ISDA Safe, Efficient Markets

ISDA response to FCA's second consultation on Brexit: Proposed changes to the Handbook and Binding Technical Standards – CP18/36

The International Swaps and Derivatives Association ("ISDA") welcome the opportunity to respond to FCA's second consultation paper on Brexit: Proposed changes to the Handbook and Binding Technical Standards.

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has more than 900 member institutions from 68 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org.

In particular, we wish to highlight the following points, which we elaborate on in the body of our response:

- We understand that the FCA is looking for the respondents to this consultation to identify key implementation challenges and any areas of their onshoring that do not work. That is a challenging task. In our response, we have focussed on identifying specific challenges in implementing the Markets in Financial Instruments Transparency-related BTS for derivatives, EMIR, Benchmarking, Market Abuse, Emissions and contractual recognition of bail-in onshored regimes.

- Our members ask the FCA for a period of forbearance post 29 March 2019 from the proposed onshoring changes and seek to comply on a best efforts basis. Specifically:
    a. We ask for a period of forbearance for entities on the new onshored EMIR derivatives trade reporting requirements;
    b. A period of forbearance should firms need to reclassify their existing EMIR counterparty classifications;
    c. Confirmation that the FCA will use its temporary transitional power should UK Benchmark Administrators need to adjust the composition of their oversight function;
    d. Confirmation that, like the PRA, the FCA intends to use its temporary transitional power to delay the obligation to include a contractual recognition of bail-in term in EEA law governed liabilities that are created or materially amended after exit day.

- ISDA details a further three areas, specific to its mission of fostering safe and efficient derivatives markets, where treating the EEA as a third country would result in a cliff edge. We would welcome confirmation from the FCA that it will either phase in these requirements or not follow its baseline approach. These relate to:
    a. Definition of OTC derivatives under EMIR;
    b. Availability of intragroup exemptions for transactions between UK and EEA counterparties; and
    c. Impact on EMIR REFIT and derogations under EMIR.

Q1: For those rules where we use powers under the EUWA, do you think any of the proposed changes in this CP or in relevant SIs represent a significant risk to compliance for your firm in time for exit day? If yes, please specify which and explain why this is the case, including projected time needed to comply with requirements were they to come into effect on exit day.

The cumulative impact of all the proposed changes as a result of onshoring, in this CP and in others, means that it is exceedingly challenging to respond to this CP with a projected time needed to comply with the requirements were they to come into effect on exit day, save to say that a period of transitional relief and forbearance would be necessary. Should the scenario occur in which the UK leaves the EU in March without a withdrawal agreement, we understand that the FCA would seek to issue a series of communications and plan of close engagement with firms, setting out FCA expectations of readiness. At that point, it may be more possible to detail compliance challenges in more depth and the evidence you have requested for the duration of transitional relief.

MIFID

The CP acknowledges that some of the sectoral changes, most notable the MiFID transparency-related BTS, are not without several onshoring challenges (para 5.19, page 40). The transparency regime was designed and calibrated with the assumption that it would apply across 28 national markets. Our members second those challenges and call for the FCA to share its analysis, as it develops, on this bifurcation of what was 28 national markets to now UK, albeit plus relevant area, and EU. Without this analysis, it is very challenging for members to look through the onshoring changes and see what the calculations will look like and what they will show in the new world upon the creation of a UK FIRDS and (effectively therefore) an EU27 FIRDS which will then produce UK and EU calculations for transparency, liquidity thresholds and position reporting.

In particular, we ask for the FCA to make several clarifications around the specification of ‘relevant area’.

It should also be noted that there is a likely impact to buy-side firms which currently rely upon trading with systematic internalisers in order to satisfy transparency obligations. These firms may be required to discharge transparency obligations themselves post Brexit due to bifurcation of the systematic internaliser regimes. Developing the requisite infrastructure to discharge these obligations, including dependencies on third parties (APAs / ARMs) will require forbearance during the implementation of change.

