

Financial Services Authority

**The UK notification  
process for market-  
making activities  
and primary market  
operations**

September 2011



# Overview

1. As of 1 November 2012 the Regulation (EU) No 236/2012 of the European Parliament and the Council on short selling and certain aspects of credit default swaps<sup>1</sup> ('the Regulation') will be directly applicable in the UK. This will result in the current UK short selling regime being repealed from 1 November and consequently removed from FINMAR 2.
2. The Regulation will require investors to provide notifications to a competent authority of net short positions above 0.2% that they hold in shares, sovereign debt and sovereign credit default swaps (CDS) and disclose to the public any net short positions in the issued share capital once it breaches a higher threshold of 0.5%. The Regulation also places obligations on investors when entering into uncovered short positions in shares and sovereign debt in regards to locating the stock in question.
3. Article 17 provides for certain exemptions for market-making activities and primary market operations specifically for requirements to make notifications and public disclosures of net short positions and the restrictions on entering into uncovered short sales. These exemptions can be used by persons that have made a legitimate notification to the relevant competent authority at least 30 days before the exemption is intended to be employed and where the competent authority has not prohibited its use.
4. The notification procedure is not an authorisation or licensing process by the competent authority.
5. The competent authority can, however, prohibit the use of the exemption at any time, either during the 30 calendar days from receipt of the notification, or subsequently if the conditions of the exemption are no longer be satisfied by the person
6. **The exemptions apply only to the transactions carried out in performance of market-making activities and as authorised primary dealers; it does not apply to the entire scope of activities carried out by the notifying person.**

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1 Regulation (EU) No 236/2012 of the European Parliament and the Council of 14 March 2012 on short selling and certain aspects of Credit Default Swaps, (OJ EU No L 86/1 of 24 March 2012).

7. Article 17(9) and 17(10) require the competent authority to be notified, by a person who has previously given a notification, should any changes occur that affect their eligibility, or intention, to use the exemption.

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# 1 Definitions

## Market-making activities

8. Under Article 2(1)(k) the definition of ‘market-making activities’ are the activities of an investment firm, a credit institution, a third-country entity, or a firm as referred to in point (l) of Article 2(1) of Directive 2004/39/EC<sup>2</sup> (MiFID), which is a member of a trading venue or of a market in a third country, the legal and supervisory framework of which has been declared equivalent by the Commission pursuant to Article 17(2) where it deals as principal in a financial instrument, whether traded on or outside a trading venue, in any of the following capacities:
  - i. by posting firm, simultaneous two-way quotes of comparable size and at competitive prices, with the result of providing liquidity on a regular and ongoing basis to the market;
  - ii. as part of its usual business, by fulfilling orders initiated by clients or in response to clients’ requests to trade; or
  - iii. by hedging positions arising from the fulfilment of tasks under points (i) and (ii).

## Authorised Primary Dealers

9. An ‘authorised primary dealer’<sup>3</sup> is a natural or legal person who has signed an agreement with a sovereign issuer or who has been formally recognised as a primary dealer by or on behalf of a sovereign issuer and who, in accordance with that agreement or recognition, has committed to dealing as principal in connection with primary and secondary market operations relating to debt issued by that issuer.

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2 Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC.

3 As defined in Article 2(1)(n) of the Regulation.

4 The UK notification process for market-making activities and primary market operations (September 2011)

## Competent Authority

10. A person wishing to use the exemption is required to make its notification to the FSA where the UK is the person's home Member State.<sup>4</sup>
11. Authorised primary dealers will be required to make their notification to the competent authority of the Member State of the sovereign debt concerned. Persons requiring the use of the exemption in relation to UK sovereign debt will be required to notify the FSA.
12. Third country entities not authorised in the EU<sup>5</sup> must notify the competent authority of the main trading venue in the EU in which they trade. The third country entity is required to assess its activity in the course of the preceding year on the basis of the turnover (as defined in Article 2(9) of Commission Regulation (EC) No 1287/2006<sup>6</sup>) on a certain venue when performing market-making activities in Europe and identify on which trading venue (i.e. regulated market or MTF) it is the most active. If that venue is within the UK then the notification should be made to the FSA.
13. As with EU entities the relevant competent authority for third country entities acting as authorised primary dealers is the Member State of the concerned sovereign debt. Those entities wanting to use the exemption in relation to UK sovereign debt will be required to notify the FSA.

