.12 Expanding the scope of the DTO to include SOFR supports greater financial stability through consistent application of internationalstandards, such as the G20 mandate. The availability of an equivalence decision with the US – the market with most of the liquidity for SOFR – means that UK firms subject to the DTO will continue to have access to the deepest pool of liquidity once our determination is in force. More liquid markets and transparent markets are associated with greater market stability in times of financial stress that, in turn, supports the UK's international competitiveness.

Environmental, social & governance considerations

2.13 In developing this CP, we have considered the environmental, social and governance (ESG) implications of our proposals and our duty under s. 1B(5) and 3B(c) of FSMA to have regard to contributing towards the Secretary of State achieving compliance with the net-zero emissions target under section 1 of the Climate Change Act 2008.

2.14 Overall we consider that our proposals which aim to improve market efficiency and reduce systemic risk could indirectly support the low-carbon transition by promoting financial stability and better resource allocation.

Equality and diversity considerations

2.15 We have considered the equality and diversity issues that may arise from the proposals in this CP.

2.16 Overall, we do not consider that the proposals materially impact persons in any of the groups with protected characteristics under the Equality Act 2010 (in Northern Ireland, the Equality Act is not enacted but other anti-discrimination legislation applies). However, we will continue to consider the equality and diversity implications of the proposals during the consultation period and will revisit them when making the final rules.

2.17 In the meantime, we welcome your responses to this consultation in this area.

Chapter 3

Changes to the classes of derivatives subject to the derivatives trading obligation

Overview and background

3.1 The derivatives trading obligation implements in the UK the G20 commitment to improve the functioning of derivatives markets by mandating that all standardised OTC derivatives be traded on exchanges or electronic trading platforms. Currently, 13 jurisdictions have implemented the trading mandate, which sits alongside the other G20 commitments of central clearing, trade reporting and margin requirements for non-centrally cleared derivatives.

3.2 For a derivative or class of derivatives to be subject to the DTO they must be: (i) subject to the CO; (ii) admitted to trading on at least a UK trading venue; and (iii) sufficiently liquid to trade only on those venues. Once these conditions are satisfied, we can make rules specifying the classes of derivatives should be subject to the DTO.

3.3 The procedure for making changes to the classes of instruments subject to the DTO is set out in Article 32 MiFIR. We are required to maintain a public register specifying the derivatives that are subject to DTO, the venues where they are admitted to trading or traded, and the dates from which the DTO takes effect.

3.4 A class of derivatives, or a subset thereof, is deemed sufficiently liquid on the basis of the criteria specified in Article 32 and RTS 4. We are required under Article 32(5) to amend, suspend or revoke existing RTS if there is a material change in these criteria.

3.5 Once a class of derivatives is in scope of the DTO, transactions within that class can only be concluded on regulated trading venues or third country trading venues that are considered to be equivalent for these purposes.

3.6 There have been changes to the liquidity profile of certain OTC derivatives since the DTO was brought into force in 2017. One of the drivers was the recommendation by the Financial Stability Board (FSB) to reform Interbank Offered Rates (IBORs). This was in response to cases of attempted manipulation and concerns about the robustness of IBORs in light of the decline in liquidity in key interbank unsecured funding markets.

3.7 Given the early adoption of SONIA as a replacement of GBP LIBOR, in PS21/13 we removed derivatives referencing GBP LIBOR from the DTO and replaced them with OIS referencing SONIA. This change entered into force on 20 December 2021. Similarly, because of the transition from USD LIBOR to SOFR, in Handbook Notice 108 we removed derivatives referencing USD LIBOR from the DTO. The change entered into force on 24 April 2023.

3.8 In relation to the transition from USD LIBOR to SOFR, the benchmark RFR for USD, there have been a number of regulatory actions. On 12 August 2022, the Commodity Futures Trading Commission (CFTC) issued final rules amending the US swap clearing requirement to:

- include SOFR OIS with a maturity range of 7 days to 50 years in the clearing mandate
- remove contracts referencing USD LIBOR from the clearing requirement

3.9 Regarding the same products, the Bank of England (the Bank) published amendments on 24 August 2022 to their clearing obligation to:

- include OIS that reference SOFR, entering into effect 31 October that year
- remove USD LIBOR products, entering into effect 24 April 2023

3.10 On 1 December 2022, we proposed removing USD LIBOR derivatives from the scope of the DTO. As mentioned above, we finalised this in Handbook Notice 108 on 31 March 2023.

3.11 Our and the Bank's actions were made in parallel with central counterparties (CCPs) no longer clearing USD LIBOR products, from 24 April 2023 onwards.

3.12 The CFTC approved on 7 July 2023 a made-available-to-trade (MAT) determination for certain SOFR OIS, meaning that these SOFR OIS products were from 5 August 2023 subject to the trade execution requirement and can now only be executed on a registered swap execution facility (SEF). This is equivalent to the DTO in the UK.

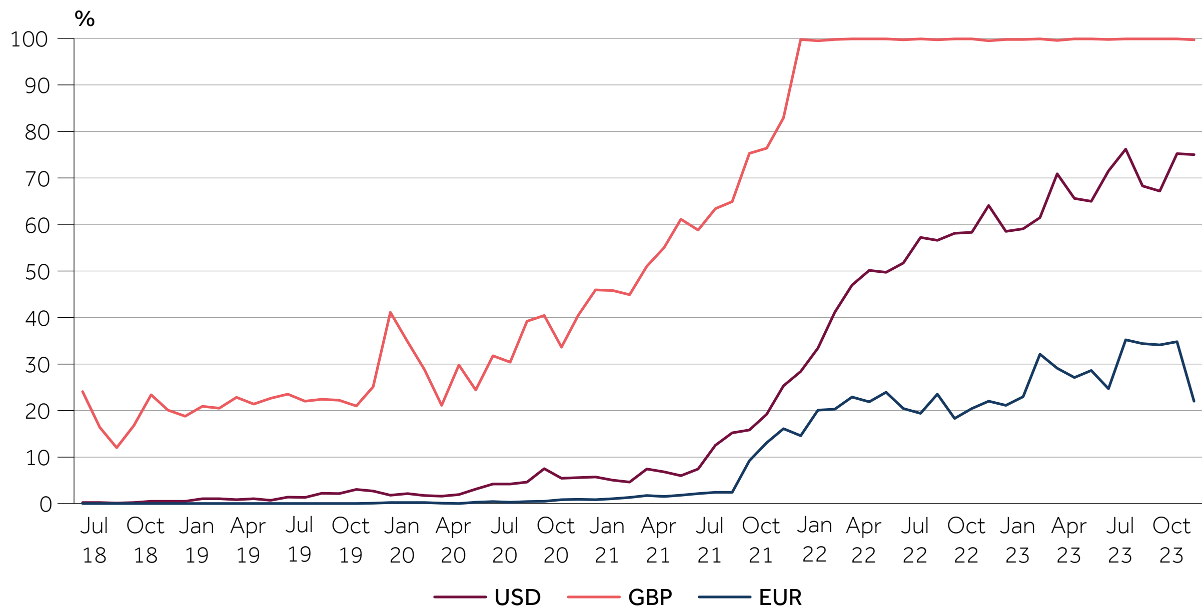
3.13 The transition related to interest rate benchmark reform, which is the main driver of this review, is at different stages for the currencies in scope of the DTO. The available evidence indicates that the adoption of RFRs has now reached an advanced stage for US dollar markets. We continue to monitor RFR adoption for markets denominated in other currencies.

3.14 We use the ISDA-Clarus RFR Adoption Indicator to assess the state of adoption of RFRs in all major jurisdictions and currencies. An ISDA-Clarus white paper provides details of the scope of data used and how the indicators are constructed.

3.15 To summarise, ISDA-Clarus data are collected from all major CCPs that clear OTC and exchange traded derivatives (ETD) in six currencies (AUD, CHF, EUR, GBP, JPY and USD). Only cleared transactions are covered. The data on interest rate derivatives (IRD) are standardised and collated to produce notional-equivalent volumes in six tenor buckets. The notional data are converted into a maturity-neutral measure of risk, DV01 (dollar value of 1 basis point change). The measures of volumes are broad, covering many OTC IRD products (IRS, OIS, FRAs and basis swaps), as well as short-term interest rate futures contracts. RFR volumes are measured across both swaps and futures.

3.16 The ISDA-Clarus RFR Adoption Indicator shows the proportion of derivaties trading transacted in RFR instruments. For derivatives denominated in USD this had risen to 75% at the end of 2023. It has steadily increased since 2021, as shown in Figure 1 below.

Figure 1: Proportion of derivatives trading activity transacted in RFR per currency



Source: Clarus Financial Technology.

3.17 The proportion of trading in USD RFRs, which are all SOFR-based products, is less than the equivalent measure for GBP RFR (SONIA). This is because other non-RFR products that are not LIBOR based, such as swaps based on FedFunds, remain actively traded, especially at short maturities.

3.18 As a further comparison, at the time when we proposed incorporating SONIA products into the scope of the DTO in March 2021, its adoption rate was 51%. When SONIA was confirmed within the DTO in October 2021, it was 61%.

The UK DTO

3.19 We propose bringing certain SOFR OIS derivatives under our DTO. We also committed to this work in our Handbook Notice 108.

3.20 We propose to amend UK RTS on the trading obligation for certain derivatives (onshored Commission Delegated Regulation (EU) 2017/2417) using our powers under Article 32(5) UK MiFIR and section 138P FSMA. Our draft amendments can be found in Appendix 1.

3.21 Article 32(2) UK MiFIR specifies that in order for the DTO to take effect the class of derivatives must meet both of the following criteria:

- the **venue test**: it must be admitted to trading or traded on at least one relevant trading venue
- the **liquidity test**: there must be sufficient third-party buying and selling interest in the class of derivatives so that it is considered sufficiently liquid to trade only on the relevant trading venues

3.22 Article 32(3) and (6) of UK MiFIR and UK RTS 4 (onshored Commission Delegated Regulation (EU) 2016/2020) list a set of criteria and provide further detail respectively for determining whether a class of derivatives or a relevant subset thereof is sufficiently liquid as below:

- The average frequency and size of trades over a range of market conditions, having regard to the nature and lifecycle of products within the class of derivatives
- The number and type of active market participants including the ratio of market participants to products/contracts traded in a given product market
- The average size of the spreads

Data sources

3.23 We have collected information from a variety of sources, some quantitative and others qualitative. We used data from EMIR trade repositories. We have also used data and metrics that are publicly available and spoken to various market participants to gather market intelligence on the effect of interest rate benchmark reforms and transition plans on the DTO. Gathering information and market intelligence from multiple sources allows us to evaluate the different dimensions of current and prospective liquidity and to ensure that analysis and conclusions are sufficiently robust.

3.24 The EMIR data we have used cover the period of 2023. We receive EMIR data only in relation to those trades that have a UK nexus.

3.25 In relation to data on spreads we rely on publicly available information derived from ICE Swap Rate and qualitative information provided by trading venues.

3.26 We also have had regard to the ability of UK firms to have access to third country trading venues that are deemed equivalent for the purposes of the DTO, in particular from US SEFs where most of the liquidity in SOFR OIS can be found.

Liquidity analysis

3.27 In line with UK RTS 4 we have not set fixed thresholds to assess liquidity (e.g. a specific level for the average frequency of trades). Instead, we compared liquidity of SOFR OIS against the derivatives which are currently in scope of the UK DTO.

3.28 Our approach required an assessment to be carried out over a period of time of sufficient length to seek to ensure that market liquidity is consistently resilient and that the analysis is not distorted by seasonality.

3.29 Having regard to the criteria and framework under UK MiFIR and UK RTS 4 for assessing whether there is sufficient third-party buying and selling interest for a class of derivatives to be considered sufficiently liquid, we conducted analysis as to whether these criteria are met. No single liquidity measure is determinative on its own but rather it should be considered alongside all other measures.

3.30 We are also required to have regard to the impact that the DTO may have on the liquidity of the class of derivatives and on end users that are not financial entities.

3.31 Our starting point is the subset of SOFR OIS that are in scope of the CFTC's US trading mandate. In our view, the available evidence from the MAT determinations and the need to have regard to international consistency suggest that we should consider the same set of derivatives for our liquidity analysis. Hence our analysis focuses on the following benchmark tenors: 1, 2, 3, 4, 5, 6, 7, 10, 12, 15, 20 and 30 years.

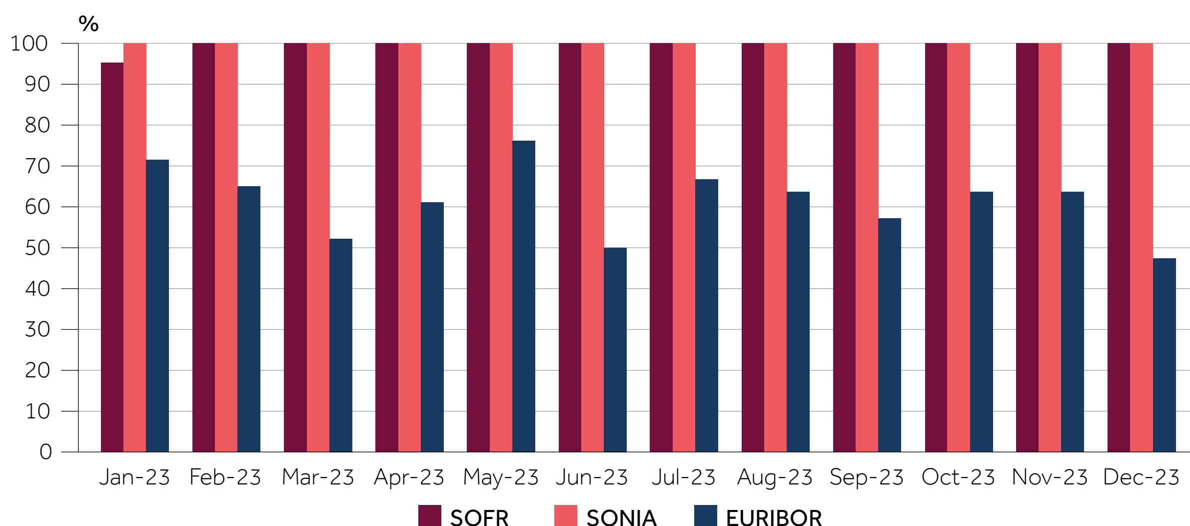
Average frequency and size of trades

3.32 We are required to consider the average frequency of trades as measured by the number of days in which trading takes place and by the number of transactions. This includes metrics reflecting the volumes traded in the relevant market, such as the average daily turnover and the average value of trades. We must also take into account the distribution of trading executed on trading venues compared with OTC and be satisfied that the assessment of liquidity is over a sufficiently long period of time to control for seasonal or episodic factors.

Number of days in which trading took place

3.33 Figure 2 below shows the percentage of days (excluding non-working days) on which trading took place. It represents the number of trading days on which at least one trade was executed on any trading venue or OTC, based on UK EMIR data – which covers trades involving at least one UK counterparty. As Figure 2 shows, SOFR OIS are very active, trading a daily basis except in January 2023.

Figure 2: Proportion of trading days in which derivatives trading took place

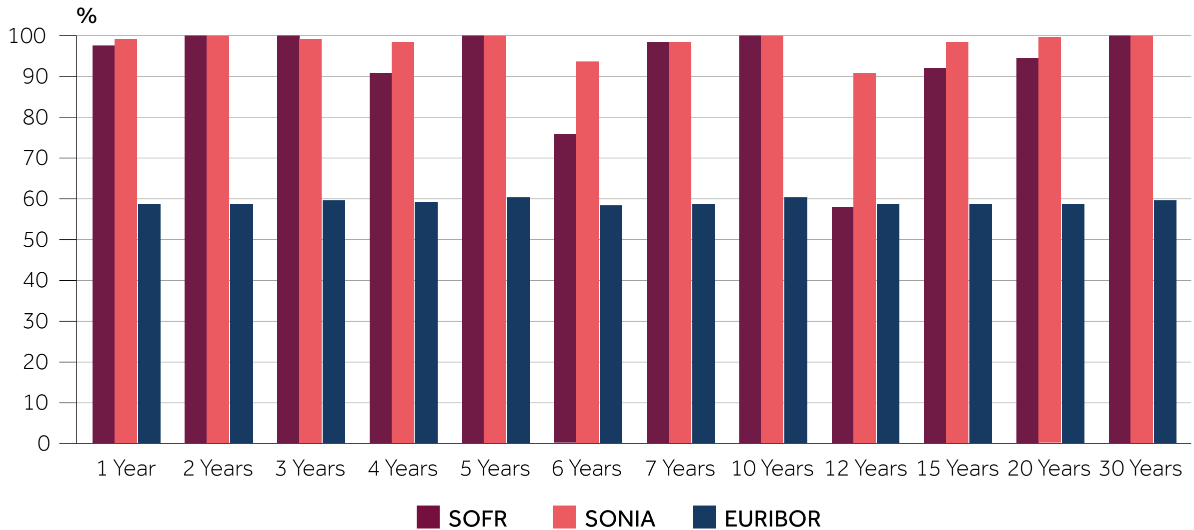


Source: FCA EMIR data.

3.34 Whilst at a class level they are traded on a daily basis, we need to ascertain whether this is the case across all tenors, or whether the majority of the activity is concentrated only on certain tenors. Looking at the activity levels of the individual tenors, it appears that the vast majority of tenors are generally traded daily with some other tenors being less

actively traded (but still more than 75% of the trading days). Nonetheless, the level of activity in SOFR, in terms of proportion of active trading days, is comparable with that of SONIA. See Figure 3 below.

Figure 3: Proportion of trading days in which derivatives trading took place, across tenors

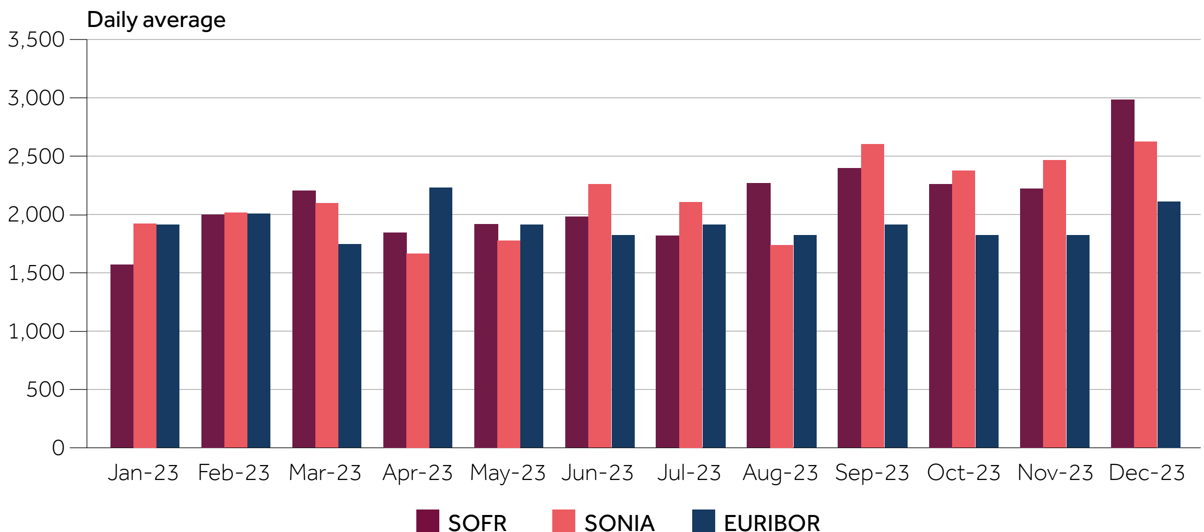


Source: FCA EMIR data.

Number of trades

3.35 The evidence from the daily average number of trades in Figure 4 below shows that liquidity in SOFR swaps is substantial and at least comparable with products already within the scope of the DTO. The daily average figures has more or less been consistent, during 2023, ranging between 1,500 and 3,000 daily trades with higher liquidity towards the end of last year.

