Wholesale Markets Review
Securities and Markets, Financial Services Group
HM Treasury
Horse Guards Road
SW1A 2HQ

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Consultation on the wholesale markets review

Norges Bank Investment Management (NBIM) appreciates the opportunity to respond to the wholesale markets review conducted by HM Treasury (HMT). The response we provide is based on our experience as an active participant in UK markets.

NBIM is the investment management division of the Norwegian Central Bank ("Norges Bank") and is responsible for investing the Norwegian Government Pension Fund Global in a globally diversified manner. NBIM held assets valued at GBP 931 billion as of 31 December 2020, of which GBP 67 billion was invested in UK equities and bonds of UK issuers.

As a long-term investor NBIM has a vested interest in well-functioning financial markets that facilitates the efficient allocation of capital and promotes long-term economic growth and thus in a regulatory environment for trading in financial instruments that facilitates such outcomes.

We support the overarching objectives and principles guiding the HMT Wholesale Markets Review of upholding regulatory standards, delivering fair and proportionate regulation, and promoting openness and competitiveness, which are well aligned with our considerations when responding to consultations in different jurisdictions.

Equity markets

We commend the emphasis by HMT on the best outcome for investors in UK markets and the reassessment of current statue that limits the investment firms' ability to achieve this when executing transactions for their clients.

We find that access to trading venues that operate under pre-trade transparency waivers as well as auctions on regulated markets are features of the marketplace that help us access more natural liquidity (effectively let us trade with other end investors) and limit the cost of equity trading as measured by implementation shortfall. For us this measure is a key indicator of market quality.

Pre-trade transparency in equity markets

The price discovery process in equity markets takes place on a liquid and competitive marketplace with multiple venues, electronic order books and firm, transparent bids and offers. This process provides the reference prices when investment firms are to secure best execution for their clients.

Investment firms can use waivers from pre-trade transparency under certain conditions while maintaining their obligation to achieve best execution. This system of waivers from execution on markets with pre-trade transparency (lit markets) are needed to the extent that price discovery and market quality would deteriorate if too small a fraction of trading volume took place on these venues.

The required fraction of trades that need to be conducted on lit markets to provide efficient reference prices and maintain overall market efficacy is uncertain. We are not aware of analysis that estimates this level with any precision, and we would not expect significant deterioration in overall market quality if a somewhat larger fraction of overall transactions were executed without pre-trade transparency. An equilibrium fraction of so-called dark trading consistent with market efficiency could well emerge absent regulation.

We question whether the current regulatory framework limiting the use of pre-trade transparency waivers, specifically the so-called double volume cap (DVC) is an efficient measure to induce market efficiency. The use of transparency waivers in a specific instrument can vary over time for technical or other reasons that have no bearing on the future use of waivers for the instrument. Thus, we share the assessment of the HMT review and welcome the intention to remove the DVC. [Question 28]

A trading venue operating under the "reference price waiver" and matching orders at the mid-point should reflect both the UK and non-UK trading venues and establish a suitable reference price based on a combination of venues, including the market that first admitted the instrument to trading and the most relevant market in terms of liquidity. [Question 30]

We also welcome the intention to consider permitting matched principal trading by an MTF, when such matching is conducted in accordance with clear, transparent and non-discretionary rules. Such matched principal trading would also be executed without pre-trade transparency and be similar to some of the activity conducted on so called "broker crossing networks" prior to MIFID II. In our view the prime responsibility of the firm should be to secure best execution for their clients. From our perspective matched principal trading by an MTF would allow access to natural liquidity and facilitate best execution. Thus, the current restrictions could be repealed. [Question 4]

A related topic is the proposal to allow Systematic Internalisers to execute client orders at the mid-point within the best bid and offer for trades below "Large in Scale", provided the executed price is within the SIs’ quoted prices and the execution is in a size not larger than the quoted size. While mid-point execution is attractive to an end investor like us, we are concerned about potential conflicts of interest introduced by this proposal. Information about trade intentions revealed to the SI in the process of requesting execution may be utilized subsequently by the SI even in the case that the trade was not consummated.

