



HM Treasury

# **Transposition of the Markets in Financial Instruments Directive II**

---

March 2015





HM Treasury

# Transposition of the Markets in Financial Instruments Directive II

---

March 2015



© Crown copyright 2015

This publication is licensed under the terms of the Open Government Licence v3.0 except where otherwise stated. To view this licence, visit [nationalarchives.gov.uk/doc/open-government-licence/version/3](http://nationalarchives.gov.uk/doc/open-government-licence/version/3) or write to the Information Policy Team, The National Archives, Kew, London TW9 4DU, or email: [psi@nationalarchives.gsi.gov.uk](mailto:psi@nationalarchives.gsi.gov.uk).

Where we have identified any third party copyright information you will need to obtain permission from the copyright holders concerned.

This publication is available at [www.gov.uk/government/publications](http://www.gov.uk/government/publications)

Any enquiries regarding this publication should be sent to us at [public.enquiries@hmtreasury.gsi.gov.uk](mailto:public.enquiries@hmtreasury.gsi.gov.uk)

ISBN 978-1-910337-07-4  
PU1750

# Contents

---

		Page
Chapter 1	Introduction	3
Chapter 2	Third Countries	9
Chapter 3	Data reporting services	13
Chapter 4	Position limits and reporting	21
Chapter 5	Unauthorised persons	25
Chapter 6	Structured deposits	29
Chapter 7	Power to remove board members	33
Chapter 8	Organised trading facility	37
Chapter 9	Binary options	39



# 1 Introduction

---

## Context

The Markets in Financial Instruments Directive (2004/39/EC) (“MiFID”) was a significant development in the regulatory architecture of the EU. It replaced the Investment Services Directive (93/22/EEC) (“ISD”), establishing a new regulatory regime for securities and derivatives markets. MiFID introduced, for example, the concept of “multilateral trading facilities” (“MTFs”) and “systematic internalisers” (“SIs”) and imposed pre- and post-trade transparency on these entities (in certain cases) and others.

MiFID was agreed in 2004 as a level 1 or framework directive, which followed the Lamfalussy process (a four-level approach to the production and implementation of EU single financial services market legislation). The level 1 directive applied from 1 November 2007 and is supplemented by the following level 2 legislation, adopted by the European Commission (“Commission”) in August 2006:

- Commission Directive 2006/73/EC (“MiFID Implementing Directive”), which deals predominantly with the organisational and conduct requirements for investment firms
- Commission Regulation 1287/2006/EC (“MiFID Implementing Regulation”), which sets out a number of the details regarding the MiFID secondary markets regime

The UK transposed MiFID using the Financial Services and Markets Act 2000 (“FSMA”) architecture. In particular, Part 4 (now Part 4A) authorisation for investment firms, Part 18 recognition for regulated markets and Schedule 3 for EU “passporting” of investment services and activities. Secondary legislation was made to amend FSMA to give effect to this. Amendments were made to the FSMA (Regulated Activities) Order 2001 (“RAO”) to ensure that the range of MiFID services and activities, as well as the financial instruments to which it relates, were properly captured in domestic law. A number of statutory instruments made under FSMA were also amended as part of the MiFID transposition.<sup>1</sup> In addition, much of the transposition was achieved through FCA rules<sup>2</sup> made under FSMA powers which enable the FCA to make rules in respect of authorised persons.

## MiFID II

The aim of MiFID was to strengthen the single market for investment services and activities, thereby harmonising investor protection and increasing competition in EU financial markets. Many of these aims were achieved, such as allowing trading venues and investment firms to operate across the EU. However, technological development, the increasing complexity of both products and services and the flaws highlighted by the financial crisis led the European Commission to suggest a significant number of revisions to the initial directive in its consultation of 8<sup>th</sup> December 2010. The result of this consultation and review is the Markets in Financial Instruments Directive (2014/65/EU) (“MiFID II”) and the Markets in Financial Instruments Regulation (Regulation 600/2014) (“MiFIR”), which were approved by the European Parliament on 15 April 2014 and by the European Council on 13 May 2014. MiFID II and MiFIR were

---

<sup>1</sup> HM Treasury, *UK implementation of the Markets in Financial Instruments Directive (MiFID) (2004/39/EC)*, (15 December 2005).

<sup>2</sup> Then the FSA rules. The Financial Services Authority (“FSA”) was replaced by the Financial Conduct Authority (“FCA”) on 1 April 2013.

subsequently published in the Official Journal of the EU on the 12 June 2014 and came into force on 2 July 2014.

MiFID II and MiFIR together make significant changes to the current MiFID framework. In particular, they will 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.

## **MiFID II: Timeframe and Approach**

Member States must adopt and publish by 3 July 2016 the measures transposing MiFID II into national law, and must apply those provisions from 3 January 2017. MiFIR will apply from 3 January 2017 and given MiFIR is a regulation it will automatically become part of UK domestic law on the date on which it applies.

In order for these key dates to be met, there are a number of work-streams that have to be completed. At the European level there are two major technical projects underway. The first is in relation to delegated acts. The Commission is required, by several provisions of MiFID II and MiFIR, to adopt delegated acts providing further specification of the level 1 rules (the existing MiFID implementing directive and regulation will be repealed). ESMA received a mandate from the Commission on 23 April 2014 to provide technical advice to assist the Commission on the content of these delegated acts<sup>3</sup> and on 19 December 2014 provided its advice. The Commission is now considering this advice and will adopt delegated acts during the course of 2015.

The second European level work-stream is the development of Regulatory Technical Standards ("RTS") and Implementing Technical Standards ("ITS"). ESMA is required to provide drafts of these, in relation to a number of MiFID II and MiFIR provisions, for submission to the Commission in the main by, respectively, 12 and 18 months from entry into force of the Directive and the Regulation. ESMA launched a consultation on most of the technical standards on 19 December 2014 which set out issues and questions in relation to the draft RTS and ITS it will develop.

MiFID II will be transposed in the UK primarily through the FSMA architecture in the same way MiFID was. This will involve a combination of secondary legislation and FCA rules. However, MiFID II, unlike MiFID, imposes some obligations on market participants who will be neither authorised persons, nor recognised investment exchanges ("RIE"). Specific provisions will be required for these persons as they do not readily fall into the existing FSMA structure and the FSMA does not grant the FCA powers to make rules in respect of such persons. In this respect, the primary intention of this consultation document is to set out the technical drafting of the secondary legislation required to implement MiFID II and invite comment and feedback from stakeholders. The government has set out this draft legislation in the annexes to this consultation. It is expected that the draft legislation will be made in 2016.

There are ongoing discussions between Member States and the Commission on the transposition of MiFID II. These are intended, so far as possible, to ensure that the level 1 directive is consistently applied across the EU. Following these discussions, the government may decide to revise areas of its approach set out in this consultation, particularly where areas of uncertainty are clarified.

---

<sup>3</sup> As well as the subjects covered in the ESMA technical advice, the Commission has previously committed to bringing forward delegated acts to clarify MiFID's coverage of foreign exchange forwards. The Commission wrote to ESMA on this issue in July 2014: [http://www.esma.europa.eu/system/files/ec\\_letter\\_to\\_esma\\_on\\_classification\\_of\\_financial\\_instruments\\_23\\_07\\_2014.pdf](http://www.esma.europa.eu/system/files/ec_letter_to_esma_on_classification_of_financial_instruments_23_07_2014.pdf)



The FCA will set out and consult on the necessary changes to its rules and relevant handbooks. This is likely to be towards the end of 2015 when there is greater certainty about the MiFID II and MiFIR implementing measures.

## **MiFID: Principles of Implementation**

The Government's general approach to transposition is to follow the previous approach under MiFID. This approach is underpinned by the following principles – to which there are some exceptions:

- Continuity: changes to the current UK legislative regime required by MiFID II will be enacted by amendments to FSMA, the RAO and related statutory instruments
- Copy out: transposition should mirror as closely as possible the original wording of a directive and go no further than the requirements of MiFID II, except where there is a clear justification and authority to do otherwise
- Transparency: the UK is providing draft secondary legislation as early as possible to provide stakeholders with the opportunity to review and comment

Part of the continuity is that in making changes to the RAO the government is not seeking to make fundamental changes to its structure, but to work within the existing framework. The Government believes that this is consistent with minimising the burden of the implementation process.

In addition to a request for comments on the draft secondary legislation the government seeks comments on its general policy approach to certain policy areas. In these cases, we have not provided draft legislation.

Further, although we have provided drafting in a number of areas, given the ongoing work-streams specified above this is subject to amendment. In particular, following the finalisation of the delegated acts by the Commission there may have to be a number of drafting alterations.

## **Draft Statutory Instruments**

Four draft statutory instruments giving effect to the transposition approach mentioned above are in the Annexes to this consultation document. Those draft statutory instruments are:

### 1. Draft Financial Services and Markets Act 2000 (Markets in Financial Instruments) Regulations 2016 (Annex A)

This draft instrument:

- Designates the FCA, PRA and the Bank of England as competent authorities for the purposes of MiFID II and MiFIR – the FCA will be principally responsible for supervision of compliance with MiFID II and MiFIR, but it affects the organisational requirements of a number of the banks and all of the major investment firms supervised by the PRA and touches on CCPs who are authorised and supervised by the Bank of England
- Provides for the exercise of the optional exemptions in Article 3(1)(a) to (c) of MiFID II
- Creates the position limit regime

- Imposes obligations on certain persons who do not hold Part 4A FSMA authorisation in relation to algorithmic trading, provision of direct electronic access services, acting as a general clearing member and the synchronisation of business clocks
- Amends FSMA provisions as required as a consequence of the wider transposition
- Amends the Financial Services and Markets Act 2000 (Recognition Requirements) Regulations 2001 to provide for:
  - The FCA to make rules for the purposes of the Regulations
  - The organisational requirements on Recognised Investment Exchanges (“Exchanges”)
  - Commodity derivative position management and reporting requirements
  - Requirements on the operation of regulated markets, multilateral trading facilities and organised trading facilities by Exchanges
  - The ability of Exchanges to provide data reporting services
- Makes consequential amendments to other statutory instruments made under FSMA.

## 2. Draft Financial Services and Markets Act 2000 (Data Reporting Services) Regulations 2016 (Annex B).

This draft instrument provides for the UK regime which requires persons operating data reporting services as listed in Section D of Annex I to MiFID II to be regulated. It requires persons providing such services to be authorised by the FCA and imposes obligations on them. It also provides for the administration and enforcement of the regime, which will be undertaken by the FCA.