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4 Article 2(1)(i) of the Regulation

5 Regulation Article 17(8)

6 Commission Regulation (EC) No 1287/2006 of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards recordkeeping obligations for investment firms, transaction reporting, market transparency, admission of financial instruments to trading, and defined terms for the purposes of that Directive.

# 2 Exemptions

14. The provisions of Article 17(1) exempt transactions performed due to market making activities from net short position transparency requirements (Articles 5, 6 and 7) and the restrictions on uncovered short sales in Articles 12, 13 and 14.
15. According to Article 17(3), persons acting as authorised primary dealers are not required to notify net short positions in sovereign debt, are not subject to the restrictions on uncovered short sales in sovereign debt instruments and are not prohibited from entering into a sovereign CDS transaction that results in an uncovered position as referred to in Article 4.
16. Use of the exemptions under Articles 17(1) and 17(3) can only be made where a notification of intent to use the exemption has been made in writing to the FSA<sup>7</sup> at least 30 calendar days before the intended first use of the exemption.
17. The FSA can prohibit the use of the exemption by the notifying person if it considers that the person does not satisfy the conditions of the exemption. The justified prohibition would be communicated in writing within the 30 calendar days of the complete notification being received including all relevant information.
18. The FSA can also, at any time, decide to prohibit use of the exemption where there have been changes in the circumstances of the notifying person so that they no longer satisfy the conditions of the exemption. This may result from our own assessment or from a subsequent notification received from the notifying person indicating a change affecting its ability to use the exemption.<sup>8</sup>

## Scope

19. The exemption under Article 17(1) relates to the market making activities of a person that has properly notified the FSA. It does not exempt of the notifying person for all of their activities.

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<sup>7</sup> Or, depending on when the notification is made, its successor entity. This applies to subsequent references in this note to the FSA.

<sup>8</sup> under Articles 17(9) or (10)

20. To qualify for the exemption market making activities must be undertaken, whether on or outside a trading venue, by the following entities<sup>9</sup>:
- i. an investment firm that deals as principal in a financial instrument in any of the two capacities and related hedging activities specified in Article 2(1)(k); or
  - ii. a credit institution that deals as principal in a financial instrument in any of the two capacities and related hedging activities specified in Article 2(1)(k); or
  - iii. a third-country entity that deals as principal in a financial instrument in any of the two capacities and related hedging activities specified in Article 2(1)(k); or
  - iv. a firm as referred to in point (l) of Article 2(1)<sup>10</sup> of MiFID, that deals as principal in a financial instrument in any of the two capacities and related hedging activities specified in Article 2(1)(k).
21. The entity as defined above can notify its intention to use the exemption if:
- i. it is a member of a trading venue (or a market in a third country with a declared equivalent regime) where,
  - ii. it deals (whether on the trading venue or OTC) as principal in,
  - iii. a financial instrument for which it claims the exemption.
22. If these conditions are satisfied then the market making activities of the notifying entity in or related to that particular instrument may be exempted from Articles 5, 6, 7, 12, 13 and 14 (depending on the class of instrument in question).
23. All persons considering use of the market-making exemption should note the following:
- The exemption only covers activities when, in the particular circumstances of each transaction, they are genuinely undertaken in the capacity of market making as defined in Article 2(1)(k). Consequently, persons notifying the intent to make use of the exemption are not expected to hold significant short positions, other than for brief periods.
  - Arbitrage activities (in particular those executed between different financial instruments but with the same underlying) are not considered market-making activities under the scope of the Regulation and therefore cannot be exempted.
  - When carrying out hedging activities under Article 2(1)(k)(iii), the size of the position acquired for the purpose of hedging should be proportionate to the size of the exposure hedged in order for this activity to qualify for exemption.
  - The notification requirements in respect of sovereign CDS (Article 8) are not exempted under Article 17 of the Regulation. If we suspend the restrictions

