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UK implementation plans for MiFID II and MiFIR

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UK based firms should review the recently published HM Treasury and FCA papers regarding the implementation details for MiFID II and MiFIR. Nonetheless, there will remain a considerable amount of work to be done much closer to the implementation date of 3 January 2017 given the expected publication dates of the critical final Level 2 implementing measures.

We set out an overview of the implementation of MiFID II and proposed UK plans in our Briefing Paper of July 2014. This Briefing Paper provides an updated timeline, and highlights some points of interest contained within the recently published UK documents.

Background

The two main areas of concern for MiFID II and MiFIR are financial market structure transparency regulation and investor protection. There are two linked pieces of legislation:

- MiFID II Level 1: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:JOL_2014_173_R_0009&from=EN – which amends rules on the authorisation and organisational requirements for providers of investment services and investor protection.
- The Markets in Financial Instruments Regulation (MiFIR): http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:JOL_2014_173_R_0005&from=EN which improves transparency and competition of trading activities.

The impact of technological development, the increasing complexity of both products and services and the flaws highlighted by the financial crisis led the European Commission to suggest that revisions to MiFID I were necessary. The resulting MiFID II and MiFIR texts came into force on 2 July 2014. They are to take effect from 3 January 2017.

The question is whether they, together, will make the significant changes for which they are designed. They are intended to lead to changes in market structure, the transparency regime for the trading of financial instruments, commodity derivative markets, reporting of transactions to regulators, investor protection and supervisory practices and powers.

Timeframe

Attached to this Briefing Paper is an updated timeframe, setting out expectations for publication of EU documentation and UK implementation aspects.

One particular challenge for local regulators and firms is that there are still many elements of the jigsaw which are yet awaited:

- The Commission is required to adopt various delegated acts providing further specification of the Level 1 rules under MiFID II and MiFIR.

  Although ESMA has delivered its advice on the content of these delegated, and we can start to plan in reliance upon it, the Commission is yet to decide on the precise terms of these delegated acts and these may not entirely follow ESMA's recommendations.

- The second European level work stream is the development of regulatory technical standards (RTS) and implementing technical standards (ITS). Whilst we have ESMA consultations on most of these, again we do not have the final versions. These should be forthcoming during the course of 2015.

HM Treasury proposals for transposition of MiFID II in the UK

HM Treasury's March 2015 paper on Transposition of MiFID II does contain some specifics, with draft statutory instruments contained within it for transposition. (MiFIR is a Regulation and it automatically becomes part of UK domestic law with effect from 3 January 2017.) For details of the HM Treasury proposals, please see: https://www.gov.uk/government/consultations/transposition-of-the-markets-in-financial-instruments-directive-ii.

Key points arising include:

- **The third country regime**

  Member States have the option to continue to operate their existing national regime (which may or may not require third country firms to establish a branch) provided this does not treat third country firms more favourably than EU based firms – or they may elect into the new regime under Article 39 of MiFID II. The new possible Article 39 regime involves a third country firm establishing an authorised branch which comply with the criteria specified by Article 39 (2) of MiFID II and, if such is established, MiFIR provides that it can passport any wholesale investment services or activities (to per se professional clients and eligible counterparties only) into other Member States from that branch once the Commission has adopted a positive equivalence decision in relation to the relevant third country jurisdiction under MiFIR ("the MiFIR third country passport").

  The UK Government is minded *not* to exercise the Article 39 MiFID discretion to apply the MiFID II regime because the current UK regime is considered to work well. Third country persons can currently set up a UK subsidiary which seeks FCA or PRA authorisation if they wish; seek FCA or PRA authorisation if they have a UK branch which has a UK permanent place of business; or operate in providing investment services or performing activities for UK based clients and counterparties on a cross border basis from a third country without the need for FCA or PRA authorisation if they fit within particular exclusions, notably the overseas persons exclusions in Article 32 of the Regulated Activities Order and exclusions that correspond to those currently in Article 2 of MiFID I.