## 3. Draft Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) Order 2016 (Annex C).

This draft instrument amends the RAO to:

- Provide that operating an organised trading facility is a regulated activity
- Provide that structured deposits are within the scope of certain specified activities
- Make emission allowances a specified investment
- Make options and futures specified investments in certain circumstances involving alternative investment fund managers
- Transpose the Article 2 MiFID II exemptions
- Make consequential amendments to the RAO

Please note this draft instrument has been drafted as if a change to the RAO has already been made in relation to Binary Options (discussed below). See in particular Article 11(j) of the draft. The reason for this is to avoid including references to existing MiFID implementing measures in a draft instrument which is providing for the transposition of MiFID II.

## 4. Draft Financial Services and Markets Act 2000 (Qualifying EU Provisions) (Amendment) Order 2016 (Annex D).

This draft instrument amends the Financial Services and Markets Act 2000 (Qualifying EU Provisions) Order 2013 to make MiFIR a qualifying EU provision for various parts of FSMA to ensure that the FCA and PRA have the appropriate powers to perform their roles arising from MiFIR.

## Binary Options

Separately, the government is providing draft secondary legislation provisions which will provide that certain binary options are regulated and supervised by the FCA, rather than the Gambling Commission, and invites comments in relation to the proposed legislative amendments to the RAO.

## How to respond

Responses are requested by **18 June 2015**. The government cannot guarantee that responses received after this date will be considered.

The government invites feedback on the draft secondary legislation in the annexes to this consultation and the accompanying impact assessment, in addition to the specific questions raised in this consultation document.

Responses can be sent by email to [mifid2consultation@hmtreasury.gsi.gov.uk](mailto:mifid2consultation@hmtreasury.gsi.gov.uk). Alternatively, they can be posted to:

MiFID 2 Consultation, Securities and Markets, Financial Services Group, HM Treasury, 1 Horse Guards Road, London, SW1A 2HQ.

When responding, please state whether you are doing so as an individual or representing the views of an organisation. If you are responding on behalf of an organisation, please make clear who the organisation represents and, where applicable, how the views of members were assembled.

## Confidentiality

Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes (these are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 and the Environmental Information Regulations 2004).

If you would like the information that you provide to be treated as confidential, please mark this clearly in your response. However, please be aware that under the FOIA, there is a Statutory Code of Practice with which public authorities must comply and which deals, among other things, with obligations of confidence. In view of this, it would be helpful if you could explain why you regard the information you provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances.

In the case of electronic responses, general confidentiality disclaimers that often appear at the bottom of emails will be disregarded unless an explicit request for confidentiality is made in the body of the response.



## 2 Third Countries

---

Article 39 MiFID II provides that a Member State “may require that a third country firm [non-EEA firm] intending to provide investment services or perform investment activities with or without any ancillary services to retail clients or to professional clients within the meaning of Section II of Annex 2 in its territory establish a branch in that Member State”. MiFID II therefore permits Member States to choose whether they require a third country firm to establish a branch in their jurisdiction when they provide MiFID investment services to retail or elective professional clients. This represents a departure from MiFID which did not prescribe harmonised requirements regarding the ability of third country firms to access EU markets and Member States have discretion (within broad parameters) in relation to how they treat such firms. The government proposes to retain the current regime (insofar as it is permitted by MiFID II) and is seeking comment in relation to this policy position. In order to ensure the best feedback from respondents on this matter the consultation document below, a) sets out the current UK regime; b) describes the discretionary MiFID II provisions (and the non-discretionary MiFIR provisions) in relation to third country firms; and c) the rationale for maintaining the current system (insofar MiFID II permits this).

### The current UK regime for third country firms

Under the current UK regime, third country persons are subject to the same general prohibition as UK persons against providing investment services or performing activities in the UK without authorisation. Broadly speaking, there are currently three routes by which a third country person can navigate the general prohibition.

- First, a third country person may establish a UK subsidiary which could apply to the FCA or PRA for authorisation in its own right under Part 4A of FSMA. Included as part of the authorisation conditions is the need to satisfy the relevant threshold conditions set out in schedule 6 of FSMA. It would be possible for such a subsidiary to exercise EU passporting rights to carry on investment services and activities in other Member States in accordance with MiFID 1 or CRD IV.
- Second, a third country firm may be authorised by the FCA or PRA if it has a UK permanent place of business – a UK branch. This assessment is primarily of a prudential nature (of the third country firm and its home country’s prudential standards), and cooperation with the third country jurisdiction in which the firm is authorised is an important factor. The PRA has also recently issued a supervisory statement in which it explains its risk appetite for authorising and supervising UK branches of third country firms<sup>1</sup>. Where a third country firm with a UK branch is authorised it will not be able to benefit from any EU passporting rights (and this would be the case for any other Member State that permits authorisations of third country firms with local branches).
- Third, there are a limited set of circumstances in which a third country person can provide investment services or perform activities with UK-based clients and counterparties on a cross-border basis, from the third country, without the need for any FCA or PRA authorisation. This route is made possible through exclusions that are provided for in UK legislation, in particular:

---

<sup>1</sup> Supervising international banks: the PRA’s approach to branch supervision - SS10/14: <http://www.bankofengland.co.uk/pr/Pages/publications/ss/2014/ss1014.aspx>

- the exclusion for “overseas persons” in Article 72 of the RAO, which includes exclusions for particular investment services and activities carried on in the context of a “legitimate approach” or carried on “with or through” an authorised or exempt UK person; and
- miscellaneous exclusions that correspond to those currently in Article 2 of MiFID 1.

The concept of “legitimate approach” is linked to the UK restriction on making financial promotions. It allows cross-border business to be carried out on the basis that the overseas person has not solicited in any way the particular service to be provided to the UK client, (which is similar to the MiFID II and MiFIR concept of “own exclusive initiative”) and also permits certain limited forms of client solicitation along the lines of exemptions in the FSMA Financial Promotions Order 2005 (“FPO”). These exemptions include, for example, certain types of solicitations made to certified high net worth individuals and previously overseas customers – both of which might be categorised as retail clients under the UK conduct rules transposing MiFID.

The UK currently has a specific regime for authorisation of third country exchanges, Recognised Overseas Investment Exchanges (“ROIEs”).

## **MiFID II: Third Countries**

The implementation of MiFID II will lead to changes to the structure of regulation regarding third country firms. In respect of access to the EU for third country firms, MiFID II is divided into two interconnected parts, dealing separately with, on the one hand, per se professional clients and eligible counterparties (in MiFIR), and on the other hand, retail and elective professional clients (in MiFID II).

As MiFIR is a directly applicable EU regulation, there is no discretion in relation to its implementation, except where its text indicates otherwise. Under MiFIR, national regimes that apply to a third country firm providing wholesale business (to per se professional clients and eligible counterparties) will continue until a positive decision is taken by the Commission in respect of the effective equivalence of that third country jurisdiction to EU prudential and business conduct standards. For three years following this equivalence decision, third country firms will continue to be able to provide services under the national regime. Following this, a third country firm that is registered with ESMA from the relevant jurisdiction will be able to provide investment services to or perform activities directly with wholesale clients anywhere in the EU without the requirement to establish an EU branch (Article 46 MiFIR). Where no positive equivalence decision is adopted, the existing third country regimes in Member States will apply in respect of wholesale business.

In relation to business conducted with retail and elective professional clients, a Member State may continue to operate its existing national regime (which may or may not require the establishment of a branch), provided this does not treat third country firms more favourably than Union firms, or may elect into the new regime under Article 39 MiFID II. This provides (as noted above) that Member States may require third country firms seeking to provide investment services and activities to retail and elective professional clients to do so from local branches, which are authorised and supervised in accordance with specified criteria. In particular, if a branch is required under Article 39 MiFID II the following would apply:

- where a third country firm seeks to perform investment services or activities to retail or elective professional clients (i.e. clients that have elected to be treated as a professional rather than retail) in a particular Member State, that third country firm must first

establish an authorised branch in that Member State, and must conduct those activities with such clients from the authorised branch

- in order to be authorised for retail and elective professional business, that branch would have to comply with the criteria specified by Article 39(2) MiFID II (some of which overlap with a number of existing UK authorisation conditions). In addition to the existence of cooperation agreements between the third country and the Member State, two notable additions in comparison to the UK regime are the Article 39(2) requirements that the branch must have sufficient initial capital and the third country firm's jurisdiction of establishment must pay due regard to relevant anti-money laundering regulations
- where a third country firm establishes a branch in a Member State that has been authorised in accordance with Article 39 MiFID II, 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 ("MiFIR Third Country Passport")

In any case, for all client types, MiFID II does not restrict the performance of investment services and activities to EU clients by third country firms on a cross-border basis where this is at the client's "own exclusive initiative".

MiFID II's and MiFIR's third country regimes do not cover the authorisation of third country exchanges. The UK's ROIE regime can therefore continue although the current outcomes-based equivalence test for authorising ROIEs will need to extend to the requirements imposed on regulated markets under MiFID II and MiFIR.

### **Proposed UK approach to exercising MiFID II discretions**

The government is minded not to exercise the discretion to apply the MiFID II regime specified at Article 39 MiFID II (and as outlined above). This is because it is considered that current regime has the virtue of being sufficiently tailored to client types and to the risks in question and balances the need to maintain investor protection, market integrity and financial stability, while remaining open to business internationally.

If the UK were to elect into the Article 39 MiFID II regime, the government considers there would be a number of consequences, these are:

- the UK's overseas persons exclusions would be substituted with the narrower concept of reverse solicitation (own exclusive initiative) for retail and elective professional clients. This could allow the "with or through" exclusion to continue to operate under certain circumstances. However, it could narrow the ability of third country firms to conduct investment activity in relation to retail and elective professionals, for example, in relation to self-certified sophisticated investors who are classified as retail clients under the MiFID classifications
- the conditions for authorisation in Article 39(2) MiFID II would need to be incorporated into the existing threshold conditions (the requirement for branch capital would be a new addition, for example). However, the economic effect of this would be mitigated in certain respects as there is a degree of overlap between the current UK conditions and the Article 39(2) MiFID II conditions
- the branch itself would need to be used when dealing with retail and elective professional clients

The government acknowledges that in not electing to implement the Article 39 MiFID II regime, the UK retail client base will not be able to rely on the strengthened branch requirements specified at Article 39(2) MiFID II. Additionally, in deciding not to apply Article 39 MiFID II, UK branches will not have the benefit of the MiFIR Third Country Passport described above. This means that third country firms who establish branches in the UK, will not be able to passport wholesale business across Europe. Instead they will have to establish a legal subsidiary with appropriate MiFID authorisations in the relevant member states. However, the availability of the MiFIR Third Country Passport would in any case only become available if and when the Commission makes a positive equivalence decision in respect of the firm's third country jurisdiction.

