“Onshoring” Statutory Instruments Comment Series: Markets in Financial Instruments

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Financial Markets Law Committee[1]

This paper has been prepared by the FMLC Secretariat.[2]

[1] In view of the role of the Bank of England, the Financial Conduct Authority and HM Treasury in the U.K.'s preparations for withdrawal from the E.U., Sinead Meany, Sean Martin and Peter King took no part in the preparation of this paper and the views expressed should not be taken to be those of the Bank of England, the FCA and HM Treasury.

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1. EXECUTIVE SUMMARY AND INTRODUCTION

1.1. The role of the Financial Markets Law Committee (the "FMLC" or the "Committee") is to identify issues of legal uncertainty or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks and to consider how such issues should be addressed.

1.2. In June 2016, the U.K. voted by way of an in/out referendum to withdraw from the European Union (known colloquially and in this paper as "**Brexit**"). On 29 March 2017, HM Government took the first step in the withdrawal process and officially served notice to the E.U. of the U.K.'s withdrawal under Section 50 of the Treaty on European Union ("**TEU**"), beginning a two-year "notice" and negotiation period, and setting the date on which the U.K. will withdraw from the E.U. ("**Exit Day**") as 29 March 2019.[3] A post-Brexit longer-term relationship is, as yet, undecided and, therefore, preparations on the domestic front have focused on a "no deal" eventuality.[4]

1.3. A key element in HM Government's plan to ensure continuity in law during and after Brexit in the U.K. is the European Union (Withdrawal) Act 2018 (the "**Withdrawal Act**") which aims, *inter alia*, to incorporate into U.K. law all applicable E.U. legislation and to give powers to Ministers to make such amendments to retained law as are necessary to deal with any deficiencies arising from withdrawal.[5] In furtherance of these aims, HM Treasury has begun to publish drafts of statutory instruments ("**SIs**") which will "onshore" E.U. legislation related to the financial markets.[6]

1.4. This paper considers legal uncertainties arising from the changes proposed by the draft Markets in Financial Instruments (Amendment) (EU Exit) Regulations 2018 (the "**draft MiFI SI**"). The draft MiFI SI makes amendments to retained law derived from

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3 Legislative provisions defining Exit Day as 29 March 2019 can be found in the European Union (Withdrawal) Act. Section 20(4) of that Act gives a Minister of the Crown the power to amend the definition of Exit Day so that it correctly refers the day on which the E.U. Treaties cease to apply to the U.K.

4 Discussions between the U.K. and the E.U. to agree on a post-Brexit deal are underway—and a 21-month transitional or "implementation" period during which the U.K. will continue to participate in the single market and customs union has been tentatively agreed. See, Blitz, J., "UK and EU agree 'decisive step' with 21-month Brexit transition", Financial Times, (19 March 2018), available at: https://www.ft.com/content/f418a8b2-2b69-11e8-9b4b-bc4b9f08f381.

5 Text of the European Union (Withdrawal) Act 2018 is available at: http://www.legislation.gov.uk/ukpga/2018/16/pdfs/ukpga_20180016_en.pdf.

6 A list of the statutory instruments published in relation to the financial services, included those which have been put before Parliament for approval, can be found on the following webpage: HM Government, *Financial services legislation under the EU (Withdrawal) Act 2018,* (first published 9 August 2018), available at: https://www.gov.uk/government/collections/financial-services-legislation-under-the-eu-withdrawal-act?utm_source=ed3e24c1-615b-4397-a940-f10eb4c57fcd&utm_medium=email&utm_campaign=govuk-notifications&utm_content=immediate.

Directive 2014/65/EU on markets in financial instruments ("**MiFID II Directive**") and Regulation (EU) No 600/2014 on markets in financial instruments ("**MiFIR**") (known collectively as "**MiFID II**"). These are the key pieces of E.U. legislation which govern the buying, selling and organised trading of financial instruments, such as shares, bonds, units in collective investment schemes and derivatives. MiFID II has been implemented in the U.K. through several pieces of domestic secondary legislation, including the Financial Services and Markets Act 2000 (Markets in Financial Instruments) Regulations 2017 (the "**MiFI Regulations 2017**"), the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (the "**RAO**") and the Data Reporting Services Regulations 2017. Each of these is also amended by the draft MiFI SI.

