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Brexit: Update

As Politicians Head Back to Brussels, Regulators Take Action

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While the UK Parliament voted to give the Prime Minister the mandate to go back to Brussels, and re-open the negotiations, resolution of the Brexit dilemma remains as elusive as ever. The next UK vote is scheduled for February 14th, just six weeks from the Brexit cliff edge and risk of no deal. While financial services firms have been planning for this worst-case scenario, challenges remain which will have potential ramifications for the industry – from the ability to access data to changes in liquidity formation, as well as the ability to trade as a third country. However, regulatory progress away from the political debate is now making headway. Memoranda of Understanding (MMOU) in the event of a no-deal Brexit have now been agreed in substance between ESMA and the FCA[1, 2] covering co-operation arrangements and supervisory convergence. It appears that the regulators are now moving ahead of the politicians to provide the industry some semblance of clarity as we approach the Brexit deadline.

UK Politics & the EU Response

Opening up the WA is fraught with difficulty. Despite the EU-27 Member States remaining united on the previously agreed WA, as stated previously a number of members states are keen to make their own amendments (May's Deal is Rejected: What Is the Impact on Financial Services?). Taking the process back to the drawing board is a risky strategy with under 27 working days remaining[3].

Even if renegotiation is successful, both the EU institutions and UK parliament, House of Commons and House of Lords, will then need to ratify the new deal before March 29th. With this continued political uncertainty, firms need to continue to work towards the likelihood of a hard Brexit regardless.

Despite the recent announcement by ESMA and the FCA, the exact text of the MoUs have not been published and will need to be agreed & signed by the remaining 27 EU member states. In principle, the MMOU will allow information to be shared on issues including market surveillance and will allow certain activities to continue to be carried out by UK-based entities on behalf of counterparties based in the EEA. However, a number of key areas still require clarification:

1) Where and how to trade

a. Delegation & Equivalence
After agreement with the 27 Member States, under the MMOU funds domiciled and regulated in the EU will be able to "**delegate" services back to the UK in the manner that they do today**[4]. However, without equivalency of trading venues, EU firms planning on delegating services back to a UK trading desk will still face challenges. This has implications for all instruments traded but in particular for dual-listed instruments under the Share Trading Obligation.

b. The Share Trading Obligation (STO)
Under Article 23 of MiFIR, shares listed on EEA venues must trade on approved venues, regulated markets (RMs), multilateral trading facilities (MTFs), systematic internalisers (SIs) or third country venues deemed equivalent. This covers MiFID II investment firms, as well as UCITS and AIFMs that provide MiFID II services or delegate portfolio management to a MIFID II firm.

Article 23 does exclude the STO from share trading that is non-systematic, ad hoc, irregular and infrequent; or activity that is carried out between eligible and/or professional counterparties that does not contribute to price discovery. However these exclusions are limited as there is no list of which trading activity does not contribute to price discovery nor a definition of what is deemed systematic.

[1] https://www.fca.org.uk/news/press-releases/fca-agrees-mous-esma-and-eu-regulators-allow-cooperation-and-exchange-information
[2] https://www.esma.europa.eu/convergence/brexit
[3] https://services.parliament.uk/calendar/#!/Calendar/Commons/MainChamber/2019/3/28/events.html
[4] https://www.esma.europa.eu/press-news/esma-news/esma-and-eu-securities-regulators-agree-no-deal-brexit-mous-fca

Therefore in the event of a hard Brexit, and without equivalence, an EU asset manager either providing MiFID II services or delegating portfolio management will potentially no longer be able to access trading venues or SIs based in the UK. Given the liquidity that currently trades on these venues this could have a substantial impact on their ability to trade. For example 32% of CAC40 is currently traded via SI, 42% of which are registered in the UK[5].