The government acknowledges that the Article 39 MiFID II third country regime has a number of potential benefits and invites stakeholder's views on whether the UK should further consider implementing the MiFID II third country regime, as described above.

If post-consultation the government's proposed approach to maintaining the existing UK regime, rather than exercising its discretion to elect into the Article 39 MiFID II regime, is carried forward, there are still likely to be a number of consequential changes to legislation or FCA/PRA rules, such as, how the UK will approach third country firms that have Article 39 branches in other Member States.

### **Questions on the Third Country Regime**

- 1 Do you agree the UK should maintain its current third country regime and not implement Article 39 MiFID II? Please explain your reasons why and supply any evidence you have to support your answer.

If you do not agree, please provide your views on:

- a) what would be the likely or expected economic and non-economic consequences of implementing the MiFID II third country regime?
- b) what impact would the implementation of Article 39 MiFID II have in relation to retail cross-border business currently conducted under applicable exclusions?

Please supply any evidence you have to support your answers.



# 3 Data reporting services

---

Article 59(1) MiFID II places an obligation on Member States to require that the provision of the data reporting services (“DRS”) as a regular occupation or business be subject to prior authorisation. The DRS specified at Annex 1, Section D MiFID II, are:

- Consolidated Tape Providers (“CTPs”)
- Approved Publication Arrangements (“APAs”)
- Approved Reporting Mechanisms (“ARM”)

A firm providing one or more of these services is referred to below and in the draft legislation as a Data Reporting Services Provider (“DRSP”).

The government proposes to create a specific regime for the DRSs which is independent of the RAO (although linked in certain respects). The proposed legislation is set out in the draft Financial Services and Markets Act (Data Reporting Services Regulations) 2016 (the “DRRs”) at Annex B and provides for a specific set of regulatory requirements and responsibilities that operate on each DRSP, which reflect the obligations set out in MiFID II in relation to each type of DRSP. It is considered that creating a specific regime for DRS is appropriate, given that the activity of providing a DRS is separate and distinct in scope and nature from investment services and activities under MiFID II (which are provided for in the RAO). The overall intention of the government in designing a separate DRS regime is to ensure that the activity of each DRSP is carried out in the UK in a way that reflects the nature of the obligations specified by MiFID II in a proportionate manner, while providing certainty and clarity to those who fall within the DRRs.

In transposing the obligation in Article 59(1) MiFID II the DRRs prohibit a person from operating on a DRS in the UK, unless authorised as a DRSP under the Regulations. Article 59(2) MiFID II provides a derogation to the authorisation requirement specified at Article 59(1) MiFID II, stating “by way of derogation from paragraph 1, Member States shall allow an investment firm or a market operator operating a trading venue to operate the data reporting services of an APA, a CTP and an ARM, subject to the prior verification of their compliance with this Title. Such a service shall be included in their authorisation”. The government has sought to ensure this derogation is effective through Regulation 5 of the DRRs. In particular, Regulation 5 specifies that no person may carry on a data reporting service in the United Kingdom unless they are either:

- a DRSP acting in accordance with an authorisation granted under these Regulations
- an investment firm or a credit institution which is operating an MTF or an OTF acting in accordance with Title V of MiFID II
- a recognised investment exchange acting in accordance with Title V of MiFID II
- a DRSP established in an EEA State other than the UK, authorised in its home member state in accordance with Title V of MiFID II

The government is proposing to extend the derogation to a “credit institution” (as well as an investment firm) that is operating an MTF or an OTF, given that these institutions can (on similar terms) perform the same activity as investment firms.

On the basis of the above, entities that wish to perform DRSs will be required to submit an application for authorisation under Regulation 7 of the DRRs. The precise information required

will be developed, in part, through RTSs pursuant to Articles 61(4) and 61(5) MiFID II, as specified in the DRRs. The FCA will also consult on the requirements regarding verification of compliance for those entities specified at Regulation 5(1)(b)-(e) DRR (for example, investment firms operating an MTF) in order to fully transpose the derogation noted above. However, as a consequence (of Regulation 5 DRR) a person who is not an entity specified above (at paragraph 3.3) and authorised to carry out the relevant DRS, will be in breach of the prohibition, specified at Regulation 5 of the DRRs, when providing these services in the UK. Those in breach of the general prohibition in this regard shall be guilty of an offence and will be liable on summary conviction to a fine (not exceeding the statutory maximum) or on conviction on indictment to a fine.

The powers provided to the FCA to cancel authorisation in relation to this activity are necessary to transpose the provisions set out at Article 62 MiFID II. The FCA will have the power to cancel authorisation in a number of circumstances, as set out at Regulation 10 of the DRRs. In particular, authorisation will be withdrawn from a DRSP if it no longer meets the conditions under which authorisation was granted or has seriously and systematically infringed the provision of MiFID II or MiFIR.

## Defining DRSPs

It is important that there is certainty in regard to:

- a) which entities fall within the DRRs
- b) the regulatory obligations these entities have to comply with

In this respect, the specific definition for each type of DRSP is outlined below (under the relevant sub-headings: CTP, APA and ARM) and the government asks for comments in relation to each of these. More broadly, the government seeks comments in relation to its general approach with regard to the structure of the DRSP definitions.

The DRRs follow the definitions set out in MiFID II in respect of each DRSP, which refers to the characteristic that the relevant entity is authorised. The definition therefore has an element of circularity to it that could give rise to uncertainty regarding who falls within the regime. This approach to the DRS definitions in MiFID II might be contrasted with the usual approach to defining an entity which is subject to regulatory obligations by way of reference to the specific nature of activities performed. For example, the MiFID definition of "investment firm" is: "any legal person whose regular occupation or business is the provision of one or more investment services to third parties and/or the performance of one or more investment activities on a professional basis". Where a person meets these criteria and is not otherwise exempt it will require authorisation as an investment firm, authorisation is therefore a consequence rather than a part of the definition.

The government recognises that views have been expressed that the definitions (set out in MiFID II) have been structured in this to provide that the requirement to be authorised is formally elective for DRSPs. The government does not agree with this view and considers that it is clear that a person must be authorised in order to provide a DRS (see in particular Article 59 MiFID II). However, the government would welcome any comments on this point and on its interpretation of Title V of MiFID II, particularly in view of the difficulty with giving content to a definition for CTPs (discussed further below).

As noted above the UK's general transposition approach is to "copy out" the provisions of MiFID II where possible and the government has followed this approach in relation to the definition of DRSPs. However, the government acknowledges that this drafting might create uncertainty about when an entity is required to be authorised. In this respect, the government is seeking

consultation responses in relation to how it should approach the transposition of DRSPs and how it should define each DRSP. In particular, whether it should depart from its general approach (regarding “copy out”) and align the definition, in relation to all three DRSP’s, with the approach for investment firms.

## **General Operating Conditions**

Part 3 of the DRRs sets out the operating requirements that are applicable to all DRSPs. In particular, Regulation 12 DRRs places regulatory obligations on a DRSP’s management body which must, inter alia, be of sufficiently good repute and have sufficient knowledge, skill and experience and commit sufficient time, to perform its duties. This obligation on all DRSPs reflects the obligations specified at Article 63 MiFID II. Additionally, the draft DRRs take account of the Article 63(1) MiFID II provision that notes “where a market operator seeks authorisation to operate an APA, a CTP or an ARM and the members of the management body of the APA, the CTP or the ARM are the same as the members of the management body of the regulated market, those persons are deemed to comply” with the requirement that the management body are of sufficiently good repute and possess sufficient knowledge, skills and experience (see Regulation 12 DRRs). However, given the DRSPs are different in regulatory nature and purpose to one another, there are specific operating requirements for the different categories of DRSP, in Regulations 13, 14 and 15 in relation to APAs, CTPs and ARMs, respectively, which reflect the relevant MiFID II provisions. These are described below and further set out in the DRRs.

## **Consolidated Tape Provider (“CTP”)**

MiFID II introduced the category of CTP in order to achieve a consolidated view of post-trade transparency data. Following increased competition between trading venues post-MiFID, it has been suggested that liquidity fragmentation was making it difficult to get a consolidated market view of post-trade information. MiFID II seeks to remedy this difficulty. Recital 117 MiFID II states that, “now that a market structure is in place which allows for competition between multiple trading venues it is essential that an effective and comprehensive consolidated tape is in operation as soon as possible. The introduction of a commercial solution for a consolidated tape for equities and equity like financial instruments should contribute to creating a more integrated European market and make it easier for market participants to gain access to a consolidated view of trade transparency information that is available”. Further, the CTP regime envisages the authorisation of CTP(s) that are in competition with each other, “serving the market to the greatest extent possible and ensuring that consistent and accurate market data is made available” (Recital 117 MiFID II).

In order to achieve the policy intention set out above, Article 65(1) MiFID II places Member States under an obligation to require a CTP to have adequate policies and arrangements in place to collect the information made public in accordance with Articles 6 and 20 MiFIR, consolidate it into a continuous electronic data stream and make the information available to the public as close to real time as is technically possible, on a reasonable commercial basis, (the “Equity and Equity-like CTP Obligation”). There is a further obligation on Member States to require a CTP to have adequate policies and arrangements in place to collect the information made public in accordance with Articles 10 and 21 MiFIR, consolidate it into a continuous electronic data stream and make available to the public the information specified at Article 65(2) MiFID as close to real time as is technically possible, on a reasonable commercial basis (the “Non-Equity CTP Obligation”). In relation to the Non-Equity CTP Obligation, Article 93 MiFID II provides that this obligation does not commence until 3 September 2018; the DRRs make this distinction in Regulation 3.

The information is required to be made available free of charge 15 minutes after the CTP has published it, and be efficiently and consistently disseminated in a way that ensures fast access to the information, on a non-discriminatory basis and in formats that are easily accessible and utilisable for market participants. In this respect, it is intended that a CTP will collect the information made public for equity, equity-like and (at a later stage) non-equity financial instruments from APAs and trading venues and consolidate this into a continuous electronic data stream thereby making the information available to the public as close to real time as technically possible.

ESMA will draft RTSs in relation to the CTP regime, as specified at Article 65 MiFID II. In particular, it will provide RTSs on the financial instruments data which must be provided in the data stream, and for non-equity instruments, the trading venues and APAs which need to be included (Article 65(8)(c) MiFID II).

