UK legal and regulatory developments

HM Treasury's consultation on the UK implementation of MiFID – proposed changes to the scope of regulated activities

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INTRODUCTION

The Markets in Financial Instruments Directive (MiFID)¹ entered into force as European legislation on 30th April, 2004, and was due to be turned into domestic laws and regulations by member states by 30th April, 2006. The European Commission proposed putting back the 30th April, 2006, deadline by six months to 30th October, 2006, and allowing member states an additional six months up until 30th April, 2007, before bringing those laws and regulations into effect. Following discussion among member states, the Commission's proposal has been amended and the deadline for finalising implementing laws and regulations is now set at 31st

January, 2007, with the deadline for those laws and regulations taking effect being 1st November, 2007.

In December 2005, HM Treasury (HMT) issued a consultation document on the UK implementation of MiFID. MiFID requires revisions to UK legislation (mainly to the Financial Services and Markets Act 2000 (FSMA) and its secondary legislation) and to the *FSA Handbook*. The Treasury's consultation focuses on the necessary legislative changes. Proposed changes to the *FSA Handbook* will be dealt with in an FSA consultation document expected in the first half of 2006. This paper analyses HMT's proposals for implementing MiFID's scope provisions.

IMPLEMENTING MIFID'S SCOPE PROVISIONS

The activities and investments that are currently subject to regulation by the FSA are set out in the Regulated Activities Order (RAO).² Whether a firm is within the scope of regulations and, as a consequence, requires FSA authorisation depends on whether it is carrying out an activity specified in the RAO by way of business in the UK, whether it is within any of the exclusions related to that activity, and whether it is carrying out that activity in relation to the investments specified in the RAO.

LEGAL ARCHITECTURE

Implementing MiFID's scope provisions will require amendments to the RAO and, in considering how best to implement the scope of MiFID, three main approaches were considered by HMT:

- (1) rewriting the existing RAO activities and instruments, where necessary, using language taken from the relevant European directives including MiFID;
- (2) creating a new RAO activity of carrying out a MiFID service or activity which would be expressed in language taken from the directive;
- (3) transposing MiFID using the existing RAO activities and investments (with extensions as required) and a MiFID 'override', the effect of which would be to provide for an exclusion in the RAO to be disregarded if it is incompatible with MiFID. Such an approach reflects the way in which

MiFID's predecessor, the Investment Services Directive (ISD),³ was implemented.⁴

According to the HMT consultation paper, following discussion with industry, it was decided that the third approach should be taken on the basis that this would minimise the costs to the FSA and firms of changes in the RAO by removing the need for significant numbers of changes in permission statements and revision to the FSA's register of authorised firms and regulatory reporting systems. The main disadvantage of such an approach is that it makes transposition of MiFID less transparent. To try and deal with this issue, HMT proposes to highlight the fact that exclusions are subject to the override by stating so expressly in each of the relevant articles.

DEFINITION OF AN INVESTMENT FIRM

The existing definition of an investment firm in article 4(5) of the RAO includes wording that has the effect of including within its scope persons performing investment services or activities who are incorporated in or formed under the law of non-EEA states. The reason for this is that article 5 of the ISD requires that non-EEA firms must not be given more favourable treatment than EEA firms and, if investment firm were not defined to include non-EEA firms, such persons would be able to rely on exclusions from the RAO which are not available to EEA firms. Significantly, there is no equivalent of

article 4 in MiFID, and the approach taken in the consultation draft of the revised RAO is to confine the definition of ‘investment firm’ to EEA firms. This results in an unequal treatment of EEA and non-EEA firms in respect of authorisation in the UK in that the latter will have access to a wider range of exclusions from the FSA authorisation requirement, although cannot benefit from the MiFID passport. Although concern has been expressed about the potential competitive advantage that this approach gives rise to, HMT is generally committed to avoiding going beyond the minimum required in implementing directives and is therefore consulting on the basis of restricting the definition of investment firm to EEA firms. Respondents are invited to comment on whether such an approach is appropriate, and it is therefore possible that the proposed approach may be changed.

INVESTMENT SERVICES AND ACTIVITIES

The Treasury believes that (pending the finalisation of MiFID’s implementing measures), all the services and activities in MiFID are encompassed within the breadth of the current activities in the RAO. In the light of this, HMT is considering making a change to the list of regulated activities in just one area namely, operating a multilateral trading facility (MTF). Firms currently operating MTFs are within the scope of UK regulation by virtue of articles 14, 21 or 25 of the RAO, which relate to dealing in investments as principal, dealing in investments as agent and arranging deals

in investments. Technically, no change is necessary to the scope of the RAO to accommodate the regulation of MTF operations. Notwithstanding this, HMT proposes to revise the RAO by inserting a new activity of operating an MTF on the basis that, in this case, it is relatively easy to achieve a greater degree of clarity and only a small number of firms are affected.