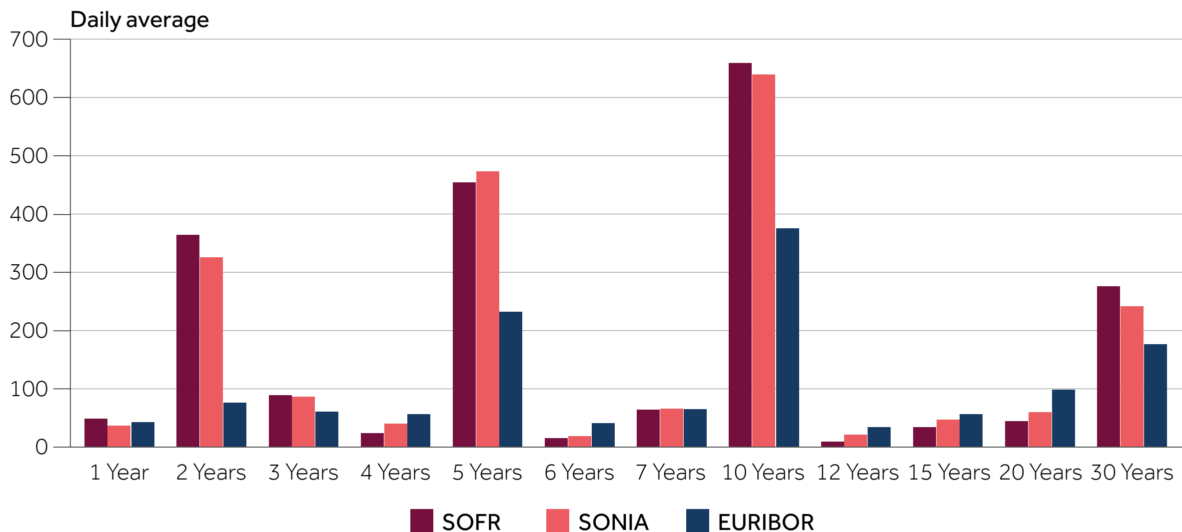
Figure 4: Number of derivatives trades



Source: FCA EMIR data.

3.36 The analysis at the tenor level shows that certain benchmark tenors, such as the 2, 5, 10 and 30 years, are particularly liquid. This is a known pattern present in other OTC derivatives where the 2, 5, 10 and 30 years tenors are benchmarks that attract significant liquidity. In any case, trading activity is present across the entire maturity spectrum. SOFR, in comparison to other products within the scope of the DTO, exhibits greater activity in trade count across most of the tenors.

Figure 5: Number of derivatives trades, across tenors



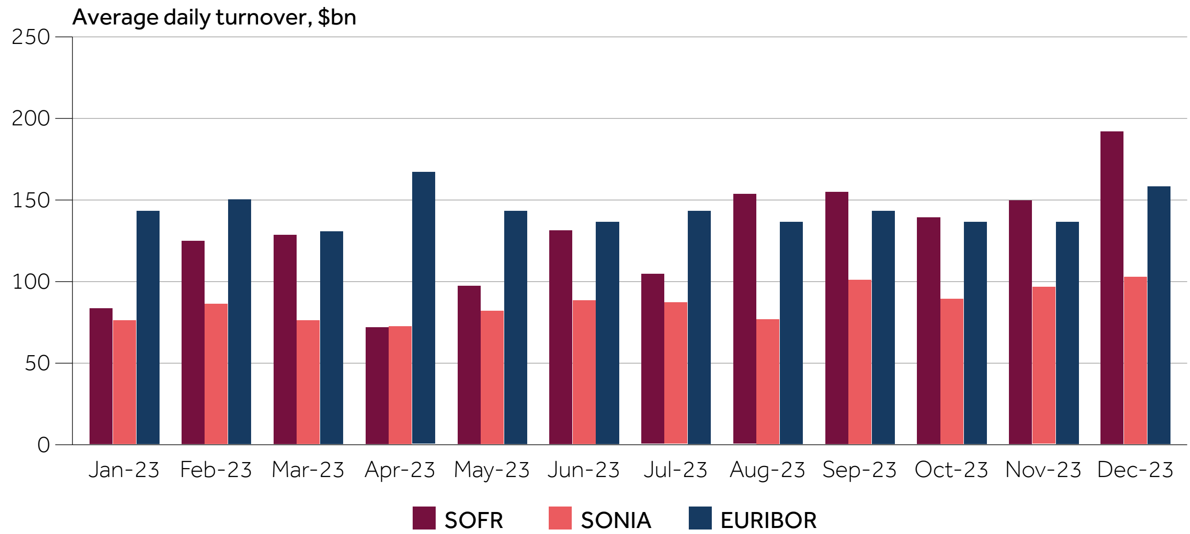
Source: FCA EMIR data.

3.37 In determining whether a class of derivatives is suitable for the DTO, we should have regard to the extent to which derivative transactions already take place either on regulated venues or are mainly executed bilaterally OTC. EMIR data shows that for SOFR OIS in 2023 the on-venue to OTC ratio is about 50%:50% by number of trades, and 34%:66% by volume.

Average daily turnover

3.38 Trading activity measured by the average daily turnover shows a somewhat similar picture as that for trade count. The average daily turnover ranges between $80bn and $190bn daily, as shown in Figure 6 below.

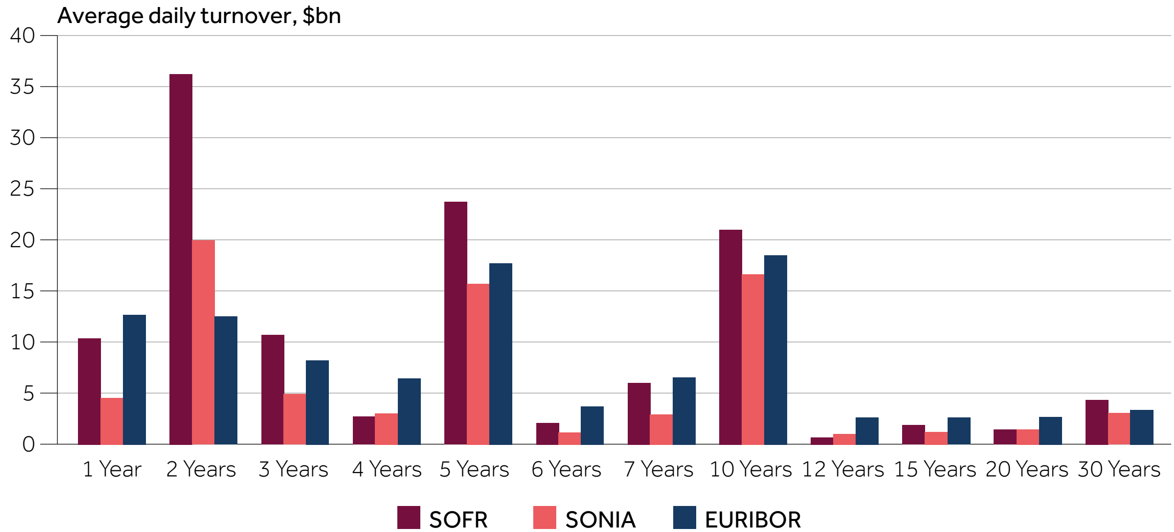
Figure 6: Derivatives turnover



Source: FCA EMIR data.

3.39 Similar to the average daily number of trades, Figure 7 below shows liquidity is robust across most of the maturity spectrum, albeit as expected, given the higher DV01 longer tenors have smaller daily turnover.

Figure 7: Derivatives turnover, across tenors

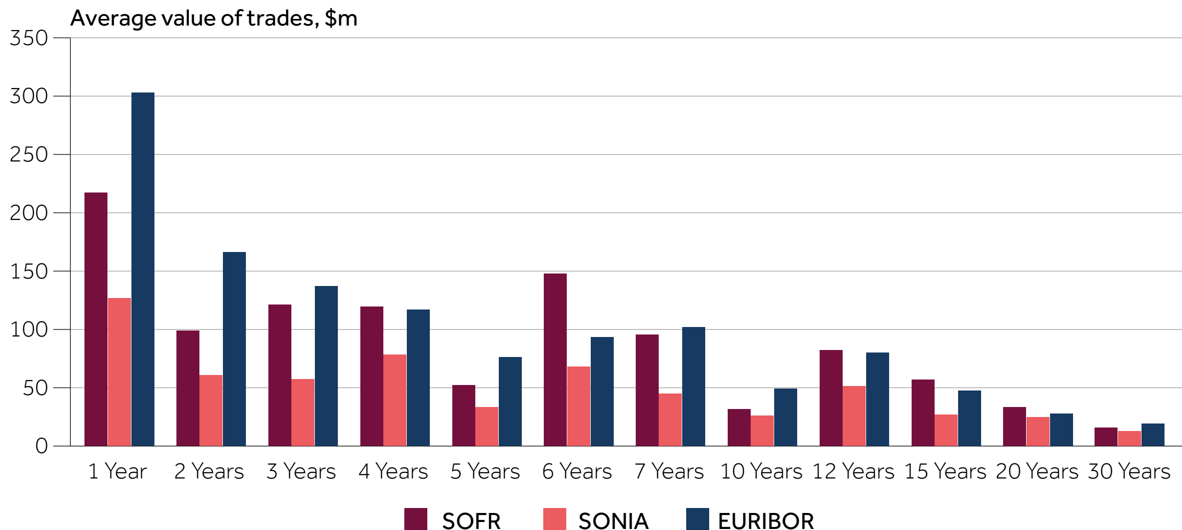


Source: FCA EMIR data.

Average value of trades

3.40 Figure 8 below shows the average value of trades appears to be generally comparable between SOFR, SONIA and EURIBOR products, across all tenors.

Figure 8: Average value of derivatives trades, across tenors



Source: FCA EMIR data.

Number and type of market participants

3.41 We are required to consider the breadth of participation in the relevant market and the ability of market participants to source liquidity from multiple trading venues and liquidity providers. We consider that greater participation in the relevant market and therefore greater diversity of market participants should be correlated with greater and more resilient liquidity. The relevant metrics are the number of active market participants, the number of trading venues that admit the relevant class of derivative and the number of market makers under a binding agreement or obligation to provide liquidity.

3.42 RTS 4 requires us to consider the following metrics:

- the total number of market participants trading in that class of derivatives or relevant subset thereof is not lower than two
- the number of trading venues that have admitted to trading or are trading the class of derivatives or a relevant subset thereof
- the number of market makers and other market participants under a binding written agreement or an obligation to provide liquidity

The analysis should compare the ratio of market participants to the average size of trades and the average frequency of trades.

3.43 The number of active market participants appears to be high for all products and greater than the minimum number of 2 as set out in UK RTS 4. UK EMIR data show that there are in excess of 500 market participants in SOFR swaps across the whole range of tenors for the International Money Market (IMM) trade start class and over 300 market participants for the spot starting trade start class. This compares with approximately 280 market participants in SONIA swaps for the IMM class, and approximately 870 in SONIA swaps and 530 in EURIBOR swaps for the spot starting class. A wide range of different types of firms trade SOFR OIS, large broker-dealers, smaller investment firms, buy-side investors, proprietary trading firms and corporates.

3.44 SOFR swaps are available to trade on a number of UK trading venues. Section 2.1 of our DTO register lists 16 UK trading venues for which OIS products can be traded. All of these venues offer SOFR products to trade on their respective venues. In addition to UK trading venues, UK market participants also have access to overseas trading venues that are deemed equivalent for the purposes of the DTO.

3.45 Liquidity in OTC derivatives markets is mainly provided outside the market making obligations or binding agreements that are typical in equity markets. Absence of firms acting as market makers should not be interpreted as evidence of poor liquidity as, in line with the evidence on spreads below, bid and offer prices from liquidity providers, including through incentive schemes, are available on a regular basis.

Average size of spreads

3.46 UK RTS 4 requires us to take into consideration a proxy where information on spreads is not available.

3.47 We consider the daily publication of the USD SOFR 1100 ICE Swap Rate settings by ICE Benchmark Administration as evidence that the SOFR swaps are characterised by a level of liquidity comparable to swaps already subject to DTO requirements. The ICE Swap Rate is based on a methodology based on quotes available on regulated, electronic, trading venues or eligible dealer to client prices. USD SOFR 1100 ICE Swap Rate settings are available for the same tenors, from 1 to 10 years and for 15, 20 and 30 years, and at the standard market sizes, between $10 and $75 million, applicable for the determination of USD SOFR 1100 ICE Swap Rate fixings.

Table 1: products and tenors in which ICE Swap Rate is published

Tenor	SOFR	SONIA	EURIBOR
1 year	•	•	•
2 years	•	•	•
3 years	•	•	•
4 years	•	•	•
5 years	•	•	•
6 years	•	•	•
7 years	•	•	•
8 years	•	•	•
9 years	•	•	•
10 years	•	•	•
12 years		•	•
15 years	•	•	•
20 years	•	•	•
25 years		•	•
30 years	•	•	•

Source: ICE Benchmark Administration.

3.48 Considering the aforementioned pre-trade quotes, we observe that the average daily total volumes available for each order book snapshot totalled $6.9bn for the 1-4 year tenor products, $2.9bn for the 5-9 year tenor products and $1.3bn for the 10-30 year tenor products during May 2024. This provides an indication of the volume of orders that have been submitted by traders for these products, and consequently the degree of activity for them. These data points from the order book are used to calculate the ICE Swap Rate the each respective product. The ability to publish an ICE Swap Rate for a given product is an indication that there had been sufficient activity in those products. These volumes have been consistent month on month throughout 2024 to date.

Proposals

3.49 Based on our liquidity analysis we consider that SOFR OIS are sufficiently liquid to be brought under our trading obligation.

3.50 The evidence on the number of days where transactions occur, the total and daily average number of transactions and volume executed are consistent with high and persistent liquidity over the course of 2023. While certain tenors are materially less liquid than others, SOFR OIS are not less liquid than the existing classes of derivatives in scope of the DTO. SOFR OIS are traded in large sizes, generally larger than those executed in SONIA OIS and EURIBOR swaps.

3.51 SOFR swaps are widely traded by a large number of market participants and benefit from the support of liquidity providers, albeit generally there are no firms that provide liquidity on the basis of market making schemes.

3.52 While we were able to collect only aggregate information on spreads, the evidence from the ICE Swap Rate benchmark is consistent with the availability of pre-trade information and bid and offer prices in standard market sizes.

3.53 We therefore propose to add OIS derivatives referencing SOFR to the DTO. We propose to impose the DTO for SOFR OIS to trade start types spot-starting and IMM (next 2 IMM dates) with tenors of 1, 2, 3, 4, 5, 6, 7, 10, 12, 15, 20 and 30 years. According to our analysis, these are sufficiently liquid. Our proposals mirror the trade execution requirement set in the CFTC's MAT determination.

Table 2: proposed additions to the scope of the DTO

Trade start type	Spot (T+2)	IMM (next 2 IMM dates)
Optionality	No	No
Tenor	2,3,4,5,6,7,10,12,15,20,30Y	1,2,3,4,5,6,7,10,12,15,20, 30Y
Notional type	Fixed Notional	Fixed Notional
Fixed leg		
Payment frequency	Annual	Annual
Day count convention	Actual/360	Actual/360
Floating leg		
Reset frequency	Annual	Annual
Day count convention	Actual/360	Actual/360

3.54 Under this proposal, we have brought within scope the 12-year benchmark SOFR product. However, as demonstrated during our analysis, this product is not as widely traded as other benchmark tenors we are proposing to bring within scope of the DTO. We also observe that it is a benchmark tenor for which no ICE swap rate is published. We therefore seek stakeholders' views as to whether it would be appropriate to bring 12-year SOFR products in the scope of the DTO. We note that the CFTC, in its MAT determination, has made the 12-year SOFR product subject to its trade execution requirement for spot starting swaps and IMM swaps with a par fixed rate, but not for IMM swaps with a standard coupon fixed rate.

3.55 We want to ensure an orderly adoption of the DTO obligations. Following industry engagement, we recognise that our proposed amendments have implications for firms' systems. We propose our changes to come into force 3 months after the publication of our policy statement. We believe that this should allow market participants sufficient time to implement system changes required in order to meet the revised DTO. We note that market participants were able to meet the change in scope of the DTO to incorporate SONIA products, between the publication of our final policy on 15 October 2021 and it entering into effect 20 December 2021.

Question 1: **Do you agree with the liquidity analysis set out above? If not, please explain why and provide supporting data where possible.**

Question 2: Do you agree with our proposal to bring into scope the stated SOFR derivative products? If not, please explain why and provide supporting data where possible. In particular, do you have views as to whether 12 year SOFR products should be brought into scope?

Question 3: Do you agree with the implementation timeframe, for the amendment of the scope of the DTO to enter into effect 3 months after the publication of our policy statement? If not, please explain what transition period is needed and why.

Chapter 4

Exemptions for post-trade risk reduction services

Overview and background

4.1 Post-trade risk reduction (PTRR) services are arrangements that enable counterparties to manage their exposure to types of risk that arise from derivatives portfolios such as counterpary risk and operational risk, without altering their fundamental market positions. Their use involves the insertion of market-risk neutral transactions into existing netting sets.

4.2 Under MiFIR, trades concluded as part of portfolio compression are exempted from the derivatives trading obligation, best execution requirements, and pre- and post-trade transparency (subject to aggregated information being made public). The provision of portfolio compression is also exempted from the obligation to seek authorisation as a trading venue when operating a multilateral system. The purpose of the exemptions is to remove barriers that could prevent the use of portfolio compression which supports the reduction of systemic risk.

4.3 Portfolio compression is not the only risk reduction service used by firms with derivatives portfolios. Since MiFID II entered into force in January 2018, post-trade risk reduction services have become more widely used by market participants.

4.4 The WMR consultation asked whether transactions in other types of PTRR services should be treated in the same way as transactions arising from portfolio compression. The majority of respondents to the consultation were in favour of expanding the exemptions to other risk reduction services, provided that appropriate conditions were in place for the exemptions to apply. Transactions that solely originate from risk reduction services are non-price forming and so having them comply with requirements such as the trading mandate would not improve transparency or market efficiency.

4.5 In the WMR consultation response in March 2022, the Treasury confirmed the intention to bring forward legislation that delivers those changes. FSMA 2023 gives us the rule-making power to make such changes.

4.6 Part 2 of Schedule 2 to FSMA 2023 achieves the same outcome in relation to the Bank's power to exempt PTRR services from the CO under UK European Market Infrastructure Regulation (onshored Regulation (EU) No 648/2012) (UK EMIR).

4.7 Article 5 of UK EMIR requires that all OTC derivative contracts that are subject to the CO to be centrally cleared through a CCP. The Bank is responsible for setting the products subject to the clearing obligation under UK EMIR. The list of the classes of derivatives in scope of the CO can be found on the Bank's Public Register for the Clearing Obligation.

4.8 For a derivative or class of derivatives to be subject to the DTO they must be subject to the CO. The financial instruments subject to the DTO are therefore a subset of those subject to the CO. We have been liaising with the Bank during the development of these proposals and have agreed with the Bank to proceed with this consultation in advance of the Bank consulting on whether transactions arising from PTRR services should be exempted from the CO.

4.9 In January 2024, the International Organisation of Securities Commissions (IOSCO) published a consultation report to obtain a better understanding of the important role PTRR services and their providers play within the global derivatives market. The report identified potential policy considerations and risks associated with the use and provision of PTRR services and presented good practices in this area. We have considered the report's findings in this consultation.

PTRR services

4.10 PTRR services are provided by third party firms, i.e. firms that are not a counterparty in the risk reducing service. They provide a mechanism for market participants to reduce second order portfolio risks from pre-existing derivatives positions. Second order portfolio risks include operational, basis and counterparty credit risk. The reduction of these risks frees firms' regulatory capital and lowers initial margin (IM) requirements with positive effects to systemic risk.

4.11 Except in circumstances where contracts are offset by identical but opposite positions, PTRR services generally operate on the principle of market risk equivalence as they replace one portfolio of contracts with another. Following a PTRR run, the outcome position is equivalent in terms of market risk to that of the original position but it reduces other types of risks. Firms do not intend to increase or reduce market risk when entering into a PTRR run.

4.12 PTRR services establish new derivatives contracts on the basis of pre-agreed risk-parameters (or tolerances) set by participating firms rather than on the basis of the interaction between bid and offers prices. No price negotiation takes place during a risk reduction run and the outcome is binding for all participants.

4.13 There are three types of PTRR services commonly used in the market: portfolio compression, portfolio rebalancing and basis risk optimisation.

Portfolio compression

4.14 Portfolio compression involves the termination of existing off-setting transactions between multiple participants and, where necessary, their novation.[1]

4.15 The process reduces the number of contracts and the gross notional (or different measure of risk), without materially affecting the market risk of the portfolio. The result helps reduce operational costs, optimise capital usage and manage counterparty credit risk more effectively.

