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Financial Regulation Monthly Breakfast Seminar

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Overview

Brexit update

Anne Mainwaring

Definition of ‘exit day’ amended in the European Union (Withdrawal) Act 2018 (EUWA)

- Exit day is when the key provisions of the EUWA will take effect
- This was previously defined in the EUWA as 11.00 pm on 29 March 2019
- This has been amended by the European Union (Withdrawal) Act 2018 (Exit Day) (Amendment) Regulations 2019 to 11.00 pm on 12 April 2019

FCA guidance on EU non-legislative materials in a no-deal scenario

- Non-legislative materials such as guidelines and recommendations and Q&As are not being onshored and will not be incorporated into UK law
- However, these materials remain relevant and the UK regulators have specified that firms should continue to apply any guidelines on the application of EU law as they did before exit day, interpreting them in light of Brexit and the associated legislative changes
- If the regulators have previously notified that they will not comply with all / part of a pre-exit Level 3 measure, they will continue with this approach post-exit (presumably, where they have informally told firms they disagree with a Level 3 measure this approach will also continue)

FCA guidance on EU non-legislative materials in a no-deal scenario (cont.)

- Therefore, firms can work on the assumption that they can carry on their existing approach to Level 3 materials, taking a “sensible” approach to references that are no longer relevant post-exit (e.g. references to passporting in EU non-legislative material can generally be ignored)
- The regulators will consider Level 3 materials produced by the ESAs post-exit, including where existing material is updated, and where appropriate to do so will set out their expectations

ESMA Statement on the Share Trading Obligation

- ESMA statement on the impact for the share trading obligation in a no-deal scenario
- Article 23 of MiFIR requires investment firms to conclude transactions in shares admitted to trading on a regulated market or traded on an EU trading venue on:
    1. RMs,
    2. multilateral trading facilities,
    3. systematic internalisers, or
    4. third-country trading venues assessed as equivalent by the EC
- The ESMA statement assumes that the EC does not make an equivalence decision in respect of the UK

ESMA Statement on the Share Trading Obligation (cont.)

- The share trading obligation does not apply to transactions in shares which are traded in the EU on a non-systematic, ad-hoc, irregular and infrequent basis
- ESMA previously specified in November 2017 that *“while the Commission is preparing equivalence decisions for the non-EU jurisdictions whose shares are traded systematically and frequently in the EU, the absence of an equivalence decision taken with respect to a particular third country's trading venue indicates that the Commission has currently no evidence that the EU trading in shares admitted to trading in that third country's regulated markets can be considered as systematic, regular and frequent”*

ESMA Statement on the Share Trading Obligation (cont.)

- ESMA states this guidance did not take into account the possible complications in the case of a no-deal Brexit
- *"Considering the strong ties and interconnections between the UK and the EU27 financial markets, it cannot reasonably be assumed that all shares admitted to trading on a UK regulated market are traded on a non-systematic, ad-hoc, irregular and infrequent basis in the EU27 and are therefore out of the scope of the trading obligation"*
- ESMA therefore sets out the following assumptions for shares which are ToTV in the EU:
    - EU27 shares are within the scope of the trading obligation;
    - GB shares are traded on a "non-systematic, ad-hoc, irregular and infrequent" basis in the EU27, <u>unless those shares qualify as liquid in the EU27</u>

ESMA Statement on the Share Trading Obligation (cont.)

- ESMA has published a list of shares with an EU27 or GB ISIN that would be subject to the share trading obligation in a no-deal scenario
- This list will therefore need to be checked in order to determine the application of the EU share trading obligation

FCA Response

- The statement from ESMA has made clear that the EU's STO will apply to all shares traded on EU27 trading venues that are shares of firms incorporated in the EU (EU ISINs) and of companies incorporated in the UK (GB ISINs) where these companies' shares are 'liquid' in the EU
- This means EU banks, funds and asset managers will not be able to trade these GB or EU ISIN shares in the UK, even where the UK is the home listing of the British or EU company
- In addition, the onshoring of EU legislation means that the UK will also have a STO – if the UK applies the same approach as ESMA to the scope of the UK STO this would result a large degree of overlap between the UK and EU obligations

