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13 February 2019

Financial Regulation Monthly Breakfast Seminar

Overview

- The latest on Brexit
- FCA's consultation on further amendments to SMCR including clarification on the position of Head of Legal
- FCA's consultation on its approach to cryptoassets
- FCA Fine - Paul Stephany

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The latest on Brexit

Carl Fernandes and Anne Mainwaring

FCA guidance on temporary transitional power in a no-deal scenario

- FCA has outlined how it intends to use the temporary transitional power it has been given to help address the cliff edge effects of a no-deal Brexit
- The FCA intends to make use of this power to ensure that firms can generally continue to comply with their regulatory obligations as they did before exit
- The FCA has however highlighted certain areas where it would not be consistent with its statutory objectives to grant transitional relief and where firms therefore need to begin preparing to comply with the changed obligations now on the assumption that there will be no implementation period

FCA guidance on temporary transitional powers in a no-deal scenario (cont.)

- In these areas the FCA expects firms to take "reasonable steps" to comply with the changes to their regulatory obligations by exit day but makes clear that it intends to act proportionately
- "This means that, in the event that the UK leaves the EU without an implementation period, we will not take a strict liability approach and do not intend to take enforcement action against firms and other regulated entities for not meeting all requirements straight away, where there is evidence they have taken reasonable steps to prepare to meet the new obligations by exit day"
- Note however that the FCA is planning to take a slightly stricter line in relation to transaction reporting

FCA guidance on FIRDS and transaction reporting in a no-deal scenario

- Transitional relief will not be given in relation to transaction reporting and therefore the FCA has provided an overview of what firms need to do now to comply with the on-shored transaction reporting regime from exit day:
  - All firms who want to access FCA FIRDS to support their transaction reporting obligations will need to connect (either directly or via a third party) to FCA FIRDS
  - UK trading venues will need to prepare to transaction report for transactions on their venues by their EEA members (who are not operating through a UK branch)
  - EEA firms who operate through a UK branch, and who enter the temporary permissions regime, will need to either connect directly to the MDP or use an ARM to be able to transaction report to the FCA
- FCA has specified it will not take a strict liability approach to compliance following a no-deal Brexit but it should be noted that the FCA expects firms unable to comply immediately to back-report missing, incomplete or inaccurate transaction reports as soon as possible

FCA agrees MoUs with ESMA and EU regulators to allow cooperation and exchange of information

- The following MoUs have been agreed in relation to cooperation and the exchange of information in the event the UK leaves the EU without a withdrawal agreement and implementation period:
  - A multilateral MoU with EU and EEA NCAs covering supervisory cooperation, enforcement and information exchange; and
  - An MoU with ESMA covering supervision of Credit Rating Agencies and Trade Repositories
- In particular this means that EU fund mangers will be able to continue to delegate portfolio management services to firms located in the UK post-exit which would otherwise have been prohibited
- Note that no agreement appears to have been reached in relation to TREM

HMT draft legislation to allow the UK to make timely equivalence decisions in relation to the EU

- Post-exit HMT will take on the role of making equivalence decisions under onshored legislation
- HMT has been given temporary powers to make equivalence decisions in relation to EEA Member States to come into force on exit day – therefore avoiding any market disruption that could result if there were a 'gap' in equivalence
- The temporary power will also enable HMT to make equivalence decisions more quickly than under the onshored equivalence frameworks meaning post-exit it will also be able to implement new equivalence decisions promptly

ESMA Q&As on prospectuses and transparency

- ESMA has published two new Q&As in relation to the Prospectus Directive that will be relevant only in the event of a no-deal Brexit
- Q&A 104 provides that prospectuses and supplements approved by the FCA before 29 March 2019 cannot be used in the EU27 / EEA after a no-deal Brexit
  - Open offers in the EU27 / EEA based on a prospectus approved by the FCA are unlikely to be able to continue on 30 March if there is a hard exit – instead it is likely the issuer would have to start a new offer once a prospectus is approved in the EU27 / EEA
  - An issuer wishing to make a new offer to the public, or seek a new admission to trading on a regulated market, in the EU27 / EEA where the prospectus was approved by the FCA pre-exit (and is still valid) would need to have a prospectus approved in its new EU27 home Member State before doing so

ESMA Q&As on prospectuses and transparency (cont.)

- This contrasts with the UK approach where the government has determined that prospectuses passported into the UK before exit day will be grandfathered for use in the UK until their validity expires
- Q&A 103 addresses the choice of home Member State for issuers that currently have the UK as their home Member State under the PD and specifies that issuers should choose between the Members States in which they have offers/admissions made after withdrawal or where they have admissions made before withdrawal which continue after withdrawal

ESMA Q&As on prospectuses and transparency (cont.)