A separate question is whether an investment firm could operate a Systematic Internaliser (SI) and an Organised Trading Facility (OTF) within the same legal entity. We are confident that the current regulation prudently delineates the investment firms own risk taking from the trade facilitation, and do not see the need to explore the possible conflicts of interest that could otherwise arise. [Question 5 and 6]

Trading in equity markets

The Share Trading Obligation (STO) restricts the ability of the investment firm to pursue best execution and is particularly restrictive when a substantial part of liquidity is situated outside of the UK. We agree that the STO is not conducive to price formation or to best execution by investment firms and could be repealed. [Questions 34]

The government proposes to remove obligations on investment firms that pursue algorithmic market making strategies and trading venues to enter into binding market maker agreements, and that non-obligatory incentive schemes may be better suited to achieve the intended objective of increasing liquidity and orderly trading.

We would point out that carefully executed market making strategies in continuous trading and orderly markets should be expected to produce sufficient economic returns over time and that specific incentives or agreements should not be necessary to secure liquidity provisioning or orderly markets. The requirement on trading venues and algorithmic liquidity providers to enter into binding agreements is superfluous. [Question 35]

Non-obligatory incentive schemes offered by trading venues will often take the form of rebates for specific order types at the expense of other order types. The resulting competitive fee structures at different trading venues can be complex and ex post analysis of trade performance require extensive analysis both across venues and between trades on the same venue.

Our concern is that venue competition based on systematic discrimination of order types introduces an agency issue between the investment firm and the customer. Investment firms that trade for an institutional investor client base will usually receive a fixed rate of commission. Fixed rate commissions from clients combined with differentiated and complex trading venues fees create asymmetries that can lead to potential misalignment of incentives. An algorithmic execution which maximises rebates or minimizes the trading fees for the investment firm, may come at the expense of best possible execution for the customer. [Question 36]

Equity market resilience

The issue of market resilience has been accentuated by various technological and cybersecurity incidents that has occurred on various European venues. Multilateral trading facilities and other trading venues should be able to facilitate continuous trading in the listed securities in the instance of disruption at the primary exchange. The closing auction is a particularly important liquidity event and specific contingencies should be in place to secure its execution. A requirement on Regulated Markets to establish continuity arrangements with alternative venues to execute closing auctions in the case of disruption on the primary exchange may be a cost-effective way to establish such contingencies. [Questions 17-19]

Fixed Income and Derivatives Markets

NBIM primarily trade in investment grade fixed income securities across credit and sovereign bonds and our comments pertain to these parts of the market. We share the observation made in the HMT review that MIFID II regulation have not achieved the desired transparency improvements when it comes to fixed income and derivative trading. Consequently, the regulation has had limited impact on market efficiency and price formation.

The lack of timely and complete trade data in Fixed Income and Derivatives markets is a significant shortcoming of the current market structure. The legislative ambition of MIFID II has not been fulfilled. An improved transparency regime that can facilitate the creation of a comprehensive post-trade consolidated tape in fixed income markets would be a significant achievement that could lead to improved price discovery and liquidity in the marketplace.

Pre-trade transparency in bond markets

Current fixed income markets are based on indicative prices, request for quotes, indication of interest and negotiations on a principal to principal basis. Our experience is that the current market is reasonably efficient under normal conditions. The indicative prices and volumes that are available to us through various MTFs is a sufficient basis for necessary pre-trade analysis and a means to obtain firm quotes in the sizes we require. This is not to say that further gains to market quality cannot be achieved through regulatory change that foster real transparency, liquidity and better price discovery.

The information that is currently made available under pre-trade transparency rules is costly and complex to internalise and of limited value from a business perspective. An example is a transparent and distributed offer that is made by a Systematic Internaliser (SI) to a customer. This offer will often not be available to another customer and the information cannot be acted upon. Removing the current pre-trade transparency requirements will not have an impact on our fixed income business.