EU STO vs UK STO

- ESMA specifically acknowledges this overlap risk:
  - ESMA “recognises that its approach may lead to an overlap of trading obligations for a number of shares and potentially a greater level of fragmentation of trading should the UK apply an identical approach”
- Original purpose of ESMA’s November 2017 statement was to avoid a situation where firms were required by the STO to execute away from the main pool of liquidity undermining best execution

Share Trading Obligation - impact

- Scope of conflicts:
  - Conflicts potentially will arise when an instrument is ToTV in both the UK and the EEA
- Cross-border order routing:
  - EEA entities prohibited from routing orders for UK execution unless the UK receives a positive equivalence determination
  - UK entities potentially prohibited from routing orders for EEA execution unless the UK entity routes orders via a non-UK entity prior to execution (assuming the FCA's narrow reading of the STO)

No-Deal Exit Planning

- UK firms will be subject to onshored legislation from exit day
- However, temporary transitional relief will apply subject to certain exceptions where firms will need to comply with the onshored requirements from exit day
- Onshoring can therefore be considered in terms of day 1 and day 2 impact
- Identify which of these changes are subject to transitional relief (note that whilst the regulators have called out some of the areas where transitional relief will not apply they have not called out all of these day 1 obligations therefore firms need to identify these by reviewing the Transitional Directions and the relevant SIs)
- Develop day 2 implementation plan to ensure compliance with all of the applicable onshoring changes not within the scope of the day 1 assessment by the end of the transitional period

Day 1 Impact – No Transitional Relief

The regulators have specifically called out that transitional relief will not apply in the following areas:

- MiFID II transaction reporting
- EMIR reporting obligations
- Issuer rules (for EEA entities that have securities admitted to trading or traded on UK markets)
- Contractual recognition of bail-in and contractual stays in resolution
- Short selling notifications
- Use of credit ratings for regulatory purposes in the UK
- Securitisation
- FSCS coverage and disclosures

Day 1 Impact – No Transitional Relief (cont.)

There are various other general areas where transitional relief will not apply, including:

- Changes to the geographical scope of a regime
- Changes that affect the regulatory perimeter / financial promotions regime
- Areas in relation to which there are special transitional arrangements in the relevant SI (i.e. the TPR, MiFID transparency regime)
- Areas in relation to which HM Treasury may make an equivalence decision (excluding under the CRR and Credit Ratings Agencies Regulation)
- Changes that migrate a function of an EU institution to HM Treasury or the UK regulators

The recent MiFID II Q&As on best execution, suitability, costs and charges, reverse solicitation and product governance

Rob Moulton

Best execution – RTS 27

- RTS 27 reports must distinguish between:
    - Liquidity that is subject to a pre-trade transparency waiver and
    - Liquidity subject to pre-trade transparency requirements (which is “truly visible”)
- RTS 27 applies to “other liquidity providers”
    - Always considerable controversy over meaning of this phrase
    - Had been thought to mean firms providing liquidity in a similar way to market makers, for instance, IOIs
    - ESMA now says it includes firms “that facilitate the trade which is finally concluded on the trading venue” (?)

Suitability reports – use of generic statements

- ESMA says firms cannot use a tick-the-box approach and/or generalising phrases
  - Must state on an individualised basis not only if but how the recommendation meets objectives, risk tolerance, ability to bear losses, knowledge and experience, and any other relevant information
  - Avoid "the recommended product is suitable because it matches your risk tolerance"
  - Use "the recommended product matches your risk tolerance: it is categorised as a risk class 3-product, this matches your risk tolerance which is level 3"
- Firms can use standardised templates, but pre-phrased statements must be granular enough to refer to different aspects of the suitability assessment and information gathered, and there must be an option for advisors to add "further aspects"

Costs and charges

- Ex-ante information must be in a “fully individualised, transaction-based manner”
  - (Apparently) objective of MiFID II is to ensure clients’ awareness of applicable costs and charges that will actually be incurred, as well as enabling a comparison
  - ESMA says this is only achievable if the disclosures are specific to the transaction (especially ISIN-based)
- Firms can use a grid or table providing it is sufficiently granular, individualised, and transaction based (and not in a brochure that sets out tariffs that may not be applicable to a client)
- Must also be disclosed as a percentage

Costs and charges (cont.)