- ESMA has also published a new 'no-deal' Q&A in relation to the Transparency Directive which notes that an issuer which had the UK as its TD home Member State before withdrawal and is admitted to trading on one or several regulated markets in the EU27 / EEA must determine its TD home Member State and disclose this without delay post 29 March
- ESMA is of the view that for these purposes the Member State where the issuer's securities are admitted to trading on a regulated market should be considered its home Member State

ESMA Statement on the use of UK data in ESMA databases under a no-deal Brexit

- In the event of a no-deal Brexit no new UK related data will be received and processed by ESMA nor published on the ESMA website from 30 March 2019
- Reference data submitted by UK trading venues and SIs will be terminated on 30 March – ESMA notes that this will remove from the scope of the MiFIR transaction reporting requirements and the transparency regime financial instruments that are only available for trading on UK venues and that "initially" this means that the number of instruments within scope of these requirements will be significantly reduced
- In the case of a no-deal Brexit ESMA will freeze the quarterly calculations for the SI determination for equity instruments and bonds, the quarterly determination of the liquidity status of bonds and the monthly DVC publications for a period of two months after Brexit

…and the FCA response

- FCA published a statement saying it welcomes the statement published by ESMA on the use of UK data in ESMA databases and the performance of MiFID II calculations in the EU27 if the UK leaves the EU in a no-deal scenario and that it views ESMA's statement as a pragmatic approach to how MiFID II will operate in the EU27
- FCA's expects to set out its approach to using its temporary powers to operate MiFID II in the UK by the end of February but emphasises that the powers are there to help avoid significant short-term disruption in a no-deal scenario and that its approach will provide continuity in the operation of the transparency regime in the UK, taking into account trading activity in both the UK and the EU27 where appropriate and practicable

ESMA statement on EMIR derivatives reporting in the event of a no-deal Brexit

- Clarifies certain instances relating to derivatives reported under Article 9 of EMIR in a no-deal scenario
- Reflects that, in a no-deal scenario, the EMIR reporting obligation will not apply to UK counterparties who will not therefore be expected to report any derivative concluded on 29 March and onwards to an EU trade repository meaning there will be a decoupling between the data reported by the EU27 counterparty and the UK counterparty
- Consequently, following 29 March, the derivatives where at least one of the counterparties is an UK-based entity (i.e. EU27-UK, UK-EU27, UK-UK) will not be reconciled and will therefore be excluded from the inter-TR reconciliation process

ESMA statement on EMIR derivatives reporting in the event of a no-deal Brexit (cont.)

- UK counterparties will be required to comply with the recordkeeping obligation under Article 9(2) of EMIR until 29 March and subsequently with those established under UK law
- ESMA also emphasises that the only possibility for EU27 data to be made accessible by UK-based TRs after 29 March 2019 is that the TR is recognised in the EU
- Following 29 March 2019, access by UK authorities to EMIR data reported pre- and post-29 March is linked to (i) an equivalence decision by the EC, an international agreement and a cooperation arrangement under Article 75 of EMIR or (ii) an equivalence decision by the EC under Article 76a of EMIR
- In neither of these are in place as of 29 March 2019, there will be a temporary cut in UK authorities access to EMIR data

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FCA's consultation on further amendments to SMCR incl. clarification on the position of Head of Legal

David Berman

The Head of Legal

- The FCA is proposing to exclude the Head of Legal from the scope of SMCR
- The proposal is relevant for firms subject to the Overall Responsibility requirement
- A Discussion Paper was issued in 2016 to consider whether or not the Head of Legal should be captured within SMF 18
- The majority of respondents said that the Head of Legal should be excluded

The Head of Legal (cont.)

- Key arguments for exclusion concerned legal professional privilege and the independence of the role
- However, the Head of Legal will be a Senior Manager if he/she also holds another SMF, for example, CF16 (Compliance Oversight)

The Client Dealing function

- The definition of the Client Dealing Function captures a potentially wide range of individuals
- The FCA proposes to amend the description to exclude individuals whose tasks do not require them to exercise a significant amount of discretion, judgement or technical skill
- Excludes roles that are simple or largely automated
- The exclusion will apply in respect of the following activities:
  - Persons taking part in (i) dealing as principal or as agent, or (ii) arranging (bringing about) deals in investments
  - When the firm is acting in the capacity of an investment manager, persons taking part in that activity and carrying on functions connected to this

The Client Dealing function (cont.)

- The proposed amendments clarify that there is no need to certify the functions described in parts 1(b) and 2(b) below:
    1. The following activities:
        a) Advising on investments other than a non-investment insurance contract; or
        b) Performing other functions related to this, such as dealing and arranging
    2. The following activities:
        a) Giving advice in connection with corporate finance business; or
        b) Performing other functions related to this
- In the FCA's view, an individual must <u>also</u> be carrying out the functions in parts 1(a) and 2(a) for the function to apply, and the functions in part (a) of both do require judgment and skill

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FCA's consultation on its approach to cryptoassets

Stuart Davis

CP 19/3 – Guidance on regulation of cryptoassets

- Primarily a review of when cryptoassets can constitute specified investments under the RAO
- Also provides guidance when cryptoassets can be considered financial instruments under MiFID II, or fall within the PSRs or the EMRs
- Exchange tokens
  - Decentralised means of buying goods and services
- Security tokens
  - Behave like shares etc.
- Utility tokens
  - Access to goods or services, without security rights

FCA's analysis of cryptoasset market (cont.)