EMIR

Reporting

The onshored EMIR brings implications for derivatives trade reporting, introducing a requirement to report to a trade repository (TR) in the UK both new derivatives transactions entered into from exit day and modifications and terminations, from exit day onwards, of existing transactions already reported under EMIR. At the present time, there is no published regulatory guidance on how trades should be seeded to the database of a newly authorized UK TR. The options seem to be that TRs transfer the data from a European TR which is then verified by the reporting entity or the data transfer is managed by the reporting entity themselves. In either case, a period of forbearance is requested from both FCA and ESMA for entities to reconcile their reports between the UK and EU TRs, and to exit their UK positions/transactions from EU TRs. Some of our members have suggested that at least three months' forbearance would be necessary, although other members do not feel that this is sufficient time and suggest a period of at least six months' forbearance.

There is a great deal of uncertainty pertaining to the types of data that needs to be maintained in repositories for trades that straddle exit day. EMIR reporting is on a T+1 basis and regulators have been asked to provide guidance on various reporting scenarios around Brexit (e.g., a transaction with a Trade Date of 29 March 2019 being reported on 1 April (post-Brexit), will have been executed pre-Brexit). We request FCA guidance as to the cut-off time for determining when trades are reported to ESMA and when they are reported to the FCA.

There is uncertainty in relation to historical transactions which are no longer live at the point when UK reporting becomes active. We ask the FCA to confirm urgently that these will remain in the EU trade repositories and will not be required to be backloaded/seeded in the UK trade repositories.

Our members ask for clarity on the reporting of collateral where the calculations are carried out on positions pre-Brexit, but are reported post-Brexit.

We note that for forbearance to be effective, it would be required from both the FCA and ESMA.

Counterparty classification

Due to EMIR onshoring, it may be necessary to review existing counterparty classifications, i.e. whether entities established in the UK are FCs, NFC+ or NFC-.

Furthermore, if an entity were to move to or from being an FC, that entity would have different reporting requirements. This would impact that entity's processes and, if their reporting is delegated to another entity, it will impact the entity providing the delegated reporting service. Again, a period of forbearance would be required whilst firms reviewed their classifications.

Benchmarks

We note that Commission Delegated Regulation (EU) 2018/1637 includes certain requirements regarding the composition of the oversight function of benchmark administrators. To the extent the Benchmarks Regulation SI makes amendments to the scope of limb (a) of the definition of 'regulated-data benchmark', and if the definition of 'supervised entities' is limited to UK entities, UK benchmark administrators may need to adjust the composition of their oversight function (particularly for regulated-data benchmarks, in light of Article 1(4) of the Delegated Regulation, although noting also paragraph 1 of the Annex (which references supervised entities)). This could be difficult for firms to implement in advance of exit day, and confirmation of the use of the temporary transitional power in these circumstances would be helpful.

Furthermore, Article 4(1) of the Commission Delegated Regulation (EU) 2018/1644 provides that cooperation arrangements (in the EU version, between ESMA and a third country) shall require the parties to refrain from disclosing information exchanged under the cooperation arrangements, except where the party disclosing has given its written consent or where disclosure is necessary and proportionate under "Union or national law". When contrasted with the wording used in Article 4(3) (which refers to "applicable data protection legislation in the jurisdictions of the competent authorities which are party to the respective cooperation arrangement"), the suggestion is that Article 4(1) only captures EU or Member State law. Article 4(1) has been amended in the FCA consultation to capture "English law or other law applicable in the jurisdictions in which the competent authorities which are party to the relevant cooperation arrangement are located". We would suggest that "English law" be amended to instead refer to "the laws of the United Kingdom or any part thereof".

Contractual recognition of bail-in

ISDA welcome the FCA's proposal to amend IFPRU 11.6.3R so that the requirement does not apply in respect of EEA law governed liabilities that were created before exit day. We agree that the resultant risk to the resolvability of firms is low, and that in the event that the Bank of England does identify existing EEA law governed liabilities which might constitute a substantive impediment to the resolution of a particular firm, it may use its power of direction to address this issue.

We would also welcome confirmation that, like the PRA, the FCA intends to use its temporary transitional power to delay the obligation to include a contractual recognition of bail-in term in EEA law governed liabilities that are created or materially amended after exit day.