- Costs and charges should use the same terminology as in MiFID II, and the use of “commercial” terminology must link to the MiFID terminology
- Taxes – ESMA thinks that MiFID distinguishes between transaction or service-based taxes, and taxes related to income/revenue generated by the investment
  - (Which seems sensible)
- Specific guidance relating to portfolio management
  - Must be based upon the value of the assets and the anticipated portfolio approach (model or bespoke)

Costs and Charges (cont.)

- Modified ex-ante disclosure – PRIIPs:
  - Firms may use cost components specified in the KID to fulfil MiFID II ex-ante costs and charges obligations
  - ESMA clarifies that for products with non-linear charging structures firms could use either the adjusted raw annualised data or Reduction in Yield indicator as the basis for the MiFID II costs and charges calculation

Reverse solicitation

- MiFID says that reverse solicitation cannot be used, where a one-off service has been provided, to sell the same product or service again later on
- Only during the course of a transaction may a firm offer the client another product or service of the same category
- Clear Brexit implications

Product governance – CoCos

- CoCo-bond funds are generally not compatible with retail target markets
  - Nor are benchmarks which are predominantly composed of CoCo-bonds
- Manufacturers and distributors should consider excluding retail investors from the target market, and review CoCo-bond funds already in the market in the next cycle of the product review process

The SEC's latest statements on research unbundling

Rob Moulton

Reminder – what is the issue?

- Although not caught directly by MiFID II, US broker-dealers wishing to send research to EU asset managers must be able to value and price research separately, to enable EU asset managers to comply with their obligations under MiFID II
- However, if a US broker-dealer receives “hard dollars” or a specifically definable payment for research from an EU asset manager, the exemption typically relied on by broker-dealers from the definition of “investment adviser” under the US Investment Advisers Act of 1940 may no longer be available (which carries with it fiduciary responsibilities, certain principal trading restrictions and other obligations)

SEC's no-action relief

- On 26 October 2017, the SEC issued a series of "no-action" letters addressing the issues raised by MiFID II
- The no-action relief means that broker-dealers may receive research payments from money managers in hard dollars or from advisory clients' research payment accounts
- The no-action relief is temporary and expires 30 months after 3 January 2018 (i.e. July 2020)
- The SEC stated at the time that it would "monitor and assess the impact of MiFID II's requirements on the research marketplace…in order to ascertain whether more tailored or different action is necessary"

SEC's latest statements

"*There are indications that market solutions are developing that may make extending the no-action relief unnecessary. For example, I understand that some fund managers are using reconciliation or reimbursement processes to deliver cost transparency while addressing compliance. At the same time, some broker-dealers have explored or taken steps to offer research through a registered advisory business…*

As of today, taking into account the breadth and flexibility of the Advisers Act, we (the staff) are not yet convinced, based on the data and analysis we have received, that we can support a recommendation to create a permanent blanket exemption from the protections of the Act for providers of research to institutional asset managers."

Speech by Dalia Blass, Director, SEC Division of Investment Management
(18 March 2019)

SEC's latest statements (cont.)

"*In addition to the regulatory compliance issues…I am concerned that the broad availability of research may be reduced as a result of MiFID II. I am particularly interested in hearing from [the SEC Investor Advisory Committee] regarding how MiFID II has changed the dynamics of the provision of research. For example, has MiFID II reduced the supply of research overall and/or the availability of research from a variety of broker-dealers, including smaller and specialized firms? Has MiFID II reduced the quality of research overall, or in particular sectors or for particular size issuers? More particularly, are advisers encountering challenges in obtaining the coverage and quality in research that they need to support their advisory services?*"

Jay Clayton, SEC Chairman (28 March 2019)

The potential impact of the EU's proposed new legislative framework for investment firms on the Remuneration Codes