## **CTP Definition**

Subject to the consultation on the general approach to defining DSRPs outlined above, the UK has copied out the CTP definition provided by MiFID II into the DRRs. In this respect, a CTP is defined as a person authorised under Regulation 9 to provide the service of collecting trade reports for financial instruments made in accordance with Articles 6, 7, 10, 12, 13, 20 and 21 MiFIR from regulated markets, multilateral trading facilities, organised trading facilities and APAs and consolidating this information into a continuous electronic live data stream providing price and volume data per financial instrument.

An entity that collects trade reports as specified above will be required to be authorised, in accordance with Regulation 9 of the DRRs. However, in relation to CTPs the question arises as to what level of "consolidation" is needed before the requirement to be authorised is triggered. In this respect, the "consolidation" obligation will differ between the Equity and Equity-Like CTP Obligation and the non-Equity CTP Obligation. As noted above ESMA will draft RTSs for the Non-Equity CTP Obligation (which is in any event subject to a delayed application pursuant to Article 93 MiFID II).

In relation to the Equity and Equity-Like CTP Obligation, it is considered that an entity would be deemed to be a CTP where it is providing trade data with respect to all equity and equity-like instruments traded on all trading venues. For example, to be a CTP in respect of equity and equity-like instruments an entity would have to provide a consolidated tape for 100% of the trading in these instruments. It follows therefore that an entity which consolidates post-trade data for a lower percentage of trading in equities and equity-like instruments would not be a CTP and will not be required to be authorised. On the other hand, such an entity will not have the benefit of the CTP passport specified in Article 60(2) MiFID II. The underlying public policy rationale for requiring a CTP to provide 100% data coverage is for market competition to take place on the basis of quality of service to clients "rather than breadth of data covered" (Recital 117 MiFID II).

The government, however, acknowledges that issues may arise from requiring that an entity is only obliged to be authorised when providing CTP data services on a comprehensive basis (i.e. 100% coverage). In particular, no entity may currently be providing 100% coverage of the equity and equity-like market, or entities which are providing such coverage may opt to cover less than 100% of the equity and equity-like market in respect of the CTP services. However, MiFID II provides for ESMA to review by 2019 whether the CTP regime is functioning effectively (Article 90(2) MiFID II). If it is found that the CTP system has failed to provide the necessary information, the Commission has the ability to request that ESMA operate a tender process leading to a single pan-EU CTP provision being implemented by the Commission.

There are difficulties in consulting early on these provisions. In particular, how other Member States might approach the matter is uncertain. A disparate approach across Member States to the issue of coverage may have implications as to how service provision below 100% coverage is treated across borders when there are varying positions as to whether that lawfully requires authorisation or not, and whether passporting rights are engaged.

## **Obligations on a CTP**

A CTP will have to comply with the regulatory obligations specified in the DRRs. As noted above, the primary requirement is to provide a continuous electronic data stream and make information available to the public as close to real time as is technically possible, on a reasonable commercial basis. In relation to the meaning of “reasonable commercial basis” this will be further set out by the Commission through delegated acts.

A CTP will have to operate in compliance with a number of other obligations specified by Article 65 MiFID II, which have been transposed into the DRRs. In particular, the CTP provider will be required to operate and maintain effective administrative arrangements designed to prevent conflicts of interest. A market operator or an APA who also operates a consolidated tape, is required to treat all information collected in a non-discriminatory fashion and shall operate and maintain appropriate arrangements to separate different business functions. The requirements on trading venue operators are proposed to be implemented by way of amendments to relevant FCA Rules applicable to these operators. Further, a number of additional obligations are also subject to RTS, as specified by MiFID II Article 65(6) and (8).

## **Approved Publication Arrangement (“APA”)**

An APA is defined in the DRRs as an entity authorised under Regulation 9 of the DRRs to provide services to an investment firm in order for it to meet its obligations under Articles 20 and 21 MiFIR. As noted above this definition is in accordance with the general approach of the UK transposition, to copy out the provisions of MiFID II where possible. Therefore, an entity that provides the service of publishing trade reports on behalf of investment firms pursuant to Article 20 and 21 is required to be authorised under the DRRs.

There is perhaps less uncertainty in respect of the definition of APAs than in relation to the CTP definition (set out above). This is because the definition is tied to specific obligations set out in MiFIR. Article 20 MiFIR states that, “investment firms which, either on own account or on behalf of clients, conclude transactions in shares, depositary receipts, ETFs, certificates and other similar financial instruments traded on a trading venue, shall make public the volume and price of those transactions and the time at which they were concluded. That information shall be made public through an APA”. A similar obligation is placed on investment firms in relation to bonds, structured finance products, emission allowances and derivatives traded on a trading venue in Article 21 MiFIR. In this respect, an investment firm is required to make the specified information public through an APA. Therefore, where an entity is publishing trade reports, on behalf of investment firms, in the manner set out above, it will be required to be authorised under Regulation 9 of the DRRs.

The APA is required to have adequate policies and arrangement in place to make public the information required under Articles 20 and 21 MiFIR as close to real time as is “technically possible” on a reasonable commercial basis (see Regulation 13 DRRs). The Commission is empowered to adopt delegated acts to clarify what constitutes a reasonable commercial basis and no further detail on this is specified in the DRRs. However, Article 64 MiFID II provides that the information shall be made available free of charge 15 minutes after the APA has published it and sets out information that is required to be made public by the APA, such as identification of

the financial instrument and the price at which the transaction was concluded, which is transposed at Regulation 13 DRRs.

The APA will be subject to the provisions relating to authorisation (Regulations 7-11) and the operating conditions specified at Regulations 12 and 13. In particular, the operating conditions place the APA under an obligation to ensure that it maintains effective administrative arrangements designed to prevent conflicts of interest with its clients. APAs, who are also market operators or investment firms, are required to treat all information collected in a non-discriminatory fashion and shall operate and maintain appropriate arrangements to separate different business functions. It is proposed to implement the requirements for trading venue operators by way of amendments to relevant FCA Rules applicable to such operators.

## **Approved Reporting Mechanism ("ARM")**

An ARM is defined in the DRRs as an entity authorised under Regulation 9 of the DRRs to provide services to an investment firm in order for it to meet its obligations under Article 26 MiFIR. Again this definition is in accordance with the general approach of the UK transposition to copy out the provisions of MiFID II where possible. Therefore, an entity that provides the service of reporting transactions on behalf of investment firms pursuant to Article 26 is required to be authorised under the DRRs.

As with APAs, there is perhaps less uncertainty in respect of the definition of ARMs than in relation to the CTP definition (set out above). Again this is because the definition is tied to specific obligations set out in MiFIR. However, the government considers that where an entity is reporting transactions, on behalf of investment firms, in the manner required by Article 26 MiFIR, it will be required to be authorised under Regulation 9 of the DRRs.

Article 66(1) MiFID II requires Member States to require an ARM to have adequate policies and arrangements in place to report the information required under Article 26 MiFIR II as quickly as possible and no later than the close of the working day following the day upon which the transaction took place. The Article further provides a mandate for ESMA to develop RTSs on a number of issues regarding the obligation to report, including the data standards and formats in relation to these reports. Investment firms are required to make such reports and can either do so themselves or through an ARM.

MiFID II specifies a number of regulatory obligations that ARMs must comply with. In particular, an ARM must operate and maintain effective administrative arrangements designed to prevent conflicts of interest with its clients. An ARM that is also a market operator or investment firm shall treat all information collected in a non-discriminatory fashion and shall operate and maintain appropriate arrangements to separate different business functions. In general, this and the other obligations specified at Article 66 MiFID II have been transposed into the DRRs at Regulation 15. However, as noted above, it is proposed to implement the requirements for trading venue operators by way of amendments to relevant FCA Rules applicable to such operators.

## **DRRs and FCA Powers**

Given the intention to create a separate authorisation regime for DRSPs in Regulations, it is necessary to provide for the administration and enforcement of it. It is considered necessary (pursuant to Article 69 MiFID II) and proportionate to apply a number of the FCA's investigatory powers to these entities. In particular, the ability of the FCA to require information and carry out investigations is required under Article 69 MiFID II. These necessary powers and enforcement provisions are specified at Part 6 of the DRRs and include, inter alia, the following being applied to DRSPs:

- section 165 FSMA (the power to require information)
- section 166 FSMA (reports by skilled persons)
- section 166A FSMA (appointment of skilled person to collect and update information)
- section 167 FSMA (appointment of persons to carry out general investigations)
- section 168 FSMA (appointment of persons to carry out investigations in particular cases)

Further to the application of the powers listed above, the government also considers it reasonable and proportionate to create and apply provisions akin to section 89 (Misleading statements) and section 90 Financial Services Act 2012 (Misleading impressions) to DRSPs. This is considered proportionate given that complex business models may exist, where a DRSP is engaged in more than one type of DRS or carrying out other functions such as operating an investment firm, market operator or a trade repository. In these cases, a DRSP may have an incentive to give misleading impressions or statements in order to benefit the activities of the investment firm or other entity connected with it. However, there are already conflict of interest obligations that DRSPs have to comply with under the RTS and the DRRs. For this reason the Government has not provided draft legislation in relation to section 89 and 90 Financial Services Act 2012, but invites comments on the policy suggestion.

## Questions on DRRs

- 2 Do you agree that it is appropriate and proportionate to create a separate regulation for DRSs and in particular not to include them as regulated activities under the RAO?
- 3 Do you agree with the general approach to implementation of Title IV MiFID II including copying out the definitions in respect of CTPs, ARMs and APAs? If not please suggest an alternative, such as following the structure of the 'investment firm' definition.
- 4 Do you consider that it is reasonable and proportionate to apply something akin to section 89 FSMA and section 90 Financial Services Act 2012 to a DRSP? If you do not consider it reasonable or proportionate please specify why.
- 5 Do you agree with the transposition of the FCA powers in the DRRs? Do you consider that any further powers are necessary?





# 4 Position limits and reporting

---

## Position Limits

MiFID II sets out a position limit regime for commodity derivatives traded on trading venues and for economically equivalent OTC contracts. The position limit regime requires each Member State competent authority to establish the size of a net position (in line with the methodology for calculation determined by ESMA set out in RTS) in commodity derivatives traded on trading venues in that State and economically equivalent OTC contracts which any person can hold (Article 57(1) MiFID II). The policy rationale underlying the position limit regime (and also the position management and reporting regimes described below) is related to the G20 commitment to improve the regulation, functioning and transparency of the financial and commodity markets to prevent market abuse and to support orderly pricing and settlement conditions (see Recital 127, MiFID II).

