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Brexit Law – your business, the EU and the way ahead

Brexit Statutory Instruments – a series of briefings

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Markets in Financial Instruments (Amendment) (EU Exit) Regulations 2018

This paper is part of a series of briefings for clients and contacts of Allen & Overy on the review of financial services statutory instruments (**SIs**) to be laid down under the European Union (Withdrawal) Act 2018 (the **Withdrawal Act**).

Introduction

The purpose of the SIs is to help with a range of legal issues caused by the UK's exit from the EU. One of the main issues is deficiencies in retained EU law that may occur from the UK's exit.

The revised Markets in Financial Instruments Directive (**MiFID**) and the Markets in Financial Instruments Regulation (**MiFIR** and together with MiFID referred to as **MiFID II**) are the key pieces of EU legislation that govern the conduct and operation of EU financial markets participants. MiFID II governs the buying, selling and organised trading of financial instruments such as shares, bonds, units in collective investment schemes and derivatives. MiFID II took effect in early 2018 and aimed to create more robust and efficient market structures introducing requirements for more transactions to be conducted through trading venues, increasing transparency, introducing safeguarding for algorithmic and high frequency trading and strengthening investor protection.

MiFID II also contains the rights for EEA investment firms to provide investment services cross-border within the EEA and also to establish branches in another EEA state on the basis of their authorisation in their home member state.

What does the MiFID SI do?

The Markets in Financial Instruments (Amendment) (EU Exit) Regulations 2018 (the **MiFID SI**) seeks to provide a backstop that ensures the continued functioning of MiFID II in the UK, were the UK and EU to fail to come to agreement on a withdrawal deal by 29 March 2019. It therefore assumes that there will be no cooperation with EU authorities. The MiFID SI aims to ensure that the UK financial markets continue to operate in a fair and transparent manner post EU withdrawal and ensures that investors will continue to be afforded the same protections as today. The changes in the MiFID SI will not take effect on 29 March if a transitional agreement with the EU is reached.

Modified application of requirements for firms operating under the Temporary Permissions Regime

The EEA Passport Rights (Amendment, etc, and Transitional Provisions) (EU Exit) Regulations 2018 establish a temporary permission regime (**TPR**) for EEA firms which have exercised passporting rights in the UK at the point of exit. The MiFID SI provides transitional relief for such firms in respect of certain of the rules under MiFID II and MiFIR. Specifically:

- the post-trade transparency, transaction reporting and financial instrument reference data reporting requirements of MiFIR are disapplied for firms operating under the TPR on a cross-border services basis (but will apply to firms operating under the TPR with branches)
- it purports to disapply the requirements of MiFIR relating to transparency where a firm operating under the TPR complies with the equivalent provisions under the EU MiFIR
- similarly, it purports to disapply Chapter II (organisational requirements), III (operating conditions) and VI (data provision obligations of data reporting service providers) of the onshored MiFID Org Regulation where a firm operating under the TPR complies with the equivalent provisions under the EU MiFID Org Regulation

Changes to the transparency regime

MiFIR introduced wide-ranging pre-trade and post-trade transparency requirements to EU markets. These are based on various thresholds (liquidity, double volume cap) derived from calibrations against the EU markets as a whole. This presents challenges post-Brexit, as those thresholds will no longer be appropriate to the UK market. This issue could be dealt with by recalibration (or removal) of the transparency standards or by continuing to adhere to an 'EU plus UK' transparency regime based on the existing standards by agreement with the EU, should the EU be willing to do so. Reflecting this uncertainty, and to provide the flexibility for the UK to take any option, the MiFID SI grants broad-ranging temporary powers for a period of up to four years from Brexit to the UK Financial Conduct Authority (**FCA**) with respect to the operation of the transparency regime. These new FCA powers include the ability for the FCA to:

- suspend the transparency requirements in respect of certain instruments
- amend transparency calibrations and direct the application of the double volume cap mechanism
- determine the 'relevant area' for transparency calculation

Alignment of treatment of EU states with that of third countries

Consistent with the policy approach of the government on Brexit, the MiFID SI generally provides that EU states are treated as third countries. As a result, concepts in MiFID II and MiFIR which extend on an EU-wide basis are generally redrawn to cover the UK only (for example the concept of a regulated market is changed from EU-regulated markets to UK-regulated markets). However, certain exceptions to this general approach have been made "to help provide for a smooth transition for market participants by maintaining existing outcomes as far as possible". The exceptions include:

- EEA emission allowances will continue to be a financial instrument.
- Energy forwards that must be physically settled and are traded on Organised Trading Facilities (**OTFs**) in the EU will continue to be excluded from the definition of financial instruments.
- The Ancillary Activities Exemption (**AAE**) will continue to be based on UK and EU market data. There will be a separate SI to fix deficiencies in the Regulated Activities Order (**RAO**), which will maintain the current provision granting firms an exemption from the general prohibition on carrying out a regulated activity, until they can perform the annual calculation determining whether they still meet the terms of the AAE. If the calculation indicates that they no longer qualify for the AAE, then the exemption under the RAO will continue, provided they seek authorisation as a MiFID investment firm within a specified period.
- UK firms will be able to treat Undertakings for Collective Investment in Transferable Securities (**UCITS**) in the EU as automatically non-complex instruments.

Temporary permission regime for data reporting service providers

The MiFID SI introduces a temporary permission regime for EU-authorised data reporting service providers of up to one year.

