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Mitigating the impact of a hard Brexit: trading obligations under MiFIR

The share trading obligation (STO) and the derivative trading obligation (DTO) refer respectively to the provisions set in Art. 23 and 28 of the Markets in Financial Instruments Regulation (MiFIR)[1] requiring investment firms that undertake trades in shares admitted to trading or traded on a trading venue and certain classes of derivatives to ensure these trades take place on an EU trading venue, or a third-country trading venue assessed as equivalent.

With less than 4 months to go before the end of the transition period set for Brexit and given the growing likelihood of a hard Brexit[2], the scope of the STO and DTO is a major source of concern for EU-27 investment firms. From 1 January 2021, UK trading venues will become third-country trading venues and are unlikely to benefit from an equivalence recognition before 31 December 2020.

In such context, one can expect the UK STO and DTO to overlap with those foreseen in MiFIR. The cumulative application of UK and EU laws would have a detrimental impact on the ability of EU-27 investors and intermediaries to transact on instruments subject to both EU and UK rules, and hence would damage the competitiveness of EU-27 entities without contributing to the protection of investors or the integrity of EU markets. Clarifying the scope of the trading obligations is hence of the utmost importance to ensure a level-playing field between EU-27 investment firms and their international competitors, and ultimately to protect the EU's sovereignty regarding the financing of its economy, in light of the EC and the co-legislators' ambition to revamp the CMU project.

AMAFI (the French financial market association) and ASSOSIM (the Italian financial markets intermediaries association)[3] consider the best way to achieve this objective would be to clarify the scope of the trading obligations through the MiFID II quick fix[4] adopted on 24 July the European Commission (EC) as part of a global package bringing targeted amendments to capital market rules in an effort to boost the capital markets' capacity to support Europe's recovery.

In order to avoid the negative consequences ensuing from the application of both EU and UK trading obligations after Brexit, we call on EU co-legislators to make two specific clarifications. First, the co-legislators should clarify that, unless otherwise explicitly stated, MiFIR provisions are not intended to have extraterritorial effects, and that the EU STO and DTO should not apply to third-country branches of EU-27 investment firms. Second, as recommended by ESMA in its recently issued report[5], the scope of the STO should be limited to shares admitted to trading with an EEA ISIN, while trading on third-country venues should be deemed in compliance with the STO when undertaken in the third-country's domestic currency.

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[1] Regulation (EU) No 600/2014 of the European parliament and of the Council of 15 May 2014 on Markets in Financial Instruments and amending Regulation (EU) No 648/2012
[2] Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and The Committee of the Regions
[3] More information about each association can be found in Appendix 2
[4] Coronavirus response: How the Capital Markets Union can support Europe's recovery: Review of the markets in financial instruments directive
[5] *"MiFID II/MiFIR Review Report on the transparency regime for equity and equity-like instruments, the double volume cap mechanism and the trading obligations for shares"*. ESMA70-156-2682, 16 July 2020

1. THE TERRITORIAL APPLICATION OF DTO UNDER MIFIR

Branches of EU-27 investment firms located in the UK face the cumulative application of two sets of rules. These entities, while operating for non-EU clients, are obliged to comply with both MiFIR DTO and with the transposed DTO in UK legislation.

As a consequence, these branches will see their ability to trade the derivatives subject to both DTOs severely restrained, making US swap execution facilities the only option available to trade these instruments. Pushing liquidity to migrate to US SEFs would obviously be an unfortunate and paradoxical development at a time where the Union tries to repatriate the trading of Euro denominated swaps.

To avoid this situation, three solutions can be contemplated:

- a decision by the EC assessing UK trading venues as equivalent;
- an adjustment of the application scope of the DTO, based on the currency denomination of the instruments;
- a clarification by the EC indicating that the DTO does not apply to branches of EU-27 investment firms located in a third-country, at least when they trade with non-EU clients.

While theoretically the easiest and most effective way-out for this issue, we consider that an EU decision assessing UK venues as equivalent is not a realistic solution in the current political context around Brexit negotiations, and that an adjustment of the application scope of the DTO based on currency denomination implies a close coordination with UK authorities and could be contradictory with the initial objectives set by the G20 summit in Pittsburgh[6] to move trading in standardised OTC derivative contracts to venues.

In light of these elements, we call on the EC to make clear that Art. 28 MiFIR does not have extraterritorial effects and more specifically that branches of EU-27 investment firms established in a third-country are not subject to the EU DTO. Ideally, this clarification should be extended, to ensure that, unless otherwise explicitly stated, MiFIR provisions do not intend to have extraterritorial effect.