Market Abuse Regime

MAR Article 17 concerns the public disclosure of inside information. Article 17(1) sets the requirements for public disclosure of insider information for issuers and Article 17(2) sets out the requirements for public disclosure of insider information for an emission allowance participant. This means that emission market participants are subject to different standards than issuers. This is because, what constitutes inside information in the emissions market, is less clear. We note that Regulation 12 (Disclosure requirements) of the onshored UK MAR SI applies Article 17 to issuers who have requested or approved admission of their instruments on a UK regulated market, UK MTF or UK OTF (which is in line with Article 17 of MAR as it stands today) and also to "emission allowance market participants registered in the UK".

We wish to flag that, since Article 17 of MAR does not currently refer to emission allowance market participants, some of our members find the inclusion of '(c) emission allowance market participants registered in the United Kingdom' confusing. It is unclear whether this is intended to apply the disclosure requirements for issuers under Art 17(1) to emission allowance participants on top of the bespoke regime for emission allowance participants already in Article 17(2) (which would be an odd result, because the purpose of Article 17(2) is to ensure that emission allowance market participants are not subject to the regime under 17(1), which was designed for issuers and is highly unclear in the context of an emission allowance market participant), or whether it was simply intended to clarify that Article 17 as a whole applies not just to issuers but also to emission allowance market participants.

While we realise that this comment goes beyond the scope of this CP, we would welcome clarification from the FCA on this point. If the FCA is not able to clarify this point, we would welcome confirmation that the FCA will raise this with HMT for clarification.

Emission auctions

ISDA notes that the UK's Department for the Environment will cease to have standing as an account administrator in the Emissions Trading Scheme (ETS) (see: https://www.gov.uk/government/publications/meeting-climate-change-requirements-if-theres-no-brexit-deal/meeting-climate-change-requirements-if-theres-no-brexit-deal). We see here a risk that European Emissions Allowances (EUAs) that are held in UK ETS accounts will remain valid as ETS compliant EUAs but will no longer freely transferrable to and from those UK accounts.

This could affect market makers in EUAs and entities (regardless of where they are based) that hold EUA inventory within UK based ETS custody accounts. Indeed, UK ETS accounts are administered by the UK Department for the Environment, which would no longer have standing as an ETS account administrator following a no-deal Brexit. Therefore the transferability of EUA inventory to and from UK ETS accounts may be compromised. Affected market participants could be prevented from transferring their EUA inventory from their UK ETS custody accounts, impacting their ability to make delivery against OTC and exchange delivery obligations. Then the only solution would be for affected market participants to open separate ETS custody accounts in EU jurisdictions other than UK ahead of Brexit. Typically, this process takes around 6 weeks from application to approval, but that can vary depending on the entity and member state's requirements.

We ask for a period of forbearance from both European and UK authorities in this matter and recommend that it be contained in a Memorandum of Understanding.

We underline that the issue is related to UK based ETS custody accounts and not to the validity of EUAs. Indeed, current EUA inventory will remain valid and redeemable, post Brexit. The UK has taken a legislation to bring forward the compliance date for EU ETS operators in the UK in respect of the 2018 EU ETS compliance year. As a result, all 2018 'UK allowances' are valid, indistinguishable from and fungible with any other 2018 EU EUAs and these allowances are eligible for compliance purposes during Phase III trading period (2013 – 2020).

Money Market Funds (MMFs)

The key issue for ISDA is that OTC derivatives can continue to be used as eligible assets to MMFs, and we understand that this will continue once this regime is onshored. However, we wish to reiterate the wider industry recommendation that the Statutory Instrument and references in the MMF reporting template point to the existing UK implementation of COLL, rather than UCITS. Specifically,

We note that the cross-reference to "regulated market" in the MMF reporting template in the CP has been amended so that the current reference is to Article 50 UCITS Directive: this covers both EU and non-EU markets (and note that limbs (b) and (c) are broader than the MiFID regulated market definition as they refer more generally to markets that operate regularly and are recognised and open to the public).