1.5. As with all the SIs published in pursuit of the aims of the Withdrawal Act, the FMLC understands that the draft MiFI SI has been laid before Parliament with the intention of implementing a policy position arising from a "no deal" Brexit. The Committee does not comment on matters of policy or the form that future regulatory approaches, if any, should take and this report should not be understood to constitute comments thereon. Nevertheless, the Committee has drawn attention to some legal and operational uncertainties which will arise in a "no deal" context in which it is anticipated the draft investment fund SIs will be implemented.

2. LEGAL UNCERTAINTIES AND IMPACT

<u>References to other legislation</u>

2.1. As the legislation amended by the draft MiFI SI contains cross-references to definitions, standards and rules from other relevant pieces of directly applicable, domestically implemented (pre-Brexit) or retained (post-Brexit) E.U. law, the SI caveats such references by inserting into the amended law provisions to freeze the referenced law or rules. The FMLC notes, generally, that these provisions freeze the law at two points in the future so as to allow market participants to plan for a post-Brexit, "no deal" future. In amending domestic secondary legislation, regulations 2 and 3 of the SI insert paragraphs which instruct readers that any references to E.U. regulation, decision or tertiary legislation are to be read as references to the law "*as it has effect on the day on which the Markets in Financial Instruments (Amendment) (EU Exit) Regulations 2018 are made*". References to sourcebooks published by the U.K.'s Financial Conduct Authority

("**FCA**") are to be taken as references to rules made and guidance issued by the FCA *as it has effect on Exit Day*.[7]

2.2. While the FMLC understands the practical need to have a snapshot of E.U. law as of the date on which the MiFI SI is made—that is, because certain provisions of the MiFI SI come into force not on Exit Day but on the day after the SI is made—this does give rise to two potential areas of complexity. First, the Committee is unsure about how the SI as currently drafted, with references to E.U. legislation "as of the date on which these Regulations are made", will take into account any changes in E.U. law—including, for example, *via* opinions of the European Court of Justice—in the *interregnum* before Exit Day. Second, and similarly, the Committee observes that the SI would have to adapt were the proposed 21-month implementation period to be agreed, during which the U.K. will continue to receive E.U. law which comes into effect. In that case, the cross-references in the SI to other E.U. legislation which were cut-off by Exit Day will presumably be amended to refer to a cut-off date which is the date at which the implementation period ends. A similar exercise would be needed for references to the day on which the draft SI is enacted, which gives rise to concerns that the existence of two snapshots will complicate the continued reception of E.U. law.

2.3. There is, of course, the related question of how the law will evolve as and when the FCA updates relevant sections of the Handbook—the FMLC notes that, in order for the law to refer to the correct version of the FCA Handbook, a new SI might be necessary to correct the reference. Such additional steps—and the potential for a gap in the time between the amendment to the FCA Handbook and the relevant legislation being updated—carry potential legal and operational uncertainty. For example, the definition of professional client in Article 2 of the onshored MiFIR is amended include a reference to requirements set out in Chapter 3.5 of the Conduct of Business sourcebook. Any time these requirements are updated, various pieces of retained law will also need to be amended. The FMLC would recommend that HM Treasury and/or the FCA clarify how subsequent updates to guidelines and rules will be reflected in the legislation.

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[7] Regulation 26 of the MiFI SI inserts into Article 2 of the onshored version of MiFIR the following clauses:

> (64) any reference in this Regulation to a sourcebook or manual is to a sourcebook or manual in the Handbook of Rules and Guidance published by the FCA containing rules made by the FCA under FSMA as the sourcebook or manual has effect on exit day;
>
> (65) any reference to the PRA rulebook is to the rulebook published by the PRA containing rules made by that Authority under FSMA as the rulebook has effect on exit day.