A first element supporting the exclusion of third-country branches of EU-27 investment firms comes from the scope of application of MiFID as highlighted in the EC's Q&A on MiFID1[7]:

Question: "*To what extent does MiFID apply to non-EEA branches of EEA investment firms?*"

Answer: "*MiFID does not apply to non-EEA branches of EEA investment firms (...)*".

While this interpretation was given under MiFID 1, there are no provisions in MiFID II evidencing a clear break from this view. Moreover, the scope remained substantially the same under MiFID2. This statement is also supported by ESMA's view on the use of non-EU branches[8], where *"the use of non-EU branches [must be] based on objective reasons linked to the services provided in the non-EU jurisdiction and [should] not result in a situation where such non-EU branches (…) provide services back into the EU."* Under this view, there would be no reason for EU authorities to impose non-EU branches to comply with rules that are designed to protect EU investors and to ensure the integrity of EU markets.

[6] Recitals (25) and (26) of MiFIR
[7] *"Q&As published by the Commission on MiFID Directive 2004/39/EC"*, European Commission.
[8] *« MiFID II Supervisory briefing on the supervision on non-EU branches of EU firms providing investment services and activities"*, ESMA35-43-1493, 6 February 2019

Besides, our interpretation is also supported by the fact that several provisions of the MiFID II regime make express references to non-EU branches of EU investment firms (*e.g.* the transaction reporting provisions under Art. 26 of MiFIR), while Art. 28 contains no such reference.

What is more, we believe that the application of the EU DTO to non-EU branches serves in no way the main objective of this provision. This reasoning stems from a similar position adopted by ESMA when responding to a question about the scope of the Benchmark regulation[9].

Following a similar rationale, we consider there is no reason for the EU DTO to apply to non-EU branches of EU-27 investment firms providing investment services to non-EU clients.

2. LIMITING THE SCOPE OF THE EU STO TO TRANSACTIONS UNDERTAKEN IN AN EU CURRENCY ON SHARES ADMITTED TO TRADING WITH AN EEA ISIN

The current scope of application of the EU-27 STO was clarified in a public statement[10] released by ESMA on 29 May 2019. Considering potential difficulties to execute orders on shares admitted to trading on a EU venue, but with only marginal liquidity in the Union, the Authority clearly stated that only shares with EEA ISINs are within the scope of the EU-27 STO.

While this clarification was quite welcome, in a Post-Brexit context, the trading obligation as it stands still exposes EU-27 investment firms to the scarcity of available liquidity in the Union for a number of dual listed EEA shares (*e.g.* for which the issuer chose to have its share listed on both a EU and a UK regulated market), for which a significant part of the liquidity is currently located in the UK. In addition, being obliged to trade on EU venues for shares registered in a non-EU currency in the books of a third country central security depository would expose EU-27 investors and intermediaries to significant foreign exchange and operational risks.

The report published by ESMA on 16 July 2020 on equity market transparency includes a recommendation to amend Art. 23 of MiFIR. The amendment suggests that the restriction of the scope of the STO to EU ISINs should be included in the Level 1 text (MiFIR). It also suggests that trading on third country platforms should be considered as compliant with the trading obligation if it is carried out in the domestic currency of the third country in question.

We support ESMA's recommendation and believes that this proposition would enable EU-27 investment firms to access the main liquidity pools for most of the dual-listed shares, considering that a vast majority of trades occurring in UK trading venues on those shares are undertaken in GBP.

In addition, regarding the territorial scope of application of Art. 23 MiFIR, and according to the same arguments laid out above for the DTO, we believe that the STO should not apply to third-country branches of EU-27 investment firms.

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[9] : *Q4.4 Does the provision of and contribution to benchmarks that are used outside the European Union only fall within the scope of the BMR?* A4.4 (…) The BMR's objective is to ensure the proper functioning of the European market and a high degree of consumer and investor protection vis-à-vis benchmarks at Union level (…). In contrast, it is not the ambition of the BMR to protect users of benchmarks worldwide, **possibly conflicting with any applicable third country regimes**. (…) ESMA therefore considers that the BMR does not apply to the provision of benchmarks that are exclusively used outside the Union. (…) An administrator providing a benchmark exclusively to users outside the Union **would have to comply with any applicable third country regimes** with respect to benchmarks. (*ESMA70-145-11, 11 December 2019, page 9*)

[10] *"Public Statement: Impact of Brexit on the trading obligation for shares (Article 23 of MiFIR)"*, ESMA70-154-1204, 29 May 2019.