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<sup>9</sup> Article 2(1)(k) of the Regulation

<sup>10</sup> Firms which provide investment services and/or perform investment activities consisting exclusively in dealing on own account on markets in financial futures or options or other derivatives and on cash markets for the sole purpose of hedging positions on derivatives markets or which deal for the accounts of other members of those markets or make prices for them and which are guaranteed by clearing members of the same markets, where responsibility for ensuring the performance of contracts entered into by such firms is assumed by clearing members of the same markets.

on entering into uncovered positions in sovereign CDS due to adverse market conditions<sup>11</sup>, persons who held uncovered positions in sovereign CDS would be required to make notifications if the relevant thresholds are breached.

## The Financial Instrument approach

24. Article 17(1) states that the provisions of Article 5, 6, 7, 12, 13 and 14 shall not apply to transactions performed due to market making activities. Those market making activities are defined as dealing as principal in *a financial instrument*<sup>12</sup> (emphasis added). Consequently, the exemption applies to activities in respect of a financial instrument, i.e. on an instrument by instrument basis and should not be considered as a blanket exemption for market making activities in all financial instruments.
25. Any notification submitted should refer to a particular share or shares or sovereign issuer. The market-making activities which could be subject to the exemption should therefore be in relation to:
  - i. shares of an issuer subject to the Regulation;
  - ii. sovereign debt issued by a sovereign issuer as defined by the Regulation; or
  - iii. CDS on sovereign debt of a sovereign issuer as defined by the Regulation.

## Related instruments

26. The exemption for market-making activities is therefore in respect of three categories of instruments: (i) shares; (ii) sovereign debt; and (iii) sovereign CDS which are within scope of the transparency requirements and restrictions.
27. However, because market-making activities as defined in Article 2(1)(k) of the Regulation might be carried out on other financial instruments related to these instruments it should be acknowledged that the exemption can also be employed in respect of the related instruments; e.g. (but not limited to) derivatives.
28. When notifying the intention to use the exemption for market making activities in these related instruments the notifying entity should provide information regarding the underlying basic instrument and the category of the related financial instrument pursuant to section C of Annex I of MIFID on which the market-making activity are carried out. The FSA is prepared to treat sovereign CDS as a related instrument to sovereign debt as well as a basic instrument in its own right for the purposes of the market maker exemption.

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11 Article 14

12 Article 2(1)(k)

## Trading Venue Membership requirements

29. Any person intending to make use of the exemption for market making activities and notifying us of their intention will need to be a member of a trading venue<sup>13</sup> or of an 'equivalent' market in a third country where it deals as principal in a financial instrument in any of the two capacities and related hedging activities specified in Article 2(1)(k) of the Regulation.
30. Entities domiciled outside the EEA intending to make use of the exemption will need to be a member of an EEA trading venue or of a market in a third country whose legal and supervisory framework has been declared equivalent by the Commission pursuant to Article 17(2).<sup>14</sup>
31. In either case, the instrument in question will need to be admitted to trading or traded on that venue or market of which the person is a member. In the case of a related financial instrument it will be sufficient for the membership to be of a trading venue on which the underlying instrument is admitted to trading.
32. If the notification is in relation to a related instrument (e.g. an option, ETF, etc) it is not necessary for the notifying entity to also be a member of the trading venue where the underlying instrument is traded (unless they are notifying of the intention to use the exemption for the underlying as well). However, for each instrument for which the exemption is to be used the entity will need to be a member of a trading venue on which that related instrument is traded.
33. It should be noted that the notifying person is not required to conduct the market making activities on that venue or market where the membership exists, nor is it required to be recognised as a market maker or liquidity provider under the rules of that trading venue or market. There is also no requirement to have a separate contractual obligation to carry out market making activities.

