CAPCO

MIND THE GAP:

BRIDGING THE POST-BREXIT REGULATORY DIVIDE

SPEED READ

- Post-Brexit MIFID II regulatory divergence between the EU and the UK has been compounded by 'Quick Fix' amendments made to both regimes' reporting requirements.
- The 'Quick Fix' amendments were introduced by both EU and UK regulators to aid the recovery of financial markets following the impact of the COVID pandemic.
- The EU 'Quick Fix' amendments cover the phase-out of paper-based communications, exempting costs and charges disclosure, removing research charges, and suspending best execution reports for venues until 2023.
- The UK 'Quick Fix' amendments broadly reflect the EU changes, but deviate further by streamlining investor protection requirements and outright removing certain MiFID II provisions for best execution.
- Investment firms should review the differences between the EU/UK versions of the 'Quick Fix' amendments to assess the impact on existing reporting processes – and how they should be adapted to meet both sets of requirements.

OVERVIEW

Introduced in 2018, the Markets in Financial Instruments Directive (MiFID II) harmonised wholesale markets regulation across EU member states. Once the United Kingdom left the EU, the triggering of the Withdrawal Act (EUWA) saw the transposition of EU law into UK domestic law, MiFID II included. Since the end of the Brexit transition period on December 31, 2020 the UK has made multiple changes to EU MiFID II requirements as the UK Government and the Financial Conduct Authority (FCA) have sought to address perceived deficiencies in the transposed UK MiFID II regime, such as the administrative reporting burden for investment firms. These changes also address the UK's post-Brexit priority of promoting global competition in the UK market at the cost of regulatory divergence with the EU.

The divergence between EU and UK MiFID regulatory regimes has been compounded by respective 'Quick Fix' amendments introduced in 2021. Both sets of 'Quick Fix' amendments aim to support the financial recovery of markets following the economic impact of COVID-19 by simplifying reporting requirements for investment firms. However, the UK's amendments go beyond the EU's proposed changes by further streamlining and removing certain MiFID provisions – most notably, changes to existing inducements rules on research and the removal of the requirement to produce reports linked to best execution.

Although the changes to the UK MIFID II regime may result in a lighter burden for investment firms operating solely in UK wholesale markets, this widening regulatory divergence inevitably poses operational and compliance challenges for those firms operating across both EU and UK markets. Below we explore this divergence and its impact on market participants.

EU MIFID II QUICK FIX

The impact of COVID-19 on financial markets prompted the European Securities and Markets Authority (ESMA) to introduce an amendment to MiFID II (EU/2021/338 Directive) – the EU Quick Fix – in February 2021. The aim of the EU Quick Fix was to support EU member states' recovery in the wake of the pandemic by simplifying existing reporting requirements to alleviate the administrative burden on investment firms. These included the phase-out of paper-based communications and exempt costs and charges disclosure for eligible counterparties and professional clients, removing research charges, and suspending best execution reports for venues until February 28, 2023 (RTS 27).

UK MIFID II QUICK FIX

In response to the EU Quick Fix, the FCA published a consultation paper in April 2021, *Changes to UK MIFID's conduct and organisational requirements* (CP21/9). CP21/9 proposed alterations to the existing inducements rules on research plus the removal of the requirement to produce reports linked to best execution (RTS27 & 28). The consultation closed in June 2021 and the final policy position published in the policy statement *Changes to UK MIFID's conduct and organisational requirements* (PS21/9) in November 2021.

The changes were intended to provide relief to trading venues and brokers by removing the need to prepare and publish best execution reports, with the FCA stating that, on balance, best execution reporting requirements "carry costs for firms but have not delivered the intended transparency benefits" [1].

The FCA also indicated that legislation would be required to change other areas covered by the EU Quick Fix. This was addressed by the Markets in Financial Instruments (Capital Markets) (Amendment) Regulations 2021, also known as the UK Quick Fix SI. This made several changes to the transposed UK MiFID II regulation to complement the changes proposed by the FCA PS21/9, with many changes effective from July 26, 2021 and hence some months prior to the EU Quick Fix.