The proposed amendment would replace this with a cross-reference to "regulated markets" as defined in Article 2(1)(13A), (13B) or (13) MiFIR (as onshored). Therefore, this is potentially narrower than (or at least not identical to) the current reference to Article 50 UCITS Directive, with the implication that the 'OTC' category could also capture a slightly wider/different scope of instruments.

Q3: Do you agree that we have correctly identified all relevant amendments in our draft Handbook and BTS text related to the cross-cutting issues set out above? Do you have any other points you wish to raise regarding our approach to these cross-cutting issues?

The key message we wish to make here, with regards to identifying areas of onshoring which do not work technically, is that we would recommend that the FCA consider setting up an expedited approach by which they can quickly correct any deficiencies found in onshoring post exit (or when these are identified, if before exit). Our members are concerned that (a) it may not be possible to identify all deficiencies within the timescale of this consultation and (b) any deficiencies may be the result of the cumulative effect of many moving parts and therefore may not come to light before exit, or until such times as relevant systems are operating for example.

We welcome the FCA's approach to cross-cutting issues, subject to the comments made in response to CP18/28 and set out again below:

References to EU legislation and to "relevant implementing measures"

We understand that the FCA's general approach will be to amend the Handbook to refer to new or revised UK legislation rather than the EU equivalent, but that there will be some exceptions where the FCA has found good reason to retain a reference to EU legislation. Does the FCA intend to publish a list of these exceptions and the reasons for retaining them?

In some places (e.g., COBS 6.2B.29), the Handbook includes extracts from the relevant EU legislation. Some of these extracts refer to other provisions of EU legislation (e.g., to particular articles of MiFID2). The FCA's proposed Handbook changes would replace these references to provisions of EU legislation with a reference to the relevant UK legislation or Handbook provision. However, where these extracts refer to a provision of EU legislation "and the relevant implementing measures", it is unclear where firms should look for the relevant implementing measures. Where the Handbook currently refers to "the relevant implementing measures" without specifying what those implementing measures are, does the FCA intend to include a specific reference to the relevant Handbook rule or BTS?

Our members opine that the most helpful approach they would like to see is for the Handbook to reflect both the references to the original source EU legislation [in square brackets] and new or revised UK legislation and that the references to ‘and relevant implementing measures’ are replaced by a specific reference to the relevant implementing measure. Whilst we understand that this is unlikely to be possible in the time available before 29th March, members would encourage FCA to consider making these changes in the near future.

Our members also request that the FCA set out their approach to onshoring the recitals to EU legislation – i.e. by confirming that recitals are onshored in their entirety (and identifying places where this does not work). While we understand that the FCA considers that all of the detail contained in the recitals will be reflected in the relevant onshoring legislation, in practice members obtain a significant level of guidance from recitals to EU legislation. We would

welcome confirmation that members may continue to interpret onshored EU legislation in line with existing recitals in the absence of specific UK guidance to the contrary.

We note that there is no proposal to amend the recitals to BTS (which will be incorporated into UK domestic law by virtue of the European Union (Withdrawal) Act 2018 – note 83 of the explanatory notes to this legislation states that the "*full text of any EU instrument (including its recitals)*" will be captured by the Act). The recitals contain a number of references to concepts that will not be retained in the UK onshored version of the applicable BTS, including references to the Union/Member States or concepts which have otherwise been deleted (e.g. 'Member State of reference').

As these unamended recitals will become part of the UK legislative framework, it would be helpful to understand whether it is intended that the content of these recitals will continue to be used in construing the provisions of onshored BTS.

Benchmarks

We note also the following minor points:

- Amendments to BENCH: We note that there is a discrepancy between the amendment made to the reference to "legislation made under that regulation" in rule 2.3.3G and the fact that no change is made to the equivalent wording in rule 2.1.1G(5).
- Commission Delegated Regulation (EU) 2018/1642 – Reference to 'competent authority' in Article 9 to be changed to 'FCA'.
- Commission Delegated Regulation (EU) 2018/1645 – Reference in Annex A Section A sub-heading to 'Union' to be changed to 'United Kingdom'.
- Commission Delegated Regulation (EU) 2018/1646 – Reference in Annex II footnote 1 to 'same competent authority' to be changed to 'FCA'.