DERIVATIVES

The range of derivatives within MiFID is wider than the range of derivatives within the RAO. A major difference relates to options. Under the current RAO, only a limited range of physically settled options fall within article 83 of the RAO; in particular, the only commodity options are those relating to precious metals. The range of derivatives within the scope of MiFID includes cash settled options relating to commodities, physically settled options relating to commodities that are traded on a regulated market and/or an MTF, and physically settled options on commodities relating to options that are traded off-exchange for non-commercial purposes, which have the characteristics of other derivative financial instruments having regard to whether, *inter alia*, they are cleared and settled through recognised clearing houses or are subject to regular margin calls. Although, the definition of ‘commodity’ for the purposes of MiFID has not been finalised, the draft implementing ‘level 2’ measures published by the European Commission in February 2006 define commodity as ‘any goods of a tangible nature that are capable of being

delivered, including metals and their ores and alloys, agricultural products and energy such as electricity'. Although this definition appears in draft implementing measures and could yet change, there is no doubt that the final definition will run well beyond precious metals.

One problem in determining the exact scope of financial instruments in MiFID is that the boundaries between spot contracts and derivative contracts are not clear cut. The draft implementing measures include a definition of spot contract, but this is provided in the context of determining what contracts fall within the categories of physically settled OTC commodity derivatives and exotic derivatives in C(7) and C(10), respectively, in section C of annex 1 to MiFID. The lack of certainty over the boundary between spot contracts and forward contracts raises the issue of the extent to which MiFID goes beyond the range of futures in article 84 of the RAO. For example, it is not obvious to what extent, if any, MiFID captures what have hitherto been regarded in the UK as commercial foreign exchange forward contracts outside the scope of the RAO.

To accommodate the broader scope of derivative instruments within MiFID, HMT proposes simply to amend articles 83, 84 and 85 of the RAO to include options, futures and other derivatives in MiFID which do not fall into the current UK definitions. This approach is largely a function of the wider decision to minimise change to the RAO, although HMT points out that some parties have suggested that the differences between the scope of articles 83–85 of the existing RAO and the scope

of derivatives in MiFID should be more clearly signposted. In the light of the uncertainty about the outcome of the implementing measures, HMT has decided not to adopt this approach for now but will revisit the issue when the directive's implementing measures have been finalised, with a view to achieving greater clarity about the expansion of scope.

EXEMPTIONS AND EXCLUSIONS

MiFID contains a number of exemptions, and HMT's approach to implementing these exemptions is to copy them out into the RAO so that they exist alongside the current exclusions. Such an approach means that, in order to work out whether a person's activities are excluded from the scope of the RAO, they will need to consider both the applicability of the current exclusions as well as the MiFID exemptions. As HMT accepts, the MiFID exemptions are ambiguous, and there is therefore some uncertainty about MiFID's scope. Although the HMT consultation paper itself does not deal with this issue, it refers to the fact that the FSA's consultation paper on MiFID implementation will provide information on the interpretation of the MiFID exemptions.

In implementing MiFID, HMT has to decide whether or not the exclusions in the RAO are compatible with MiFID or whether a MiFID 'override' needs to be applied to them. The same issue arose when the UK had to implement the ISD and, currently, exclusions in the following articles of the RAO are subject to the ISD override: 15, 16, 19, 22, 23, 29, 38, 68,

69, 70 and 72E Given that most of the ISD exemptions are copied over to MiFID, HMT has understandably taken the view that none of these exclusions is wholly compatible with MiFID, and that it will therefore be appropriate to apply an override to them.

There are three exclusions in the RAO, those in articles 67, 71 and 72, which are not subject to the ISD override but to which HMT believes that it might be appropriate to apply the MiFID override, or otherwise modify the substantive provision.

The article 67 exclusion relates to investment services provided in the course of professional activity (for example by lawyers, accountants and the like). Although this is akin to the exemption in article 2(1)(c) of MiFID, the article 67 exclusion is in fact wider than the exemption in that, unlike the exemption, it does not require the professional activity to be governed by regulation or a code of ethics. Accordingly, HMT proposes to apply a MiFID override to this exclusion.

