

*FCA, Markets in Financial
Instruments Directive II
Implementation -
Consultation Paper I*

(CP15/43)

December 2015

Key Points

- The FCA published its first MiFID II consultation paper on 16 December 2015.
- The consultation paper includes the FCA's proposals on trading venues, transparency, market data and algorithmic and high-frequency trading.
- Much of the EU's MiFID II package is in regulations that have direct effect in the UK.
- Several sections in the FCA Handbook are no longer required and will be deleted.
- Regulated firms will have to familiarise themselves with the detail of EU legislation which will supersede the Handbook with respect to important aspects of MiFID II.

Background

On 16 December 2015, the Financial Conduct Authority ("**FCA**") published the first of two consultations on MiFID II, entitled *Markets in Financial Instruments Directive II Implementation – Consultation Paper I* (CP15/43) (the "**Consultation Paper**").¹

The Consultation Paper covers the FCA's proposed implementation of MiFID II rules on secondary trading in financial instruments. It builds to a large extent on the FCA's earlier discussion paper on the UK implementation of MiFID II (DP15/3), which was released in March 2015.² In particular, it consults on the following topics:

- changes to the requirements for trading venues and systematic internalisers;
- pre-trade and post-trade transparency;
- data reporting services;

- algorithmic and high-frequency trading requirements;
- passporting and UK branches of non-EEA firms;
- amendments to the FCA Principles for Business; and
- changes to the FCA's perimeter guidance.

However, the Consultation Paper does not cover MiFID II conduct issues. The bulk of the conduct of business requirements in MiFID II will be finalised in delegated acts that are not expected until 2016. Consequently, the FCA has not consulted on conduct issues, including the following issues:

- inducements and investment;
- recording of telephone calls and e-mails;
- appropriateness;
- conflicts of interest; and
- product governance.

In fact, much of the Consultation Paper is concerned with deleting sections of the FCA handbook. MiFID II will be implemented by way of a directive (the "**MiFID II Directive**") and a regulation, the Markets in Financial Instruments Regulation ("**MiFIR**"). MiFIR will have direct effect in the UK so matters covered by MiFIR will not be transposed into FCA regulation. As a result, matters covered in the Handbook under MiFID I will no longer be in the Handbook for the purposes of MiFID II. The matters in MiFID II that will not be in the Handbook include:

- the double volume cap on so-called "dark" trading;
- the trading obligation in shares;
- recordkeeping requirements;
- transaction reporting;

¹ The consultation paper is available at <http://www.fca.org.uk/your-fca/documents/consultation-papers/cp15-43>.

² <https://www.fca.org.uk/news/dp15-03-mifid-ii-approach>

- financial instrument reference data;
 - the obligation to trade on a regulated market ("**RM**"), multilateral trading facility ("**MTF**"), or organised trading facility ("**OTF**");
 - the clearing obligation for derivatives traded on a regulated market;
 - portfolio compression; and
 - non-discriminatory access to central counterparties and trading venues, and to licensed benchmarks.³
- In addition, the FCA has stated its intention to publish a MiFID II Permissions and Notifications Guide. This will contain a detailed guide to firms applying for permissions and making notifications to the FCA; for example, it will include detail on the process for applying for waivers from the MiFID II transparency requirements.

This differs from the FCA's approach in MiFID I, when the MiFID Implementing Regulation was transposed into FCA rules. However, it is in line with recent FCA approach to EU regulations, such as the Capital Requirements Regulation or regulations made under the Alternative Investment Funds Managers Directive ("**AIFMD**")

Although this eases the pressure on the FCA, the complexity of the task facing regulated firms, who must resort to several sources of law and regulation, should not be underestimated.

Recognising the growing regulatory burden on firms, the FCA has proposed several means to steer the sector through the thickets of MiFID II. The FCA has stated that it will include references to EU regulations in the Handbook, and has proposed additional guidance material for firms:

- The Consultation Paper includes a prototype MiFID II Handbook Guide for trading venues and data reporting services providers.⁴ This contains a brief overview of the various texts, whether in directly applicable legislation or in the Handbook, that will apply to such entities. The FCA has offered to produce further Handbook Guides for other areas if it is considered to be helpful.

Trading venues

New rules for RMs, MTFs and OTFs

The Consultation Paper explores the new MiFID II requirements that will apply to each category of trading venue:

RMs: The proposed rules update the regulatory framework by adding new obligations relating to algorithmic and high-frequency trading, direct electronic access, tick sizes, business continuity, and systems and controls. The rules will be made by way of changes to the Recognised Investment Exchanges sourcebook ("**REC**"). Firms will be expected to comply with the detailed requirements set out in EU regulatory technical standards ("**RTS**"), which will be referenced, but not copied out, in REC.

MTFs: MiFID II will change the requirements for MTFs, which have been aligned to a greater with those for RMs. These include requirements in relation to systems and controls, non-discriminatory access, business continuity and conflicts of interest. A new section sets out rules on the functioning of an MTF, including requirements for risk management, financial resources, and best execution. The new requirements will be set out in the Market Conduct sourcebook ("**MAR**") in MAR 5.