In addition to establishing position limits, MiFID II has introduced new powers for competent authorities to require information on commodity derivative positions; to request a person reduce the size of a position and to limit a person from entering into a commodity derivative. The UK is mindful that ESMA will draft RTSs covering a significant number of aspects of the position limits regime and that these RTS are still to be finalised. In particular, the RTS will set criteria and methods for determining whether a position qualifies as reducing risks directly relating to commercial activities, the methods to determine when positions of a person are to be aggregated within a group, and the criteria for determining whether a contract is an economically equivalent OTC contract to that traded on a trading venue (Article 57(12) MiFID II).

Draft secondary legislation that transposes the position limit regime, required by Article 57 MiFID II is provided for comment in Annex A to this consultation paper.

Given that the position limit regime imposed by MiFID II will apply to persons holding positions in relevant contracts whether or not the persons are authorised, the Government has decided that it is preferable for the position limit regime required by MiFID II to be created as a “standalone” regime, rather than applying the requirements separately (i.e. in respect of authorised persons and persons not required to hold authorisation).

The legislative transposition is in Part 3 and Part 5 of the Financial Services and Markets Act 2000 (Markets in Financial Instruments) Regulations 2016 (“FSMA Regulations 2016”) (see Annex A).

In particular, Regulation 6 requires the FCA to establish and apply position limits on the maximum size of the net position which a person may hold. It also requires persons to observe those limits.

The territorial scope of the position limits regime has two aspects to it.

First, the contracts it covers. For limits set by the FCA this will include commodity derivatives traded:

1. Only on UK trading venues and economically equivalent OTC contracts; and
2. On contracts traded on UK trading venues and the same contracts traded on trading venues in other EEA countries that are the same as contracts traded on UK trading

venues and economically equivalent OTC contracts where the UK is the most liquid market for those contacts.

Second, the persons with positions to whom the limits might apply.

In respect of the limits which the FCA will be required to set, the limits apply to any persons regardless where they are situated, provided there is a link to a contract traded on a UK market. This means that where two persons in a third country with no link to the UK trade economically equivalent OTC contracts the limits do not apply.

It should also be noted that the UK is obliged under Article 57(14) MiFID II to ensure that the FCA has powers to help enforce position limits set by competent authorities in other EEA States. Regulation 6 makes clear that persons in the UK must abide by those limits and that the FCA's enforcement powers are available, where it may be appropriate to use those, to it.

When calculating the position any person holds in order to determine whether they are within an established limit, it will be possible for the FCA to approve in any one case that a position, in relation to positions held by or on behalf of a non-financial entity and which is objectively measurable as reducing risks directly relating to the commercial activity of that non-financial entity, not count towards the limit calculation. ESMA will provide a RTS on the criteria and methods for determining whether a position qualifies as reducing risks directly related to commercial activities and the procedures for the FCA approval process (Article 57(12)(a) and (f) MiFID II).

The administration and enforcement powers of the FCA in relation to position limits are set out in Part 5 of the draft Regulations. These powers are the same the new obligations MiFID II imposes on "unauthorised persons" (which are transposed in Part 4 of the Regulations).

Regulation 6 also provides for the ability of the FCA to refer disputes with other competent authorities as to the establishment of position limits to ESMA for binding mediation.

The FCA will be required under Regulation 7 to establish position limits in accordance with ESMA methodology unless there are exceptional reasons objectively justifying a departure from that. The position limits will be set by the FCA on the basis of all positions held by a person and those held on their behalf at an aggregate group level in order to:

- a) Prevent market abuse
- b) Support orderly pricing and settlement conditions.

The further requirements in relation to the position limit regime are set out in Regulation 7, which reflect the requirements of Article 57 MiFID II. In particular:

- a) Regulation 7(3) places the FCA under an obligation to review and reset a position limit where there is a significant change in deliverable supply or open interest or other significance change on the market based on its determination of deliverable supply and open interest
- b) Regulation 7(5) requires the FCA (where it has received an opinion from ESMA that it does not consider that a position limit the FCA has set is in accordance with its methodology) to either modify the position limit in accordance with ESMA's opinion or notify ESMA with the reasons why it considers that a modification is unnecessary
- c) The FCA has been provided with further powers in relation to the position limits regime to take account of Articles 69(2)(o) and 69(2)(p) MiFID II, which provide the relevant competent authority with the power to intervene in relation to commodity derivatives and this provision has been transposed into secondary legislation at

Regulation 10. This gives the FCA the power to limit the ability of any person falling within its supervisory scope for these purposes, from entering into a commodity derivative or “restrict the size of position any person may hold in a commodity derivative including by requiring any person to reduce the size of a position held” by issuing a supervisory notice

The further details of the position limit regime are subject to RTSs and will also be specified in FCA rules.

## **Position Management**

MiFID II requires trading venues that offer trading in commodity derivatives to have appropriate position management controls in place to mitigate the effects of a large or dominant commodity derivatives position (Recital 128 MiFID II). Specifically, Article 57(8) MiFID II places an obligation on Member States to ensure that a trading venue which trades commodity derivatives apply position management controls. Infringement of these sections is specified as an infringement of MiFID II and the FCA is required to have sanctions for non-compliance (Article 70(3)(xxxv) with position management controls (Article 57(8)) and reporting those controls to the FCA (Article 57(10) MiFID II).

In terms of a trading venues ability to effectively manage positions, MiFID II specifies a number of minimum powers that these entities must have, including to:

- a) monitor the open interest positions of persons
- b) access information about the size and purpose of a position or exposure entered into
- c) require a person to terminate or reduce a position, on a temporary or permanent basis
- d) where appropriate, require a person to provide liquidity back into the market at an agreed price and volume on a temporary basis with the express intent of mitigating the effects of a large or dominant position

To the extent that these obligations apply to Investment Firms and Credit Institutions operating trading venues these obligations will be detailed in FCA Rules made under FSMA powers relating to authorised persons. This is consistent with the transposition of MiFID requirements in relation to trading venues operated by such entities.

To the extent they relate to trading venues operated by Recognised Investment Exchanges these obligations are proposed to be added to the Schedule (new paragraphs 7BA and 7BB) to the Financial Services and Markets Act 2000 (Recognition Requirement) Regulations by the FSMA Regulations 2016 (see Annex A).

## **Position Reporting**

Article 58(1) MiFID II requires Member States to ensure that an investment firm or a market operator operating a trading venue which trades commodity derivatives or emission allowances or derivatives thereof make public a weekly report with the aggregate positions held by different categories of persons for each commodity derivatives or emission allowances or derivatives thereof traded on their trading venue and communicate that report to the FCA and separately ESMA (see also Recital 129 MiFID II). It also requires them to provide a complete breakdown of the positions held by all persons, including the members or the participants and the clients thereof on their trading venue daily to the FCA. The UK is mindful of the forthcoming level 2 measures by ESMA and the Commission in relation to position reporting. ESMA is mandated to draft ITS by 3 January 2016 on the format of the reports and breakdowns required under Article

58(1) MiFID II. The Commission will adopt delegated acts to specify the thresholds referred to in Article 58(1) MiFID II.

Further, Article 58(2) MiFID II places an obligation on investment firms, which trade in commodity derivatives, emission allowances or derivatives thereof outside a trading venue to provide the competent authority of the trading venue (where these specified instruments are traded) with a complete breakdown of their positions taken in commodity derivatives or emission allowances or derivatives traded on a trading venue and economically equivalent OTC contracts, as well as of those of their clients and the clients of those clients until the end client is reached.

As with the position management requirements, position reporting requirements will be detailed in FCA Rules made under FSMA powers for Investment Firms and Credit Institutions and inserted to the Schedule to the Financial Services and Markets Act 2000 (Recognition Requirement) Regulations by the FSMA Regulations 2016 (see Annex A) for Recognised Investment Exchanges.

### **Questions on position limits**

- 6 Do you agree that the regulation adequately transposes the position limit regime established by Article 57 MiFID II?
- 7 Do you agree that the amendments to the Recognition Requirement Regulations adequately transposes the position reporting and management regime established by Articles 57 and 58 MiFID II?
- 8 Do you agree that the position reporting and management regime established by Articles 57 and 58 MiFID II for Investment Firms and Credit Institutions operating trading venues be detailed in FCA Rules?
- 9 Do you agree that the powers of the FCA reflect those provided for under MiFID II? In particular, in relation to Article 69(2)(p) and 69(1)(j) MiFID II.
- 10 Do you have any further comments on the drafting of the secondary legislation in respect of the position limits and reporting regimes?

# 5 Unauthorised persons

---

MiFID II will apply to certain entities in circumstances where they are otherwise exempt from being authorised. Article 1(5) MiFID II notes that Articles 17(1) to (6) shall also apply to members or participants of regulated markets and MTFs who are not required to be authorised under MiFID II pursuant to points (a), (e), (i) and (j) of Article 2(1) MiFID II. Article 2(1) MiFID II, (a), (e), (i) and (j) refers to the following entities:

- insurance undertakings or undertakings carrying out the reinsurance and retrocession activities referred to in Directive 2009/138/EC when carrying out the activities referred to in that Directive
- operators with compliance obligations under Directive 2003/87/EC who, when dealing in emission allowances, do not execute client orders and who do not provide any investment services or perform any investment activities other than dealing on own account, provided that those persons do not apply a high-frequency algorithmic trading technique
- collective investment undertakings and pension funds whether coordinated at Union level or not and the depositaries and managers of such undertakings
- persons:
  - (i) dealing on own account, including market makers, in commodity derivatives or emission allowances or derivatives thereof, excluding persons who deal on own account when executing client orders
  - (ii) providing investment services, other than dealing on own account, in commodity derivatives or emission allowances or derivatives thereof to the customers or suppliers of their main business

provided that:

- for each of those cases individually and on an aggregate basis this is an ancillary activity to their main business, when considered on a group basis, and that main business is not the provision of investment services within the meaning of this Directive or banking activities under Directive 2013/36/EU, or acting as a market-maker in relation to commodity derivatives
- those persons do not apply a high-frequency algorithmic trading technique
- those persons notify annually the relevant competent authority that they make use of this exemption and upon request report to the competent authority the basis on which they consider that their activity under points (i) and (ii) is ancillary to their main business

Article 1(5) MiFID II provides that where entities that would otherwise fall into the above specified MiFID exemptions and which are members or participants of a regulated market or an MTF, and not otherwise authorised pursuant to MiFID or FSMA, the provisions specified at 17(1) to (6) MiFID II apply to these entities.

In relation to Article 1(5) MiFID II the government is seeking to ensure effective transposition, by proposing to apply the relevant requirements of Article 17 MiFID II to those categories of entity

that would otherwise be exempt (those entities specified above). See in particular Parts 4 and 5 of the FSMA Regulations 2016.