This broad package of UK reform looked at the onshore regulatory regime and adapted it to the specific structure of UK wholesale capital markets by introducing significant changes to client communications and reporting requirements. The changes also formed part of the UK Government post-Brexit strategy to increase the competitiveness of the UK as a hub for capital markets by simplifying the MiFID regime and removing those regulatory requirements deemed as costly and/or providing little benefit or protection for investment firms.

Prior to these amendments, the EU MiFID II regulation's implementation and reporting requirements were criticized for creating a significant burden for investment firms [2]. The intent of investor protection provisions is to increase transparency and information around how investment firms execute client orders and the outcomes they obtain for those clients. However, as part of CP21/9 the FCA highlighted the high costs associated with meeting certain reporting requirements which have not always generated significant real-world improvements for investors. For example, that deletion of the best execution obligation on venues to produce RTS 27 and RST 28 reports was justified on the basis "that these have not delivered on objectives, since they are little used by investors or investment firms with best execution obligations and are costly to produce" [3].

MIFID II DIVERGENCE GOING FORWARD

The amendments and areas of divergence between the EU and UK signal a gradual but significant deepening of the divide between the EU and UK versions of MiFID II. Hopes for a broad regulatory equivalence between both parties has been fading as additional rule changes proposed as part of the UK Wholesale Markets Review (WMR) – which concluded on September 24, 2021 – illustrates the UK's growing ambitions to diverge from the EU. The WMR was established by HM Treasury to improve the UK's regulation of secondary markets, takes advantage of the UK's newfound 'sovereignty' in financial services following Brexit [4]. Among HM Treasury's changes in the WMR are plans to scrap caps on the amount of trading done in so-called dark pools, private venues where investors can trade shares without signalling their plans to the rest of the market in advance. The WMR also sets out changes to how much pre- and post-trade information is provided publicly across the stock and bond market, and to remove limits on the number of commodities contracts traders can hold [5].

The MiFID II UK Quick Fix amendments, together with changes set out in the WMR, underline the contrasting philosophies and approaches between the EU and UK on how markets should be regulated. The EU has continued to focus on developing harmonised and transparent markets as a priority. Despite temporary reporting relaxations via the Quick Fix amendments, ESMA intends to maintain those requirements – including those for best execution – to enhance market transparency and ensure investor protections are upheld. In contrast, the UK seeks to enhance its competitiveness as a global financial centre to attract business from outside the EU by streamlining regulation, restoring domestic powers and reducing the barriers to entry to position itself as a more attractive place to do business.

However, despite the push towards divergence, the FCA maintains that it will not be making sweeping changes to the MiFID rulebook, stating "we are still very much signed up to the overall objectives of the MiFID regime" [6] . There is little appetite across the UK industry for MiFID II to be scrapped wholesale due to the significant investments into compliance and reporting programmes made by firms since it was implemented in 2018. The current FCA amendments to MiFID seek to reduce the burden of regulation without significantly changing the Directive's protections for investors and wider market integrity.

For investment firms based and operating in the UK, the relaxation of the domestic MiFID II regime may be welcome, but global investment firms are left having to deal with two sets of regulatory obligations. Investment firms will need to be able to navigate an increasingly fragmented regulatory landscape and the increased costs and complexity that will inevitably arise as the more the UK diverges, the more fraught its access to the EU's financial markets may become.

Such firms will have to choose between adopting a jurisdiction-by-jurisdiction approach to compliance or whether to align with the highest regulatory standard across all the markets in which they operate. This will require an assessment of existing reporting models to consider which option is most effective in the longer term. Both approaches will inevitably require the tailoring of reporting processes – through updated transaction reports, remediation and BAU processes – to ensure that new requirements are met. In particular firms should focus on the following considerations:

- **Impact assessment** – Complexity will continue to grow in step with regulatory divergence, underlining the need for investment firms operating across both the EU and UK to closely monitor regulatory changes. To this end, firms should perform an impact analysis, assess build-out requirements, create a delivery roadmap, and determine a solution design.
- **Transformation and remediation support** – With investment firms' legal entities, trading activities and counterparties falling under two regulatory regimes, developing dual reporting flows will be a high priority to ensure dual compliance. Global project management capabilities for large-scale change programmes – impacting multiple functions, regions, entities, and product areas – will need to be implemented.