We assume that references to EU legislation in the onshored BTS will be amended as necessary to refer to the applicable UK onshored version.

Co-ordination between UK and EU in relation to reporting and data

We would welcome confirmation that UK FIRDS and EU FIRDS will be synchronised to enable "cross-pollination" between the two systems. This would remove a reliance on market infrastructure to ensure that data is included in one or both FIRDS systems, and should reduce the risk of under or over reporting.

We would also welcome confirmation that the FCA has considered co-operation with ESMA to synchronise any data that is reported to both the EU and to the UK, and to avoid double reporting (e.g., where a UK firm and an EU firm trade with one another).

Other points

Status of MiFID2 validation rules: We do not see mention of the MiFID2 transaction reporting validation rules. These rules are implemented by APAs and ARMs, so any changes to the validations would require infrastructure/system changes. If the FCA intends to make any changes to the validation rules that would apply, this needs to be communicated as soon as possible so that firms can start planning to adjust their build if required.

As well as the FCA adopting existing ESMA Q&A's, our members request that ESMA Q&As are also adopted for a period of time post-Brexit. This will allow for queries / comments raised and still outstanding with ESMA to be aligned with UK reporting, for example.

Q17: Are there any proposed changes where you think we should not follow the baseline approach of treating the EEA as a third country? If so, why?

Whilst we understand that the FCA follows HMT's baseline approach of treating the EEA as a third country, there are a number of provisions which would require UK firms to give different treatment to third country firms depending on whether or not an equivalence decision exists in relation to the relevant third country. Since no such requirement currently exists in relation to UK firms' treatment of EEA firms, if no equivalence decision is made before exit day this will have a significant impact on UK firms' dealings with EEA firms.

We have summarised these provisions below.

We understand that the FCA intends to use its powers to phase in new requirements in a proportionate manner, bearing in mind the FCA's statutory objectives and the implementation challenges faced by firms, and we would welcome confirmation from the FCA that it will either phase in these requirements or not follow its baseline approach of treating the EEA as a third country, as appropriate.

- **Definition of OTC derivatives under EMIR**: Under onshored EMIR, a derivative transaction that is executed on an EEA trading venue will qualify as an "OTC derivative" unless the EEA or the relevant EEA jurisdiction has been determined to be equivalent. As a result, that transaction will count towards a UK entity's clearing threshold and may have an impact on whether or not they are required to comply with the margin and clearing obligations, and whether transaction reporting follows OTC or ETD methods, among others. We would welcome confirmation from the FCA that it will use its temporary transitional powers to ensure that UK entities may continue to treat derivatives executed on EEA trading venues as exchange traded derivatives for a transitional period until HMT has adopted the necessary equivalence decisions.

- **Availability of intragroup exemptions for transactions between UK and EEA counterparties**: We understand that the FCA and PRA will adopt BTS in relation to

the margin and clearing obligations along the lines set out in the PRA's CP26/18. The PRA CP indicated that the PRA proposes to delete the derogation for cross-border intragroup transactions where no equivalence decision is available, as the EMIR onshoring SI already provides for a period of up to 3 years from exit day during which intragroup transactions that are currently exempt from clearing and margin requirements will continue to be exempt.

Given the difficulties experienced to date in obtaining equivalence decisions under EMIR, unless the FCA, PRA and HMT are confident that all necessary equivalence decisions will be in place by the end of the 3 year transitional period we would ask the FCA and PRA to consider retaining the existing derogation and aligning the period of the derogation with the period in the EMIR onshoring SI so that if additional time is required this derogation period can be extended.

While we realise that this is outside the scope of the CP, we would draw the PRA's attention again to the difficulties in interpreting the equivalence requirement under the intragroup exemption, and the uncertainties that arise in the event that a third country jurisdiction implements margin rules that only cover part of the population of OTC derivatives subject to margin under EMIR. We would welcome further guidance on this from the PRA and would be happy to discuss this further.