1 Examples of portfolio compression services include the LCH SwapAgent service provided by Quantile Technologies Limited and the triReduce service by TriOptima AB.

4.16 The termination of existing transactions is done where the service provider identifies transactions with matching characteristics. These transactions are then netted off against one another to reduce the gross notional amount outstanding.

4.17 Where it is not possible to find matching transactions to offset one another – the service provider uses risk-replacement transactions. This process involves the creation and accepting of nearly matching trades to achieve the best result.[2] To undertake such risk replacement transactions, the service provider uses tolerances with the aim to enhance the efficiency of the compression run in order to rebuild the original market risk profile of the portfolio using standardised transactions in relation to parameters such as the maturity dates or rates. The elimination of derivatives contracts and the simplification of the overall structure of a portfolio reduces operational risk and frees regulatory capital. The efficiency of a compression exercise depends on the level of participation and on the tolerances applied. The larger the participation the greater the efficiency is.

Portfolio rebalancing

4.18 Similar to portfolio compression, portfolio rebalancing aims to help market participants reduce their counterparty risk without changing their market risk. However, unlike compression, portfolio rebalancing involves inserting new transactions into the portfolios of participants to change (increase or decrease, or redistribute) the non-market risk in each sub-portfolio with a view to reduce non-market risk of the whole portfolio (but leaving each counterparty with an unchanged level of market risk overall).[3]

4.19 Without terminating any transaction in the underlying portfolio, the new "rebalancing" transaction offsets part of the risk between the parties using identical but opposite positions. Even as more transactions may be entered into by the counterparties, their counterparty risk reduces as the risk is redistributed.

4.20 Transactions resulting from portfolio rebalancing are based on the identified risk sensitivities of the whole portfolio – such as interest rate risk – rather than the risk sensitivities of each transaction.

4.21 To maintain its market-neutral characteristic, portfolio rebalancing exercises are multilateral so that the offsetting transactions are found amongst a web of counterparties, leaving the total impact of all transactions across all portfolios unchanged overall.

4.22 In practice, rebalancing exercises, which reduce overall credit risk exposures between counterparties, have a knock-on effect of reducing liquidity strains through reducing the size and volatility of initial margin requirements that market participants must post (given their lower, rebalanced exposure to counterparties).

2 Unlike trade termination (off-setting of matching transactions), risk replacement trades are new trades replacing one or more compressed trades. Such trades will be subject to the regulatory requirements in force at the time even where they originated as part of the compression cycle.

3 Examples of portfolio rebalancing services include the RESET service provided by BrokerTec Europe Limited, the triBalance service provided by TriOptima AB and the LCH SwapClear service by Quantile Technologies Limited.

Basis risk optimisation

4.23 Swaps generally have structures with long durations, periodic payments and fixings of cash flows on a transaction by transaction basis.

4.24 Basis risk optimisation works to reduce mismatched exposure to second order fixing risks which arise from trading activity based on the structure of the instruments traded or the accumulation of imbalanced exposures over time (for example, sensitivities of an interest rate swap portfolio to a daily change in EURIBOR fixing).

4.25 This reduction in exposure is done without terminating any positions but rather by introducing equal and opposite transactions to neutralise second order fixing or strike risk of the original positions. Similar to portfolio compression and portfolio rebalancing, this service can reduce second order risk without changing the overall market risk of the portfolio.[4]

4.26 In addition to resulting in non-price forming transactions; portfolio compression, rebalancing and basis risk optimisation share a common characteristic in that their efficiency in reducing risk and freeing IM and capital should increase with the level of participation.

Question 4: **Do you agree with the descriptions provided for portfolio compression, portfolio rebalancing, and basis risk optimisation? If not, why not?**

Legislative framework

4.27 Schedule 2 to FSMA 2023 revoked Article 31 MiFIR on portfolio compression (and therefore also the articles which stemmed from it: Articles 17 and 18 of the MiFIR Delegated Regulation (Commission Delegated Regulation (EU) 2017/567)) and replaced it with a new Article 31 on risk reduction services.

4.28 New Article 31(1) of UK MiFIR provides a definition of risk reduction service and empowers us to disapply certain obligations in relation to activities and transactions – as further specified by us – that are carried out as part of a risk reduction service or to persons that provide such services. We can exercise such power only where it advances one or more of our statutory objectives.

4.29 We can disapply: the best execution obligation, the obligation to be authorised as a trading venue when operating a multilateral system in MAR and the derivatives trading obligation in Article 28 MiFIR.

4.30 In essence, under Article 31 we can:

1. disapply some or all the relevant obligations, where different obligations can be disapplied for different risk reduction services

4 Examples of basis risk optimisation services include the Reset service provided by TriOptima AB.

2. describe the characteristics of risk reduction services that can benefit from the exemptions
3. set the conditions that firms that intend to use the exemption shall comply with

We set out below our proposals for each of these powers.

4.31 FSMA 2023 specifies that, to be eligible for exemptions, risk reduction services must a) not give rise to price forming transactions; and b) be provided for the purpose of reducing non-market risks in derivatives portfolios.

Proposals

Disapplication of the relevant obligations

4.32 We propose that eligible PTRR services shall not be subject to the following obligations:

1. the best execution obligation in section 11.2A of the Conduct of Business sourcebook
2. the obligation in rule 5AA.1.1 in the Market Conduct sourcebook to operate a multilateral system as a multilateral trading facility (MTF) or an organised trading facility (OTF), if you are a firm with a Part 4A permission
3. the trading obligation imposed by Article 28 MiFIR

4.33 Best execution aims to protect investors by ensuring their orders are executed fairly, promptly and at the best available price. Positions that are submitted to risk reduction services, and their related transactions, are not transactions that result from the execution of an order and are not intended to achieve the best possible price, to minimise cost or maximise the speed and likelihood of execution. These parameters are not relevant for risk reduction services and maintaining a best execution obligation would not be compatible with their intended purpose.

4.34 The obligation in rule 5AA.1.1 in our Market Conduct sourcebook requires that where a firm operates a multilateral system from an establishment based in the UK, it must operate it as an MTF or OTF. We note that, while multiple participants interact under the systems operated by a risk reduction service provider, interaction is different from that occurring on a trading venue as firms providing PTRR services do not compete on the basis of price, volume or time of transactions. The application of trading venue requirements, such as those related to transparency, electronic trading, circuit breakers and suspension would not be meaningful to the operation of risk reduction services.

4.35 The trading obligation imposed by Article 28 of UK MiFIR is primarily aimed at improving transparency to enhance price formation and strengthen market integrity. The transactions which emerge as a result of PTRR services are non-price forming and therefore, do not support the price discovery process. By their nature, PTRR services operate amongst two or more counterparties where no buying and selling interests interact. As a result, requirements relating to post-trade transparency, while typically applicable and appropriate for trading venues, are ill-suited to PTRR services.

Question 5: Do you agree that eligible post-trade risk reduction services should not be subject to the best execution, the obligation to seek authorisation as a trading venue, and the derivatives trading obligation? If not, please explain why.

Characteristics of eligible risk reduction services

4.36 Revised Article 31 sets the legislative parameter for risk reduction services in 31(3) and (6). This includes that such services may only be post-trade services that do not give rise to any transactions that contribute to the price discovery process and defines "risk reduction service" as:

a. *service provided to two or more counterparties to derivatives transactions for the purpose of reducing non-market risks in derivatives portfolios [...]*

4.37 We propose that eligible risk reduction services must meet three additional essential characteristics. Those characteristics, together with what is already set in FSMA 2023, separate systems operated by risk reduction services from other systems, including those of trading venues. We understand that those characteristics are shared by the three risk reduction services covered above. These characteristics would ensure that the exemptions only apply to those activities that are unable to meet the obligations they are exempted from while making the regime flexible enough to recognise new risk reduction services that may emerge in the future.

4.38 We propose the following characteristics of an eligible post-trade risk reduction:

1. it is provided by a firm that is not party to a transaction resulting from the service
2. it is operated on the basis of non-discretionary rules set in advance by the operator that are based on specified parameters
3. results in a single set of transactions that bind all the participants

4.39 Requiring the service to be performed by a third-party provider is necessary to ensure the integrity of the service and the absence of conflicts of interest. We believe this also prevents undermining the purpose of the DTO.

4.40 To determine overall risk reduction opportunities and fairness in the provision of the service, it is necessary that the rules determining the risk reduction outcomes are non-discretionary, transparent and reflect the risk parameters that they intend to minimise. This would also ensure that participants have no undue influence in the risk mitigation exercise.

4.41 Risk reduction exercises are binding on an all-or-nothing basis across all participants. This removes the possibility for market participants to choose which trades they agree to execute and enhances the integrity and efficiency of the process.

4.42 Having regard to the characteristics set out above and those in the new Article 31 UK MiFID (to be non-price forming and reduce non-market risk) we would deem portfolio compression, portfolio rebalancing, and basis risk optimisation eligible post-trade risk reduction services.

Question 6: **Do you agree with the three characteristics identified to determine eligible post-trade risk reduction services? If not, please explain why.**

Question 7: **Are there any additional characteristics we should consider including for "eligible post-trade risk reduction services"? If yes, please explain which characteristics and why.**

Question 8: **Do you agree portfolio compression, portfolio rebalancing and basis risk optimisation are eligible post-trade risk reduction services? If not, please explain why.**

Conditions to be applied to risk reduction services

4.43 Article 17 of the MiFIR Delegated Regulation sets out the conditions to be fulfilled by firms providing portfolio compression for the transactions concluded under their systems to benefit from the exemptions. It covers the need for firms providing portfolio compression to have agreements with users of the service in place in relation to the legal effects of portfolio compression and the time at which those effects become legally binding.

4.44 Article 31(3) UK MiFIR also requires firms providing portfolio compression to keep complete and accurate records of all portfolio compression exercises which they organise or participate in.

4.45 Given the importance for risk reduction services to be based on clear and transparent terms and for risk parameters to be known in advance by users, we propose to maintain broadly the conditions listed in Article 17 within our rules on PTRR services, but to amend them so they apply more to all eligible risk reduction services. The fulfilment of these conditions will make the PTRR service agreement with its users an "eligible agreement" for the purpose of our rules. The definition of an "eligible agreement" can be found in Annex A of the relevant instrument in Appendix 1.

4.46 We also propose to maintain the obligation for firms providing risk reduction services to keep complete and accurate records of all risk reduction exercises which they organise or participate in and for such records to be made promptly available to us upon request. This ensures that the use of risk reduction services is compatible with our market integrity objective by maintaining adequate supervision of the activity.

Question 9: **Do you agree with the conditions included for providers of eligible risk reduction services to fulfil for the definition of an eligible agreement if using the exemptions in Article 31 UK MiFIR? If not, please explain why.**

Question 10: Do you agree with the condition that providers of post-trade risk reduction services shall maintain complete and accurate records of all risk reduction exercises they organise or participate in, and for such records to be made promptly available to the FCA upon request? If not, please explain why.

4.47 Currently, Article 31(1) UK MiFIR exempts portfolio compression from the pre and post-trade transparency requirements applicable to trading venues and investment firms when concluding transactions in derivatives. Article 31(2) however, imposes a public disclosure requirement. Article 18 of the MiFIR Delegated Regulation specifies what information firms shall make public in relation to transactions concluded through a portfolio compression exercise in line with 31(2).

4.48 The information that currently needs to be disclosed under Article 18 includes the list of derivatives submitted to portfolio compression, the derivatives that are changed or terminated and those replacing them, and the notional amount that is compressed. The information must be made public through an APA, which is the same channel used by investment firms to report their market transactions.

4.49 Revised Article 31 UK MiFIR deletes the existing provisions and provides us with the power to make rules to disapply the derivatives trading obligation, best execution obligations and the obligation for a multilateral system to operate as a trading venue in respect of (i) activities or transactions carried out as part of a specified risk reduction service and (ii) persons involved in performing risk reduction services. It also does not cover the transparency requirements that should apply to transactions that are part of a specified risk reduction service but allows us to impose conditions in relation to risk reduction services.

4.50 We understand that the absence of a specific flag for risk reduction services, complicates the ability of market participants to identify trades that originate from portfolio compression, or other types of PTRR services, from other transactions. We also recognise that the reporting of risk reduction transactions in the same way as any other transaction imposes a cost on their users which is not justified given the value of the information disclosed.

4.51 We propose to use our rulemaking power to disapply the transparency requirements to transactions that arise from risk reduction services rather than require them to be reported with a flag.

4.52 While transactions concluded as part of a risk reduction service are not price forming, we are of the view that market participants should continue to have access to some information about the risk that is submitted and the outcomes that result from the risk reduction services provided. The information would more easily allow firms and regulators to understand the scale of risk reduction services as well as their trends. We hence propose to amend the provisions in Article 18 to apply the disclosure requirement specified by that article to all risk reduction services benefitting from the exemption.

4.53 In line with the existing requirements for portfolio compression, we propose to require providers of risk reduction services to publish – no later than the close of the following business day after a PTRR service exercise is complete – the essential information about the transactions resulting from a risk reduction exercise. For portfolio compression, this includes the following information:

a. total number of transactions and aggregate volume submitted for compression
b. total number of transactions and aggregate volume of derivatives terminated or modified

4.54 For other risk reduction services, the disclosure will include:

a. the total number of new derivative transactions
b. the value of these transactions expressed in terms of aggregate volume

4.55 In contrast to the current publication arrangements, we do not propose to maintain the obligation to publish through an APA. While some firms may want to continue to use the arrangements provided by APAs, we see no reason to mandate their use given that the content and frequency of the information is different from those of market transactions.

4.56 The benefit of such an approach is that it would minimise undue costs on firms where the use of APAs is deemed disproportionate to the benefit that the information provides to the public.

Question 11: **Do you agree with maintaining a form of public disclosure for PTRR services? If not, please explain why.**

Question 12: **Do you agree with the information required to be disclosed under the proposed condition of public disclosure by providers of PTRR services? If not, please explain why? Please include any additional information you consider necessary for inclusion in our public disclosure requirement.**

4.57 As with the current portfolio compression requirements, it will be a matter for firms providing risk reduction services to determine whether the services provided meet the requirements set that enable the DTO, best execution requirements and multilateral system obligations to be disapplied. However, we propose to require firms providing risk reduction services to notify us of the intention to rely on the exemptions. The notification therefore requires a description of the services provided to evidence them as eligible post-trade risk reduction services and will need to be updated when there is a change in the types of services provided. The notification would allow us to monitor the use of PTTR services and related exemptions.

4.58 Our proposed rules on PTRR services can be found in Annex C of Appendix 1.

Question 13: **Do you agree with our proposal to introduce a notification requirement for firms operating a PTRR service as laid out above? If not, please explain why.**

4.59 Following industry engagement, we recognise that some of the changes we propose have implications for firms' systems. We also want to ensure an orderly adoption of possibility of benefitting from the exemptions and for firms to have adequate arrangements for the publication of the information about risk reduction services concluded under their systems. We propose our changes to come into force 3 months after the publication of our policy statement.

Question 14: **Do you agree with our proposed implementation timeline for the changes in Handbook to apply to risk reduction services? If not, please explain why. Please include any additional factors you would like us to consider.**

Chapter 5

FCA power to suspend or modify the derivatives trading obligation

Overview and background

5.1 In 2019 Parliament established the Temporary Transitional Power (TTP), giving UK regulators the temporary power to delay the application of, or otherwise modify, regulated firms' regulatory obligations in relation to financial services, where their obligations had changed as a result of the amendments made to EU legislation through the onshoring process.

5.2 In December 2020 we published a statement noting our intention to use our powers under the TTP to modify the application of the UK DTO, and a Transitional Direction for the DTO and supporting guidance.

5.3 The direction allowed firms subject to the UK DTO, trading with, or on behalf of, EU clients subject to the DTO, to transact or execute those trades on EU venues, providing that certain conditions are met. The conditions are that:

a. Firms take reasonable steps to be satisfied the client does not have arrangements in place to execute the trade on a trading venue to which both the UK and EU have granted equivalence
b. The EU venue has the necessary regulatory status to do business in the UK – such venues include those that are a Recognised Overseas Investment Exchange, have been granted the relevant temporary permission, or their activities meet all of the conditions required to benefit from the Overseas Person Exclusion

5.4 In the guidance on the TTP direction on the DTO we clarified that our direction did not apply to transactions where the client is not established in the EU, to transactions concluded on a proprietary basis or to transactions concluded by two third country entities through their UK branches.

5.5 The purpose of the direction was, in absence of mutual equivalence between the UK and the EU, to avoid disruption for market participants – in particular for UK branches of EU firms who would be subject to conflicting obligations – and avoid fragmentation of liquidity in DTO products.

5.6 In March 2021 we published a statement noting that we had not observed any market or regulatory developments in the first quarter of 2021 that justified a change in our approach. We, therefore, continued to use the TTP to modify the application of the DTO as set out in December 2020.

5.7 Our power to make a direction modifying the DTO under the TTP will expire on 31 December 2024. However, FSMA 2023 inserted Article 28a into UK MiFIR that empowers us to suspend or modify the DTO where necessary and in order to advance one or more of our objectives, subject to the Treasury's consent. Parts of Article 28a are provided in the box below.

Article 28a: Suspension or modification of Article 28

a. The FCA may direct that the trading obligation imposed by Article 28(1) and (2) (the "DTO") is suspended or modified in accordance with the direction if it considers that the suspension or modification—

- is necessary for the purpose of preventing or mitigating disruption to financial markets, and
- advances one or more of the FCA's operational objectives referred to in section 1B(3) of FSMA.

b. A direction under this Article may provide for the DTO to be suspended or modified —

- in the case of all persons to whom the DTO applies or only to such persons or descriptions of persons as are specified in the direction;
- in the case of all derivatives to which the DTO applies or only to such derivatives, or classes of derivatives, as are specified in the direction;

c. by reference to the venues on which derivative transactions are concluded under the DTO;
d. subject to conditions
[...]

5.8 Article 28a allows us to suspend or modify the DTO only where we consider the suspension or modification necessary for the purpose of preventing or mitigating disruption to financial markets and advances one or more of our operational objectives.

5.9 If those conditions are met, we can suspend or modify the DTO in relation to different elements of the DTO: the persons to which it applies, the classes of derivatives that are in scope and the trading venues where firms can discharge their DTO requirement.

5.10 Before suspending or modifying the DTO, we must consult the Bank and the Prudential Regulation Authority (PRA) and seek consent from the Treasury. While we are not required to consult publicly on the use of this power of direction, we are using this consultation to signal our intention to do so and to explain how we intend to exercise it.

5.11 Alongside a direction published under Article 28a, we are required to prepare a statement setting out an explanation of the purpose of the direction including the ways in which it will mitigate disruption to financial markets and advance one or more of our operational objectives.

5.12 Where there is no change in the conditions that justify the use of the direction, we can renew our direction after 6 months.

5.13 In the future, we may consider setting out the direction in the FCA Handbook using new powers we may exercise under the Smarter Regulatory Framework, at which point the requirement to publish a statement every 6 months will no longer apply.

Proposals

5.14 With our power to make a TTP direction modifying the DTO expiring in December 2024, if no action is taken by us, some firms in particular UK branches of EU investment firms would be caught by the conflicting EU and UK DTO obligations resulting in disruption to markets.

5.15 Maintaining the modification of the application of the DTO established by the TTP direction, will avoid firms being caught by conflicting obligations. Our review of the approach in March 2021 showed no disruptions in derivatives trading occurred thanks to the modification of the DTO. Since then, we have not observed market or regulatory developments that justify a change in our current approach.

5.16 We therefore propose to use our UK MiFIR Article 28a power of direction to modify the DTO in such a way as to achieve an outcome equivalent to that achieved by the TTP direction. Compared to the TTP direction, we intend to adjust our new direction to reflect the changes to the scope of the UK and EU DTO following the transition from LIBOR to risk free rates, so that it only applies to transactions in classes of derivatives that are subject to the DTO in both the UK and in the EU.

5.17 This will allow persons to continue to be able to trade derivatives in scope of the DTO on EU trading venues in certain circumstances. For example, UK-authorised firms, including asset managers and UK branches of EU firms, will be able to execute transactions on EU trading venues, where certain conditions apply.