  HM Treasury's initial view is that they will keep the existing UK regime and not exercise the discretion to apply the MiFID II regime under Article 39 of MiFID. The Government is consulting as to whether this approach is the right one or whether it should elect for the Article 39 MiFID third country regime, which might have a number of potential benefits, including providing the possibility of the MiFIR third country passport.

- **New DRS authorisation regime**

  There will be a new authorisation regime, which is to be separate from the Regulated Activities Order regime, for those providing **Data Reporting Services (DRS)** which is to cover:

  - Consolidated Tape Providers – CTPs;
  - Approved Publication Arrangements – APAs;
  - Approved Reporting Mechanisms – ARMs.

  Although a separate authorisation regime, it is proposed to apply to it appropriate administration and enforcement powers, and so the Section 165-168 FSMA provisions are intended to be applied so that there are necessary powers and enforcement provisions in place. The Government is also considering creating and applying provisions akin to Section 89 on misleading statements and Section 90 on misleading impressions of the Financial Services Act 2012 to Data Reporting Services providers.

- **New types of regulated activities**

  Three new activities are to be added to the Regulated Activities Order:

  - operation of an organised trading facility;
  - performing specified activities in relation to structured deposits; and
  - performing investment services and activities in relation to emission allowances.

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- **OTFs**

  For the new category of investment service, the operation of an **organised trading facility or OTF** (alongside regulated markets and MTFs), the FCA are providing for an amendment to the Regulated Activities Order. It is proposed that the issue of how OTF firms conduct matched principal trading and principal trading in illiquid sovereign bonds are dealt with within the FCA Rules rather than requiring, for example, OTF operators to have a "dealing as principal" permission. This though is a point for discussion as to whether it is necessary to require firms to apply for a separate dealing in investments as principal permission in addition to the activity of operating an OTF if they engage in matched principal trading as an operator.

- **Structured deposits**

  In relation to structured deposits, there will be some new regulated activities introduced under the Regulated Activities Order which are intended to be switched on insofar as is necessary to cover the Article 1(4) MiFID II concepts of selling or advising.

- **Power to remove Board members under MiFID II**

  A regulator must at least have the power to "require the removal of a natural person from the management board of an investment firm or market operator". The FCA have identified two options: Option A is that, with the replacement of the Approved Persons regime for "relevant authorised persons" by the Senior Managers and Certification regime from 7th March 2016, the reliance on the existing powers for Approved Persons could in the main be sufficient, but they would not apply to recognised investment exchanges. The alternative option – Option B – would be a standalone power for exchanges, as an alternative to the existing FSMA powers to whom they apply.

FCA's Discussion Paper 15/3

The FCA's consultation on changes to its rules will be later in 2015. Its March 2015 publication is just a Discussion Paper. The FCA's Discussion Paper can be found at: http://www.fca.org.uk/news/dp15-03-mifid-ii-approach.

Key points arising include:

- **Application of MiFID provisions to insurance based investments and pensions**

  The FCA seems to be concerned that, with pensions liberalisation, there could be new risks of inappropriate sales of insurance based investments to consumers as well as MiFID II investments and so there is a particular focus on this area.

  The DP proposals follow through on the FCA's intention of trying to look at comparable products, and ask for views on extending the application of the appropriateness test so that it would apply to non-advised sales of complex insurance based investments and pensions. The FCA may choose to apply aspects from MiFID II's test to determine whether such products should be treated as complex (e.g. having a structure which makes it difficult to understand the risks involved or products that embed a derivative, or on the basis of any test established in the MiFID implementing measures).

  The FCA did not apply the appropriateness test to insurance based investment products at the time of implementing MiFID I but they are considering it with MiFID II, despite the fact that the Insurance Distribution Directive (formerly IMD II) is going to introduce appropriateness for complex insurance based investments, and it is still unclear whether it will replicate the MiFID II requirements.

  In addition, although the UK has many provisions relating to product governance and remuneration standards for sales staff and advisers already, more generally, the FCA is looking to consider to what extent it should apply MiFID II's obligations, for looking at the target market when designing products and when not remunerating staff in a way that conflicts with the duty to act in the best interests of their client, to insurance based investments and pensions.

