Financial Conduct Authority

Regulator Assessment: Qualifying Regulatory Provisions

Title of proposal: Conflicts of Interest in Dark Pools (TR 16/5)

Lead regulator: FCA

Date of assessment: March 2016

Commencement date: July 2016

Origin: Domestic

Does this include implementation of a Cutting Red Tape review? No

Which areas of the UK will be affected? N/A

The FCA made an information request and conducted on-site visits to firms operating dark pools to better understand how the pools were promoted to clients and how conflicts of interest arising from use of the pools, whether internal, or externally with clients, were managed. In order to support firms in their existing review and improvement programs for their infrastructure, we subsequently wrote to each firm noting our observations on industry practice as explained to us and any areas of a firm's dark pool operation considered to be weak. We also published a general report to industry reminding operators to adhere to existing rules and describing some good and poor practice that we observed across the peer group.

We found that the degree of adherence to the rules regarding promotion, disclosure and best execution was good with no serious breaches requiring significant action. Senior management was reminded to consider periodically whether their existing processes continued to be sufficiently robust and take their own decisions as to whether they wished to strengthen one area or another in response to external market developments or due to internal expansion or change of their business model.

Most firms had existing development projects underway due to the competitive nature of the business and the need for continuous innovation and investment. We do not envisage that the published report or the letters to firms would result in any significant additional work for firms beyond what we typically expect in the normal course of business as usual investment and process reviews. Most of our comments were to encourage firms to be clear about their strategic thinking rather than to invest in further technological change. Firms were very interested to know how their operating practices compared to those of their immediate peers and this was addressed in a generalised manner via our private and public feedback.

https://www.fca.org.uk/publication/thematic-reviews/tr16-05.pdf

Which type of business will be affected? How many are estimated to be affected?

Fewer than 20 investment banks and stand-alone Multilateral Trading Facilities (MTF's) operate dark pools in the UK and this number is expected to shrink rather than grow as Broker Crossing Network (BCN) pools will be phased out with implementation of MiFID II. Future investment activity by operators will also be limited in this context.

Price base year	Implementation date	Duration of policy (years)	Business Net Present Value	Net cost to business (EANDCB)	BIT score
2016	2016	10	-£1.23	£0.0	£0.5

Please set out the impact to business clearly with a breakdown of costs and benefits

We do not envisage that this thematic review will cause a significant incremental increase in business costs beyond annual review and change costs incurred in the normal course of business. The intention of the review and report was to (a) provide a status report to firms on their implementation of existing rules, (b) remind firms of the need to periodically review their business in the context of existing rules in the context of market developments and their evolving business strategy, and (c) provide comparative feedback to individual firms as to some relative areas of weakness and examples of best practice. No new rules or additional Guidance was introduced by this work as regards the FCA's approach and requirements. All feedback was consistent with existing requirements and what the FCA had already communicated directly to industry and individual firms.

Examples of how firms might reasonably respond to our observations include: review of marketing materials for regional tailoring if needed, considering the adequacy of senior management oversight of what is a complex and fast-developing business activity, improving policies, processes and training materials during the next review cycle. A series of questions were posed that management might incorporate into its internal discussions on best practice assessment. The incremental costs of these optional changes would be de minimus.

No particular systematic breaches were identified that would trigger a need for significant direct investment across the industry or at any individual firms. Conducting a gap analysis on existing processes versus best practice standards would not be burdensome. Firms may choose to continue with their existing processes or strengthen existing systems as they deem appropriate. The major change agents are MiFID II and the Market Abuse Regime (MAR) at the EU level and the questions posed in our review are in the context of initiatives already underway in response to those new regulations.

Although the relevant rules require reviews of the documentation there will be a cost to firms to consider whether they are complying with the rules, and our report is likely to involve firms in additional activity beyond BAU. This would include familiarisation with the reports contents and a gap analysis of their existing processes plus any rectification required.

We assume impact for 20 firms, as a proxy for the extended operator community. We estimate that familiarisation with the report or feedback letters (if received) and a gap analysis versus existing procedures would cost an average of £61,000/firm (90 man days at various staff levels at a weighted average cost of £680/day)[1]. There are no other material, salient factors that can be reasonably quantified.

Please provide any additional information (if required) that may assist the RPC to validate the BIT Score.

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[1] This cost analysis *is based on our broader supervisory knowledge of how firms respond to our thematic review* and directly from informal feedback to the FCA from firms on their response to this publication

It should be noted that firm senior management has a responsibility to periodically review systems and controls and the effort noted above is part and parcel of such periodic reviews rather than supplementary work. Incremental technological changes arising from our report would not be significant but we note that significant technology investment is underway across the industry as a result of MiFID II*

From a qualitative standpoint, it can reasonably be expected that firms will undertake periodic if not annual reviews to assess and improve the quality of processes, controls and related staff training as well as apply renewed vigour to the oversight of client business activity. This is to reflect changes in the industry, target markets or the firm itself (e.g. expansion, new products) rather than regulations. This effort will have the wider impact of helping to improve overall integrity of the UK market.

* Note: Investment by banks operators will be moderated by the fact that Broker Crossing Networks (i.e. their dark pools) will be banned under MiFID II].