5.18 We will maintain the conditions set out in our original direction, which is that firms will need to be satisfied their clients do not have arrangements in place to execute the trades on a trading venue to which both the UK and EU have granted equivalence and that the EU venue has the necessary regulatory status to do business in the UK. We would also expect firms to be able to demonstrate that they have taken reasonable steps to establish that the conditions are met.

5.19 Our proposed direction can be found in Appendix 1.

5.20 By preventing market disruptions, we would use our power to advance our market integrity objective. The proposed approach would also be in line our secondary objective to support the international competitiveness and growth of the UK economy in the medium to long term. The modification of the DTO in the way proposed by us would allow firms based in the UK to continue doing a range of international business and serve their global clients, while upholding our G20 commitment in respect of the trading of OTC derivatives.

Question 15: **Do you agree that we should use our UK MiFIR Article 28a power of direction to achieve an outcome equivalent to that achieved by the TTP as outlined above? If not, please explain why.**

Annex 1

Questions in this paper

Question 1: Do you agree with the liquidity analysis set out above? If not, please explain why and provide supporting data where possible.

Question 2: Do you agree with our proposal to bring into scope the stated SOFR derivative products? If not, please explain why and provide supporting data where possible. In particular, do you have views as to whether 12-year SOFR products should be brought into scope?

Question 3: Do you agree with the implementation timeframe, for the amendment of the scope of the DTO to enter into effect 3 months after the publication of our policy statement? If not, please explain what transition period is needed and why.

Question 4: Do you agree with the descriptions provided for portfolio compression, portfolio rebalancing, and basis risk optimisation? If not, why not?

Question 5: Do you agree that eligible post-trade risk reduction services should not be subject to the best execution, the obligation to seek authorisation as a trading venue, and the derivatives trading obligation? If not, please explain why.

Question 6: Do you agree with the three characteristics identified to determine eligible post-trade risk reduction services? If not, please explain why.

Question 7: Are there any additional characteristics we should consider including for "eligible post-trade risk reduction services"? If yes, please explain which characteristics and why.

Question 8: Do you agree portfolio compression, portfolio rebalancing and basis risk optimisation are eligible post-trade risk reduction services? If not, please explain why.

Question 9: Do you agree with the conditions included for providers of eligible risk reduction services to fulfil for the definition of an eligible agreement if using the exemptions in Article 31 UK MiFIR? If not, please explain why.

Question 10: **Do you agree with the condition that providers of post-trade risk reduction services shall maintain complete and accurate records of all risk reduction exercises they organise or participate in, and for such records to be made promptly available to the FCA upon request? If not, please explain why.**

Question 11: **Do you agree with maintaining a form of public disclosure for PTRR services? If not, please explain why.**

Question 12: **Do you agree with the information required to be disclosed under the proposed condition of public disclosure by providers of PTRR services? If not, please explain why? Please include any additional information you consider necessary for inclusion in our public disclosure requirement.**

Question 13: **Do you agree with our proposal to introduce a notification requirement for firms operating a PTRR service as laid out above? If not, please explain why.**

Question 14: **Do you agree with our proposed implementation timeline for the changes in Handbook to apply to risk reduction services? If not, please explain why. Please include any additional factors you would like us to consider.**

Question 15: **Do you agree that we should use our UK MiFIR Article 28a power of direction to achieve an outcome equivalent to that achieved by the TTP as outlined above? If not, please explain why.**

Annex 2

Cost benefit analysis of bringing SOFR OIS in scope of our trading obligation

Introduction

1. Section 138I FSMA requires us to publish a cost benefit analysis (CBA) of our proposed rules. A CBA means an analysis of the costs, together with an analysis of the benefits that will arise if the proposed rules are made'. A similar CBA obligation applies under section 138S FSMA when we propose to make modifications to technical standards.

2. This analysis presents estimates of the significant impacts of our proposal. We provide monetary values for the impacts where we believe it is reasonably practicable to do so. For others, we provide a qualitative explanation of their impacts. Our proposals are based on weighing up all the impacts we expect and reaching a judgement about the appropriate level of regulatory intervention.

3. In this CP, we are proposing the following changes:

   a. bring swaps on the US risk-free rate SOFR (Secured Overnight Financing Rate) OIS (overnight index swap) into the scope of the DTO
   b. define the types of PTRR services that can be exempted from DTO
   c. set out how we intend to use our new power to modify or suspend the DTO to certain transactions under current transitional powers which expire in December 2024

4. In this CBA, we set out our assessment of the costs and benefits of our proposals to bring SOFR OIS into the DTO.

5. We are not undertaking cost benefit analysis of our proposal related to how we intend to use our new power to disapply the DTO to certain transactions. This is because we are not required to do a CBA when exercising the power of direction. To note also that the use of the power of direction would maintain the same outcomes currently delivered using our existing powers which will expire at the end of 2024.

6. The CBA has the following structure:

   - The Market
   - Problem and rationale for intervention
   - Options assessment
   - Our proposed intervention
   - Baseline and key assumptions
   - Summary of impacts
   - Benefits
   - Costs

- Wider economic impacts
- Monitoring and evaluation

The Market

7. Interest rates swaps are contracts where parties agree to swap payments over a specified period of time in the same or different currencies. Our proposals here apply to SOFR OIS.

8. Interest rate swaps are contracts where parties exchange a fixed rate of interest for the floating on a specified fixed notional amount. For example, one party pays 5.3% interest while the other party pays the floating rate on a notional amount of $100million. SOFR is a reference interest rate, established in 2018 to replace LIBOR (London Inter-Bank Offered Rate) as LIBOR was not based on underlying transactions but rather the expert judgement of participating banks and therefore making the benchmark susceptible to manipulation. SOFR swaps are swaps where the benchmark rate on the floating leg of the swap is the SOFR rate.

9. The interest rate swap market is one of the most important derivatives markets for the trading and hedging of interest rate risk. Interest rate swaps are used by financial firms to hedge the difference in the interest rate exposure of their assets and liabilities whereas non-financial firms use the swap market in the management of the interest rate risk of their corporate debt.

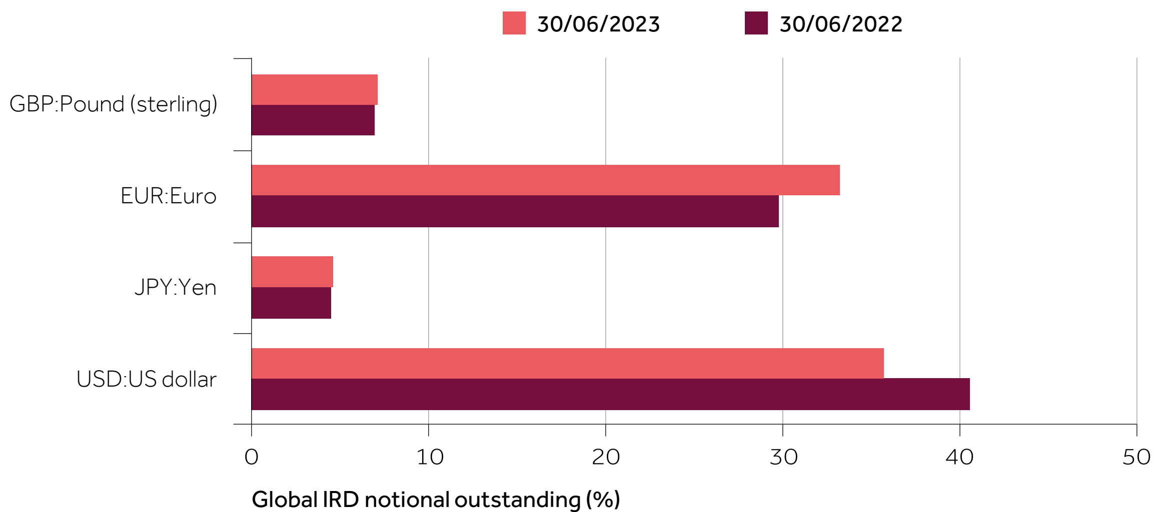
10. Interest rate derivatives (IRD) represent by far the largest sector of both Over-The-Counter (OTC) and exchange-traded markets. They account for 80% of the total amount outstanding in all OTC derivatives. IRD notional outstanding totalled $573.7 trillion at the middle of 2023[5], a rise of 14.2% versus mid-year 2022. Interest rate swaps (IRS) make up the bulk of OTC instruments, while short-term interest rate futures dominate exchange volumes.

11. The latest data on OTC derivatives from the Bank for International Settlements (BIS) shows a rise in notional outstanding, gross market value and gross credit exposure of OTC derivatives during the first half of 2023 compared to the first half of 2022. The upswing was primarily driven by growth in IRD amid rising interest rates for major currencies.

12. BIS data shows that US-dollar denominated IRD notional outstanding totalled $204.8 trillion at mid year 2023, up by 0.4% from mid-year 2022. It accounted for 35.7% of total IRD notional outstanding as of end-June 2023 compared to 40.6% as of end-June 2022 (Figure 9). Euro-denominated IRD notional outstanding totalled $190.6 trillion at mid-year 2023, up by 27.4% compared the middle 2022. It comprised 33.2% of total IRD notional outstanding mid-year 2023 (Figure 9). Sterling-denominated IRD notional outstanding was $40.7 trillion at end-June 2023, up by 16.8% compared to mid-year 2022, comprising 7.1% of total notional outstanding mid-year 2023 (Figure 9).

5 BIS Statistics Explorer: Table D7

Figure 9: Global IRD notional outstanding by currencies (as a % of the total IRD notional outstanding)



Source: BIS OTC Derivatives Statistics.

13. Within the class of interest rate derivatives, interest rate swaps (IRS) are the largest product traded. IRS notional outstanding increased by 12.5% to $465.9 trillion[6] in the middle of 2023 and accounted for just over 80% of total IRD notional outstanding.

14. By currency, average daily turnover of OTC interest rate derivatives was highest for US dollar, $2.3 trillion, followed by Euro $1.8 trillion and Pound (sterling) $350 billion (notional) in April 2022[7].

15. US-dollar denominated OIS traded notional grew by 54.5% to $54.4 trillion in the first half of 2023 from $35.2 trillion in the first half of 2022. Euro-denominated OIS traded notional rose by 60.9% to $26.4 trillion from $16.4 trillion and sterling-denominated OIS traded notional rose by 60.9% to $26.4 trillion from $16.4 trillion and sterling-denominated IRS traded notional declined by 40.7% to $4.7 billion from $8.0 billion[8].

16. Most derivative trading is divided between dealer-to-client trading venues (MTFs), inter-dealer trading venues (a mix of MTFs and OTFs) and OTC dealer-to-client trading. Dealer-to-client trading is split between MTF and OTC trading. OTC trading allows dealers to offer bespoke prices to clients.

17. Multilateral Trading Facility (MTF) is a multilateral system operated by an investment firm, a qualifying credit institution or a market operators that brings together multiple third party buying and selling interests in financial instruments. Organised Trading Facility (OTF) is a multilateral trading system operated by investment firm, a qualifying credit institution or a market operator in which multiple third party buying and selling takes place. In contrast to MTFs, the operator of an OTF exercises discretion in the order matching process.

6 BIS Statistics Explorer: Table D7
7 OTC interest rate derivatives turnover in April 2022 (bis.org)
8 Key-Trends-in-the-Size-and-Composition-of-OTC-Derivatives-Markets-in-the-First-Half-of-2023.pdf (isda.org)

18. There are 17 UK trading venues where the classes of derivatives subject to the trading obligation are available for trading, 16 of which are available for trading OIS. Of the 16 venues which are available for OIS trade, 9 are classified as MTF venues and the remaining 7 as OTF venues.

19. There are different types of participants in IRS markets. Dealers that provide liquidity in the market. On the other side, the users of IRS who seek to use IRS to hedge and manage the interest rates they face. These include banks, other financial firms such as insures, non financial firms and pension funds that seek to manage the risk of both their assets and liabilities (e.g. bonds they have issued).

20. According to the latest BIS triennial survey, conducted by the Bank of England, the UK remains the largest centre for OTC interest rate derivatives activity accounting for 45.5% of global turnover in April 2022, slightly lower than the market share of 50.6% recorded in April 2019[9].

21. The BIS triennial survey shows that in 2022 (the latest available data), the ten largest firms contributed around 96% of average daily turnover in OTC interest rate derivatives in the UK[10].

22. Trading obligations were introduced following the 2009 G20 commitment in Pittsburgh to move trading of standardised and liquid OTC derivatives on to trading venue. The DTO is part of a broader G20 commitment aimed at improving transparency in the derivatives markets, mitigating systemic risks and protecting against market abuse. The DTO requires that financial and certain non-financial counterparties conclude transactions in standardised and liquid OTC derivatives only on eligible trading venues (TV).

Problem and rationale for intervention

23. In this section we provide a description of the policy problem and the rationale for our intervention. We discuss the harms that our proposals are seeking to address and the market failures that cause these harms.

24. Trading in IRS takes place on either trading venues or OTC. Currently a significant proportion of the trading of SOFR OIS is OTC dealer client trade. OTC markets are less formal markets, where dealers act as market makers by quoting prices to other dealers and clients and sometime bilateral negotiation between the two.

25. OTC trading is characterised by a lack of pre-trade transparency, i.e. less information about potential trades is available to customers. Customers can choose to use OTC or trading venues to enter into contract. Individual customers may access better prices trading OTC, rather than on trading venues, as they get better prices or they are able to execute their trades more quickly and with more certainty and therefore they may prefer to use OTC markets. However, these trades do not add to the information available to other market participants about the current orders in the market, and the prices and quantities that they can potentially trade at (the addressable liquidity).

9 Foreign exchange and OTC derivatives markets turnover survey – 2022 | Bank of England
10 Foreign exchange and OTC derivatives markets turnover survey – 2022 | Bank of England

26. We note that there is only harm from the lack of pre-trade information in markets where there are sufficient volumes. Increased pre-trade transparency can, for example, expose liquidity providers to the risk of trading with informed market participants. This adverse selection increases when trading on trading venues, compared to trading in OTC markets. Hence, the incentive for large trades (where the risks are greater) more typically happen OTC.

27. The SOFR OIS market is the largest interest rate swap market globally. Trading in SOFR OIS is already subject to the swap trading mandate in the US. Our analysis at Chapter 3, shows that there are significant volumes within the UK nexus that would support increased transparency from requiring SOFR OIS to be traded in trading venues. In the following sections, we identify the harm that arises from this lack of pre-trade transparency in SOFR OIS. Firstly, there are higher costs for trading SOFR OIS. Secondly, the lack of liquidity and transparency of pre-trade information also impacts negatively on investors' ability to make informed decisions about the optimal portfolio and ability to manage interest rate risks effectively.

Reduced market liquidity and higher trading costs

28. Fewer orders on trading venues which are visible to all market participants will increase the costs of trading for market participants. This is because fewer orders on venues will make it harder to match order flow and therefore make the matching of order less effective, increasing the costs of trading.

29. There is evidence both theoretical and empirical that increasing pre-trade transparency in markets increases liquidity and lowers trading costs in financial markets.

30. The empirical academic evidence on trade transparency in swaps market is limited and mainly focuses on US markets following the introduction of transparency and the trading mandate under Dodd-Frank Act. Empirical research by Benos, Payne and Vasios (2020)[11] investigated the impact of the Dodd-Frank Act that the Dodd-Frank intervention brought a significant proportion of swap trading on to trading venues (through the trading mandate). The paper found that requiring IRS swaps to be trade on venue improved liquidity (as a result of increased competition between dealers) and reduced execution costs as a result. The improvement in liquidity from the trading mandate was in the range of 12%-19%.

31. There is also evidence from other markets that pre-trade transparency can reduce the costs of trading. For example, Hendeshott and Jones (2005)[12] showed that reduced transparency reduced liquidity in for Exchange-Traded Funds (ETFs). Boehmer Sar and Yu (2005) found that increased pre-trade transparency increased liquidity in equities.

32. While there is less empirical or theoretical evidence for this, the higher trading costs arising from a lack of transparency may be particularly prevalent during times of stress in financial markets. Liquidity providers may widen bid-ask spreads, or even exit the market when stress events increase the uncertainty of the value of an asset.

11 Benos E, Payne R, Vasios M. Centralized Trading, Transparency, and Interest Rate Swap Market Liquidity: Evidence from the Implementation of the Dodd–Frank Act. Journal of Financial and Quantitative Analysis. 2020;55(1):159-192.

12 Hendershott, T., & Jones, C. M. (2005). Island Goes Dark: Transparency, Fragmentation, and Regulation. The Review of Financial Studies, 18(3), 743–793.

33. We also note that in financial markets, liquidity begets liquidity. Increased liquidity (and therefore better prices and speed of trading) will attract more participants and increased trading volumes. These increased trading volumes will again drive trading costs lower and improve price formation.

Sub-optimal returns for investors and unhedged risks

34. Without a clear view of prices, potential counterparties do not have a clear view of market prices to inform their hedging and investment decisions and therefore may not manage the interest rate risk effectively. Incomplete information about prices will prevent investors from making more informed decisions regarding the optimal portfolio composition and their ability to hedge and manage risk. Consequently, not only are they trading more/less than they might otherwise do if they had a more complete picture of market activity. Thus raising the costs of fund raising, reducing the funds raised or exposing investors to greater amounts of interest rate risk. Higher transaction costs will also negatively impact participants' ability and/or willingness to adjust their portfolios quickly.

35. Excess risk exposure in firms makes individual participants less resilient to shocks. There is therefore a direct cost to individual firms from this risk, either through the costs associated with the impact of downside risks or through the change in behaviour to reduce risks, other than by hedging in financial markets. Further, SOFR OIS is a key market for the financial markets to efficiently reduce and allocate risk. Failing to effectively use SOFR OIS swaps to do this will increase the risks in the financial system and make it less resilient to shocks.

The drivers of harm

36. The harm described above arises from the following drivers:

- Externalities
- Asymmetric information

Externalities

37. Trading OTC is individually more advantageous for many participants. This may be because dealers may offer slightly better prices to trade OTC, compared to the prevailing prices in markets. However, partticipants making these choices do not consider the impact of removing their orders from trading venues on other market participants. Both liquidity and price efficiency have positive externalities. Liquidity, for example, is associated with a "network externality": the more liquid a market is, the easier it is to trade in that market, and so the more attractive that market becomes to individuals who want to trade. This further increases liquidity.

38. Price efficiency, has some of the properties of a public good because prices contain information that is both valuable and freely available to everyone: a trade that contributes to price discovery does not only benefit the counterparties involved but also the rest of the investors. Price efficiency can also be linked to the level of investor participation: the greater the number of informed market participants, the larger the amount of information that prices incorporate.

39. Since liquidity and efficiency are associated with positive externalities, the private benefit of market participants does not capture the full social benefit of an efficient and liquid market. In other words, market participants are not compensated for the wider benefits that their participation brings about. This suggests that market participants will not have the right incentives to contribute to liquidity and efficiency at the level that maximises social welfare[13].

Asymmetric information

40. Given that there is a significant proportion of trading occurring OTC, market participants do not have a complete view of current available liquidity in the market. This information can be exploited by dealers who utilise this information asymmetry to widen spreads and subsequently the trading cost that are paid by participants.

41. Even when trading on trading venue, in order for market participants to be fully informed, the information must first be available and then accessible at a cost that justifies its beneficial use. Trading venues by their very nature provide more information than OTC markets about addressable liquidity. Where trading remains OTC, investors looking to trade instruments have less information about prevailing prices and available liquidity. Dealers who have access to multiple datasets may be at a competitive advantage compared to those who don't. Investors group may include a disproportionate number of smaller firms, who may suffer from making suboptimal decisions while participating in the market.

Options

42. We compare our proposal to alternative options such as the option of not applying the DTO to liquid SOFR OIS, our 'Do nothing' approach and alternative option of applying the DTO to some of the SOFR OIS tenors. Alternative options such as including some or none of the 12 tenors are unlikely to be as efficient as our preferred option. This is because we seek alignment internationally and in particular with the US trading mandate where most of SOFR OIS liquidity is.

43. By virtue of Article 28 MiFIR, we are required to ensure that financial and certain non-financial counterparties conclude transactions in standardised and liquid OTC derivatives only on regulated trading venues or equivalent third country venues.

44. The obligation applies to classes of derivatives that we bring under the trading mandate. Before bringing classes of derivatives under the DTO, we are required to consider

13 Dodd, R (2002), 'The economic rationale for financial market regulation', Special Policy Report 12, Financial Policy Forum, Derivatives Study Center, available at www.financialpolicy.org/fpfspr12.pdf

whether the derivatives are: a) subject to the derivatives clearing obligation (CO); b) admitted to trading on at least one regulated trading venue; and c) sufficiently liquid to trade only on those venues.