Regulation 11 would apply to a person in the UK engaging in algorithmic trading who is not required to be authorised under Part 4A FSMA in order to perform investment services and activities, who is a member or participant of a regulated market or multilateral trading facility, and to whom Article 2(1) a, e, i or j MiFID II applies. This section places a number of obligations arising from Article 17 MiFID II on such firms, including to:

- have systems and controls that are of sufficient quality, do not contribute to disorderly trading and are fully tested
- meet notification and reporting requirements to the FCA concerning their algorithmic trading and that record keeping requirements are met
- comply with the market making requirements

Regulation 12 would apply to a person in the UK providing the service of direct electronic access to a regulated market or MTF who is not required to be authorised under Part 4A FSMA in order to perform investment services and activities, who is a member or participant of a regulated market or multilateral trading facility, and to whom Article 2(1) a, e, i or j MiFID II applies (reflecting the obligations specified by Article 17(5) MiFID II in relation to such persons). In particular, this regulation places a number of obligations on such a person, including, inter alia, that the person must have in place effective systems and controls which ensure a proper assessment and review of the suitability of clients using the service, monitor the transactions for the reasons specified at Regulation 12(2)(b) and ensure that there is a binding written agreement between themselves and the client which satisfies the requirements specified at Regulation 12(2)(c).

Regulation 13 would apply to a person in the UK providing the service of acting as a general clearing member who is not required to be authorised under Part 4A FSMA in order to perform investment services and activities, who is a member or participant of a regulated market or multilateral trading facility, and to whom Article 2(1) a, e, i or j MiFID II applies (this reflects the obligations specified by Article 17(6) MiFID II in relation to such persons).

## **Unauthorised Persons FCA powers**

Article 69(1) MiFID II requires that competent authorities be given all supervisory powers, including investigatory powers and powers to impose remedies, necessary to fulfil their duties under MiFID II and MiFIR. Article 69(2) MiFID II further provides a list of powers that at a minimum satisfy the requirement specified at Article 69(1) MiFID II. These provisions should be read in conjunction with the relevant MiFID II recitals which note that MiFID II should provide a minimum set of supervisory and investigative powers to competent authorities of Member States in accordance with “national law” (Recital 137) which guarantees the respect of fundamental rights, including the right to privacy (Recital 138). In order for the FCA to be able to fulfil its duties under MiFID the UK considers it is appropriate to provide the FCA with various powers in relation to unauthorised persons.

As the unauthorised persons (specified above) are required to fulfil and comply with certain regulatory obligations, the FCA requires the power to be able to enforce and impose remedies for any breach of such obligations performed by these unauthorised persons.

Part 5 of the MiFID II Regulations provides for the FCA powers in respect of the obligations MiFID II imposes on unauthorised persons. This administration and enforcement regime follows the approach taken in the DRRs, which is discussed in more detail in the DRR and FCA powers

section in the Data Reporting Services chapter. The Government considers that this is a reasonable and proportionate means of giving effect to the MiFID II requirements in this regard. Note, the Government does not consider that applying provisions akin to sections 89 and 90 of the Financial Services Act 2012 is justified here, however.

Part 5 also applies to Part 3 of the MiFID II Regulations, which relates to Position Limits.

## Benchmarks

Article 37 MiFIR potentially applies to certain persons (any person with proprietary rights to the benchmark) that would fall within the scope of that Article but may be unauthorised (because they do not conduct regulated activities, under the RAO). The FCA does not have enforcement powers in respect of these persons (subject to the Benchmark Regulation<sup>1</sup> bringing such persons within the regulatory perimeter). Once further clarity is available on the final form of the Benchmark Regulation, the government will need to consider further whether it is necessary to amend FSMA so that a “person with a proprietary right to a benchmark” is subject to certain FCA enforcement powers and rights of information (such as certain of those specified at Part XI FSMA).

## Current UK regime and Benchmark Regulation

The draft Financial Services and Markets Act 2000 (Qualifying EU Provisions) (Amendment) Order 2016 (the Order) attached, at Annex D, ensures that FSMA is applied to certain provisions of MiFIR and directly applicable EU Regulations made under it. In particular, it enables the FCA and PRA to enforce directly applicable requirements arising from MiFIR in relation to persons in the United Kingdom (Article 3, for example, specifies that MiFIR is a directly applicable EU regulation for purposes relating to the regulation of RIEs). In this respect, the obligations arising from MiFIR are directly enforceable on authorised entities and the specific unauthorised entities set out above (to the extent that FSMA has been specifically applied to these entities, as described above).

However, unauthorised entities that are not otherwise caught (as set out above) or because they are not carrying out regulated activities (as set out in the RAO) will fall outside of the FCA’s powers, in relation to, for example, Part XI FSMA. The FCA would therefore not be able to appropriately enforce the obligations set out at Article 37 MiFIR in relation to these entities. The UK currently regulates the activities of (a) providing information in relation to a specified benchmark (Article 63O(1)(a)) (b) administering a specified benchmark is also a regulated activity specified at Article 63O(1)(b). The UK regime is currently limited in scope to “specified benchmarks”, but this is expected to be expanded by the Benchmark Regulation. Currently the UK regime does not capture all persons with a proprietary right to a benchmark (as set out at Article 37 MiFIR) and to extent that these are persons who are not otherwise caught under the RAO, the FCA will not have sufficient powers to request information or enforce the obligations set out at Article 37 MiFIR.

As set out above, given the expected expansion of the regulatory perimeter from the Benchmark Regulation, it remains to be seen whether there will, as a matter of practice, be a class of person who has a proprietary right in relation to a benchmark, to which the FCA will not have adequate powers in relation to (in enforcement terms and its ability to request information).

---

<sup>1</sup> See the Commission proposal for a Regulation on indices used as benchmarks in financial instruments and financial contracts (18 September 2013).

### Questions in relation to unauthorised persons

- 11 Do you agree with the transposition drafting and approach to unauthorised persons?
- 12 Do you agree that the powers provided to the FCA in respect of unauthorised persons are appropriate in light in particular of Article 69 MiFID?



# 6 Structured deposits

---

MiFID II has introduced a number of regulatory obligations with respect to structured deposits (which are outside the scope of MiFID). The rationale for bringing structured deposits within the scope of MiFID II (to the extent described below) is set out at Recital 39 MiFID II, where it is noted that structured deposits have emerged as a form of investment product which are not appropriately regulated, compared to other structured investments. MiFID II therefore seeks to contribute towards “levelling the playing field” across structured investments with the aim of harmonising investor protection across Europe in relation to these investment products (i.e. structured deposits as a form of investment product, excluding deposits linked solely to interest rates, such as Euribor or Libor).

Accordingly, Article 1(4) MiFID II applies the following provisions to Investment Firms and to Credit Institutions, when selling to or advising clients on structured deposits:

- Article 9(3): relating to management body oversight
- Article 14: relating to investor compensation scheme
- Article 16(2), (3) and (6): relating to organisational requirements
- Articles 23-26: relating to conflicts of interest, the provision of information to clients, the assessment of suitability and appropriateness and reporting to clients and provision of services through the medium of another investment firm
- Article 28: relating to client order handling
- Article 29 (excluding Article 29(2)): relating to obligations of investment firms when appointing tied agents
- Article 30: relating to transactions executed with eligible counterparties
- Articles 67-75: relating to the designation of and supervision by competent authorities, cooperation between member states, powers of the competent authority, sanctions for infringement, reporting of breaches and rights of appeal

As is clear from the above, structured deposits are distinct from the financial instruments specified at Annex 1, Section C, insofar as the provisions of MiFID II only apply as specified above. In particular, MiFID II does not apply Article 5 (Requirement for Authorisation) to persons performing investment services and activities in relation to structured deposits. Therefore MiFID II does not explicitly require or compel Member States to ensure that Investment Firms or Credit Institutions be authorised, by the competent authority, where they carry out certain activities in relation to structured deposits. However, it is the government's view that in order for the FCA and the PRA to be able to effectively supervise the obligations specified by Article 1(4) MiFID on investment firms and credit institutions, it is necessary to bring certain regulated activities within the UK regulatory perimeter when carried on in relation to structured deposits. On this basis, the government has, as part of this consultation, provided draft secondary legislation that amends existing UK legislation (primarily the RAO), through the Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) Order 2016 (provided at Annex C) (“Amendment Order 2016”).

## Structured Deposit Definition

It is proposed to amend Article 3 of the RAO to include the definition of “structured deposit”, which is copied out from MiFID II (see Article 3 of the Amendment Order 2016). In this respect, the government notes that the acceptance of deposits which have a structured payoff is currently part of the activity of accepting deposits under Article 5 RAO and continues to also fall within that Article. The draft amendment to Article 3 RAO simply specifies a particular form of deposit (structured), which give rise to additional obligations that otherwise do not affect other deposits within the meaning of Article 5 RAO.

## Structured Deposit: Regulated Activities

A number of amendments are being proposed to the RAO to transpose Article 1(4) MiFID II. In particular, the following regulated activities have been extended so as to apply to structured deposits (see Article 6 of the Amendment Order 2016):

- Article 21 RAO (“Dealing in investments as agent”)
- Article 25(1) RAO (“Arranging deals in investments”)
- Article 25(2) RAO (“Making arrangements with a view to transactions in investments”)
- Article 37 RAO (“Managing investments”)
- Article 53 RAO (“Advising on investments”)

It is considered that the amendments to the RAO specified in this paragraph are necessary to ensure appropriate transposition of Article 1(4) MiFID II (insofar as legislative amendment is required); this is because Article 1(4) MiFID II explicitly refers to the activities of “selling” and “advising clients”. The government considers that the activity of “selling” would capture the regulated activities set out above. To take the amended regulated activities in turn:

- Article 21 relates to the act of sale, occurring where a person deals as an agent on behalf of another person
- It is considered that the activity specified by Article 25(1) RAO “arranging (bringing about) deals in investments” is also related to the act of sale. This is the case as the activity is only performed in relation to Article 25(1) RAO where the arrangements bring about, or would bring about, the transaction to which the arrangement relates. This is because of the exclusion in Article 26 RAO (Arrangements not causing a deal), which excludes from Article 25(1) RAO arrangements which do not bring about or would not bring about the transaction to which the arrangements relate
- It is also considered that the wider activity specified by Article 25(2) RAO (“Making arrangements with a view to transactions in investments”) should be widened to include the making of arrangements with a view to transactions in relevant structured deposits. This is the case, even though the activity within Article 25(2) RAO is not limited by the requirement that the arrangements would bring about the transaction to which they relate (as in Article 25(1) RAO). It is considered that the reference to “selling” in Article 1(4) MiFID II is wide enough to capture arrangements that are made with a view to transactions in structured deposits. For example, where a person is introduced to an entity who is selling such structured deposits (and where Article 33 RAO does not apply). This will therefore capture activity undertaken by appointed representatives. This is considered appropriate given Recital 40 MiFID II, which provides that “investment firms and credit

institutions when selling or advising clients in relation to structured deposits should be understood as when acting as intermediaries for those products issued by credit institutions that can take deposits in accordance with Directive 2013/36/EU". The reference to intermediaries could therefore be said to capture firms carrying out the activity of "making arrangements with a view to transactions in investments". The amendment proposed to Article 25(2) RAO is also consistent with the pre-existing structure of the RAO