3. AMENDING MIFIR AND MITIGATING BREXIT'S IMMEDIATE EFFECTS

In light of the elements outlined above and given the imminence of a no-deal Brexit, we urge EU's co-legislators to amend the MiFID 2 quick fix accordingly during the upcoming institutional negotiations. In this regard, we drafted two propositions of amendment to MiFIR (see Appendix 1). The first proposition amends Art. 23 MiFIR, by clarifying its application scope as suggested in ESMA's recommendation, and by excluding third-country branches. The second proposition amends Art. 28 by excluding third-country branches from its application scope. While we are aware that the current changes brought to the MiFID II / MiFIR framework do not include amendments to MiFIR, we feel that the urgency of the current situation calls for quick action, and would not sustain the length of a standard procedure.

While we hope the European Commission and co-legislators will engage constructively with the propositions outlined in this paper, we believe that a temporary tolerance by EU-27 supervisors on the application of the trading obligations under MiFIR to branches of EU-27 investment firms established in the UK would avoid operational difficulties that will arise from 1st January 2021 onwards. We are aware of the regulatory difficulties ensuing from such concessions and relies on the judgment of the supervisors to propose a mediated tolerance that would provide market participants with a reasonable level of legal certainty without altering the trading patterns and liquidity levels guaranteed by the trading obligations within EU markets.

APPENDIX 1: PROPOSED AMENDMENTS

Article 23 MIFIR

Trading obligation for investment firms

1. An investment firm shall ensure the trades it undertakes in shares admitted to trading and having their main pool of liquidity, based on the ISIN code, on a regulated market or traded on a trading venue shall take place on a regulated market, MTF or systematic internaliser, or a third-country trading venue assessed as equivalent in accordance with Article 25(4)(a) of Directive 2014/65/EU, as appropriate, unless:

(a) their characteristics include that they are non-systematic, ad-hoc, irregular and infrequent;
(b) they are carried out between eligible and/or professional counterparties and do not contribute to the price discovery process; or
(c) in relation to trades executed on a third-country trading venue, they are denominated in the domestic currency of that third country.

The requirements laid down in this paragraph shall not apply to transactions undertaken by third countries' branches of EU investment firms.

Article 28 MIFIR

Obligation to trade on regulated markets, MTFs or OTFs

1. Financial counterparties as defined in Article 2(8) of Regulation (EU) No 648/2012 and non-financial counterparties that meet the conditions referred to in Article 10(1)(b) thereof shall conclude transactions which are neither intragroup transactions as defined in Article 3 of that Regulation nor transactions covered by the transitional provisions in Article 89 of that Regulation with other such financial counterparties or other such non-financial counterparties that meet the conditions referred to in Article 10(1)(b) of Regulation (EU) No 648/2012 in derivatives pertaining to a class of derivatives that has been declared subject to the trading obligation in accordance with the procedure set out in Article 32 and listed in the register referred to in Article 34 only on:

(a) regulated markets;

(b) MTFs;

(c) OTFs; or

(d) third-country trading venues, provided that the Commission has adopted a decision in accordance with paragraph 4 and provided that the third country provides for an effective equivalent system for the recognition of trading venues authorised under Directive 2014/65/EU to admit to trading or trade derivatives declared subject to a trading obligation in that third country on a non-exclusive basis.

The requirements laid down in this paragraph shall not apply to transactions undertaken by third countries' branches of EU investment firms.

APPENDIX 2: ABOUT AMAFI & ASSOSIM

Association française des marchés financiers (AMAFI) *is the trade organisation working at national, European and international levels to represent financial market participants in France. It acts on behalf of credit institutions, investment firms and trading and post-trade infrastructures, regardless of where they operate or where their clients or counterparties are located. AMAFI's members operate for their own account or for clients in different segments, particularly organised and over-the-counter markets for equities, fixed-income products and derivatives, including commodities. Nearly one-third of members are subsidiaries or branches of non-French institutions.*

Italian Financial Markets Intermediaries Association (Associazione Intermediari Mercati Finanziari – ASSOSIM)
ASSOSIM represents the interests of the intermediaries active on the Italian financial markets, namely, Italian investment firms, investment banks and subsidiaries of foreign investment services providers. Its members account for nearly the entire amount of the transactions carried out on the Italian stock markets as from Italy, and more than 80% when considering cross border transactions.