45. The Bank of England brought US SOFR OIS under their CO since 24 August 2022. These instruments are also already subject to the US trading mandate, the equivalent of our DTO, as required by the Commodity Futures Trading Commission (CFTC) since 5 August 2023. Consequently, we considered whether to include SOFR OIS within the DTO. Different tenors (length of time to between initiation and expiration of the swap contract) have materially different volumes and therefore only some tenors can bear the additional transparency of requiring trading on trading venues. The greatest volumes typically happen in the so called benchmark tenors which are swaps lasting whole years (e.g. 1 year or 2 years from initiation).

46. Our starting point for considering which tenors to include within the DTO is the subset of SOFR OIS that are in scope of the CFTC's US trading mandate. In our view, the available evidence from the Made Available to Trade (MAT) determinations and the need to have regard to international consistency suggest that we should consider the same set of derivatives for our liquidity analysis. Hence our analysis focuses on the following benchmark tenors: 1, 2, 3, 4, 5, 6, 7, 10, 12, 15, 20 and 30 years. We considered whether we should include all, some or none of the tenors within the DTO.

Our proposed intervention

47. The policy objective of the DTO is to ensure that trading of OTC derivatives that are sufficiently liquid takes place on TVs. In the absence of action, the DTO will not cover derivatives referencing relevant replacement near risk-free rates (RFR) for which liquidity is sufficient to apply the DTO.

48. Article 32 UK MiFIR sets out the procedure for determining which derivatives are subject to the DTO. This requires establishing that the derivatives: (i) are subject to the CO; (ii) must be admitted to trading on at least one of the aforementioned trading venues; and (iii) must be sufficiently liquid to trade only on those venues.

49. If these conditions are satisfied, we can make rules specifying which of the class of derivatives should be subject also to the DTO, i.e. traded on trading venues.

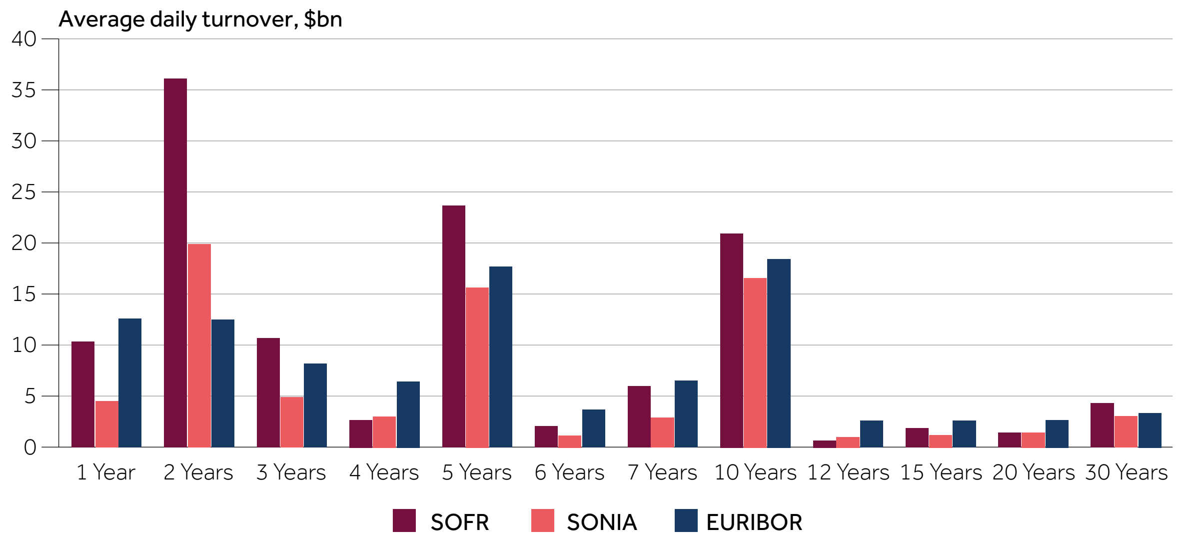
50. We therefore propose to add OIS derivatives referencing SOFR to the DTO. We propose to impose the DTO for SOFR OIS to trade start types spot-starting and IMM (next 2 IMM dates) with tenors of 1, 2, 3, 4, 5, 6, 7, 10, 12, 15, 20 and 30 years. According to our analysis, these are sufficiently liquid. A class of derivatives, or a subset thereof, is deemed sufficiently liquid on the basis of the criteria specified in Article 32 MiIFIR and RTS 4. This criteria includes assessment of:

- The average frequency and size of trades over a range of market conditions
- The number and type of active market participants
- The average size of spreads

51. Our liquidity analysis in chapter 3 includes assessment of all of the above criteria. In Figure 10 below we show derivatives turnover across maturity (by tenor). This indicates

that liquidity across most of the maturity spectrum is robust, with 2Y, 5Y and 10Y tenors showing particularly robust liquidity.

Figure 10: derivatives turnover, across tenors



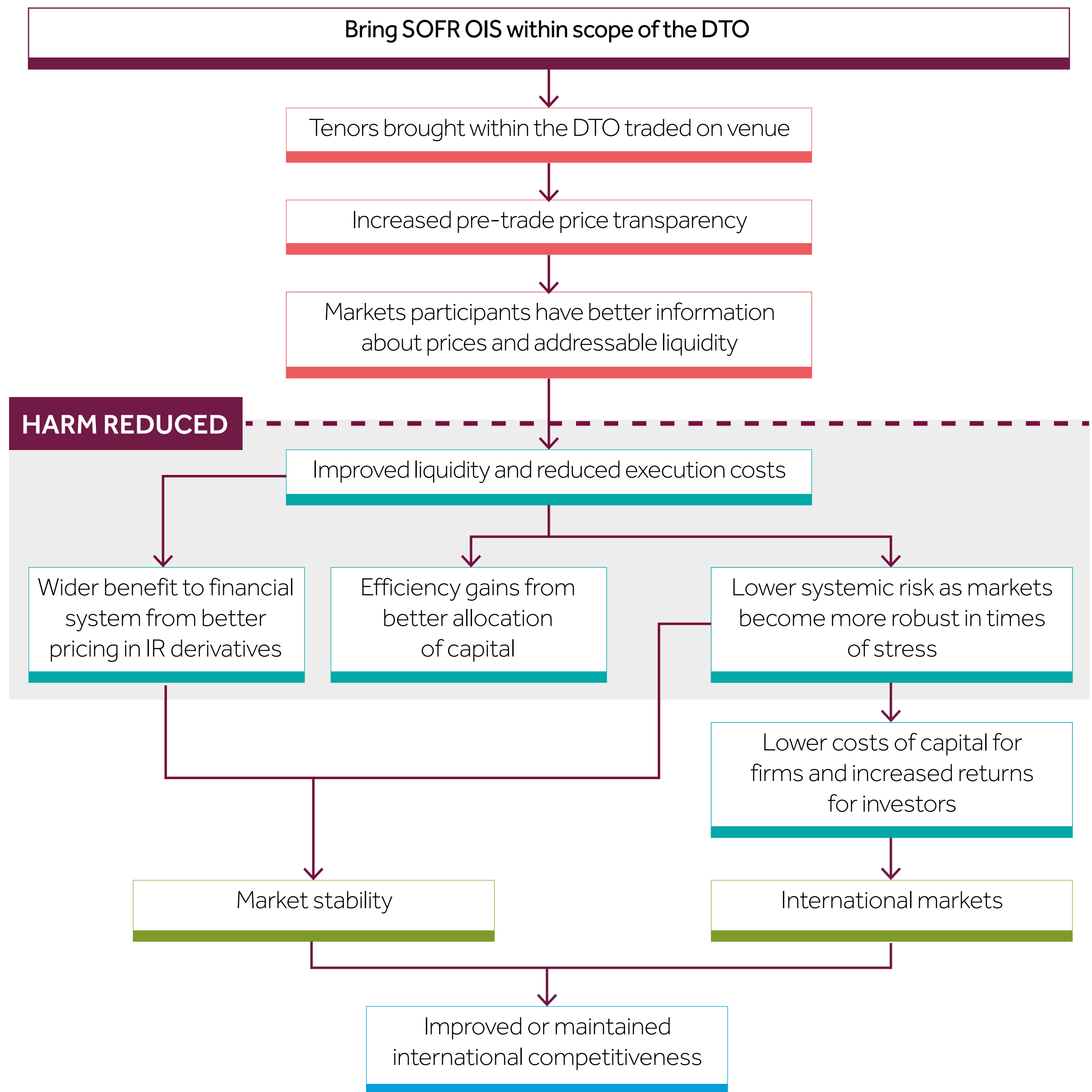
Source: FCA EMIR data.

52. These changes will be made in light of the interest rate benchmark reform and the Bank of England and CFTC modifying the CO by bringing OIS referencing SOFR under the clearing mandate.

53. We should note that EU benchmark reform process, which included reforming the benchmark and continuing with its use, resulted in much of the liquidity remaining with EURIBOR whereas not much liquidity has migrated over to the OIS products. As a result, EURIBOR is included in the DTO whereas, EU OIS products (such as EONIA, ESTR etc.) are not so widely traded hence, not part of the DTO.

54. The causal chain below shows the mechanisms by which we expect our proposal to lead to benefits and advance our primary objectives. We also show how our proposal advances our secondary objective for international competitiveness and growth.

Figure 11: the causal chain



Baseline and key assumptions

Baseline

55. The costs and benefits of our proposals must be measured against a baseline. In this section we explain our assumptions for the baseline, and we also explain the key assumptions we made when analysing the costs and benefits of our proposals.

56. Absent our proposed intervention, the pre-trade transparency regime for SOFR OIS would continue as it is. The baseline assumption we have used in our CBA is that without our proposed intervention, existing proportion of SOFR OIS trade continues to be conducted outside trading venues. Given that LIBOR transition has been completed and we don't expect changes to SOFR OIS trading requirements globally, we do not expect any material changes in trading volumes caused by external events in our baseline.

57. The proposed modifications represent a proportionate adaptation of the existing rules to reflect transition away from LIBOR and to new rates. This adaptation of existing rules follows the review of the classes of OTC derivatives that should be subject to the DCO and DTO. We have already amended the DTO previously. We removed LIBOR referenced instruments as per below table.

Table 3: Recent policy changes

Policy Paper	Change to the DTO	Effective date
PS21/13	We removed derivatives referencing GBP LIBOR and replaced them with OIS referencing SONIA	20 December 2021
Handbook Notice 108	We removed derivatives referencing USD LIBOR	24 April 2023

58. In PS21/13, we recognised that the liquidity profile of the derivatives market will continue to evolve as the interest rate benchmark unfolds. In PS21/13, we noted we may propose further amendments to the scope of the DTO in due course. Our subsequent monitoring of liquidity profiles suggests that new classes of derivatives now need to be brought in scope for the UK DTO. Our analysis shows that SOFR OIS are sufficiently liquid to be brought under the DTO.

59. Certain benchmark swaps on the US RFR, SOFR, have been deemed subject to the CO since 2022 and to the US trading mandate, the equivalent of our DTO, since 2023.

60. We are currently consulting in CP 23/32 on changes to the transparency regime for bonds and derivatives. We are proposing to include SOFR OIS as category 1 instrument under the new transparency regime and this would mean pre and post trade transparency of trades, unless the trade is above the Large-In-Scale (LIS) threshold. This would mean that transparency in affected contracts, including SOFR OIS, are likely to benefit from our transparency proposals.

61. Given that the LIBOR transition has now finished and that we do not expect any changes to the trading requirements for SOFR OIS globally, we do not expect any material changes in the traded volumes or the values from external impacts. However, we do expect improvements in liquidity (and this may cause an increase in volumes traded) from our proposals on transparency in our baseline. We don't think this will materially affect the overall proportionality of the proposals.

Key assumptions

62. The benefits that arise from our proposals are dependent on proportion of trades that are moved onto venues from OTC. In 2023, 36.2% of UK IRD traded notional took place on TVs, 46.1% was executed by Systematic Internalisers (SIs)[14] and 17.7% was reported as XOFF (meaning that these trades were executed off venue but are related to financial instruments available for trading on a venue)[15].

63. We have the data which enables us to distinguish the proportion of SOFR OIS trade executed on venue versus the proportion traded OTC. We therefore apply liquidity improvements solely to the proportion of USD-denominated swaps traded OTC and exclude those already traded on venue.

64. We understand that most firms already have access to TVs, however, we acknowledge that there may be a population of non-financial firms who occasionally trade SOFR OIS outside trading venues. We assume that trading through venues (through a broker) will not lead to material costs.

65. The DTO does not apply to non-financial firms below the clearing threshold or firms that are outside the UK nexus. However, a significant proportion of OTC contracts will be affected by our proposals because in most instances the counterparty to a contract involving firms directly affected by the proposals will be a UK financial firm.

66. The transition away from LIBOR has been completed. The UK has transitioned completely into RFR e.g., SONIA. The US dollar markets' adoption of RFRs is slightly lower than that for GBP. Other non-RFR products that are not LIBOR based, such as swaps based on FedFunds, remain actively traded, especially at short maturities. We do not expect further increases in volumes of trading in SOFR OIS from the transition to risk free rates.

67. We also include in our baseline the proposal to exercise our power to suspend or modify the DTO to achieve an equivalent outcome to that by the TTP that we are consulting upon in this CP. This has the effect of enabling UK and EU counterparties to continue to be able to trade swaps covered by the DTO, as other otherwise UK firms would not be able to execute trades with EU clients on EU venues. We assume that we will use our power to modify the DTO in such a way to achieve an outcome similar to that achieved by the TTP and therefore allow UK authorised firms and UK branches of EU firms to continue to trade in scope derivatives with EU clients on EU venues. This will prevent

14 FSMA 2023 defines a systematic internaliser as an investment firm which deals on own account when executing client orders outside a regulated market, an MTF or and OTF without operating a multilateral system and which a) does so on an organised, frequent, systematic and substantial basis, or b) has chosen to opt in to the systematic internaliser regime. Systematic internalisers are not a trading venues where the classes of derivatives subject to the trading obligation are traded.

15 https://www.isda.org/a/UWwgE/IRD-Trading-Activity-Reported-in-EU-UK-and-US-Markets-Full-Year-2023-and-Fourth-Quarter-of-2023.pdf

any fragmentation of markets and will maintain volumes and liquidity as UK firms can continue to trade with EU counterparties using EU venues.

Summary of Impacts

68. The tables below set out a summary of the costs and benefits described and, in some cases, estimated in our cost benefit analysis. The direct costs of our proposal to include SOFR OIS within the DTO are relatively small compared to the likely benefits. The benefits arising from our proposal are difficult to quantify, especially those benefits that are arising because of the increased liquidity. However, we do expect that moving SOFR OIS into the DTO and the resulting movement of trades subject to the DTO to have a material impact on liquidity. Small increases in liquidity will lead to benefits that materially outweigh the costs given the large size of the SOFR OIS market and the number of trades likely to move onto venues. As we noted in our section on the problem and rationale for intervention and in the section on benefits below, there is evidence that increasing pre-trade transparency will lower trading costs, where there is sufficient trading activity.

69. To demonstrate the proportionality of our proposals, we have carried out a break-even analysis to compare the one-off fixed costs with the increase in liquidity (specifically reduction in trading spread) for the policy to be net beneficial. In the CP we identified volumes of OTC trades within the UK nexus in SOFR OIS of £19.7 trillion of notional. We use the average spread from Bloomberg for the 12 tenors of OIS SOFR swaps (with a T+0 start date) over the year ending March 2024 we propose including in the DTO. We calculate the weighted average absolute spread to be 74 bps. We also calculated the volume weighted maturity of these swaps of 6 years. We can therefore calculate the total reduction in trading costs, measured by spreads, required for trading costs to outweigh the one-off fixed costs (£10.2m) of our proposals. We find that we require a 0.14% reduction in trading costs on swaps traded in 1 year for the policy to break even. We know that increased transparency of swap trading can have material benefits on the liquidity of swaps. We therefore have confidence that our proposals are net beneficial.

Table 4: summary table of benefits and costs

Group affected	Item description	Benefits (£)		Costs (£)	
		One off	Ongoing	One off	Ongoing
SOFR OIS market participants	Familiarisation cost (direct)			£0.8m	
	IT costs (direct)			£9.4m	
	Reduction in costs of trading from increased liquidity (indirect)		Not quantified		
	Potential increased trading costs for participants taking large positions and losses for liquidity providers (indirect)				Not quantified
FCA/wider society (if relevant)	More efficient capital allocation in downstream markets		Not quantified		
	More resilient financial markets in stressed conditions		Not quantified		
Total				£10.2m	

Table 5: present value and net present value

	PV Benefits	PV Costs	NPV (X years) (benefits-costs)	**NPV (X years) (Adjusted- where relevant)** (benefits – costs)
Total impact	Not quantified		-£10.2m	NA
-of which direct	0		-£10.2m	NA
-of which indirect	Not quantified		£0m	NA
Key unquantified items to consider	Increased liquidity in SOFR OIS More efficient capital allocation in downstream markets More resilient financial markets in stressed conditions		Key unquantified/non monetised items that affect both firms and consumers, or parties outside of each (e.g., wider economy)	

Table 6: net direct costs to firms

	Total (Present Value) Net Direct Cost to Business (X yrs)	EANDCB
Total net direct cost to business (costs to businesses – benefits to businesses)	-£10.2m	£1.2m

Benefits

70. In this section we describe the benefits we expect to arise from the implementation of our proposals. The benefits set out here reflect a reduction in harms described in the section on the problem and rationale for our intervention.

71. Several academic studies empirically show that competition induced by MiFID I not only reduced explicit transaction costs both at trading venue and post-trade infrastructure level but also led to an increase in market liquidity representing a reduction of implicit transaction costs. MiFID I introduced competition and fragmentation in European electronic financial markets and significantly changed the way equities are traded. While before MiFID, trading activity in Europe was highly concentrated on a stock's home market, competition between markets has been promoted since the directive has been applied at the end of 2007. As outlined by the academic literature, MiFID I

fostered competition between trading venues, thereby decreasing transaction costs and increasing liquidity. A comprehensive review of these studies is provided by Gomber and Jager (2014)[16] and summarised by Gomber et al (2018)[17].

72. The benefits that would arise from our proposals are:

- Improved liquidity and lower trading costs
- Increased returns for investors and better risk hedging
- Efficiency gains due to better capital allocation
- Help with mitigating systemic risk through standardisation of contracts and bringing greater transparency to trades

73. It is not reasonably practicable to quantify all the benefits that arise as a result of our proposed intervention. This is because it is not possible to predict the extent to which trading will be affected by our proposals and the consequences that arise from changes in trading. We do provide some indicative liquidity benefits but provide a qualitative assessment of other benefits.

74. We note that the benefits of increased liquidity and lower trading costs, and the benefits arising in the price and use of SOFR OIS will accrue to all users of SOFR OIS. We note that the majority of SOFR OIS trading is undertaken in the United States and therefore a significant proportion of the benefits will accrue there.

Improved liquidity and lower trading costs

75. The Global Financial Crisis (GFC) demonstrated that OTC trading is relatively opaque with limited availability of pre-trade and post-trade transparency to market participants. It is envisioned that a trading mandate would shift OTC trading onto a centralised platform where market participants benefit from improved pre-trade information, reduced information asymmetry and lower costs.

76. Shifting trading on to trading venues for standardised and liquid derivatives reduces fragmentation, increases transparency and thereby increases the liquidity available in the market as participants can more easily identify where they can best execute trades.

77. The academic evidence on trade transparency in swaps market is limited and mainly focuses on US markets following the introduction of transparency and the trading mandate under Dodd-Frank Act. Empirical research by Benos, Payne and Vasios (2020) for the derivatives market and Loon and Zhong (2016) for credit default swaps (CDS) market support the case for pre-trade transparency through trading of OTC derivatives on platforms.

78. Overall, pre-trade transparency changes the microstructure of the market in two ways. First, they increase pre-trade transparency by allowing participants to observe prices more easily. Second, it increases competition between swap liquidity suppliers.