OTFs: MiFID II will introduce the OTF as a new category of trading venue. The general requirements for OTFs will be similar to those for MTFs, because they are similar multilateral systems. The new requirements will include rules on trading processes, transparency, algorithmic

³ Consultation Paper, 1.22.

⁴ Consultation Paper, Appendix 3.

trading, monitoring of transactions, and financial resources. Many of the new rules will be in a new Handbook module, MAR 5A.

Systematic internalisers

New rules for SIs

MiFID II introduces changes to the SI regime by expanding the scope of financial instruments and by imposing specific pre-trade transparency obligations on the trading of bonds and derivatives. The SI regime is currently applicable to equities; under MiFID II, this will extend to equity-like instruments and non-equities.

At present, the MiFID provisions on SIs are contained in MAR 6. However, many of the MiFID II requirements for SIs are in MiFIR, which will have direct effect in the UK. Consequently, in line with the FCA's policy of removing text that is covered by EU regulations, much of MAR 6 will be deleted.

Pre- and post-trade transparency

Extended to equity-like instruments and non-equities

MiFID II will extend transparency requirements from shares to equity-like instruments (such as depository receipts, ETFs, and certificates) and non-equities (such as bonds, structured finance, derivatives and emissions allowances).

The MiFID II transparency rules are directly applicable, so the FCA proposes the deletion of Handbook rules and guidance relating to transparency. The FCA will instead provide links to the relevant MiFID II material.

The FCA does not propose any new Handbook material on transparency but may consider producing further guidance for firms depending on the feedback to its consultation.

The FCA has consulted on its proposed approach to waivers and deferrals to the transparency

regime. In particular, it wishes to know whether any aspects of the current transparency regime should be changed in relation to:

- equity waivers;
- non-equity waivers;
- the waiver application process;
- equity deferrals; and
- non-equity deferrals.

Market data

Data reporting services and transaction reporting requirements

MiFID II introduces a new Data Reporting Services Providers ("**DRSPs**") regime, consisting of approved reporting mechanisms, approved publication arrangements and consolidated tape providers. The Consultation Paper sets out the requirements and guidance in a new chapter MAR 9 for DRSPs applying for FCA authorisation.

Many of the detailed requirements for DRSPs will be outside the Handbook, being contained in UK legislation and in directly applicable EU regulation. A new chapter MAR 9A will contain references to these external sources.

The Consultation Paper also deals with transaction reporting. The FCA has decided not to apply the MiFIR transaction reporting obligations to managers of collective investment undertakings and pension funds. These managers were not strictly caught by MiFID I but the FSA had decided to apply the requirements to them because of the similarity of their activities with that of a MiFID portfolio manager; this has not been extended in relation to MiFIR.

Algorithmic and high-frequency trading

New controls and requirements

MiFID II will impose new controls on algorithmic and high-frequency trading. The FCA has proposed that the relevant controls for MTFs and OTFs should be inserted in MAR 5 and MAR 5A, whereas those for trading firms should be inserted in new MAR 7A.

The FCA's proposed text covers areas such as business continuity, systems and controls, financial crime and market abuse, direct electronic access, and tick sizes.

Passporting and branches of non-EEA firms

Updates to passporting rules and guidance

The Consultation Paper proposes technical changes to ensure that the Handbook contains correct references to new MiFID II rules on passporting, and to highlight the harmonised forms that will be required for passporting notifications.

The Consultation Paper also makes proposals to deal with the anomaly whereby branches of non-EEA firms are not subject to directly applicable regulations. The FCA plans to introduce a rule to ensure that the obligations in directly applicable regulations will apply to UK branches of non-EEA firms.

FCA Principles for Business

Extended Principles, especially for eligible counterparties

MiFID II extends conduct of business obligations and general principles that apply to firms when carrying on investment business with eligible counterparties ("**ECPs**"). MiFID II also enhances regulatory protection to local authorities, which will no longer be treated as ECPs.

The FCA proposes to amend the Principles for Business ("**PRIN**") so that they apply more generally to business conducted with ECPs, and to

remove the possibility of firms treating local authorities as ECPs where this is not appropriate.

The FCA's Perimeter Guidance

Revised scope of MiFID perimeter

MiFID II will make various changes to scope:

- a new category of trading venue, the OTF;
- a new financial instrument, emissions allowances;
- new definitions of dealing on own account and execution of client orders;
- changes in respect of derivatives; and
- extension of conduct rules to structured deposits.

The FCA has set out in the Consultation Paper proposed changes to its Perimeter Guidance ("**PERG**"), in PERG 13. These changes will provide guidance on the above issues. The FCA plans to issue a more general consultation on scope matters at a later date.

Next steps

The FCA has requested comments on the Consultation Paper by 8 March 2016. It will publish a policy statement containing its feedback and final rules in the first half of 2016.

The FCA plans to issue a second consultation paper on further MiFID II changes to the Handbook, including conduct issues, during the first half of 2016.

Member states are required to have transposed the MiFID II Directive into national law by 30 June 2016. However, uncertainties regarding the timetable for MiFID II mean that this date may be postponed.

At present, the text of the MiFID II Directive states that it will take effect from 3 January 2017. However, due to legislative delays, it is expected that the implementation of MiFID II will be delayed until January 2018.

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