The HMT proposal to limit pre-trade disclosure requirements to electronic order books and periodic auctions that currently operate under full transparency is a workable alternative. A possible demand-led transition of frequently traded, liquid and standardised instruments

towards trade execution using electronic limit order books or periodic auctions, would increase the role of regulated pre-trade transparency in the future.
[Questions 52-57]

Post-trade transparency in bond markets

The liquid market determination and complex assortment of deferral rules has left the post-trade information hard to interpret. The lack of complete, timely and interpretable data might be one reason why a consolidated tape for fixed income trading has not emerged. We agree that the definition of a liquid market could be simplified, be less dependent on quantitative formula and open for more qualitative assessment of markets on a sectoral basis. [Questions 50-51]

In principle trade information should be disseminated without delay and the rational underlying a deferral regime should be made clear to market participants. We acknowledge that bond markets are dependent on investment firms that use risk capital to facilitate risk transfer and allow market participants to trade large or illiquid positions. An immediate consequence of improved transparency might be to make it more challenging for investment firms to warehouse the resulting risk positions.

As an international investor we are concerned that different transparency regimes might emerge in nearby jurisdictions. We would be particularly concerned if long deferrals of information to the broader market were perceived to be a competitive advantage for the less transparent jurisdictions.

In the longer-term we would expect increased market transparency to lead to better information in the market about actual liquidity and the possibility to transact under different market regimes which would ultimately improve trading conditions. As such there is no optimal deferral length, but rather a path towards less use of deferrals and improved transparency, which should be the policy objective.

The deferral regime should be simplified and be based on easily observable characteristics of the Instrument such as issue size and the trade size to assess the relative liquidity or relative size of a trade. The deferral criteria based on these characteristics could vary with sectoral definitions such as the bond being considered High Yield or Investment Grade. We agree that other deferrals that are currently part of the deferral regime such as the size specific to the traded instrument (SSTI) can be removed.

Aggregation of trade data prior to dissemination is generally unhelpful and subtracts from the usefulness of the data. Volume masking in the sense that volume data is deferred longer than price data might be a pragmatic approach to limit the short-term disruption to the current model of liquidity provisioning. [Questions 58-64]

Market Data

The issue of improved post-trade transparency is closely connected to the question of a Consolidated Tape (CT). Data that would be made available through an improved, simplified, and functional post-trade transparency regime must be disseminated through a CT to realise the potential effect on market quality. The emergence of a CT would alleviate the current opaqueness of fixed income markets and have broad systemic benefits. Thus, the emergence of a CT is key to achieve important regulatory objectives.

The reason why a fixed income CT has so far not emerged may be due both to the quality of the potential product given the limited transparency allowed under current post-trade deferral regulation as well as the business considerations of potential providers given the current pricing regulation.

HMT may consider different ways to support the emergence of a CT. The support could take the form of the regulator requiring Investment Firms or Approved Publication Arrangements to make data available to potential CT providers in a standardized and accessible format at no cost.

A CT should be considered a utility that must provide its service at a “reasonable commercial basis”. Competition between various potential CT providers would ideally lead to technological innovation and price competition. However, the investments a CT provider will have to make in technology to establish the CT might be high and the commercial potential should be limited by regulatory constraints. A first mover into the market could have a strong advantage and CT provisioning may be considered a natural monopoly that offers little potential for commercial competition.

We would support a model that require broad industry participation in the governance of a CT provider to assure that the service is developed and provided on a cost-efficient and non-discriminatory basis.

In equity markets we believe that a real-time CT is likely to come at a high cost and its usefulness relative to current offerings would be limited. A starting point could be to aim for an end-of-day consolidated service offering non-conflated harmonised tick data for a reasonable fee. Such a service may also increase competition among data vendors and exchanges, hence benefiting data users. [Questions 82-91]

Conclusion

We have an interest in encouraging market structure that contributes to the quality and attractiveness of UK markets. We therefore welcome this important consultation of Her Majesty’s Treasury on the wholesale markets.

We appreciate this opportunity to share our perspective and remain at your disposal should you wish to discuss these matters further.

Yours sincerely,

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