The FCA is also exploring whether it should retain insurance based investment products and pensions in its definition of "retail investment products" in the context of independent investment advice – see Chapter 6 of their Discussion Paper - and exploring the potential impact of the revised inducement standards – see Chapter 10 of the Discussion Paper. Considering the IDD developments and the wider changes in the UK pensions landscape, the FCA does not consider it appropriate to apply the MiFID costs and charges requirements to insurance based investments and pensions at this stage.

- **Rebating commissions for discretionary management services**

In looking at areas where the UK had anticipated much of what is now MiFID II, it will be interesting to see whether the FCA will rein back in some of their more expansive unilaterally introduced provisions.

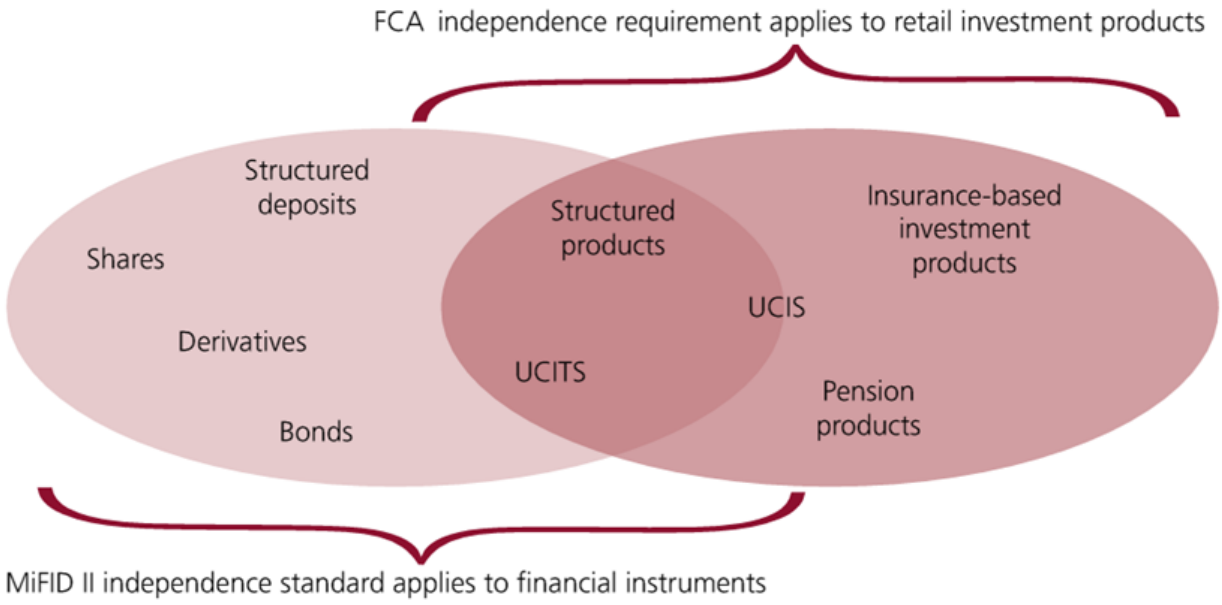
A good example is that, whilst MiFID II bans retaining third party commissions and other benefits, it does allow firms to accept these payments provided they rebate them back to the client as soon as possible after receipt. The FCA is now seeking views on whether consumer outcomes might be improved by putting in place similar rules to RDR and banning the acceptance of commissions, fees and benefits and therefore client rebating for discretionary management activities. The FCA thinks that rebating for discretionary management firms might create the potential for consumer confusion and regulatory arbitrage, although this is debatable given that those who have discretionary management services are in a distinct category from those likely to be dealing otherwise and so could clearly comprehend the position.

- **Client categorisation of local authorities**

The FCA propose three different options for implementing the re-categorisation to retail client status of local authorities under MiFID. The FCA propose that local authorities are classified as retail clients with the option to opt up to elective professional client status for both MiFID and non-MiFID business. Certainly having consistency would seem sensible.

