

Beginning of the End of EU Law in the UK?

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The Financial Services and Markets Act 2023 (“FSMA 2023”) marks a watershed moment in British legislative history. FSMA 2023 introduces sweeping changes to the financial services regulatory infrastructure and will have a profound effect on the business and operations of investment managers and other financial firms in the United Kingdom (UK). The indirect impact of FSMA 2023 will be broad, and some developments will be of keen interest to US managers and other non-UK financial firms.

Background

The changes introduced by FSMA 2023 were contemplated by the Edinburgh Reforms, announced by the government in December 2022. FSMA 2023 places the regulatory authorities and the Bank of England at the centre of designing and revising rules regulating UK financial firms and markets as well as overseeing and enforcing compliance with those rules. Policy objectives under FSMA 2023 are linked to the government’s ambitions for the UK as an independent trading nation, for example, improving the competitiveness of the UK as a financial hub with a focus on new technologies and innovation. Possibly the most dramatic effect of FSMA 2023 is the phased but wholesale repeal of EU financial services law.

The key items for investment managers under FSMA 2023 include:

- Repeal of all EU law in Schedule 1 of FSMA 2023 by end of 2023—albeit on a phased basis.
- Extending the scope of the Financial Services and Markets Act 2000 to cover a full scope of financial services activities which are subject to regulation, in addition to activities requiring Financial Conduct Authority (FCA) authorisation.
- UK regulators to take the driving seat in determining regulatory rules applicable to firms and other market participants. UK regulators will be empowered to design and dynamically review the rules, rather than implementing rules set by EU legislation.

The Edinburgh Reforms

The Edinburgh Reforms, announced in December 2022, form the context and priority list for government action. The policy objective is to maintain and build the UK as an international financial services hub employing respected high-quality regulation. The government identified 30 key areas, including the below, many of which are specifically reflected in FSMA 2023.

- New remit letters for the Prudential Regulation Authority (PRA) and FCA with clear, targeted recommendations on growth and international competitiveness.
- Repealing and reforming EU law, building a smarter regulatory framework for the UK.
- Overhaul of UK prospectus rules.

Financial Services Regulatory

- Reforming the Securitisation Regulation.
- Repealing the Packaged Retail and Insurance-based Investment Products (PRIIPs) Regulation and consulting on a new direction for retail disclosure.
- Launching a Call for Evidence on reforming the Short Selling Regulation.
- Fast-tracking secondary legislation to implement Wholesale Markets Review reforms.
- Independent Investment Research Review.
- A review into reforming the Senior Managers & Certification Regime.

Revoking and Replacing EU Law

Schedule 1 of FSMA 2023 sets out all of the retained EU law that it revokes by the end of 2023, but grants His Majesty's Treasury (HMT) the discretion to phase the revocations over time to ensure orderly transition. HMT has the option to restate revoked EU law, which may prove handy as Schedule 1 includes some 600 pieces of legislation, many of which are complex and deeply embedded in the operational practices, contracts and arrangements of the UK financial markets participants. The revoked legislation includes, among others, the Alternative Investment Fund Managers Directive (AIFMD), the Markets in Financial Instruments Directive (MiFID) and the Market Abuse Regulation.

FSMA 2023 also sets out some transitional provisions repealing or amending certain provisions of existing EU law deemed to be of specific importance, including, with respect to MiFID, revising provisions regarding pre-trade transparency, removal of the share trading obligation and the double volume cap and the derivatives trading obligation.

The government's stated policy position is to construct the new UK regulatory framework adopting a phased approach, prioritising reform of legislation "where there is the greatest opportunity for beneficial reform". The priority review categories include Wholesale Markets, Listing, the Securitisations Regime and Solvency II. These were cited under the Edinburgh Reforms of UK financial services, and others categories identified among the 30 key topics include a review of investment research, a review into reforming the Senior Managers & Certification Regime and investigating reforms to the Short Selling Regulation.