"Onshored" MiFIR and E.U. MiFIR

2.4. Chapter 1 of Part 4 of the draft MiFI SI onshores MiFIR. The draft MiFI SI refers to—and inserts provisions into the onshored version of MiFIR which refer to—"this Regulation". The term is used, however, interchangeably in reference to both the version of MiFIR "as it applies in the E.E.A." (i.e., E.U. MiFIR) (see paragraph 2D(a) inserted into Article 1 of the onshored MiFIR by regulation 25(3)) as well as the version of MiFIR "as it apples in the U.K." (i.e., onshored MiFIR) (see Article 1 new paragraph 2D(b)). In other places, however, the term "this Regulation" appears without a geographic qualifier such as in the new paragraph 2C added to Article 1 of onshored MiFIR which asserts that "This Regulation does not apply to any firm which has permission under Part 4A of FSMA to carry on regulated activities …" In this iteration, the reference is, evidently, to onshored MiFIR.

2.5. The FMLC is certain that, in view of the substantial work which has evidently gone into drafting the SI, HM Treasury is aware of this terminology. Nevertheless, the FMLC would like to highlight complexity which is introduced by referring to both E.U. MiFIR and onshored MiFIR using the term "this Regulation".

Information and thresholds published in the E.U. after exit day

2.6. Finally, Article 4 of the onshored MiFIR gives the FCA the ability to waive the obligation for market operators and investment firms operating a trading venue to make public certain pre-trade information. Article 5 of that onshored regulation sets out certain qualifications to the application of such a waiver, including the FCA's power to suspend the use of such a waiver during the temporary permissions period. Regulation 27(2)(d), therefore, adds to Article 5 of the onshored version of MiFIR the following provision.

> 3D In deciding whether to suspend the use of a waiver under paragraph 3B, or to renew a suspension under paragraph 3C, the FCA—
>
> (a) must also take into account—
>
> i. its consumer protection objective and competition objective under sections 1C and 1E of FSMA;
>
> ii. the thresholds applying under Article 5 of this Regulation as it has effect in the European Union; and

iii. the most recent information published by ESMA under Article 5(4), 5(5) and 5(6) before exit day;

[…]

This new provision gives rise to questions about the extent to which thresholds and information published in the E.U. will continue to have an impact on the FCA's determination. More specifically, if sufficient information on trading is available in the E.U., will that imply an automatic suspension of waivers in the U.K. Similar wording as in 3D(a)(iii) is used in Article 9(4B)(ii) (*Waivers for non-equity* instruments) and 11(2B)(ii) (*Authorisation of deferred publication*) and the same question arises in these cases. Clarification by way of amendment to the SI or through the publication of further guidance by HM Treasury would help set expectations and provide certainty.

"Equivalent effect"

2.7. The draft MiFI SI adds in the onshored version of MiFIR a number of provisions which explain how this domesticated MiFIR will apply upon Brexit. One provision, the new paragraph 2D inserted into Article 1 of MiFIR states:

> Subject to paragraph 2E, if—
>
> (a) a firm referred to in paragraph 2A complies with a requirement in this Regulation as it applies in the EEA ("the EEA requirement") in relation to the services it provides in the United Kingdom; and
>
> (b) the EEA requirement has equivalent effect to a requirement in this Regulation as it applies in the United Kingdom ("the UK requirement"),
>
> the firm is to be treated as complying with the UK requirement.

2.8. The FMLC appreciates that it is likely that the purpose of this provision is to reduce the possibility of unnecessary and duplicative requirements being imposed upon market participants. It is, however, unclear how this would apply in cases where provisions have a different impact under MiFIR in the E.U. and onshored MiFIR in the U.K. For example, transparency calculations might have a different impact because they are based on different "relevant areas". Would such requirements be considered to have equivalent effect? The FMLC recommends that HM Treasury issue guidance to firms on the circumstances in which "equivalent effect" will apply.