- **Vendor selection** – Third-party vendors can assist with a range of MiFID II reporting challenges. However, selecting the right solution provider is an uncertain and potentially risky investment without a proper level of due diligence and breadth of review. Firms should seek out providers with strong connections to Reg Tech companies to help identify which specialist MiFID II platforms will best meet criteria ranging from quality assurance of reporting through to advanced regulatory reconciliation and reference data testing.

WHERE DOES DIVERGENCE EXIST?

Table 1 below summarises the key EU and UK MiFID II 'Quick Fix' amendments and areas of divergence which investment firms must consider for the impact of changes to reporting operations.

Key Themes in the 'Quick Fix' are also prioritised by High, Medium, or Low levels of divergence between the EU and the UK version of MiFID II. For example, there is a high level of divergence on Best Execution Reporting because ESMA is only suspending RTS 27 reporting requirements until 2023 and keeping RTS 28 in place, whereas the UK is removing both reporting obligations entirely. Conversely for Costs and Charges where the EU and UK are aligned on reporting requirements, there is low divergence given the only difference is the date on which investment firms must comply with the amendment.

Table 1: EU & UK MiFID II quick fix changes and impact of divergence

#	Key Themes	EU MiFID II 'Quick Fix' changes	UK MiFID II 'Quick Fix' changes	Divergence	Level of Divergence (High/Medium/Low)
1	**Best Execution Reporting**	As of **28th February 2022** the obligation on execution venues to publish a RTS27 report on a variety of execution quality metrics to enable market participants to compare execution quality at different venues has been suspended until **28th February 2023**.	From **1st December 2021** UK market participants are no longer required to produce the RTS 27 reports or RTS 28 reports. This means investment firms and execution venues no longer have the obligation to produce the following: • RTS 27: reports showing a variety of execution quality metrics • RTS 28: annual reports setting out the top 5 venues used for executing client orders and a summary of the execution outcomes achieved	The EU Quick Fix only suspends RTS 27 reporting until **28th February 2023** and does not remove or suspend RTS28 which presents a clear divergence with the UK's position of deleting both RTS 27 and RTS28 reporting entirely. Although firms no longer need to produce RTS 27 reports until **28th February 2023**, the EU requirement to maintain RTS28 reports is still in place for firms looking to access the EU market. Additionally, once the EU suspension of RTS 27 reporting obligation elapses firms looking to operate across both the EU and UK will need to continue producing both sets of reports.	**High**

2	**Product Governance Exemption**	As of **28th February 2022**, product governance requirements shall no longer apply for simple corporate bonds with 'make whole clauses' where, in the event of early redemption of a bond, the issuer is required to pay to the investor holding the bond an amount equal to the sum of the net present value of the remaining coupon payments expected until maturity and the principal amount of the bond to be redeemed.	No changes to the product governance space from the UK	Neither the UK Quick Fix SI nor the FCA's Policy Statement PS21/9 make amendments in the product governance space, in contrast with the EU MIFID II Quick Fix's exemption for bonds with no embedded derivatives other than "make-whole".	**High**
3	**Ex post Reporting Requirements**	**As of 28th February 2022**, the reporting requirements to provide clients with ex post reports on services, including periodic custody statements, contract notes, portfolio management periodic reports, and 10% drop reports have been removed. Professional clients still have the right to opt-in to receive these reports, and proper records of the professional clients' opt-in communications are to be kept.	As of **26th July 2021**, there is no longer an obligation for firms providing portfolio management services to inform their client whenever the overall value of the portfolio depreciates by 10%. The reform revokes this obligation in respect of professional clients.	Unlike the EU Quick Fix, the UK does not amend the requirement to provide clients with custody statements which means this remains an obligation for UK firms. Additionally, in the UK professional clients will still have to be provided with 'essential information' concerning the execution of their order.	**Medium**
4	**Switching**	As of **28th February 2022** the requirement for investment firms to perform a cost-benefit analysis in the case of switching of financial instruments has been removed, unless this analysis is expressly requested.	As of **26th July 2021**, portfolio managers will no longer be obliged to conduct an analysis of the costs and benefits of switching investments for professional clients.	The EU Quick Fix permits professional clients to opt in to switching protections, whereas the UK Quick Fix simply removes these protections for professional clients altogether.	**Medium**