16 https://www.econstor.eu/bitstream/10419/97299/1/786354445.pdf
17 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3133161

79. Benos, Payne and Vasios (2020) assessed the impact of mandated requirements, following Dodd-Frank Act, of bringing certain interest rate swap contracts on SEF. These venues improve transparency in trading. The authors demonstrate that the move from an OTC to a more centralised, competitive market structure leads to:

- improved liquidity (as a result of increased competition between dealers)
- a reduction on execution costs (as a result of improved liquidity)
- increase in competition between swap dealers (clients interacted with 17% more dealers on average)

80. The authors found that the improvement in liquidity from the trading mandate was in the range of 12%-19%. The Dodd-Frank intervention brought a significant proportion of swap trading on to SEFs. We note the paper did not have information on the extent of swap trading on venue prior to implementation.

81. There are some differences between imposition of the trading mandate under Dodd-Frank and our proposal that mean the results are not directly applicable. This is because:

- there is already a significant amount of SOFR OIS trading on venue. In contrast, we think the vast majority of trading under Dodd-Frank was OTC, but we have not found statistics on the precise proportion
- under our baseline, SOFR OIS will be included in new transparency regime and therefore the increase in transparency under our proposals is less than under Dodd-Frank where OTC activity was very opaque

82. Therefore, the benefits in the Benos, Payne and Vasios are likely to be at the top end of the range of benefits from our proposals. However, we are not able to precisely adjust these estimates to take into account the different baseline Consequently, we do not believe it is reasonably practicable to estimate the benefits of increased liquidity and lower trading costs. We do know that where there is sufficient trading activity, moving trading activity on to venues is likely to bring about a material increase in liquidity and reduced trading costs.

Increased returns for investors and better risk hedging

83. Improved information about prices will enable investors and firms to make more informed decisions about managing their interest rate risk. The lower transaction costs (described above) will enable participants to adjust their portfolios more quickly and enable them to hedge risk more effectively. As a result, we would expect investors to be able to earn higher risk-adjusted returns and firms to lower their cost of capital (over and above the direct savings from greater liquidity and lower trading costs). Although dealers may initially suffer lower profit as a result of trades moving on venue (this being a transfer from dealers to investors), we expect that dealers will ultimately benefit from lower costs associated with higher liquidity.

Efficiency gains due to better capital allocation

84. Prices of interest rate swaps are a key determinant of a number of downstream financial products globally. A more liquid and transparent SOFR OIS market will ensure that prices reflect fundamentals more quickly. This will ensure that downstream markets more efficiently reflect fundamentals. Improved price formation leads to better capital allocation and therefore more efficient use of capital.

Mitigating systemic risks

85. GFC highlighted the possibility of a liquidity crunch for OTC derivatives trading during market stresses, where market participants were unable to close out their positions to meet liquidity needs (Financial Crisis Inquiry Commission, 2011). This is particularly acute in decentralised and opaque trading models such as OTC derivatives markets. A trading mandate could therefore mitigate a liquidity crunch through pooling of liquidity platforms.

Costs

86. We rely on our standardised cost model (SCM) for cost estimates in the CBA. In early 2023, the underlying salary and firm size data were updated. The underlying assumptions remain the same as in Annex 1 of our document "How we analyse the costs and benefits of our policies". There may be small discrepancies in the numbers reported in tables due to rounding.

87. Costs from the proposed changes to the DTO framework will vary in nature and level by market participant. Compliance costs will include, depending on the type of firm and interventions: familiarisation and legal review costs; changes to IT systems process; implementation costs. We do not expect significant ongoing compliance costs as our proposals seek to make the current regime more efficient and effective, rather than imposing wholly new requirement on firms. We do not expect any changes to firms' business models as a result of our changes.

88. There are 2 classes of firms that will be affected by our proposed changes:

- Trading venues
- Market participants including both financial and non-financial firms

89. Trading venues (including 3rd country trading venues) will be impacted only indirectly as financial and non-financial counterparties who are subject to the DTO will trade on their platforms. We expect that the costs to trading venues will be minimal. This is because EMIR data shows that for SOFR OIS in 2023 the on-venue to OTC ratio is about 50%:50% by number of trades, and 34%:66% by volume. There are 16 trading venues where OIS swaps subject to the trading obligation are traded.[18]

90. Our proposals will impact financial counterparties and non-financial counterparties as defined in Article 28 of UK MiFIR that are or could become subject to the DTO, such

18 https://register.fca.org.uk/servlet/servlet.FileDownload?file=0150X000006gbbG

investment firms and banks and non-financial firms. There are 505 firms who traded SOFR OIS identified in UK EMIR reporting. We therefore assume there are 505 firms who are directly impacted by our proposals.

91. It may also affect regulated trading venues, including overseas trading venues that benefit from an equivalence determination (currently US and Singapore), as well as EU trading venues that benefit from the proposal to use our new power to disapply the DTO to certain transactions.

Familiarisation costs

92. We expect that firms who are subject to the DTO will incur costs from familiarising themselves with our proposals. Familiarisation and legal review costs are estimated based on the assumptions of our SCM. These costs will be incurred by 505 firms that are directly affected by our proposals.

93. We anticipated there will be around 25 pages of policy documentation describing the proposals in the main body of this consultation paper with which firms will need to familiarise themselves. Our Standard Cost Model (SCM) includes assumptions around staff time needed to read policy documents, which we use to estimate costs to familiarise with policy. We further assume that 20 compliance staff at large firms, read the document at an hourly cost of £68. This results in a cost per firm of £1,500.

94. We do not expect any significant legal analysis costs as the instrument for this proposal is very short and there are no obvious legal complexity from our proposals.

95. In total, we expect one-off costs of familiarisation to the industry to be £0.8m.

IT and systems costs

96. Subject to our final rules, firms, including PTRRS providers and users, will be required to amend their systems for those instruments in scope for our proposed changes to DTO.

97. Firms will incur one-off IT costs to implement changes to their existing systems. These costs will include IT development costs, i.e. costs relating to adapting existing IT systems and testing them.

98. For IT development, we calculate one-off costs by assuming the number of total person days needed to deliver the IT project by an overall team consisting of business analysis team, design team, programming team, project management team, test team and senior management. We estimate a total of 46 persons days will be required to modify firms' existing systems and testing them to include the instruments which fall in scope for the DTO at a cost of £448 per day per person. This implies a cost per firm of £18,500.

99. There may be firms who currently do not conduct SOFR OIS trade on venue but may do so in the future. These firms are not considered in our cost assessment as we expect their number to be very small.

100. We do not expect the proposed changes to require any additional ongoing costs when compared to the baseline scenario. This is because the proposals will not require new processes or systems to be implemented, only to update existing ones.

101. In total, we expect one off IT cost of £9.4m for the 505 firms affected.

Indirect costs

102. We recognise that there could be costs to increased market transparency resulting in liquidity withdrawal of some participants, or the costs of market transparency may be borne by informed participants, i.e. large dealers and market makers (IOSCO, 2011). However, our rules around transparency should guard against this. Dealers may suffer lower profits from trades moving on venue, they will also supply liquidity on venues (and benefit from lower costs associated with higher liquidity, e.g. lower inventory costs). We note that potential lost profits borne by e.g. large dealers are a transfer from liquidity providers to investors.

103. In addition, some market participants, who although not directly affected by the DTO (as they are either outside the UK nexus and/or are small non-financial firms) are forced on to trading on venue as that is where the available liquidity is. These firms may incur costs from accessing trading venues (e.g. fees and administrative costs to access). However, we expect these costs to be minimal as many of these firms will have existing access to these venues, the costs of access are not particularly large. Alternatively, they may also have an option to access trading venue via intermediary. In addition, these firms will benefit from any increase in liquidity in SOFR OIS.

Wider economic impacts, including on secondary objective

104. On 29 June 2023 the Financial Services and Markets Bill became law (it is now the FSMA 2023) and gave the FCA a secondary objective to facilitate the international competitiveness of the UK economy (particularly the financial services sector), and its medium to long-term growth, subject to aligning with relevant international standards. We have therefore considered here the likely effects of these proposals on international competitiveness and growth. We have considered the impact of using the 7 key drivers of productivity[19]. We consider that the relevant drivers for this proposal are proportionate regulation, effective competition, market stability and international markets.

105. Driving proportionate regulation, by ensuring any cost or restriction imposed is proportionate to the benefits expected as a result for the wider regulatory system. While difficult to assess the extent of the benefits, we would expect a material increase in liquidity in SOFR OIS from our proposals. We expect these benefits to materially outweigh the relatively small compliance costs.

19 https://www.fca.org.uk/publication/corporate/secondary-international-competitiveness-growth-objective-statement.pdf

106. By moving trading on to trading venues away from OTC trading, we would expect to increase competition amongst liquidity providers. Increased competition amongst liquidity providers is one mechanism by which liquidity in SOFR OIS are brought about.

107. Increased liquidity and improved price formation in UK trading venues for SOFR OIS will make it more attractive for international financial market participants to trade in the UK. We note that some market participants may prefer to trade OTC and therefore may use other jurisdictions to trade when not directly affected by the DTO. However, the largest other venue for SOFR OIS is the US, where the swap trading mandate has pushed most trading on venue.

108. More liquid markets and transparent markets are associated with greater market stability in times of financial stress. Markets that remain liquid are less likely to suffer from extreme price movements and excess volatility. This will help prevent shocks in the financial markets being magnified with a downside impact on the real economy.

109. SOFR OIS is the largest interest rate swap market. Most trading in SOFR OIS takes place in the US. Increasing the amount of liquidity within UK markets make the UK financial markets a more attractive place to trade SOFR OIS.

110. An illustration of the value of information produced by interest rate derivatives trades is the usage of interest rate swap prices to construct the term structure of interest rates (i.e., the relationship between the IR or cost of borrowing and the time to maturity of the debt instrument also referred to as a yield). This is in turn used to price corporate bonds, mortgage-backed securities and other credit instruments[20]. This results in establishment of prices that are used throughout the economy as the basis for forming expectations and making decisions on consumption, investment, production and commercial trade. The fact that the information contained in market pricing of interest rate derivatives plays an important role in markets outside that in which they are established means that there is a wider benefit to the financial sector and the economy.

Monitoring and evaluation

111. We will consider our proposed changes successful if we see an improvement in liquidity and transparency in the relevant class of derivatives and continuity in trading and access to liquidity for UK firms.

112. To measure our success, we will:

- continue to review relevant market data on liquidity to ensure the success of our policy outcome in maintaining or improving liquidity and transparency in relation to SOFR OIS
- continue to monitor market and regulatory developments and keep use of our power to amend or modify the DTO under review

20 Fleming, M (2000), 'The benchmark U.S. Treasury market: recent performance and possible alternatives', Federal Reserve Bank of New York Economic Policy Review, Vol. 6, No. 1, pages 129–45.

Annex 3

Cost benefit analysis of exemptions for post-trade risk reduction services (PTRRS)

Introduction

1. Section 138I of the Financial Services and Markets Act 2000 (FSMA) requires us to publish a cost benefit analysis (CBA) of our proposed rules. A CBA means an analysis of the costs, together with an analysis of the benefits that will arise if the proposed rules are made. A similar obligation to publish a CBA arises under section 138A FSMA when we make modifications to technical standards.

2. This analysis presents estimates of the significant impacts of our proposal. We provide monetary values for the impacts where we believe it is reasonably practicable to do so. For others, we provide a qualitative explanation of their impacts. Our proposals are based on weighing up all the impacts we expect and reaching a judgement about the appropriate level of regulatory intervention.

3. In this CP, we are proposing the following changes:

    a. bring swaps on the US risk-free rates SOFR (Secured Overnight Financing Rate) OIS (overnight index swap) into the scope of the DTO
    b. define the types of PTRR services that can be exempted from DTO
    c. set out how we intend to use our new power to modify or suspend the DTO to certain transactions under current transitional powers which expire in December 2024

4. In this CBA, we set out our assessment of the costs and benefits of exempting PTRRS from the DTO separately. Each CBA has the following structure:

    - The Market
    - Problem and rationale for intervention
    - Options assessment
    - Our proposed intervention
    - Baseline and key assumptions
    - Summary of impacts
    - Benefits
    - Costs
    - Wider economic impacts
    - Monitoring and Evaluation

The Market

5. Post-trade Risk Reduction (PTRR) services (PTRRS) are provided by third party service providers to market participants to assist them in reducing risks. PTRRS are typically used by large market participants that hold a number of positions, often where market risk is not significant as positions net for large participants with lots of positions, but firms face significant operational, basis and counterparty credit risk.

6. There are three types of PTRRS commonly used in the market: portfolio compression, portfolio rebalancing and basis risk optimisation.

7. Portfolio compression is a process where existing transactions between participants are removed and replaced by a smaller number of new contracts, without altering existing market positions (within a small threshold). This reduces the number of contracts and the gross notional value of contracts outstanding without materially affecting market risk.

8. Portfolio rebalancing (or counterparty risk reduction) is the process where new off-setting derivatives transactions are inserted to reduce the risks of existing positions. The result of these offsetting transactions is that market risk for participants is unchanged but the credit risk exposure between counterparties is reduced. This reduces margin requirements for firms that can be costly for firms (as margin typically earns lower returns than could be earned elsewhere).

9. Basis risk optimisation is used to reduce the risk that arises from misaligned fixing dates[21] or expiry dates in hedged portfolios. The reduction in exposure is done without terminating any positions but rather by adding equal and opposite technical transactions to neutralise the second order fixing risk of the original positions.

10. Transactions arising from PTRRS are different from those executed in the market. They are:

- Market risk neutral as they are designed to not change the directional market risk of the portfolios concerned, but rather reduce counterparty, operational and systemic risk in respect of existing derivatives transactions.
- Non-price forming, i.e., they do not inform the market about the prevailing market price. While they may involve a new legal transaction (rather than trading transactions) in order to achieve the identified risk reduction result, participants are not able to post bids or offers, no price negotiation takes place and market risk neutrality means transactions are recorded away from market prices.
- Aimed at addressing second order portfolio risks: They do not offer a vehicle for taking market positions or enter into trading transactions. Their purpose is the reduction of operational, counterparty and systemic risk.
- Single bundle of multiple transactions: The risk reduction cycles are binding on all or nothing basis across all cycle participants and the transaction components are executed as a new transaction.

21 The fixing date on a swap is the date when the floating reference rate on an interest rate swap is set.

11. Trades resulting from portfolio compression are already exempt from the DTO. However, other types of PTRR services are currently not exempt from the DTO.

12. BIS Triennial Central Bank Survey shows that non-market-facing trades (including compression and back-to-back trades) contributed $798 billion, or 15% of global turnover across all OTC IR instruments in April 2022. Such trades accounted for roughly 15% of turnover in swaps and over 30% of the total turnover of options and other products[22].

13. Despite the growing use and evolution of PTRRS by market participants, there are still only a small number of firms who offer these services globally. Most smaller users, typically buy-side firms, use just one PTRRS provider whereas larger banks tend to use more than one provider for resiliency reasons.

14. The concentration of providers in the PTRRS market can be attributed to the nature of PTRRS services such as compression and counterparty risk optimisation, which require a large network of participants to be effective. The efficiency of these services increases with the number of market participants connected to a single PTRRS provider, creating a network effect that favours a few dominant players.

15. This concentration of providers raises concerns about potential higher costs for users and limited access for certain market participants, as PTRRS providers can exercise discretion in client onboarding. However, according to IOSCO research, PTRRS providers have claimed that despite their limited numbers, there is still competition between providers which promotes innovation in services they offer[23].

Problem and rationale for intervention

16. PTRRS enable market participants to reduce non-market risks arising from their existing positions. These services involve creating and cancelling contracts. Sometimes these new contracts are in the classes of derivatives that are subject to the DTO. For portfolio compression, the requirements of the DTO do not apply to such contracts. However, for other types of PTRRS, the DTO applies to these contracts. These new contracts cannot be routed to trading venues as required by the DTO as the prices are not set at, or with reference to, prevailing market prices. This complexity leads to less participants taking part in a risk reduction exercise overall. Some PTRRS providers are unable to use the most efficient offsets and instead these PTTRS use different, and typically, more complicated products, such as swaptions, for these services rather than plain vanilla derivatives included in the DTO.

17. The use of more complex derivatives in PTRR exercises may disincentivise firms from using PTRRS. Contracts involving such instruments create additional costs for firms, as complex derivatives increase the time and resources needed to monitor and manage positions. Increased complexity also makes it more difficult to manage positions effectively and therefore raises the risks of operational failure and financial losses on contracts.

22 OTC interest rate derivatives turnover in April 2022 (bis.org)
23 https://www.iosco.org/library/pubdocs/pdf/IOSCOPD760.pdf

18. Some participants are unwilling to take on the operational costs and risks of using complex derivatives. Smaller firms, in particular, are less likely to be equipped with the necessary compliance and management systems to handle these more complex transactions whereas large firms are more likely to already have portfolios of these instruments.

19. Consequently, the risk reduction arising from PTTRS is not as impactful as it otherwise could be. This means that position holders continue to hold higher counterparty risk and interest rate risk. This greater risk will result in higher initial margin and higher capital requirements from the larger positions that they hold.

20. Increased risks not only can potentially lead to downside outcomes that lead to lost profits and potentially firm solvency risks, but firms also incur costs from the mechanisms that are there to prevent solvency issues or the risks to counterparties from solvency risk. Many financial firms are required to hold regulatory capital as a result of their derivative positions. Firms entering into derivative contracts need to post initial margin on their contracts. Reducing the amount of initial margin can free up capital to be invested in more productive areas.

21. The reduction in use of PTRRS increases systemic risk in the financial system. This makes the financial system less resilient to financial shocks. Greater risks in the derivatives ecosphere increases the chance that shocks within the financial system are propagated within financial services and through to the real economy.

Options

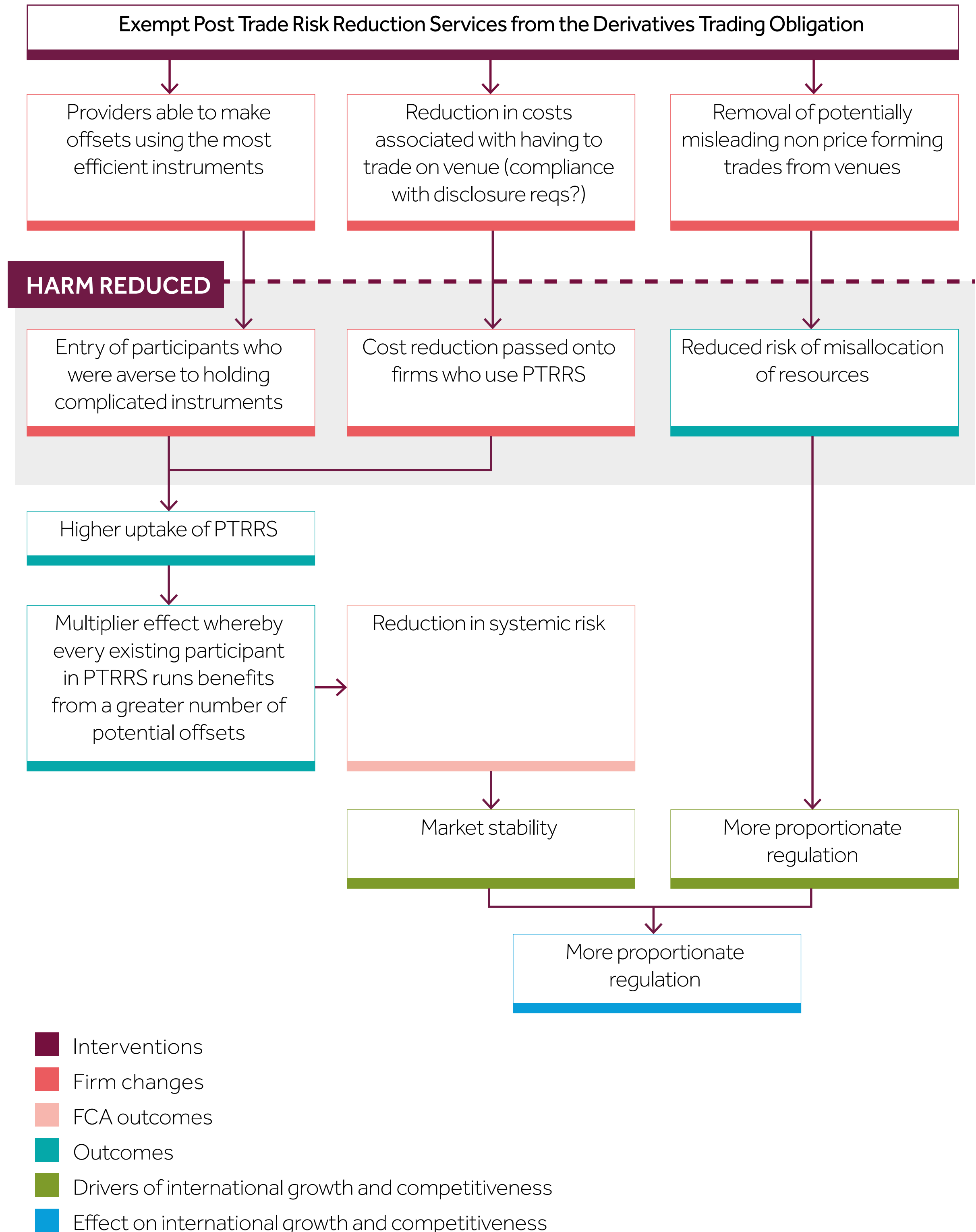
22. We compare our proposal to alternative options such as the option of not disapplying the DTO to a wider range of post-trade risk reduction services, our 'Do nothing' approach, and the option of dissaplying the DTO to specific PTRRS. Alternative options such as dissaplying specific PTRRS are unlikely to be as efficient as the preferred option. This is because we expect that the costs and benefits for each type of PTRRS will be similar in type and therefore there is no benefit from considering disapplying individual services separately.