It is expected that the process of revoking and replacing retained EU law will take some years to complete. The regulators who will be principally in charge of designing new UK-specific rules are generally required to comply with the customary consultation process requirements. Accordingly, we expect the regulators generally to consult on proposed new rules before legislation is in fact replaced. However, FSMA 2023 identifies a number of instances where the consultation process is disapplied, including where the new rules by regulators relate to retained EU law not yet revoked, where the regulator considers that the effect of the changes is to reduce a regulatory burden and where the changes have no other effects that are material. Regulatory burden in this context means a financial cost, an administrative inconvenience, an obstacle to trade or innovation and an obstacle to efficiency, productivity or profitability.

An item of not insignificant importance for the regulators will be to consider how the new UK rules can be reconciled with international regulatory initiatives and imperatives and the impact the new rules will have on firms which are required to comply with rules in multiple jurisdictions. The signing of the UK-EU Memorandum of Understanding on Financial Services Cooperation in June 2023 suggests that there may well be some informal coordination of at least some reforms, e.g., concerning the European Market Infrastructure Regulation (EMIR) and MiFID to seek to coordinate the approach where this makes sense and there is political will to do so.

Investment Research

In relation to investment research in particular, the government has expressed its support to giving managers greater choice over how research is paid for.¹ This would likely include removing the requirement to unbundle research costs, which in turn would allow the UK regime to be aligned with key jurisdictions, including the United States (US). The FCA has announced that it will commence engaging immediately with market participants on these proposals, with the aim to have a formal consultation in time for new rules to come into force in H1 2024. The FCA has also said that it is open to taking swifter action (if needed) to support particular market participants or sectors in response to regulatory changes in other jurisdictions.²

Short Selling Regulation

The government has recently published a paper in response to the review conducted of the Short Selling Regulation, and in doing so announced two significant changes to the short selling regime.³ First the government will replace the current public disclosure regime based on individual positions with an aggregated net short position regime. Individual positions will therefore not be published, but rather the overall net short position in a company's shares. Second, the government will increase the net short position disclosure threshold for reporting to the FCA from 0.1% to 0.2%, returning the threshold to where it was previously. The government has also set out other positions in response to the call for evidence which the FCA will have to take into account in exercising its rulemaking powers, including in relation to the rules on uncovered short selling and changing the current "negative list" of exempt overseas shares into a "positive list" of in scope domestic shares.

Extending the Scope of the Financial Services and Markets Act 2000

New regulatory regimes under FSMA 2023 will include the Designated Activities Regime (DAR); the new regulatory framework for Central Clearing Counterparties and Central Securities Depositories, bringing them under the supervision of the Bank of England; and the "critical third party regime", which regulates key cloud providers, other critical information technology (IT) providers and other key service providers to financial services firms, where these are considered systemically important.

DAR. The DAR creates a regulatory regime for those activities which do not require the person carrying on those activities to be subject to prior regulatory authorisation, but which nevertheless constitute activities subject to regulatory requirements, for example, reporting, trade-related restrictions or public disclosure. While HMT will determine the activities that fall within the scope of the DAR, the FCA is empowered to make relevant rules with broad discretion. The FCA will also exercise supervisory and enforcement authority, as applicable.

The DAR will house the activities that currently are legislated for in retained EU law, including short selling, derivatives trading and contributing to a benchmark, to name a few. The categories and types of activities within the scope of DAR may be expanded in the future by HMT to include other activities. For example, the consultation paper on the future financial services regulatory regime for cryptoassets suggests that public offers of cryptoassets which do not meet the definition of a security token offering may be brought within the scope of DAR, requiring offers of such cryptoassets to be conducted through a regulated arrangement. See our recent alert on the developments regarding the marketing of cryptoassets to UK investors.⁴

Some revoked EU law may not be specifically housed within the DAR, for example, FSMA 2023 revokes the UK Securitisation Regulation and the onshoring regulations (i.e., the onshored version of the EU Securitisation Regulation) and replaces them with new a new regime set out in secondary legislation, the Securitisation Regulations 2023.

New Regime for Central Counterparties and Central Securities Depositories

FSMA 2023 will add to the existing regulatory architecture by creating a new committee of the Bank of England (BoE), the Financial Markets Infrastructure Committee (FMIC). FMIC will have regulatory rulemaking and supervisory power on recognised central counterparties (CCPs) and central securities depositories (CSDs) and certain non-UK CCPs deemed to be of systemic importance. The FCA will have similar new rulemaking powers relating to Data Reporting Services Providers (DRSPs) and Recognised Investment Exchanges (RIEs).