5	**Research Unbundling**	As of **26th July 2021**, SME firms with a market cap of €1bn and below will be allowed to bundle costs for research and execution with the rationale being that revising the rules might increase the availability of research in this part of the market.	From **1st March 2022**, asset managers and research firms can exercise the options on exempting the following from the inducement rules on research: • Research on listed or unlisted SMEs below a market capitalisation of GBP 200 million • FICC research • Independent research providers who do not provide execution services and are not part of a group that includes a firm offering execution services and openly available research • Openly available research	The EU's re-bundling rules apply to companies with a market cap of less than €1bn compared to the FCA's £200m. Despite the narrower changes by the FCA, UK changes added exemptions for FICC research and independent research firms which have not been applied by the EU Quick fix amendment.	**Medium**
6	**Client Communication**	As of **28th February 2022**, all information required to be provided to clients should be provided electronically rather than on paper. Retail clients can still elect to receive paper communications and this needs to be made available free of charge.	As of **26th July 2021** the default method for firms to communicate with wholesale clients has switched to electric communication.	While the EU requires the switch to electronic communications as the default method for all clients (except for retail clients) this only applies to wholesale clients in the UK. This means that in the UK paper remains the default method of communication with retail clients whereas the EU MiFID II Quick Fix made electronic formats the default for retail clients as well. Investment firms operating in the EU will also be required to maintain processes for paper-based communications in case retail clients wish to opt in.	**Low**

7	**Costs and Charges Disclosure**	As of **28th February 2022**, professional clients and eligible counterparties are exempt from the requirement to provide details of all costs and charges, except in the case of investment advice or portfolio management. Additionally, where orders are placed via means of distance communication, all services should be able to receive costs and charges information just after the transaction has taken place.	As of **26th July 2021**, pprofessional clients and eligible counterparties are exempt from the requirement to provide details of all costs and charges, except in the case of investment advice or portfolio management. Additionally, where agreements to buy or sell financial securities are completed via distance communication, all services should be able to receive costs and charges information just after the transaction.	The EU and UK are aligned in their approach to removing the requirement for professional clients to disclose costs and charges, except for investment advice and portfolio services. The only divergence exists where EU firms were required to comply from **28th February 2022**, while for UK firms the changes applied from **26th July 2021**.	**Low**

References

1. PS21/20: Changes to UK MiFID's conduct and organisational requirements
2. CP21/9: Changes to UK MIFID's conduct and organisational requirements
3. PS21/20: Changes to UK MiFID's conduct and organisational requirements
4. Wholesale Markets Review: Consultation
5. Wholesale Markets Review: Consultation
6. The Economic Secretary to the Treasury, John Glen's speech at the Association of Financial Markets in Europe

AUTHOR

Nick Hease, Consultant

CONTACT

Tej Patel, Partner & UK Head of Regulation
tej.patel@capco.com

ABOUT CAPCO

Capco, a Wipro company, is a global technology and management consultancy specializing in driving digital transformation in the financial services industry. With a growing client portfolio comprising of over 100 global organizations, Capco operates at the intersection of business and technology by combining innovative thinking with unrivalled industry knowledge to deliver end-to-end data-driven solutions and fast-track digital initiatives for banking and payments, capital markets, wealth and asset management, insurance, and the energy sector. Capco's cutting-edge ingenuity is brought to life through its Innovation Labs and award-winning Be Yourself At Work culture and diverse talent.

To learn more, visit www.capco.com or follow us on Twitter, Facebook, YouTube, LinkedIn Instagram, and Xing.

WORLDWIDE OFFICES

APAC
Bangalore
Bangkok
Gurgaon
Hong Kong
Kuala Lumpur
Mumbai
Pune
Singapore

EUROPE
Berlin
Bratislava
Brussels
Dusseldorf
Edinburgh
Frankfurt
Geneva
London
Munich
Paris
Vienna
Warsaw
Zurich

NORTH AMERICA
Charlotte
Chicago
Dallas
Hartford
Houston
New York
Orlando
Toronto
Tysons Corner
Washington, DC

SOUTH AMERICA
São Paulo

WWW.CAPCO.COM

CAPCO
a wipro company

© 2022 The Capital Markets Company (UK) Limited. All rights reserved.

JN_4645