Our proposed intervention

23. FSMA 2023 gives us the power to disapply obligations to activities, persons and transactions executed in connection with a risk reduction service. We propose to exercise our power to disapply the DTO to a wider range of post-trade risk reduction services. A "risk reduction service" is defined in FSMA 2023 as a service provided to two or more counterparties in derivatives transactions to reduce non-market risks. FSMA 2023 also restricts PTRRS to those that result in transactions that do not contribute to the price discovery process.

24. The Figure 12 below sets out our causal chain.

Figure 12: the causal chain



Baseline and key assumptions

Baseline

25. Absent our proposed intervention, PTRRS would continue to be subject to the DTO. We expect that the use of PTRRS would grow even in the absence of our intervention due to other regulatory changes. However, for reasons described below, there is a high degree of uncertainty over the magnitude of this growth. The uncertainty over growth in PTRRS use that can be attributed to these changes rather than growth that may result from our proposed intervention is reflected in our assumptions on the number of firms using PTRRS. In the baseline, we assume there is no change to the number of PTRRS providers.

26. We expect that the Bank of England will also consult on their equivalent powers in relation to PTRRS exemption from the CO in due course. We believe this will increase the demand for PTRR services under the baseline. We are unable to predict the extent to which there will be an increase in activity. We might expect that the two exemptions target different types of derivatives as the benefits from an exemption of the clearing exemption will particularly help PTRRS for uncleared bilateral exposures, while the DTO exemption will most benefit derivatives that were traded on venue and cleared through a central counterparty.

27. In response to a survey by IOSCO (pp. 13; pp.18), PTRRS providers reported their expectation that demand for their services will increase in response to regulatory changes. For example, changes to the Basel Committee's Standardised Approach to measuring exposure at default for counterparty credit risk (SA-CCR) may lead to an increase in the use of risk optimisation services to help lower the capital required to comply with the new rules. As such, we would expect use of PTRRS to grow in the absence of our intervention.

Key assumptions

28. There are only a small number of firms that provide PTRRS. We have identified fewer than 10 providers currently operating in the market.

29. We assume that the 67 clearing members of LCH (the London venue that clears most swaps globally) that current hold interest swaps positions are currently using PTRR services. We also expect that our proposals will increase the number of participants using PTRRS (other than compression). It is highly uncertain how many firms would decide to undertake PTRRS as a result of our proposal. We assume that there would be around 100 participants in total for our calculation of costs.

Summary of Impacts

30. We think our proposals are inherently proportionate as PTRR service providers and users can choose to take up the option to use the exemption available to PTRRS from the DTO. Both types of firm will only therefore change their behaviour where the benefits from changing their approach outweigh the costs. We do not expect any significant costs to firms or other stakeholders, but we expect further benefits from lower systemic risk in financial markets arising from the reduction in risk in swap markets.

Table 7: summary table of benefits and costs

Group affected	Item description	Benefits (£)		Costs (£)	
		One off	Ongoing	One off	Ongoing
PTRRS providers and firms using PTRRS services	Familiarisation and legal review costs (direct)			£0.24m	
PTRRS providers	IT costs (direct)			£0.19m	
	Lower operational costs and risk for firms using PTRRS		Not quantified		
	Lower capital and margin costs for firms using PTRRS		Not quantified		
FCA/wider society (if relevant)	Lower system risk from reduced risks within firms		Not quantified		
Total				£0.43m	

Table 8: present value and net present value

	PV Benefits	PV Costs	NPV (10 yrs) (benefits-costs)	NPV (10 yrs) (Adjusted- where relevant) (benefits – costs)
Total impact	Not quantified	£0.43m	-£0.43m	Not relevant
-of which direct		£0.43m	-£0.43m	Not relevant
-of which indirect		£0	£0m	Not relevant
Key unquantified items to consider	Lower operational costs and risk for firms using PTRRS Lower capital and margin costs for firms using PTRRS Lower risk within firms and the wider financial system		Key unquantified/non monetised items that affect both firms and consumers, or parties outside of each (e.g., wider economy)	

Table 9: net direct costs to firms

	Total (Present Value) Net Direct Cost to Business (X yrs)	EANDCB
Total net direct cost to business (costs to businesses – benefits to businesses)	£0.43m	£0.05m

Benefits

31. Disapplying the DTO to a wider range of PTRRS would reduce the complexity of the amended positions resulting from using PTRRS. This in turn will remove the disincentive to firms unwilling to use PTRRS (other than compression) due to the complexity of instruments that PTRRS currently require them to hold. We therefore expect that the disapplication of the DTO to PTRRS will increase uptake, particularly among smaller firms. We also note the network effects resulting from the participation of new firms. As well as the new participants themselves benefiting from reduced risk due to their use of PTRRS, there is a benefit to existing participants, as a higher number of participants leads to greater risk reduction overall.

32. These changes will bring about the following benefits:

- Lower operational costs and operational risk from less complexity in positions
- Lower initial margins and regulatory capital costs from smaller net positions
- Lower risk to firms and the financial systems and greater resilience to shocks from lower gross positions

33. IOSCO[24] stated that PTRR may help counterparties to reinvest released capital, reduce counterparty risk, diminish operational risk and reduce operational risk for individual market participants, potentially lessening systemic risk and enhancing overall financial market stability. We expect any barriers to market participants from using these services will prevent users accessing these benefits. The scope for benefits are large. According to ISDA[25], portfolio compression reduced IRD notional by 67%. We have been told by market participants that PTRRS use has been restricted by the DTO. We might then expect that exempting other types of PTRRS, other than compression, from the DTO may lead to a material increase in the use and that the potential benefits may be significant.

34. We are unable to estimate the benefits. This is because we are unable to predict how PTRRS services will be used and the contracts that will be entered into if PTRRS other than compression are exempted from the DTO. Consequently, we are unable to predict how risk will change for market participants and the costs that arise from that risk.

Lower operational costs and risk for firms using PTRRS

35. At present, firms' ability to enter into risk reduction services such as portfolio rebalancing and basis risk reduction services is restricted due to the requirements of the DTO. The issue arises as and when new output transactions created under PTRRS contracts must be executed on venue whereas the portfolio of older contracts they intend to address consists of OTC contracts. This complexity forces traders to stay out of PTRRS and accept the inefficiency of not being able to optimise risks on existing OTC portfolios. This has negative impact on the ability to reduce post-trade operational inefficiencies, reduction in counterparty risk and an overall reduction in systemic risk.

Lower capital and margin costs

36. Firms that increase their use of PTRRS will be able to lower the amount of initial margin that is tied up in their outstanding derivative contracts. Freeing up this capital enables investment in higher yielding or more productive areas. This is because initial margin is required to be provided in cash or other liquid investments such as letters of credit or government bonds.

37. Many firms that use, or potentially use, PTRRS are required to hold regulatory capital on their derivatives positions.

24 IOSCO, Post Trade Risk Reduction Services Consultation Report, 2024, https://www.iosco.org/library/pubdocs/pdf/IOSCOPD760.pdf

25 ISDA, https://www.isda.org/a/FPDDE/otc-derivatives-market-analysis-interest-rate-derivatives-final.pdf

Lower risk within firms and the wider financial system

38. Reduced risks lower the chances that firms will suffer solvency issues from losses arising from counterparty risk. By reducing the likelihood of one firm's insolvency affecting other firms, the likelihood of systemic issues arising or being amplified in swap markets affected by the DTO is reduced.

Costs

Familiarisation and legal review costs

39. We expect that PTRRS firms and firms using PTRRS will incur costs from familiarising themselves with our proposal to exempt. In total, we expect there are up to around 10 PTRRS firms and 100 firms that would potentially use PTRRS under our proposal to be affected by our proposals.

40. We use standard assumptions to estimate these costs. We anticipate that there will be approximately 10 pages of policy documentation with which firms will need to familiarise themselves.

41. As per our SCM, we assume that 20 compliance staff read the document. Finally, using data on salaries from the Willis Towers Watson UK Financial Services survey, the hourly compliance staff salary is assumed to be £68, including 30% overheads.

42. We also assume that firms incur legal analysis costs. We also expect those affected will undertake a legal review of the new requirements against current practices. We, again, use standard assumptions to estimate these costs. There are around 10 pages of legal instrument to review. It is assumed that 4 legal staff will read the document. It is further assumed that each legal staff member will review the instrument in 5.5 hours. We also assume an hourly cost of £72 per hour.

43. Using these assumptions, we expect the average one-off cost to firms to be £2,200 per firm. We expect total one-off industry-wide costs of familiarisation and legal analysis of approximately £0.24m.

Costs to PTRRS providers

44. PTRRS providers will incur one-off costs to allow derivatives that are currently within scope of the DTO to be included in PTRRS.

45. To estimate PTRRS providers' implementation costs, we use our SCM. While assumptions in the SCM serve as a good proxy for the one-off costs that firms will incur, they do not necessarily reflect the exact details of the work firms will need to undertake.

46. We expect one-off costs will be mainly IT costs arising from implementing changes to their existing systems. The costs will include IT development costs, i.e., costs relating to adapting existing IT systems and testing them.

47. We calculate these one-off IT costs by assuming the number of total person days needed to deliver the IT project by an overall team consisting of a business analysis team, design team, programming team, project management team, test team, and senior management. We use assumptions contained in the SCM for the relative proportions of the different sub-teams and their daily salary costs (including overheads). In total we expect that 46 person days would be used at an average per day cost of £410 per day. This implies a cost per firm of £18,500.

48. In total, we expect one-off systems and IT costs of £185,000.

Costs to trading venues

49. At present, transactions conducted as part of PTRRS runs (excluding compression) involving classes of derivatives that are subject to the DTO must take place on trading venues. Under our proposed rule changes, these transactions would be exempt from the DTO, which may lead to a loss of revenue for some trading venues.

Indirect costs

50. PTRRS provider will incur some additional costs in running additional PTRRS exercises. These may be outweighed by the greater simplicity of running PTRRS when all potential contracts can be used to facilitate PTRRS. In addition, PTRRS providers will incur additional profits from these additional services undertaken.

51. Firms using PTRRS may incur some additional costs from using additional PTRRS services. However, firms can choose whether to participate in PTRRS runs. They will only do so where the benefits to them outweigh the costs of the services.

Costs to the FCA

52. We expect some small additional cost to ourselves from the notifications from providers of PTRRS. We do not expect these costs to be of more than minimal significance.

Wider economic impacts, including on secondary objective

53. Our proposals will increase the use of PTRRS services. Our proposals are intended to minimise unnecessary costs to firms by simplifying the regime and excluding illiquid instruments and non-price-forming trades from DTO.

54. We have considered the impact of these proposed changes using the 7 key drivers of productivity.[26] We consider that the relevant drivers for this proposal are proportionate regulation, market stability, international markets and innovation.

55. By including PTRRS within the DTO, the current rules are providing a constraint on firms' activity without a countervailing benefit for them or wider markets. Consequently, removing this restriction makes the regulatory regime more proportionate.

26 https://www.fca.org.uk/publication/corporate/secondary-international-competitiveness-growth-objective-statement.pdf

56. Increasing the use of PTRRS will reduce risk in swap markets and the risk that shocks are amplified in swap markets. This makes the system more resilient and therefore reduces systemic risk for both financial markets and the wider economy.

57. Removing the DTO restriction on PTRRS will make using UK financial markets for PTRRS more attractive for firms to use.

58. Finally, removing restrictions on PTRRS will potentially enable more innovative PTRRS to be developed, further increasing the beneficial reduction in risk that these services provide.

Monitoring and evaluation

59. We will consider our proposed changes successful if we see an improvement an uptake in PTRRS thereby a reducing systemic risk in the derivatives market. To measure our success we will monitor, through feedback from PTRRS providers, firms and trade associations, changes to the number of market participants in PTRRS providers' exercises and continue to monitor market and regulatory developments.

Annex 4

Compatibility statement

Compliance with legal requirements

1. This Annex records the FCA's compliance with a number of legal requirements applicable to the proposals in this consultation, including an explanation of the FCA's reasons for concluding that our proposals in this consultation are compatible with certain requirements under the Financial Services and Markets Act 2000 (FSMA).

2. When consulting on new rules, the FCA is required by section 138I(2)(d) FSMA to include an explanation of why it believes making the proposed rules (a) is compatible with its general duty, under section 1B(1) FSMA, so far as reasonably possible, to act in a way which is compatible with its strategic objective and advances one or more of its operational objectives, (b) so far as reasonably possible, advances the secondary international competitiveness and growth objective, under section 1B(4A) FSMA, and (c) complies with its general duty under section 1B(5)(a) FSMA to have regard to the regulatory principles in section 3B FSMA. The FCA is also required by s 138K(2) FSMA to state its opinion on whether the proposed rules will have a significantly different impact on mutual societies as opposed to other authorised persons. Similar obligations apply to the FCA under section 138S FSMA in relation to the making of standards instruments. References to our proposals below include both our proposed rules and modifications to technical standards.

3. This Annex also sets out the FCA's view of how the proposals are compatible with the duty on the FCA to discharge its general functions (which include rule-making) in a way which promotes effective competition in the interests of consumers (section 1B(4)). This duty applies in so far as promoting competition is compatible with advancing the FCA's consumer protection and/or integrity objectives.

4. In addition, this Annex explains how we have considered the recommendations made by the Treasury under s 1JA FSMA about aspects of the economic policy of His Majesty's Government to which we should have regard in connection with our general duties.

5. This Annex includes our assessment of the equality and diversity implications of these proposals.

6. Under the Legislative and Regulatory Reform Act 2006 (LRRA) the FCA is subject to requirements to have regard to a number of high-level 'Principles' in the exercise of some of our regulatory functions and to have regard to a 'Regulators' Code' when determining general policies and principles and giving general guidance (but not when exercising other legislative functions like making rules). This Annex sets out how we have complied with requirements under the LRRA.

The FCA's objectives and regulatory principles: Compatibility statement

7. The proposals set out in this consultation are primarily intended to advance the FCA's operational objective of market integrity.

8. We consider these proposals are compatible with the FCA's strategic objective of ensuring that the relevant markets function well because because they seek to promote the stability and resilience of the UK's OTC derivatives market. For the purposes of the FCA's strategic objective, "relevant markets" are defined by section 1F FSMA.

9. We consider these proposals advance market integrity by improving market transparency, mitigating systemic risk and protecting against market abuse. We consider these proposals comply with the FCA's secondary objective in advancing competitiveness and growth because more liquid and transparent markets are associated with greater market stability in times of financial stress, which, in turn, supports the UK's international competitiveness.

10. In preparing the proposals set out in this consultation, the FCA has had regard to the regulatory principles set out in s 3B FSMA.

The need to use our resources in the most efficient and economic way

11. The proposals will, if adopted, deliver a regime that allows us to monitor the use of the relevant post-trade risk reduction services and their associated exemptions.

The principle that a burden or restriction should be proportionate to the benefits

12. The proposals reduces the burden on firms by providing a more proportionate regulatory regime whereby UK-based firms are able to offer and participate in innovative and efficient post-trade risk reduction services without the need to incur disproportionate regulatory costs.

The need to contribute towards achieving compliance by the Secretary of State with section 1 of the Climate Change Act 2008 (UK net zero emissions target) [and section 5 of the Environment Act 2021 (environmental targets)

13. Overall we consider that the proposals in this CP, which aim to improve market efficiency and reduce systemic risk, could indirectly support the low-carbon transition by promoting financial stability and better resource allocation.

The general principle that consumers should take responsibility for their decisions

14. The proposals do not depart from the general principle that consumers take responsibility for their decisions.

The responsibilities of senior management

15. Our proposals do not specifically relate to the responsibilities of senior management. Nevertheless, we have had regard to this principle and do not consider that our

proposals undermine it. The desirability of recognising differences in the nature of, and objectives of, businesses carried on by different persons including mutual societies and other kinds of business organisation

16. We have had regard to the range of providers and users in derivative markets including trading venues, financial counterparties, non-financial counterparties, as well as the range of products and services these markets provide, with the aim of providing proportionate solutions based on appropriate parameters for exemptions.

The desirability of publishing information relating to persons subject to requirements imposed under FSMA, or requiring them to publish information

17. This CP sets out our policy rationale for bringing in scope of the UK DTO SOFR OIS referenced instruments, the proposed post-trade risk reduction exemptions regime, and power to suspend of modity the DTO. Where we exercise our power (given to us in Schedule 2 to FSMA 2023) to suspend or modify the derivatives trading obligation, we are required to publish a statement setting out the relevant details.

The principle that we should exercise of our functions as transparently as possible

18. By explaining the rationale for each of our proposals and the anticipated outcomes we believe we have had regard to this principle. In formulating these proposals, the FCA has had regard to the importance of taking action intended to minimise the extent to which it is possible for a business carried on (i) by an authorised person or a recognised investment exchange; or (ii) in contravention of the general prohibition, to be used for a purpose connected with financial crime (as required by s 1B(5)(b) FSMA).

Expected effect on mutual societies

19. The FCA does not expect the proposals in this paper to have a significantly different impact on mutual societies. Our proposals will apply according to the services exercised and to whom they are addressed, equally regardless of whether it is a mutual society or another authorised body.

Equality and diversity

20. We are required under the Equality Act 2010 in exercising our functions to 'have due regard' to the need to eliminate discrimination, harassment, victimisation and any other conduct prohibited by or under the Act, advance equality of opportunity between persons who share a relevant protected characteristic and those who do not, to and foster good relations between people who share a protected characteristic and those who do not.

21. As part of this, we ensure the equality and diversity implications of any new policy proposals are considered. The outcome of our consideration in relation to these matters in this case is stated in paragraphs 2.15 and 2.16 of the CP.

Annex 5

Abbreviations used in this paper

Abbreviation	Description
AIF	Alternative investment fund
APA	Approved publication arrangement
CCP	Central counterparty
CFTC	Commodity Futures Trading Commission
CO	Clearing obligation
COBS	Conduct of Business Sourcebook
CP	Consultation paper
DTO	Derivatives trading obligation
DV01	Dollar value of 1 basis point
EMIR	European Market Infrastructure Regulation
ETD	Exchange traded derivatives
EU	European Union
EURIBOR	Euro Interback Offered Rate
FCA	Financial Conduct Authority
FRA	Forward rate agreement
FSB	Financial Stability Board
FSMA	Financial Services and Markets Act 2000
IM	Initial margin
IOSCO	International Organisation of Securities Commissions
IRD	Interest rate derivatives

Abbreviation	Description
LCH	London Clearing House
LIBOR	London Inter-Bank Offered Rate
MAR	Market Conduct Sourcebook
MiFID II	The second Markets in Financial Instruments Directive
MiFIR	Markets in Financial Instruments Regulation
MTF	Multilateral trading facility
OTF	Organised trading facility
OIS	Overnight index swap
OTC	Over-the-counter
PTRR	Post-trade risk reduction
PTRRS	Post-trade risk reduction services
RFR	Risk-free rate
RM	Regulated market
RTS	Regulatory Technical Standard
SOFR	Secured Overnight Financing Rate
SONIA	Sterling Overnight Index Average
TTP	Temporary Transitional Power
UCITS	Undertakings for Collective Investment in Transferable Securities
WMR	Wholesale Markets Review
YTD	Year to date

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Appendix 1

Draft Handbook text

TECHNICAL STANDARDS (MARKETS IN FINANCIAL INSTRUMENTS REGULATION) (DERIVATIVES TRADING OBLIGATION AND TRANSPARENCY) (AMENDMENT) INSTRUMENT 2024

Powers exercised

A. The Financial Conduct Authority ("the FCA") makes this instrument in the exercise of the powers and related provisions in or under:

(1) articles 4(6), 7(2), 20(3), 22(4), 23(3) and 32(1) of Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012; and

(2) the following sections of the Financial Services and Markets Act 2000 ("the Act") as amended by the Financial Regulators' Powers (Technical Standards etc.) (Amendment etc) (EU Exit) Regulations 2018:

(a) section 138P (Technical standards);
(b) section 138Q (Standards instruments);
(c) section 138S (Application of Chapters 1 and 2); and
(d) section 137T (General supplementary powers).