Rob Moulton

Current UK Remuneration Codes for Investment Firms

Rules	Firm type	Basis
SYSC 19A	IFPRU firms (FCA solo-regulated investment firms with dealing on own account and/or underwriting/placing permissions, which are permitted to hold client money)	CRD IV
SYSC 19C	BIPRU firms (FCA solo-regulated investment firms that only have permissions for portfolio management, investment advice, execution of orders, and reception or transmission of orders, and which are not permitted to hold client money)	CRD III
SYSC 19D; Remuneration Part of the PRA Rulebook	Dual-regulated firms (investment banks authorised by the PRA)	CRD IV
SYSC 19F	Common platform firms (including banks, dual-regulated firms, IFPRU firms, BIPRU firms, and exempt CAD firms)	MiFID II

The IFD/IFR package

- Re-categorisation of all investment firms into three tiers
- Systemically important IFPRU / Dual-regulated firms will be re-categorised as “credit institutions” and subject to CRD V rather than the IFD/IFR
- Package expected to be adopted next week, with an 18-month implementation period
- Likely that the remuneration provisions will apply to performance years from 1 January 2021
- UK adoption will be affected by Brexit – package currently included in The Financial Services (Implementation of Legislation) Bill

IFD/IFR remuneration provisions

- Will apply to all investment firms subject to the IFD/IFR, with the exception of the smallest firms
- Provisions are similar to those in CRD IV (but no set bonus cap)
- Some new requirements, such as need for remuneration policy to be gender neutral
- Firms are permitted to apply the provisions on a proportionate basis, depending on their size, nature and complexity
- There are specific exemptions in relation to the provisions on deferral and payment in instruments, and the requirement to establish a remuneration committee

Potential impact

- Exempt CAD firms will become subject to formal remuneration provisions for the first time (unless they fall within the exemption for small and non-interconnected investment firms)
- Given that there are only certain specified exemptions, it could be difficult for the FCA to continue to take its current approach to proportionality (which allows many BIPRU firms, and smaller IFPRU firms, to disapply certain requirements in their entirety)
- Given that the exemption in relation to deferral and payment in instruments can only apply to code staff with variable remuneration of less than EUR 50,000 (where that is no more than one quarter of their total remuneration), this calls into question the FCA's broader use of its *de minimis* threshold in relation to the pay-out process rules (which applies to code staff earning less than £500,000 in total, where variable remuneration is no more than 33% of their total remuneration)

FCA's recent transaction reporting fines

Becky Critchley

Why is transaction reporting so important?

- Transaction reporting concerns 'lifeblood' questions for firms: do you know:
  - who are you transacting with,
  - for whom,
  - in what markets,
  - in what volumes, and
  - at what prices?
- What does it mean if you can't answer those questions accurately?
- Transaction reporting is not just about the fight against market abuse: it is also about whether firms are able to regulate, supervise and understand their own activities properly

Relevant rules

- MiFID I
  - (Old) SUP 17
  - TRUP
  - 23 reportable fields
- MiFID II
  - MiFIR Article 26
  - RTS 22
  - ESMA Guidelines on transaction reporting, order record keeping and clock synchronisation
  - 65 reportable fields

Key issues

- Three types of problem
  - Incorrect reports
  - No reports
  - Erroneous reports
- Root causes
  - Systems and controls
    - Static data
    - Counterparty reference data
  - Change management controls
  - Testing and reconciliation

Lessons from enforcement action

- Controls and processes to prevent or detect errors
    - Testing – 6 monthly
    - Oversight
- Systems and controls to maintain the accuracy and completeness of data
    - Regular maintenance
    - Periodic reconciliations
    - "Golden source"?
- Change management processes and controls
    - Governance and oversight
    - MI
    - Lines of sight
        - Communication of new business activities to the relevant person / team
        - Communication with front office

Lessons from enforcement action

- SMCR
- The importance of FCA communications
    - *The Authority has given substantial and ongoing guidance to the industry regarding Transaction Reporting requirements through Market Watch, and various tools have been provided to facilitate compliance. Despite the imposition of 12 SUP 17 fines since MiFID, industry standards have not improved to a sufficiently high standard*

Questions?