This gives significant discretion to the BoE to determine whether and what types of requirements to impose on CCPs and CSDs and whether and to what extent to replicate the requirements under EMIR or create a new, bespoke regulatory framework applicable to CCPs and CSDs. The industry will follow keenly to ensure that some useful elements under EMIR, including the requirements to facilitate straight-through processing, will not be lost under the new rules.

The Critical Third-Party Regime

FSMA 2023 also seeks to address the concerns regarding systemic risks to the financial services sector arising from their dependence on certain key third-party service providers, such as cloud service providers. The new regime applies to third-party service providers that have been designated as “critical” by HMT. The FCA and the PRA will be empowered to mandate compliance by such designated entities with certain standards. The regulators will also have supervisory and enforcement powers. The FCA and PRA are expected to consult on proposals relating to the oversight of critical third parties in Q3 or Q4 2023.

New HMT Powers Relating to Regulatory Rules

FSMA 2023 does not grant HMT the power to make regulatory rules applicable to market participants included in the new regulatory regimes (or authorised persons). However, HMT now has the power to prescribe matters to which the regulators must have regard when making rules. In addition, HMT may require the regulators to make rules applicable to specific categories of persons or activities and require them to review the rules (distinct from a separate obligation on the regulators to keep their rules under review). There have been some ruminations of concerns about the potential extent of political influence on the rulemaking the HMT powers may open the door to. HMT has historically exercised its powers judiciously and has been mindful not to undermine regulatory independence—whether a new approach will be displayed in the future remains to be seen.

New Secondary Regulatory Objective of Competitiveness

FSMA 2023 introduces a new secondary objective on the PRA and FCA to act in a way that advances the international competitiveness of the UK economy and its growth.

There is some staunch support for the new secondary objective from industry bodies, and the industry remains hopeful that the regulators will take active steps to address some key items, such as regulatory processing times for authorisation and other applications and the complexity of the regulatory requirements that may act as barrier to entry. The key to success will be to maintain high standards without compromising the high regulatory standards and the confidence of financial markets on the quality of UK regulatory oversight. While we expect revisions to many of the existing rules—and a number of consultations, calls for evidence and similar industry engagement initiatives evidence the movement in firm-facing rules, e.g., those regarding payment for investment research, the Senior Managers and Certification Regime—the UK is not seeking to revert to voluntary or self-regulated models of regulation.⁵

Supporting the UK's Trading Arrangements

As part of the post-Brexit strategy for developing the UK as a global financial centre, the UK has adopted some new approaches, introducing broader regulatory deference, including equivalence decisions, free trade agreements and mutual recognition agreements. FSMA 2023 also introduces a requirement that the regulators consider how their actions might affect notified deference decisions and to assess whether there is a material risk that a specific action will be incompatible with a deference decision by HMT. Upon identifying a material risk of such incompatibility, the regulator is required to consult HMT.

Regulatory Sandboxes for Fintech

HMT will have the power to introduce regulatory sandboxes for certain new technologies and will be able to disapply or amend some legislation and regulations to facilitate the sandboxes. The first sandbox under the regime is understood to be exploring the use of distributed ledger technology in integrated securities settlement systems.

We are following these developments with great interest and consider this an exciting time for firms. We will continue to discuss specific topics arising out of FSMA 2023 and hope to have you join us for these discussions.

If you have questions about this client alert, please contact any Akin lawyer or advisor below:

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¹ As proposed in the findings of Rachel Kent's Investment Research Review report

² <https://www.fca.org.uk/news/statements/chancellor-mansion-house-speech>.

³

https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1169119/Short_Selling_Regulation_Review_-_Government_response__1.pdf.

⁴ <https://www.akingump.com/en/insights/alerts/new-rules-on-marketing-cryptoassets>.

⁵ HMT also has powers to make recommendations to the regulators, effectively, to communicate the government's economic priorities. The regulators will be under s statutory obligation to respond to the recommendations.