- **Impact on the EMIR REFIT and derogations under EMIR**: We understand that HMT proposes to adopt "in-flight" legislation that is finalised after exit day, including the EMIR REFIT and EMIR 2.2. We would welcome confirmation from the FCA that it intends to continue the current approach of not prioritising enforcement action in relation to activities carried on by firms which have been subject to an exemption or derogation, where that exemption or derogation may have expired but will be renewed or revised under the EMIR REFIT. In particular:
    - **Pension scheme exemptions from clearing and CVA under EMIR:** The temporary exemption from the clearing obligation for pension scheme arrangements expired on 17 August 2018. However, it is expected to be renewed as a result of the changes made by the EMIR REFIT. In the interim, ESMA has published a communication indicating that it does not expect national competent authorities to take enforcement action against pension schemes or EU counterparties dealing with pension schemes where they do not comply with the clearing obligation.

      We would welcome confirmation from the FCA that it will continue this approach in relation to UK firms dealing with both UK and EU pension schemes until the onshored EMIR REFIT comes into effect.

    - **Other areas where ESMA or the ESAs have provided for regulatory forbearance**: We would also welcome confirmation from the FCA that where

regulatory forbearance currently exists (e.g., in relation to variation margin for FX transactions and in relation to the intragroup transaction exemptions from clearing) the FCA will continue this approach or consider using its power to grant formal waivers where appropriate.

Q25: Do you agree that our proposed amendments to the MiFID II transparency-related BTS are appropriate, given the provisions of the Markets in Financial Instruments (Amendment) (EU Exit) Regulations 2018 SI?

The specification of 'relevant area'

We understand that the FCA will use 'relevant area' data in addition to UK data for the purposes of pre and post trade transparency calculations.

We note that the term 'relevant area' is defined 'in relation to a financial instrument'. Our understanding is that the definition of the 'relevant area' might therefore be different for different financial instruments.

ISDA would welcome clarification from the FCA as to how it plans to apply these provisions in practice, including (a) when does the FCA expect to carry out the assessment of the volume of trading in relation to particular financial instruments (b) when will the FCA specify the 'relevant area' in relation to particular financial instruments, (c) what other parameters would determine whether a country forms part of the 'relevant area' and (d) would the FCA expect to include Switzerland in the 'relevant area' for the purposes of Article 5 MIFIR, subject to meeting the requirements of Article 5(11) and other parameters.

We would request that 'relevant area' be defined in good time prior to exit day in order that firms are afforded sufficient time to implement the requisite changes. 'Relevant area' may then be amended post Brexit, subject to reasonable notice being served upon the industry in order to implement the change.

Definition of "securitised derivatives"

We note that Table 4.1 of Annex II to the BTS onshoring Commission Delegated Regulation 2017/583 on transparency requirements refers to securitised derivatives as "transferable securities defined in Article 2(1)(24) of Regulation 600/2014/EU". This replaces a reference to Article 4(1)(44)(c) of MiFID2.

However, the UK onshored version of Article 2(1)(24) of Regulation 600/2014/EU repeats the entire definition of "transferable securities" from Article 4(1)(44) of MiFID2, not just the definition of securitised derivatives from Article 4(1)(44)(c). As a result, we understand that this reference should read "…a transferable security as defined in Article 2(1)(24)(c) of

Regulation 600/2014/EU…", to ensure that this cross-reference only captures securitised derivatives and not also other types of transferable security.

We would welcome confirmation that the FCA will review all references to securitised derivatives (including in the context of commodity derivatives, as instruments falling under Article 4(1)(44)(c) of MiFID2 are included in the definition of commodity derivatives) and ensure that they refer only to Article 2(1)(24)(c) of onshored MiFIR and not to the entire definition of transferable security.

Transitional period

We note that Article 13A provides for a transitional period for publication of transparency calculations. We welcome the transitional period and ask for confirmation from the FCA as to how the transitional period will operate in practice, and for ongoing engagement with the FCA on this subject.

For more information, please contact Fiona Taylor, ftaylor@isda.org.