- 5 Key Principles:
  - Tech neutrality (generally)
  - Apply existing regulatory perimeter but seek to close gaps where there may be consumer or market harm
  - Every token is different and needs to be separately analysed
  - Substance over form approach
  - National approach (contrast with ESMA's recent plea for EU unity)

Specified investments

- Factors indicative of a security:
  - Contractual rights and obligations
  - Entitlements to profit-share, revenue or other kind of benefit
  - Entitlement to ownership in the token issuer or other person
  - Whether a token is transferable or tradeable on any type of exchange or market
  - Direct flows of payment from the issuer to token holders

FCA's analysis of cryptoasset market

- 3 types of tokens:
  - Exchange tokens: not issued or backed by any central authority and are intended and designed to be used as a means of exchange. They are, usually, a decentralised tool for buying and selling goods and services without traditional intermediaries. Usually outside the perimeter
  - Security tokens: tokens with specific characteristics that mean they meet the definition of a Specified Investment like a share or a debt instrument as set out in the RAO, and are within the perimeter
  - Utility tokens: these tokens grant holders access to a current or prospective product or service but do not grant holders rights that are the same as those granted by Specified Investments. Although utility tokens are not Specified Investments, they might meet the definition of e-money in certain circumstances

FCA's reasoning – cryptoasset analysis

Indicative Categorisation of Key Token Types

Within regulatory perimeter

May fall within the regulatory perimeter, depending on structure

Typically outside regulatory perimeter. However consumer protection requirements may apply

Securities (e.g. shares, debt, securities, warrants, certificates)	Derivatives (e.g. futures options, CFDS)	Electronic Money/ Payment Services
• Token that gives holders a right to the issuer's profits or voting rights • Transferable token that gives holders a debt claim against the issuer or a third party • A token that gives holders rights to a security (e.g. a convertible instrument) • A token that gives holders rights to a security owned by someone else (e.g. a depositary receipt.	• Stablecoin or other token which references the value of an underling (e.g. commodities or securities) or index and gives holders a right to payment flows derived from those underlyings, or physical settlement • Token giving future right to delivery of an asset or payment flows derived from an asset, at a fixed price	• Fiat-backed stablecoin giving holders a claim against the issuer • Fiat stored-value wallet • Exchange services intermediating Fiat transfers

• Exchange token that gives holders rights against the issuer	• Utility token that gives holders rights to a payment or bonus
Exchange Tokens	**Utility Tokens**
• Bitcoin, Ether, Litecoin etc	• Pure access tokens

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FCA Fine - Paul Stephany
Rob Moulton

Background

- Two small / mid-cap IPOs in summer 2015
- Stephany managed several Newton funds
- He contacted 11 other firms (in the case of one IPO) and several firms (in the other) with details of his intentions and suggested a degree of co-ordinated action

On The Beach email

- "Sorry for the out the blue email but I wanted to urge those considering or in for the OTB IPO to think about moving to a 260m pre money valuation limit. I have done that first thing this morning with my GBP 17m order. I don't usually do last minute brinkmanship…I haven't received any indication that the books are well covered or even covered so suspect this one is still very much open to price movement. Please have a think and mention to any colleagues…"
- Some recipients ignored it. Some telephoned him. One replied they would not participate as there was correspondence "flying around…which looks quite tricky…an organised attempt to get the price down…I feel really uncomfortable being associated with it"

Market Tech call

- “Push them for it to kind of 220 price rather than 230 plus they are talking about…I will be submitting a chunky order at that 220 level…I’ve spoken to one other person so far who intends to join me in that strategy”

What issues arise?

- Proper standards of market conduct, due skill care and diligience?
- MAR?
- Competition law?
- Systems and controls?
- Principle 11 reporting?
- Buy and sell side?
- (in the future) SMCR?

What did we learn?

- The use of collective power undermines the proper price formation process
- You do not need guidance on specific circumstances to know whether you are breaching a principle
- Even if there are information asymmetries between Bookrunner and Manager, they are not problematic here because the Manager is aware of it
- You do not need to analyse anti-competitive behaviour in light of competition law when considering general principles

What did we not learn?

- The extent to which colour on the state of the book can be discussed between a Bookrunner and a Manager
- The type of information which can be discussed between Managers
- The extent to which MAR applies in these circumstances
- The impact of competition law in these circumstances
- Whether further action against individuals or firms will follow to shed light on the issue

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Questions?