- **Independence**

We have further confusion likely to follow in relation to independence. The diagram below shows the overlap between the FCA's existing independence requirements for retail investment products and the products that MiFID II's independence standard covers. (See Chapter 6 of the FCA's Discussion Paper further for details.)



Source: FCA Discussion Paper 15/3: Developing our approach to implementing MiFID II conduct of business and organisational requirements (March 2015), p28.

- **Complex products and the appropriateness test**

  Finally, but not least, the FCA note that the Commission is taking a strict interpretation of the criteria for determining the classification of products with any products excluded from the criteria for non-complex being considered complex.

  It is indicated that it is likely that any shares and bonds that embed a derivative, structured UCITS, non UCITS collective investment undertakings (including NURSs in the UK) and even some structured deposits will be considered complex. This is likely, as a consequence, significantly to reduce the types of products that can be considered non-complex, with few instruments (other than plain vanilla shares and bonds, non-structured UCITS funds and structured deposits meeting certain criteria) being able to be sold to the retail market without an appropriateness test being satisfied. The FCA's Discussion Paper acknowledges two particular consequences:

  – Firms which currently offer direct financial promotions might be particularly affected by these changes and the FCA observes: *"It is unlikely that a firm offering products through a direct offer will be able to meet the requirements of the appropriateness test. This is because the obligation to perform the appropriateness test is on the firm not the client, or potential client. This may have a particular impact on firms distributing non UCITS collective investment schemes in the UK."*

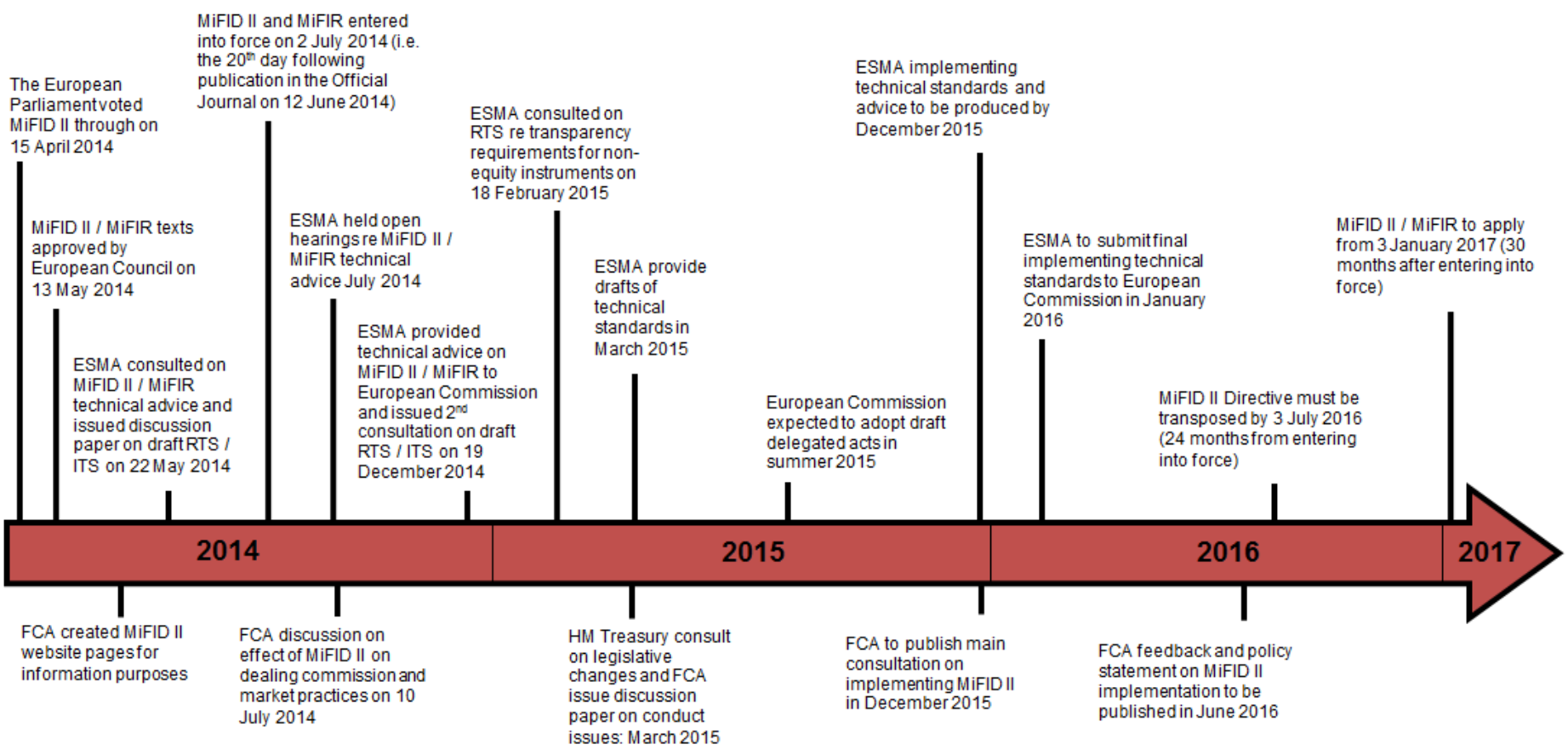
  – Online distribution models will be affected. The FCA emphasise that simply collecting information from consumers to allow them to assess whether there is knowledge and experience to understand the risks of a particular product is insufficient in itself. Firms are required to make an assessment of the client's knowledge and experience before a particular type of product could be sold.