B. The provisions referred to above are specified for the purpose of section 138Q(2) (Standards instruments) of the Act.

Pre-conditions to making

C. The FCA has consulted the Prudential Regulation Authority and the Bank of England as appropriate in accordance with section 138P of the Act.

D. A draft of this instrument has been approved by the Treasury in accordance with section 138R of the Act.

E. The FCA published a draft of this instrument in accordance with section 138I(1)(b) of the Act, accompanied by the information required by section 138I(2). The FCA had regard to representations made in response to the public consultation.

Modifications

F. The following technical standards are amended in accordance with the Annexes to this instrument.

(1)	(2)
Commission Delegated Regulation (EU) 2017/2417 of 17 November 2017 supplementing Regulation (EU) No 600/2014 of the European Parliament and of the Council on markets in financial instruments with regard to regulatory technical standards on the trading obligation for certain derivatives,	Annex A

which is part of UK law by virtue of the European Union (Withdrawal) Act 2018.	
Commission Delegated Regulation (EU) 2017/587 of 14 July 2016 supplementing Regulation (EU) No 600/2014 of the European Parliament and of the Council on markets in financial instruments with regard to regulatory technical standards on transparency requirements for trading venues and investment firms in respect of shares, depositary receipts, exchange-traded funds, certificates and other similar financial instruments and on transaction execution obligations in respect of certain shares on a trading venue or by a systematic internaliser, which is part of UK law by virtue of the European Union (Withdrawal) Act 2018.	Annex B

Commencement

G. This instrument comes into force on [*date*].

Citation

H. This instrument may be cited as the Technical Standards (Markets in Financial Instruments Regulation) (Derivative Trading Obligation and Transparency) (Amendment) Instrument 2024.

By order of the Board
[*date*]

In this Annex, underlining indicates new text and striking through indicates deleted text.

Annex A

Commission Delegated Regulation (EU) 2017/2417 of 17 November 2017 supplementing Regulation (EU) 600/2014 of the European Parliament and of the Council on markets in financial instruments with regard to regulatory technical standards on the trading obligation for certain derivatives

…

Article -1

Interpretation

In this Regulation, where a term is defined in article 2 of Regulation 600/2014/EU, as amended by the Markets in Financial Instruments (Amendment) (EU Exit) Regulations 2018, that definition shall apply for the purposes of this Regulation.

For the purposes of this Regulation, 'IMM' means the International Monetary Market operated by companies within the CME Group Inc.

Article 1

Derivatives subject to the trading obligation

The derivatives set out in the Annex shall be subject to the trading obligation referred to in Article 28 of Regulation (EU) No 600/2014.

A derivative referred to in Table 1, ~~and~~ Table 5 and Table 6 of the Annex shall be deemed to have a tenor of 1, 2, 3, 4, 5, 6, 7, 8, 9, 10, 12, 15, 20, 25 or 30 years where the period of time between the date at which the obligations under that contract come into effect and the termination date of that contract equals one of those periods of time, plus or minus 5 days.

…

ANNEX

Derivatives subject to the trading obligation

…

Table 5 Overnight indexed swaps denominated in GBP

Overnight indexed swaps – ~~GPB~~ GBP SONIA		
~~**Floating leg**~~		
Settlement currency	…	…
…		

Table 6 Overnight indexed swaps denominated in USD

Overnight indexed swaps – USD SOFR		
Settlement currency	USD	USD
Trade start type	Spot (T+2)	IMM (next 2 IMM dates)
Optionality	No	No
Tenor	2,3,4,5,6,7,10,12,15,20,30Y	1,2,3,4,5,6,7,10,12,15,20,30Y
Notional type	Fixed Notional	Fixed Notional
Fixed leg		
Payment frequency	Annual	Annual
Day count convention	Actual/360	Actual/360
Floating leg		
Reset frequency	Annual	Annual
Day count convention	Actual/360	Actual/360

In this Annex, underlining indicates new text and striking through indicates deleted text.

Annex B

Commission Delegated Regulation (EU) 2017/587 of 14 July 2016 supplementing Regulation (EU) No 600/2014 of the European Parliament and of the Council on markets in financial instruments with regard to regulatory technical standards on transparency requirements for trading venues and investment firms in respect of shares, depositary receipts, exchange-traded funds, certificates and other similar financial instruments and on transaction execution obligations in respect of certain shares on a trading venue or by a systematic internaliser

…

Article 13

Application of post-trade transparency to certain types of transactions executed outside a trading venue (Article 20(1) of Regulation (EU) No 600/2014)

The obligation in Article 20(1) of Regulation (EU) No 600/2014 shall not apply to the following:

(a) …

(aa) transactions carried out as part of an 'eligible post-trade risk reduction service' as defined in the FCA Glossary and as amended from time to time;

…

MARKETS IN FINANCIAL INSTRUMENTS REGULATION (POST-TRADE RISK REDUCTION SERVICES RULES) (AMENDMENT) INSTRUMENT 2024

Powers exercised

A. The Financial Conduct Authority ("the FCA") makes this instrument in the exercise of the powers and related provisions in or under:

(1) article 31 (Risk reduction services) of Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012; and

(2) the following sections of the Financial Services and Markets Act 2000 ("the Act"):

(a) section 137A (The FCA's general rules);
(b) section 137T (General supplementary powers);
(c) section 139A (Power of the FCA to give guidance); and
(d) section 300H (Rules relating to investment exchanges and data reporting service providers).

B. The rule-making powers listed above are specified for the purpose of section 138G(2) (Rule-making instruments) of the Act.

Commencement

C. This instrument comes into force on [*date*].

Interpretation

D. In this instrument, any reference to any provision of assimilated direct legislation is a reference to it as it forms part of assimilated law.

Amendments to the Handbook

E. The modules of the FCA's Handbook of rules and guidance listed in column (1) below are amended in accordance with the Annexes to this instrument listed in column (2).

(1)	(2)
Glossary of definitions	Annex A
General Provisions sourcebook (GEN)	Annex B
Market Conduct sourcebook (MAR)	Annex C

Notes

F. In the Annexes to this instrument, the notes (indicated by "*Editor's note*:") are included for the convenience of readers, but do not form part of the legislative text.

Citation

G. This instrument may be cited as the Markets in Financial Instruments Regulation (Post-trade Risk Reduction Services Rules) (Amendment) Instrument 2024.

By order of the Board
[*date*]

Annex A

Amendments to the Glossary of definitions

Insert the following new definitions in the appropriate alphabetical position. The text is all new and not underlined.

eligible agreement	an agreement between a *post-trade risk reduction service provider* and a market participant:

(a) that identifies the point in time that a *PTRRS* becomes legally binding;

(b) that includes legal documentation describing how *derivatives* submitted for inclusion in the *PTRRS* are terminated, replaced or modified; and

(c) in relation to which, prior to entry into force, the *post-trade risk reduction service provider*:

(i) identifies the risk tolerance of a participant, including, where relevant, specific limits for counterparty risk, market risk and cash payment tolerance;

(ii) agrees with the participants that the risk limits referred to in (i) will be incorporated into the *PTRRS* exercise;

(iii) may grant additional time, when requested, to the participants to add *derivatives* eligible for termination, reduction or modification in order to:

(A) adjust the *PTRRS* to the risk tolerance set under (i); and

(B) maximise the efficiency of the *PTRRS*; and

(iv) links the *derivatives* submitted for the *PTRRS* and provides to each participant a proposal including the following information, where applicable:

(A) the identification of the counterparties affected;

(B) the related change to the combined notional value of the *derivatives*;

(C) the variation of the combined notional amount compared to the risk tolerance specified; and

(D) new *derivatives* transactions referrable to risk tolerances submitted by participants.

eligible post-trade risk reduction service	a *post-trade risk reduction service* which meets the criteria in *MAR* 12.4 and where the *post-trade risk reduction service provider* complies with the conditions in *MAR* 12.5.
financial counterparty	(in accordance with article 28(1A) of *MiFIR*) has the same meaning as in article 2(8) of *EMIR*.
non-financial counterparty	(in accordance with article 28(1A) of *MiFIR*) has the same meaning as in article 2(9) of *EMIR*.
portfolio compression	(in accordance with article 2(1)(47) *MiFIR*) a risk reduction service in which 2 or more counterparties wholly or partially terminate some or all of the *derivatives* submitted by those counterparties for inclusion in the portfolio compression and replace the terminated *derivatives* with another *derivative* whose combined notional value is less than the combined notional value of the terminated *derivatives*.
post-trade risk reduction service	a post-trade service provided to 2 or more counterparties to *derivatives* transactions: (a) for the purpose of reducing non-market risks in *derivatives* portfolios (including, for example, *portfolio compression*); and (b) that does not give rise to any transactions contributing to the price discovery process.
post-trade risk reduction service provider	a *person* who provides a *post-trade risk reduction service*.
PTRRS	a *post-trade risk reduction service*.
relevant financial counterparty	(in accordance with article 28(1A) of *MiFIR*) a *financial counterparty* subject to the clearing obligation referred to in article 4 of *EMIR*.
relevant non-financial counterparties	(in accordance with article 28(1A) of *MiFIR*) a *non-financial counterparty* when subject to the clearing obligation in article 4 of *EMIR* in respect of *derivative* contracts pertaining to a particular asset class.
relevant obligations	(in accordance with article 31(6) of *MiFIR*) the obligations imposed by: (a) *COBS* 11.2A; (b) *MAR* 5AA.1.1R; and (c) article 28 of *MiFIR*.

transparency obligations	the obligations imposed by and under articles 8, 10, 18 and 21 of *MiFIR*.

Annex B

Amendments to General Provisions sourcebook (GEN)

[*Editor's note*: This Annex takes into account the changes introduced by the EMIR Rules (Procedures for Ensuring Data Quality) Instrument 2023, which comes into force on 30 September 2024.]

In this Annex, underlining indicates new text.

Sch 4 Powers exercised

…

Sch 4.3 G

The following additional powers have been exercised by the *FCA* to make the *rules* in *GEN*:
…
Article 21 (Monitoring and Enforcement) of the *MCD Order*
Article 78(10) of *EMIR*
Article 31 of *MiFIR*

…

Annex C

Amendments to the Market Conduct sourcebook (MAR)

[*Editor's note*: This Annex takes into account the proposals and legislative changes suggested in the consultation paper 'Improving transparency for bond and derivatives markets' (CP23/32) as if they were made final.]

Insert the following new chapter, MAR 12 (Post-trade risk reduction services), after MAR 11 (Transparency rules for transparency instruments). The text is all new and is not underlined.

12 Post-trade risk reduction services

12.1 Purpose and application

Purpose

12.1.1 G The purpose of this chapter is to specify the *eligible post-trade risk reduction services* giving rise to exemptions to one or more *relevant obligations* and *transparency obligations*.

12.1.2 G The *rules* in this chapter also set out applicable conditions for activities or transactions carried out as part of a *post-trade risk reduction service* to be exempt from one or more of the *relevant obligations* or *transparency obligations*.

Application

12.1.3 R This chapter applies to:

(1) *post-trade risk reduction service providers*;

(2) *relevant financial counterparties*;

(3) *relevant non-financial counterparties*;

(4) *third country investment firms*;

(5) *firms* subject to *COBS* 11.2A; and

(6) *transparency firms* subject to *MAR* 11.

12.2 Exemption from the relevant obligations

12.2.1 R A *relevant obligation* does not apply in respect of a transaction carried out as part of an *eligible post-trade risk reduction service*.

12.3 Exemption from transparency obligations

12.3.1 R The *transparency obligations* do not apply in respect of a transaction carried out as part of an *eligible post-trade risk reduction service*.

12.4 Characteristics of an eligible post-trade risk reduction service

12.4.1 R A *PTRRS* meets the criteria for the purposes of *MAR* 12.2 and *MAR* 12.3 where it:

(1) is provided by a *post-trade risk reduction service provider* which is not:

(a) affiliated to the market participants to whom the service is provided; and

(b) a party to a transaction resulting from the *PTRRS*;

(2) is operated on the basis of non-discretionary rules set in advance by the *post-trade risk reduction service provider* that are based on specified parameters; and

(3) results in a transaction that binds all the participants.

12.5 Applicable conditions for a post-trade risk reduction service provider to be exempt from the relevant obligations and transparency obligations

12.5.1 R A *post-trade risk reduction service provider* must perform a *PTRRS* in accordance with an *eligible agreement*.

12.5.2 R (1) A *post-trade risk reduction service provider* must make public in relation to its service of *portfolio compression*:

(a) the total number of transactions and aggregate volume submitted for compression; and

(b) the total number of transactions and aggregate volume of *derivatives* terminated or modified.

(2) A *post-trade risk reduction service provider* must make public in relation to its *PTRRS*, other than *portfolio compression*:

(a) the total number of new *derivatives* transactions; and

(b) the value of these transactions expressed in terms of aggregate volume.

(3) A *post-trade risk reduction service provider* must make public the information in (1) and (2) no later than the close of the following *business day* after a risk reduction has been completed.

12.5.3 R A *post-trade risk reduction service provider* must maintain complete and accurate records of all the *PTRRS* which they organise or participate in and make the records available to the *FCA* promptly upon request.

12.6 Notification requirement

12.6.1 R A *person* must, prior to providing for the first time a *PTRRS*, notify the *FCA* of:

(1) its intention to rely upon the exemption in *MAR* 12.2.1R and *MAR* 12.3.1R;

(2) the details of each type of *eligible post-trade risk reduction service* that it provides; and

(3) a variation in the type of *eligible post-trade risk reduction service* it provides.

12.6.2 R A *post-trade risk reduction service provider* must notify the *FCA* prior to ceasing to provide an *eligible post-trade risk reduction service*.

12.6.3 R A notification under *MAR* 12.6.1R and *MAR* 12.6.2R must be in writing and must be delivered to the *FCA* by electronic mail at [*Editor's note:* email address to be added].

FCA DIRECTION FOR THE DERIVATIVES TRADING OBLIGATION

1	**Part 1: Direction for the Derivatives Trading Obligation**		
1.1	D	This direction is made by the *FCA* under article 28A of *MiFIR* (Suspension or modification of Article 28), having consulted HM Treasury and other regulators as required by article 28a(4) and (5) of *MiFIR*, and being satisfied within the terms of article 28a(1)(a) and (b) of *MiFIR*.	
1.2	D	This direction shall come into force on 31 December 2024 at 11.01pm GMT.	
2	**Part 2: Interpretation**		
2.1	D	**EU trading venue** has the meaning contained in article 2.1.16B of *MiFIR*. **EU trading venue** also includes a venue in an *EEA State* and *EU persons* include *EEA persons*. A *person*, for these purposes, includes all forms of counterparties to which article 28 of *MiFIR* applies.	
2.2	D	Subject to 2.1D, italicised words and phrases have the meanings contained in the *Glossary* of the *FCA Handbook*.	
3	**Part 3: Modification of the derivatives trading obligation**		
3.1	D	The *FCA* directs that article 28 of *MiFIR* is modified so that a *person* ("A") does not breach it if the transaction is in accordance with (1) to (5):	
		(1)	takes place on an **EU trading venue**;
		(2)	is concluded by A when it transacts with or is executing an order on behalf of an *EU* client;
		(3)	is not a transaction to which article 2(6) of Commission Delegated Regulation (EU) 2017/579, as amended by the Technical Standards (Markets in Financial Instruments Regulation) (EU Exit) (No 1) Instrument 2019 (FCA 2019/47), applies;
		(4)	is one for which A and the *EU* client do not have arrangements to conclude on any *third country* trading venue to which article 28(1)(d) of *MiFIR* applies; and
		(5)	is one to which article 28 of *EU MiFIR* applies.
3.2	D	Article 28 of *MiFIR* does not apply to a transaction concluded by an *EEA UCITS scheme* or *EEA AIF*.	
3.3	D	The direction in 3.1 also applies to *EU firms* required to comply with *MiFIR* as a result of *GEN* 2.2.22AR of the *FCA Handbook*.	
4	**Part 4: Guidance**		

4.1	G	The *UK* derivatives trading obligation in article 28 of *MiFIR* requires certain *persons* to trade in scope derivatives on *UK* trading venues and equivalent *third country* venues when concluding relevant transactions. The current equivalent *third country* venues are in Singapore via the onshored Commission decision (EU) 2019/541 and in the USA via the operation of The Markets in Financial Instruments (Equivalence) (United States of America) (Commodity Futures Trading Commission) Regulations 2024 (SI 2024/638). The relevant *persons*, for these purposes, are "relevant financial counterparties" and "relevant non-financial counterparties" as defined by article 28(1A) of *MiFIR*; and *third country* entities to which article 28(2) of *MiFIR* refers. The relevant transactions are those to which article 28 of *MiFIR* refers.
4.2	G	The effect of this direction is to allow *persons* to continue to trade in scope derivatives on **EU trading venues** in certain circumstances, as an alternative to the eligible trading venues referred to in 4.1G. For example, *UK*-authorised *firms*, including asset managers and *UK* branches of *EU firms*, can execute transactions entered into by *EEA UCITS schemes* or *AIFs*, as the named counterparty, on **EU trading venues**, where required.
4.3	G	The effect of the conditions attaching to the direction is that it does not apply to a *firm* when either (i) concluding a transaction on a proprietary basis whilst not executing an order on behalf of an *EU* client or (ii) transacting with or executing an order on behalf of a client that is not established in the *EU*. It does not apply to a transaction concluded by 2 *third country* entities through their *UK* branches if these entities would qualify as financial counterparties under article 28(1) of *MiFIR*, if they were established in the *United Kingdom*.
4.4	G	When transacting with or executing an order on behalf of its *EU* client, A and the *EU* client do not have arrangements to conclude the transaction on any equivalent *third country* trading venue when the counterparties to the transaction do not have all the necessary access and connectivity to enable them to do so. *Firms* should take reasonable steps to determine whether or not they have arrangements to conclude transactions on equivalent *third country* trading venues, such as ascertaining the access of their clients to any such venue, taking into account previous dealings with them.
4.5	G	The direction does not affect the requirement for **EU trading venues** to carry on an activity with a *UK*-based counterparty only where the **EU trading venue** has the relevant regulatory status, for example, as a *recognised overseas investment exchange*, or where their activities meet all of the conditions required to benefit from the Overseas Persons Exclusion.
4.6	G	*EU firms* which are *third country investment firms* subject to *MiFIR* by virtue of *GEN* 2.2.22AR of the *FCA Handbook* may rely upon this direction in the same way as other *persons*.

4.7	G	The *UK* derivatives trading obligation, as modified by this direction, defines the parameters of where *persons* are able to trade. Within these parameters, *firms* must take all sufficient steps to obtain the best possible results for *clients* when executing orders, as set out in *COBS* 11.2A.2R of the *FCA Handbook*.
4.8	G	The purpose of the direction is to modify the *UK* derivatives trading obligation in order to mitigate the disruption that the *FCA* considers is likely to arise from compliance with onshored obligations, including article 28 of *MiFIR*, and advance one or more of the *FCA's operational objectives*.
4.9	G	This direction may be varied or revoked (without prejudice to any continuing effect in relation to equivalent directions under Part 7 of the Financial Services and Markets Act 2000 (Amendment) (EU Exit) Regulations 2019 (Transitional Powers of the Financial Regulators)).

By order of the Board

[*date*]

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