Transfer of functions, deletion of cooperation arrangements and incorporation of equivalence decisions

Consistent with the other SIs, the MiFID SI transfers functions performed under MiFID II (including equivalence decisions) by EU authorities to the corresponding UK authorities and responsibility for Binding Technical Standards (**BTS**) to the relevant UK regulators, and deletes provisions relating to information sharing and cooperation with EU

authorities. Responsibility for making BTS, including responsibility for correcting deficiencies in MiFID II BTS so that they operate effectively immediately on exit day and remain fit for purpose after exit has been transferred to the regulators. This is consistent with the Financial Regulators' Powers (Technical Standards etc) (Amendment etc) (EU Exit) Regulations 2018. Existing equivalence decisions will be incorporated into UK law.

Legislation amended by the MiFID SI

EU legislation

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 (**MiFIR**)

Commission Delegated Regulation (EU) 2017/565 of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive (the **MiFID Org Regulation**)

Commission Delegated Regulation (EU) 2017/567 of 18 May 2016 supplementing Regulation (EU) No 600/2014 of the European Parliament and of the Council with regard to definitions, transparency, portfolio compression and supervisory measures on product intervention and positions (the **MiFIR Delegated Regulation**)

UK legislation

Financial Services and Markets Act 2000 (Markets in Financial Instruments) Regulations 2017 (SI 2017/701) (the **MiFI regulations**)

The Data Reporting Services Regulations 2017 (SI 2017/699) (the **DRS regulations**)

Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (the **RAO**)

Areas identified by industry as requiring further consideration

How will substituted compliance work for TPR firms?

The substituted compliance concepts applicable to firms operating under the TPR are unclear in a number of respects: they seem to contemplate compliance with the EU rules amounting to compliance with the onshored rules where the former have equivalent effect, but in many cases the EU rules will not have equivalent effect (for example, if UK and EU transparency calibrations diverge).

It is not yet clear how the FCA is intending to supervise firms that are subject to the onshored UK MiFID regime when providing services into the UK on a cross-border basis, including under the temporary permissions regime. This will be discussed in a separate briefing.

Transparency – practical operation and consequences of FCA's new discretionary powers

It is unclear from the MiFID SI exactly how the FCA will exercise and communicate the exercise of its new powers to market participants. There are a number of practical difficulties that could arise for both market participants and the FCA depending on the functioning of these new powers that could for instance lead to firms maintaining multiple datasets for different aspects of the transparency and transaction reporting regimes, uncertainty as to whether or not trades executed on an EU27 venue are classed as OTC, lack of clarity around which area should be used for liquidity assessments for shares, or pre-Brexit EU-wide data sets distorting calculations in the new post-Brexit regime. It is also not clear how transparency will operate for firms in the TPR.

It is also important to note that in order for the FCA to include another jurisdiction within the 'relevant area' for transparency purposes the FCA will need to be provided the relevant data by the local competent authority. It is still unclear whether or not any regulators will share this information. As a result there is still significant uncertainty around the future 'relevant area' for the purposes of the onshored UK transparency regime and it remains likely that the area for transparency calculations will be different for the UK and the EU post-Brexit.

Transaction reporting – practical consequences for reporting gaps

Under the draft MiFID SI, UK firms will be required to report transactions in instruments which are traded on UK or EU venues and UK venue operators will be required to report reference data for instruments that are trading on those UK venues. There are several open issues around the mismatch between the transaction reporting and transparency requirements, including as to how financial instrument reference data about EU-traded instruments will pass to the FCA, and what reference data UK systematic internalisers will be required to report post-Brexit in relation to EU instruments which are not trading on a UK venue.

Cooperation agreements and cliff edge risk

The onshored UK regime has retained the requirement set out in the MiFID Org Regulation that portfolio management can only be delegated by a UK firm to a firm that is based in a jurisdiction where the competent regulator has entered into a cooperation agreement with the UK regulator. The UK regulators do not currently have any live cooperation agreements in place with national EEA regulators that would allow for the continued delegation of portfolio management from a UK firm to an EEA firm post-Brexit. As a result, if this regulation is not amended and if there are no cooperation agreements in place before 29 March 2019 then there is a risk that UK firms will no longer be able to delegate portfolio management to EEA-based portfolio managers.

Trading obligation

It is not clear that trading on an EEA-trading venue would satisfy the new UK trading obligation (for both shares and derivatives) post-Brexit and whether or not an equivalence decision will be granted pre-Brexit and also whether or not any cooperation and reciprocity agreements would be in place. As a result there is a risk that post-Brexit, EEA trading venues cease to be eligible venues and trading will be required to be concentrated into UK venues.

What does this mean for you?

The changes to the current MiFID regime that will be introduced by the MiFID SI (and any future changes made by the FCA under its current four-year discretion) have the potential to create a number of new compliance and operational burdens for the full range of UK market participants.

The new transaction reporting and transparency regimes, and how they are applied, will need to be monitored closely. Once final versions of the rules have been published together with any regulatory guidance, firms will need to start considering the impact on their current reporting systems to determine where this reporting will need to change. Current waivers may also need to be re-evaluated as the data underpinning their calculation may be subject to change.

Any EU firms carrying out business on a cross-border basis into the UK should take steps to ensure that they are aware of any new UK MiFID obligations with which they must comply and should consider closely how they can manage simultaneous compliance with both EU MiFID and UK MiFID.

Firms should review existing trading behaviours to consider alternative venues in the event that EEA venues cease to be eligible venues for any instruments subject to the trading obligation.

Next steps

- HM Treasury intends to lay the statutory instrument before Parliament early in the autumn.
- The FCA and PRA intend to consult on changes to the MiFID II BTS in the autumn, the first FCA consultation paper was published on 10 October 2018 and is available here: https://www.fca.org.uk/publications/consultation-papers/cp18-28-brexit-proposed-changes-handbook-bts-first-consultation

Your Allen & Overy contacts

For further information please speak to:

Bob Penn, Damian Carolan, Etay Katz, Kate Sumpter, Nick Bradbury,Ben Regnard-Weinrabe or your usual Allen & Overy contact.