  Whilst we await ESMA's Guidelines (due to be published in January 2016), firms might wish to start planning whether to try and accommodate the appropriateness test or to rethink distribution channels for the products which will be within the complex arena.

Firms probably cannot plan in detail some of the consequences but they can now start to see some of the areas where they will need to make changes. So some strategic thinking should commence, with review of the potential impact on investment product and services offerings and related compliance arrangements.

If you have any specific questions in relation to this briefing paper which are relevant to you, please do not hesitate to contact Kirstene Baillie or Nicholas Thompsell or your usual contact at Fieldfisher.

Timetable for implementing MiFID II / MiFIR



Note:

1. MiFID I has been applied since 2007 and MiFID II will take effect from 3 January 2017.
2. MiFID II and MiFIR require ESMA to develop draft Technical Standards and implementing Technical Standards in several areas for submission to the Commission by respectively 12 and 18 months from the entry into force of the Directive and the Regulation.
3. Also note that much of MiFID takes the forms of regulations which are directly applicable and do not need to be converted into UK domestic law and regulation. The FCA is discussing with Trade Associations and HM Treasury the best way to implement MiFID II in the UK. Note it is not simply an implementation issue but also how to adapt domestic laws and regulation to the revised legislation.

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Contacts

Kirstene Baillie
Partner - Financial Services and Funds

E: kirstene.baillie@fieldfisher.com
T: +44 (0)20 7861 4000

Guy Usher
Partner - Derivatives and Structured Finance

E: guy.usher@fieldfisher.com
T: +44 (0)20 7861 4209

Luke Whitmore
Partner - Derivatives and Structured Finance

E: luke.whitmore@fieldfisher.com
T: +44 (0)20 7861 6723

Simon Maharaj
Solicitor - Financial Services and Funds

E: simon.maharaj@fieldfisher.com
T: +44 (0)20 7861 4548

Nicholas Thompsell
Partner - Financial Services and Funds

E: nicholas.thompsell@fieldfisher.com
T: +44 (0)20 7861 4292

Edward Miller
Partner - Derivatives and Structured Finance

E: edward.miller@fieldfisher.com
T: +44 (0)20 7861 4205

John Dooley
Solicitor - Financial Services and Funds

E: john.dooley@fieldfisher.com
T: +44 (0)20 7861 4086