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FCA consults on derivatives trading obligation and post-trade risk reduction services

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On 26 July 2024, the Financial Conduct Authority (FCA) published a **consultation paper** (CP24/14) with proposals on three different but interconnected aspects of the derivatives trading obligation (DTO). Supporting the FCA's commitment to strengthen the UK's position in wholesale markets, the proposals seek to improve the regulation of secondary markets in the UK, reduce systemic risk in derivatives markets, and avoid fragmentation and disruption for firms trading over-the-counter (OTC) derivatives subject to the DTO. The consultation is part of the Wholesale Markets Review, which the FCA has been conducting with HM Treasury since 2021.

The FCA is consulting on:

- including certain overnight index swaps (OIS) based on the US Secured Overnight Financing Rate (SOFR) within the classes of derivatives subject to the DTO;
- expanding the list of post-trade risk reduction (PTRR) services exempted from the DTO and from other obligations; and
- how the FCA will use its new power to suspend or modify the DTO once its 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.

List of derivatives subject to the DTO – bringing SOFR OIS into scope

The DTO is implemented in the UK 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 FCA determines the classes of derivatives that are in scope of the trading mandate; however, before bringing classes of derivatives under the DTO, the FCA is required to consider whether the derivatives are:

- subject to the derivatives clearing obligation (CO);
- admitted to trading on at least one regulated trading venue; and
- sufficiently liquid to trade only on those venues.

SOFR OIS were made subject to the CO by the Bank of England in August 2022. The FCA notes that the instruments are also already subject to the US trading mandate, as required by the Commodity Futures Trading Commission (CFTC) since 5 August 2023, and that available evidence about the liquidity of certain SOFR OIS suggests that they are sufficiently liquid to be brought in scope of the UK DTO. The FCA therefore proposes to modify its DTO register to impose the DTO for SOFR OIS to trade start types spot-starting and International Money Market (IMM) (next two IMM dates) with tenors of 1, 2, 3, 4, 5, 6, 7, 10, 12, 15, 20 and 30 years, which mirrors the CFTC's trade execution requirement.

The FCA anticipates that moving SOFR OIS into the scope of the DTO will have a positive impact on liquidity and trading costs. In particular, the FCA expects that shifting trading on to trading venues will reduce fragmentation and increase pre-trade price transparency, and thereby increase liquidity and reduce execution costs due to market participants having better information about prices and addressable liquidity. The FCA also expects that by improving the quality of information available to firms, the risk of market abuse and disorderly trading will be reduced.

Expanding the types of exempted post-trade risk reduction services

Currently, transactions resulting from the risk reduction service of portfolio compression are exempted from the DTO and from other obligations. However, the **Wholesale Markets Review** (WMR) concluded that those exemptions should also apply to trades that arise in relation to other PTRR services.

Following the amendment by the **Financial Services and Markets Act 2023** (FSMA 2023) of Article 31 of UK MiFIR, the FCA now has the ability to make rules to exempt trades conducted as part of PTRR services if it considers it necessary or expedient for the purpose of advancing one or more of its operational objectives. The FCA can also impose conditions or exceptions where appropriate.

The FCA proposes to maintain the existing exemptions for portfolio compression trades and also proposes to expand the exemptions to trades conducted as part of portfolio rebalancing and basis risk optimisation, which are widely used risk reduction tools. Eligible PTRR services would not be subject to:

- the best execution obligation in section 11.2A of the Conduct of Business sourcebook (COBS);
- the trading obligation imposed by Article 28 of UK MiFIR; or
- the obligation in rule 5AA.1.1 in the Market Conduct sourcebook (MAR) to operate a multilateral system as a multilateral trading facility (MTF) or an organised trading facility (OTF).

The FCA sets out the characteristics that risk reduction services would need to satisfy for trades used to conduct them to be eligible for exemption. In particular, the service would need to be:

- provided by a firm that is not party to a transaction resulting from the service,
- operated on the basis of non-discretionary rules based on specified parameters, and
- resulting in a single set of transactions that bind all the participants.

The FCA also proposes to require providers of PTRR services to comply with additional disclosure and notification obligations.

The changes are aimed at advancing the FCA's market integrity objective by strengthening risk management practices, improving transparency, and enhancing the stability and efficiency of the markets. The intention is to improve the OTC derivatives market by removing information about risk reduction transactions that are currently reported to the public but do not support price formation. The FCA also believes that expanding the list of exempted PTRR services will increase the use of such services, which may reduce risk in swap markets and the risk that shocks are amplified, thereby reducing systemic risk in financial markets and the wider economy.

Power to amend or suspend the DTO

Following the UK's departure from the EU, the FCA has been using its temporary transitional powers (TTP) to modify the application of the DTO. In particular, it used the TTP to grant relief to firms subject to the DTO in order to prevent disruption in derivatives trading arising from Brexit. However, with the TTP due to expire on 31 December 2024, FSMA 2023 inserted Article 28a in UK MiFIR giving the FCA a new power of direction to enable it to suspend or modify the DTO if it considers this necessary for the purpose of preventing or mitigating disruption to financial markets and advancing one or more of its operational objectives.

The FCA proposes to exercise this new power in a similar way to how it used the TTP, as it believes the conditions that supported the use of the TTP continue to be relevant. The FCA wants to achieve an outcome equivalent to that achieved by the TTP direction, but it intends to adjust its 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 the EU.

This will enable market participants to continue to trade derivatives subject to the DTO on EU trading venues in certain circumstances. However, firms will still need to satisfy themselves that 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.

Next steps

The deadline for responses to the consultation paper is 30 September 2024. Based on the responses, the FCA will finalise the draft rules, guidance, technical standards and policy statement. It plans to publish its direction on the modification of the DTO in Q4 2024.