- The activity of managing specified at Article 37 RAO, would also be captured by Article 1(4) MiFID, given that "managing" necessarily includes within it the purchase or sale of investments
- The activity of advising specified at Article 53 RAO, is squarely within the wording of Article 1(4) MiFID II, which captures advice in relation to structured deposits

The proposed amendments to the RAO include a transitional regime set out at Article 13 of the Amendment Order 2016. This permits persons who have the permission on the date the amendments to the RAO come into force to carry out the activities set out above and who wish to carry out these activities in relation to structured deposits to take advantage of a streamlined notification regime. The person is deemed to have obtained a variation of permission if they have notified the appropriate regulator in writing of their wish to undertake the activity and the regulator has acknowledged receipt. The intention is to provide a streamlined and bespoke process for firms and regulators alike, which will assist in enabling the regulators to identify the relevant firms in time for the commencement of the new regime.

The FPO has been amended to include the definition of structured products provided above, in Article 2 of the FPO. A number of other provisions in relation to the FPO have also been switched on in relation to structured deposits (for example, structured deposits have been included in Paragraphs 3,4,5 and 7 of Schedule 1 to the FPO) (Schedule to the Amendment Order 2016). This is considered necessary to ensure consistency with how the current treatment of investment activities and instruments are treated and the amended investment activities in relation to structured deposits. It is also considered beneficial to ensure that investor protections are strengthened through appropriately regulating the invitations and inducements made by the specified unauthorised persons in relation to structured deposits. As a result of the amendments, section 21(1) of FSMA will now capture the activities (described above) in relation to structured deposits. Under the draft amendments, for example, a person is now prohibited, while in the course of business, from communicating "an invitation or inducement to engage in" the management of structured deposits, as the former is proposed as a "controlled activity" and the latter a "controlled investment" pursuant to section 21(9) and (10) of FSMA. The usual exemptions (and others where relevant) will apply to the prohibition. For example, where the person communicating the invitation or inducement is an authorised person or the content of the communication is approved by an authorised person there will be no breach of the financial promotion prohibition. The FCA will consult on amendments to the relevant parts of its rules in due course.

## Questions in relation to Structured Deposits

- 13 Do you consider the regulated activities that have been "switched on" on for structured deposits appropriate to cover the Article 1(4) MiFID II concepts of "selling or advising"? In particular, is it appropriate to treat Article 25(2) RAO and Article 37 RAO as within the meaning of "selling"?
- 14 Is the definition of structured deposits provided at Article 3 RAO clear?

- 15 Do the amendments to the FPO ensure consistency between it and the amended RAO activities in relation to structured deposits?
- 16 Do you have any further comments on the draft secondary legislation in relation to structured deposits?

# 7 Power to remove board members

---

Article 69 MiFID II requires that competent authorities shall be given all supervisory powers, including investigatory powers and powers to impose remedies, necessary to fulfil their duties under MiFID II and MiFIR. This consultation paper has referred to specific amendments to current FCA and PRA powers under FSMA to ensure that the UK has appropriately transposed these powers where new powers are required (see, for example, chapters on unauthorised persons and position limits, management and reporting).

MiFID II introduces a new provision in Article 69(2)(u), which requires that a competent authority has at least the power to “require the removal of a natural person from the management board of an investment firm or market operator”. In transposing this requirement, Member States are to have regard to the context of “national law” and “fundamental rights” (Recitals 137 and 138 MiFID II). The Government is seeking consultation responses on the best approach to transposing the Article 69(2)(u) power and sets out two options below.

- rely on the existing FSMA powers (“Option A”)
- create a new standalone power in Part V FSMA to allow the PRA or the FCA to require an institution to remove members of its board, where specific conditions are met (“Option B”)

## Option A

Currently the PRA and FCA have a number of powers in relation to “approved persons”, which would allow either regulator to prohibit a specific category of person from continuing to carry out a regulated activity. Option A is to rely on these powers as being sufficient to transpose Article 69(2)(u) of MiFID II (with the caveat that the current powers will need, in any event, to be extended to RIEs, as set out in the manner specified in Option B). If in the light of responses to the consultation, the Government pursues this option then only minor amendments to FSMA would be required.

## Current Powers

FSMA provides that individuals performing roles of significant influence or customer facing roles must be approved as individuals, (known as the approved person regime). Under the approved persons regime and related systems and controls requirements in the regulators’ Supervision and Senior Management Arrangements, Systems and Controls modules, those in controlled functions have regulatory responsibilities in relation to the organisation and control of a firm. The PRA and the FCA also have a number of powers in relation to such persons, including the power to withdraw approval. Currently company board directors performing controlled functions would be subject to the approved persons regime and therefore subject to the approved persons regime (although this would not cover RIEs, who are not subject to this regime). The approved persons regime will be replaced for “relevant authorised persons” by the Senior Managers and Certification Regime from 7 March 2016 when Part 4 of the Financial

Services (Banking Reform) Act 2013 comes into force<sup>1</sup>. As with the approved persons regime, this will not cover RIEs.

The regulators have a number of powers that can be used either in relation to the firm or in relation to particular individuals within the firm. These include the general requirements power, the general prohibition power and power to remove a senior manager's approval (sections 55L, 55M, 56, 63). Some of these include slightly more procedural requirements and others allow for more immediate action to be taken by the regulator. All are subject to a requirement to provide notice to interested parties and a right of appeal to the tribunal.

The implementation of the Senior Managers and Certification Regime will see the commencement of section 63ZB FSMA which will enable the FCA or PRA to vary an approval under section 59 for the performance of a designated senior management function in a "relevant authorised person" if the regulator considers that it is desirable to do so in order to advance a statutory objective. There are a number of restrictions on the exercise of this power set out in section 63ZC.

There are some possible limitations with relying on the FCA and PRA's existing powers in relation to Article 69(2)(u) of MiFID II. Firstly, the approved persons regime does not extend to those entities covered by Part 18 FSMA (Recognised Investment Exchanges, for instance). Clearly, there should be no gap in the current legislation in relation to the relevant universe of firms that perform MiFID investment services and activities. Secondly, in order to ensure that the power is effective from a supervisory perspective in relation to firms, arguably it should be capable of taking effect in urgent situations. This is not always the case for powers to remove a person's status as an approved person. However, the power in section 63ZB can be exercised with immediate effect if the regulator reasonably considers it necessary and we suggest below (Option B) therefore using this as a model to assist in the effective transposition of Article 69(2)(u) MiFID II.

While these existing powers could be regarded as adequately transposing Article 69(2)(u) they do not extend to all persons within the scope of MiFID II and given that there is a new requirement on competent authorities in MiFID II, it is considered there is benefit in setting out a clear standalone power.

## Option B

Given specified limitations regarding the existing powers in relation to class of person and timing, the government is seeking consultation responses to a proposal to establish a standalone power that would apply to MiFID investment firms authorised by the FCA and operators of RIEs. For MiFID investment firms generally, the new power would permit the FCA or PRA to place/modify/remove restrictions on approved persons exercising Senior Management Functions on the same basis as described at section 63ZB FSMA and section 63ZC FSMA. For market operators, the approved persons' regime does not apply to Recognised Investment Exchanges (as noted above) and therefore something specific needs to be introduced to transpose Article 69(2)(u) MiFID II for these entities under both option A and B. In this respect, we propose amending section 296 FSMA to make it explicit that the power in this section can be used to direct an RIE to remove an individual from the board.

---

<sup>1</sup> "Relevant authorised persons" are defined in section 71A FSMA. They include banks, building societies, credit unions and PRA-regulated investment firms.

## Investment Firms and Article 69(2)(u) of MiFID II

The power would be similar in approach and design to that of section 63ZB (as outlined above). In particular, the FCA or the PRA could be given the power to require a firm to remove a member of a board where a set of specific conditions are met or circumstances arise such as, that a person's actions:

- may have led to the firm contravening a requirement imposed on it under FSMA, threshold requirements or MiFIR
- may have led to the firm, in purported compliance with any requirement imposed on it under FSMA or MiFIR, knowingly or recklessly giving the FCA or PRA information which is false or misleading in a material particular
- mean that it is desirable to exercise the power in order to advance one or more of the FCA or PRA's operational objectives

The power would permit the FCA or PRA to impose requirements on firms to remove members from the management board and take effect immediately subject to a supervisory notice, and the ability to challenge at a tribunal. In particular, the restrictions operating on such a power would be similar to those specified as operating on current section 63ZB FSMA (see also section 63ZC FSMA). In particular:

- a requirement may be expressed to take effect immediately (or on a specified date) only if the regulator concerned, having regard to the ground on which it is exercising the power, reasonably considers that it is necessary for the requirement to take effect immediately (or on that date);
- if either regulator proposes to impose a requirement on a firm to remove a member from the management board with immediate effect, it must give each of the interested parties written notice. The notice must:
  - a. give details of the requirement
  - b. state the regulator's reasons for the requirement
  - c. inform the interested parties that each of them may make representations to the regulator within such period as may be specified in the notice (whether or not any of the interested parties has referred the matter to the Tribunal)
  - d. inform the interested parties of when the requirement takes effect
  - e. inform the interested parties of the right of each of them to refer the matter to the Tribunal
- if having considered the representations made by the interested parties, the regulator decides not to impose the requirement, it must give each of the interested parties written notice
- the notice must inform the interested parties of the right of each of them to refer the matter to the Tribunal
- the PRA and FCA are required to issue a statement of policy with respect to the removal of persons from the board, which should have regard to the seriousness of the contravention, the extent to which the contravention was deliberate or reckless and whether the person on whom the penalty is to be imposed is an individual

## Market Operators and Article 69(2)(u) of MiFID II

As noted above, RIEs are not subject to certain FCA powers which apply to authorised persons. The government is therefore consulting on how best to ensure that the FCA can apply the powers specified in Article 69(2)(u) MiFID II to RIEs. Currently, we consider that the best approach in relation to ensuring the transposition of Article 69(2)(u) in respect of RIEs, is to amend section 296 of FSMA explicitly noting that this section permits the FCA to direct that the recognised body place remove or place restrictions on specified individuals, who sit on the relevant recognised body's board.