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13 A regulated market or multilateral trading facility (MTF) as defined in Article 2(1)(l) of the Regulation.

14 As of 12 September 2012 no markets have been designated as equivalent by the Commission under Article 17(2) of the Regulation.

# 3 General principles and criteria of market making activities

For entities notifying of their intention to use the exemption under Article 2(1)(k)(i) of the Regulation: ‘posting firm, simultaneous two-way quotes of comparable size and at competitive prices, with the result of providing liquidity on a regular and ongoing basis to the market’.

34. An entity that intends to make use of the exemption on this basis should be able to show that it fulfils the following criteria in relation to the specified instruments. That it:
  - i. posts firm, simultaneous two-way quotes of comparable size;
  - ii. at competitive prices; and
  - iii. on a regular and ongoing basis to the market.
35. Fulfilment of these criteria could be demonstrated by, for example, providing evidence of a contractual arrangement with a trading venue to provide such services. However other evidence may be relevant.
36. The notifying entity should be able to demonstrate to the FSA upon request that it continues to meet these criteria.
37. Those entities notifying their intention to use the exemption as an **authorised primary dealer** will be required to provide evidence of their agreement with the UK sovereign issuer or provide a record of their formal recognition as a primary dealer on behalf of the UK sovereign issuer.

For entities notifying of their intention to use the exemption under Article 2(1)(k)(ii) of the Regulation: when dealing ‘as part of its usual business, by fulfilling orders initiated by clients or in response to clients’ requests to trade’.

38. The main principle for these entities is that they are able to confirm that dealing on this basis in the relevant instrument is part of its ‘usual business’ in that particular instrument. The entity should therefore consider:
  - i. to what extent it already deals on a frequent and systematic basis in the instrument in question - activities performed on an ad hoc and irregular basis

will not be considered to constitute 'usual business' for the purposes of the exemption notification;

- ii. the scale of activity in comparison to the proprietary trading in the instrument; and
  - iii. the characteristics of the instrument in question (e.g. its trading patterns).
39. Where the entity does not yet fulfil orders on behalf of clients as part of its 'usual business' in the relevant instrument but wishes to use the exemption it must have a reasonable expectation of doing so in the future.
40. It is clear that in order to use the exemption, however, the person must be fulfilling actual client orders or responding to actual client requests to trade and not dealing in anticipation of client orders or requests.

# 4 Notifications

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41. The recent ESMA consultation paper<sup>15</sup> (the ESMA CP) makes clear that notifications must be made by instrument and in the form of a closed list that enables instruments to be unambiguously identified by the competent authority. Firms should therefore be aware that we will reject any notifications that do not provide such a list.
42. The ESMA CP sets out the content requirements for notifications (paragraph 69) and we will be providing notification forms that can be used to provide this information to us.

## Timings

43. Articles 17(5) and 17(6) require that in order for an exemption to be used it must be notified to the competent authority 30 days before the person intends to make use of it. So for entities to be able to rely on an exemption for 1 November the FSA must receive a legitimate notification at the latest by 2 October.
44. It should be noted that the 30 day period is the maximum period and if we are comfortable that we are not prohibiting the use of an exemption inside this period we reserve the right to notify the entity of their ability to use the exemption in a shorter timeframe.

## Contact

45. Notifications can be made by email to [SSRMarketMaker@fsa.gov.uk](mailto:SSRMarketMaker@fsa.gov.uk) or by post. Please address post to Short Selling Market Maker Exemptions, Markets Division, Financial Services Authority, 25 The North Colonnade, Canary Wharf, E14 5HS.

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15 Consultation paper: Exemption for market-making activities and primary market operations under Regulation (EU) 236/2012 of the European Parliament and the Council on short selling and certain aspects of Credit Default Swaps.

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