The article 71 exclusion applies to employee share schemes. A similar provision can be found in article 2(1)(e) of MiFID. The MiFID exemption, however, is narrower than article 71 in that it applies only to persons who provide investment services consisting *exclusively* (emphasis added) in the administration of employee-participation schemes. This problem could be rectified either by applying the MiFID override to article 71 or by modifying its substance. The consultation paper does not express a preference for either of these two

approaches and simply asks for respondents to comment on the merits of either approach.

The effect of the article 72 exclusion relating to overseas persons is such that it allows, among other things, a UK investment firm operating outside the UK to provide services into the UK. This is not compatible with MiFID, and HMT proposes to overcome this problem by applying the MiFID override. As HMT points out, however, significant concerns have been raised about applying the override to the overseas persons exemption including the following.

- The exclusion was not thought to be incompatible with the ISD, and there is no substantive difference between MiFID and the ISD on this point.
- As a practical matter, EEA firms may need to rely on the overseas person exclusion where there are different interpretations of the scope of MiFID between their own jurisdictions and the UK, or when there are differences of view on whether a service or activity is being carried on cross-border.
- Overriding the exclusion complicates an already complex position in relation to passporting rights.
- The impact of applying the override could be to make the UK's financial markets less open than they currently are, to the detriment of London as a financial centre.

The main reason for proposing a different approach to article 72 under MiFID from that which was adopted in relation to the

ISD is to work toward the Commission's objective of ensuring greater consistency of implementation than was the case with the ISD. Needless to say, those that disagree with the approach should take the opportunity to respond to the consultation.

The Treasury has also considered whether to apply the MiFID override to paragraphs 42 and 49 of the Financial Services and Markets Act 2000 (Exemption) Order 2001 (the Exemption Order),⁵ which relate to the gas and electricity industry. The Treasury's preliminary view is that these exemptions are compatible with MiFID and changes to the statutory instrument are therefore unnecessary.

ARTICLE 3

Article 3 of MiFID allows member states not to apply MiFID to firms receiving and transmitting investment orders and/or providing investment advice as long as the relevant firms are:

- subject to regulation at national level;
- not allowed to hold clients' funds or securities;
- are only permitted to transmit orders to certain persons such as investment firms authorised under MiFID or credit institutions authorised under the Banking Consolidation Directive.⁶

The Treasury is proposing to exercise the article 3 exemption but will allow exempt firms to notify the FSA that they do not wish to be treated as exempt, in which case MiFID will apply to them, and they will be able to exercise MiFID passporting

rights. Firms which will be able to take advantage of the exemption will therefore need to balance the benefits of being exempt in terms of potentially less onerous prudential requirements against the benefits of being able to do cross-border business under a MiFID passport.

TRANSITIONAL PROVISIONS

The fact that MiFID will broaden the scope of UK financial services regulation and change the categories of activity and investments which require authorisation raises transitional issues: in particular, whether firms currently regulated by the FSA will be required to apply to vary their permissions. The Treasury is keen to reduce the costs to firms of MiFID and, as a result, in the draft RAO has included three tentative transitional provisions in articles 30–32 which are designed to ensure that:

- those authorised persons currently operating what will become an MTF under MiFID will automatically have permission to operate an MTF;
- investment firms and banks automatically have their permission extended to cover the wider range of financial instruments in MiFID;
- consistent with article 66 of MiFID, UCITS management companies automatically have their permission extended to cover the wider range of financial instruments in MiFID.

In relation to each of the above transitional provisions, there is an opt-out provision which is intended to allow those operating

an ATS to decide not to go into the new MTF regime (which would amount to a decision to cease operating an ATS), and to allow investment firms, banks and UCITS management companies to opt out of the automatic change of permission. This is to reflect the fact that those operating MTFs may not want to carry on doing so in the light of an increased capital charge, and that investment firms, banks and UCITS management companies may not wish to expand their permissions to cover a wider range of financial instruments.

The Treasury's hands are tied in terms of the need to change the RAO to reflect MiFID's increased scope. The way in which

that implementation takes place, however, carries consequences of its own, and firms should familiarise themselves with HMT's proposals in order that they can properly assess their impact and use them to inform their MiFID planning.

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References and Notes

- 1 Directive 2004/39/EC.
- 2 SI 2001/544.
- 3 Directive 93/22/EEC.
- 4 The current RAO contains an ISD override in article 4 (4).
- 5 SI 2001/1201.
- 6 Directive 2000/12/EC.