Section 296 FSMA provides that the power of direction applies where a recognised body:

- has failed, or is likely to fail, to satisfy the recognition requirements
- has failed to comply with any other obligation imposed on it by or under FSMA
- has failed, or is likely to fail, to comply with any obligation imposed on it by any directly applicable Community regulation made under the markets in financial instruments directive

Where the above is the case, the FCA may direct the body to take specified steps for the purpose of securing the body's compliance with:

- the recognition requirements
- any obligation of the kind in question
- in the case of a RIE other than an overseas investment exchange, those steps may include: the granting to the FCA of access to the premises of the exchange for the purpose of inspecting those premises; or any documents on the premises which appear to the FCA to be relevant for the purpose mentioned in subsection; the suspension of the carrying on of any regulated activity by the exchange for the period specified in the direction

The government proposes to include within the specified steps the power to require the RIE to remove an individual who sits on the relevant entity's board or place restrictions on such an individual.

## Questions in relation to power to remove member of the board

- 17 Do you consider that existing FSMA powers are sufficient for the purposes of Article 69(2)(u) MiFID? If yes, please explain how these powers do not suffer from the limitations mentioned above.
- 18 Do you agree that FSMA powers in relation to market operators have to be amended either under Option A or B?
- 19 Do you consider that Option B is appropriate to transpose Article 69(2)(u) MiFID? If not, please specify what your preferred alternative option is and how this meets Article 69(2)(u) of MiFID.
- 20 What factors do you think should be taken into account in relation to the drafting of the standalone power suggested at Option B? Please provide answers both in relation to the proposal for investment firms and market operators.



## 8 Organised trading facility

---

MiFID II creates a new category of investment service, the operation of an Organised Trading Facility (“OTF”), specified at Annex 1 Section A9 (as defined at Article 4(1)(23) MiFID II). OTFs will sit alongside regulated markets (“RMs”) and MTFs, as a third type of multilateral system in which multiple buying and selling interests can interact in a way that results in contracts. However, an OTF can only facilitate the trading of bonds, structured finance products, emission allowances or derivatives on a discretionary basis. MiFID II specifies a number of regulatory obligations and requirements in relation to the OTF investment service, in particular those in Articles 18 and 20 MiFID II.

An OTF will be able to be operated by either an Investment Firm or Credit Institution (with the appropriate Part 4A permission), or a RIE.

For Exchanges the specific requirements in relation to operating an OTF are in the proposed amendments to the Schedule to the Financial Services and Markets Act 2000 (Recognition Requirements) Regulations 2001 made in the FSMA Regulations 2016 (see Annex A). The regulatory amendments also propose to grant the FCA powers under section 286(4F) to make rules to provide further details on the obligations on Exchanges when operating trading venues.

The specific requirements for OTFs operated by Investment Firms or Credit Institutions will be transposed through FCA rules, via amendment to its handbook.

Accordingly, there are draft amendments to the RAO (new Article 25DA RAO, which is defined in a new provision specified at Article 3 RAO) in order to ensure that it transposes, to the extent necessary, the OTF category into domestic legislation through the regulated activities and Part 4A permission regime. Operating an OTF will be an investment service under the RAO and therefore in order to provide the service a person will require a license as an Investment Firm or Credit Institution under Part 4A of FSMA or as a RIE under Part 18 of FSMA.

The Amendment Order 2016 allows applications under Part 4A of FSMA to operate an OTF (or perform investment services and activities in relation to structured deposits or emission allowances) including Variations of Permissions (VOPs), to be submitted ahead of the application of MiFID on 3 January 2017. This is designed to ensure that market participants can efficiently submit such applications and provide the regulator with the ability to manage better the overall process.

Article 20(2) MiFID II provides that “Member States shall permit an investment firm ... operating an OTF to engage in matched principal trading in bonds, structured finance products, emission allowance and certain derivatives only where the client has consented to the process.” Further, OTF operators may engage in dealing on own account other than matched principal trading with regard to sovereign debt instruments for which there is not a liquid market. This raises the question of whether an OTF operator requires a separate permission to deal in investments as principal to carry on these activities in the OTF or whether a notification regime will be sufficient. The amendment to the RAO currently does not provide that an OTF operator requires such a permission as part of its authorisation process. Instead it proposed that the issue of how OTF firms that conduct “matched principal trading” and principal trading in illiquid sovereign bonds are more appropriately dealt with in FCA rules, rather than requiring, for example, OTF operators to have a “dealing as principal” permission. On this basis, the FCA will consult, in due course, on how it considers best to approach the identification of firms with an OTF permission that conduct “matched principal trading” and principal trading in illiquid sovereign bonds.

The FPO has been amended to take account of the OTF investment services specified at new section 25DA RAO, by the insertion of a new Article 4AA, ensuring that operating an OTF is considered a controlled activity in relation to financial promotions. The effect of this is that an invitation or inducement to participate in an OTF will constitute a financial promotion under section 21 FSMA (subject to any relevant exclusions).

### **Questions in relation to OTF Transposition**

- 21 Do you agree that amendments to the RAO and the Recognition Requirements Regulations appropriately transpose the MiFID II investment service of operating an OTF? In particular, do you agree that it is unnecessary 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?
  
- 22 Do you have any additional comments on how the government has transposed the MiFID II OTF regime?

## 9 Binary options

---

Binary options are a form of financial contract which pay a fixed sum if the option is exercised or expires in the money, or nothing at all if the option is exercised or expires out of the money. When transposing MiFID the UK did not extend the scope of the RAO to cover such instruments. The UK's approach to transposition of MiFID on this issue was in line with how the Committee of European Securities Regulators ("CESR") publicly analysed the scope of MiFID<sup>1</sup>. Therefore under current UK legislation binary options are classified as bets and are supervised by the Gambling Commission rather than the FCA.

However, different Member States have taken different approaches to this issue. Several Member States include binary options within the scope of their transposition of MiFID financial instruments. This creates inconsistencies in approach as to whether firms offering binary options can or cannot passport across the EU. It also means that there is confusion for potential purchasers of binary options about their status and potential inconsistencies in consumer protection for what can be risky products.

The European Commission published a Question and Answer on the coverage of binary options in MiFID on its Question and Answer database on the interpretation of MiFID<sup>2</sup>. The material on the database represents non-binding expressions of opinion by the Commission to assist firms and consumers to understand legislation. The Question and Answer on binary options indicates that the Commission believes that certain binary options are within the scope of MiFID.

The uncertainty in the EU about the status of binary options did not lead to any specific amendment to MiFID II. However, in the light of the growth of the binary options market and concerns about consumer protection, the government considers that it is appropriate to consider their status under the existing directive and revisit the UK's transposition of this element of MiFID.

The government is now of the view that binary options, where they relate to specific underlyings, are appropriately viewed as MiFID financial instruments. It therefore proposes to bring activity in relation to these instruments within the regulatory perimeter, where they are derivatives in relation to which an investment firm or credit institution is providing or performing investment services and activities on a professional basis. Such persons providing specific binary options, under the draft amendments to the RAO (as further detailed below), would require a Part 4A authorisation under FSMA and be regulated by the FCA. Although there are supportive legal considerations in deeming certain binary options "financial instruments" and specifying them as specified investments under the RAO, there are also strong policy reasons for doing so. In particular, the specific binary options (described below) present similar risks to derivatives and classifying them as financial instruments would ensure that providers would be subject to specific regulatory requirements in relation to, inter alia, organisational and capital requirements and that the range of investor protection rules in MiFID would also apply. It would also mean that the specified binary options are brought within the scope of the market abuse regime.

The government is seeking comments on its proposed draft legislation to bring certain binary options within the RAO, when provided in the circumstances specified above. In this respect the primary amendment is that to Article 85 of RAO and is set out at Annex E. Article 85 provides that contract for differences are financial instruments and where a person carries out the

---

<sup>1</sup> See discussion on page 21 of "CESR's Draft Technical Advice on Possible Implementing Measures of the Directive 2004/39/EC - 2nd Set of Mandates" [http://www.esma.europa.eu/system/files/04\\_562.pdf](http://www.esma.europa.eu/system/files/04_562.pdf)

<sup>2</sup> <http://ec.europa.eu/ygol/index.cfm?fuseaction=question.show&questionId=1095>

regulated activities set out in the RAO in relation to these that person will be subject to section 21 FSMA (the General Prohibition) and require authorisation (unless they fit within an exclusion). Examples of instruments that fall within Article 85 RAO currently are spread bets and interest rate swaps.

The proposed amendment to Article 85 RAO extends the provision of this section to include contracts to which Article 85(1) does not apply, which are settled in cash and which are a financial instrument covered by paragraphs 4 to 7 and 10 of Section C of Annex 1 to MiFID or where Article 38 of the Community Regulation 1287/2006/EC applies. The consequence of this drafting is that a binary option is a financial instrument in circumstances where similar derivative contracts would also be regarded as financial instruments, for example, where the option relates to currencies, stock indices, individual shares, commodity prices and economic statistics. The draft amendment to the RAO would therefore capture a wide range of binary options. The government is particularly seeking responses in relation to whether this draft legislation raises any problems in relation to scope of what would be captured. For example, a binary option in relation to climatic variables would appear to capture a range of binary options that might not ordinarily be considered to be financial.

It is important to note that the Amendment Order 2016 (Annex C) has been drafted as if the proposed amendments to provide for binary options mentioned above has already been made. The reason for this is to avoid the Amendment Order 2016 having to contain elements which relate to MiFID (such as the existing MiFID Commission Implementing Regulation) when its purpose is to illustrate the changes required for MiFID II (e.g. for structured deposits and OTFs).

## Questions

- 23 Do you agree that binary options should be treated as financial instruments under the existing MiFID?
- 24 Do you agree with the scope of the coverage of binary options proposed in the amendment to Article 85 of the RAO? If not, what do you think the scope should be?



### **HM Treasury contacts**

This document can be downloaded from  
[www.gov.uk](http://www.gov.uk)

If you require this information in an alternative  
format or have general enquiries about  
HM Treasury and its work, contact:

Correspondence Team  
HM Treasury  
1 Horse Guards Road  
London  
SW1A 2HQ

Tel: 020 7270 5000

Email: [public.enquiries@hmtreasury.gsi.gov.uk](mailto:public.enquiries@hmtreasury.gsi.gov.uk)