__**New powers for the Financial Conduct Authority**__

2.9. The draft MiFI SI, in order to remove the U.K. from the E.U.'s regulatory framework for financial services, has shifted the powers and functions which originally were bestowed upon the European Securities Market Authority ("**ESMA**") to bring them into the purview of the FCA. Regulation 7(3)(a) of the draft MiFI SI substitutes regulation 3(1) of the MiFI Regulations 2017 with a provision designating to the FCA "all functions of a competent authority" which are provided for in FSMA, the markets in financial instruments regulation,[8] and rules made by subordinate legislation made under FSMA conferring functions on the FCA. These new functions and powers are wide-ranging and the FMLC is aware that the FCA has initiated consultations already on its proposals to amend its Handbook and Binding Technical Standards.[9] Nevertheless, there are areas where further guidance, both to and from the FCA in respect of its new functions, would provide market certainty.

2.10. As mentioned above, Article 4 of the onshored MiFIR, for example, gives the FCA the ability to waive the obligation to publish certain pre-trade information. Article 5 of that onshored regulation sets out certain qualifications, including the use of the power in the temporary permissions period, and replaces the applicability of such a waiver from being across the "Union" by the term "the relevant area". Article 5(10) states that

> "the relevant area" consists of the United Kingdom and those countries or regions specified by the FCA by direction in accordance with Article 50B.

A similar structure is used for the designation of waivers for non-equity instruments in Article 9 of the onshored MiFIR. While Article 50B provides helpful instructions regarding oversight by HM Treasury, it is unclear what factors the FCA will take into account in designating the "relevant area".

2.11. Similarly, Article 26 of the onshored MiFIR requires investment firms which execute transactions in financial instruments shall report complete and accurate details of such

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[8] The MiFI Regulations 2017 and the Data Reporting Services Regulations 2017 both refer to MiFIR as the "markets in financial instruments regulation". As explained above, Regulations 2 and 3 of the draft MiFI SI insert provisions which dictate that any references to E.U. regulation are to be read as references to the law "as it has effect on the day on which" the draft MiFI SI is made. This provision, then, gives the FCA the powers assigned to competent authorities in MiFIR as of the day on which the SI is made.

[9] Financial Conduct Authority, *CP18/28: Brexit: proposed changes to the Handbook and Binding Technical Standards – first consultation* (10 October 2018), available at: https://www.fca.org.uk/publications/consultation-papers/cp18-28-brexit-proposed-changes-handbook-bts-first-consultation and CP18/36: *Brexit: proposed changes to the Handbook and Binding Technical Standards – second consultation* (23 November 2018), available at: https://www.fca.org.uk/publications/consultation-papers/cp18-36-brexit-proposed-changes-handbook-and-binding-technical-standards-second-consultation.

transactions to the competent authority. In Article 26(9) of MiFIR, ESMA was originally required ("ESMA shall …") to develop technical standards to specify, *inter alia*, data standards, formats and categories for the reporting of such transactions. The onshored MiFIR has removed the requirement for this, only stating that the "FCA may make technical standards …" This seems to be a light-handed approach. While ESMA's technical standards will be incorporated into U.K. law by the Withdrawal Act, market participants rely quite heavily on informal guidance issued by ESMA. The FCA's current expectation, set out in Annex III of the Consultation Paper mentioned above, is that market participants continue to apply informal guidance "appropriately" and with regard to the U.K.'s withdrawal from the E.U. It would be helpful if more guidance were issued to the FCA and the market in relation to such functions.

3. RECOMMENDATIONS AND CONCLUSION

3.1. In this paper, the FMLC has highlighted legal uncertainties arising from the draft statutory instrument which will onshore the MiFID II regime. These have included uncertainties related to: (1) references to other legislation; (2) the new requirement to determine whether E.U. regulatory requirements have "equivalent effect"; (3) information and thresholds published in the E.U. after exit day; and (4) the new powers and functions given to the FCA. In view of the substantial work which has evidently gone into drafting the SIs, the FMLC is certain that HM Treasury has already taken into account both the drafting and policy issues highlighted above. The FMLC would, nevertheless, encourage HM Treasury and HM Government to publish, wherever possible, guidance which might enable impacted funds and managers to begin planning for the future.

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