Different legal opinions are forming on possible solutions, such as;

i. As a broker "undertakes" orders on behalf of asset managers they are under no obligation to execute according to the STO. However, for European regulators "undertakes" does not preclude EEA asset managers from the STO as even if the original SI is based in the EU[1]. As per the ESMA Q&A - **"all EU investment firms that are part of a chain of transmission should ensure that the ultimate execution of the order complies with the trading obligation requirements under Article 23(1) of MiFIR[2][6]".**

ii. A stricter application of the rule would require EU listed instruments to be traded on EU venues and those listed in the UK on UK venues. While technically this works from a legal perspective, the trading reality is that few asset managers operate in this manner. Orders from different funds are aggregated to trade one block of a single instrument at a more cost-effective price point, thereby ensuring all funds are treated fairly (by receiving the same price and not multiple prices). As there are slightly different national interpretations of the rules by different EEA NCAs, it will then depend on whether the funds are listed Luxembourg, Ireland, France or Germany if orders could effectively be split and traded on the relevant venue, or whether they are captured under EU TOTV.

   One suggestion is the creation of an alternative listing on UK venues creating a new instrument which is not linked to the European instrument, thereby avoiding the STO.

For the majority of venues and brokers, acceptance of the order from the relevant buy-side counterparty will dictate the venue as it will indicate the instrument to be traded by its unique identifier either Sedol, Bloomberg code, RiC, or in the case of an ISIN, the addition of relevant currency and market.

c. Dual-listed Instruments

Currently there are an estimated 600 plus instruments which are dual-listed and are included in a number of indices such as MSCI, STOXX, S&P and FTSE indices. According to the EC, only those that are traded as frequently and systematically traded in the EU would fall under the STO[7]:

"*The EU trading obligation applies to shares listed on both exchanges in the recognised countries and in the EU ("dual listings"), on condition that trading in the EU constitutes a significant percentage of the share's global trading volume.*"

There is no clarification on what equates to a *"significant"* percentage, however, it is suggested that ESMA could apply a "*de minimis* threshold" to UK/EU27 double listed stocks, where the trading volume in these stocks in EU27 in each individual case is less than e.g. 5% of current total trading volume in the EU28. This would leave approximately between 90 and 50 instruments which could be considered as frequently and systematically traded in the EU.

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[5] *Brexit: What Matters* – Liquidnet Market Structure Commentary (September 2018)

[1] ESMA highlights that the above does not prevent SIs from hedging the positions arising from the execution of client orders as long as it does not lead to the SI de facto executing non risk-facing transactions and bringing together multiple third party buying and selling interests. ESMA is of the view that an SI would not be bringing together multiple third party buying and selling interests as foreseen in Recital 19 where hedging transactions would be executed on a trading venue (https://www.esma.europa.eu/sites/default/files/library/esma70-872942901-38_qas_markets_structures_issues.pdf)

[2] https://www.esma.europa.eu/press-news/esma-news/esma-clarifies-trading-obligation-shares-under-mifid-ii

[6] http://makingmifidiiwork.cmail19.com/t/ViewEmail/j/C721EB133D470085/AE3839C7750974191A01488700E2614F

[7] https://ec.europa.eu/info/sites/info/files/180208-notice-withdrawal-uk-financial-instruments_en.pdf

Where the bulk of trading activity occurs on UK venues, EU-27 asset managers who need to replicate indices may be required to execute on the EEA venue instead. This could have a damaging impact for end investors as it would prevent EU firms to meet their best execution requirements if they are obliged to execute on venues which have lower liquidity available than on UK trading venues.

Other possible solutions being discussed are to remove the EU-27 listing and focus liquidity on UK listing and venues where the bulk of the trading occurs. This is likely to incur further regulatory scrutiny given that this will not deliver the European intention of delivering more liquidity to EEA venues and ultimately negatively impact European Capital Markets in terms of attractiveness to list. The alternative would be to descope GB-ISINs from EU venues or to look to the option of trading according to currency. This could potentially enable a UK delegated trading desk to trade RD.AS for EU listed funds by specifying the currency in GBP on a UK venue. This could create issues where the same currencies are traded in multiple locations but demonstrates the intensity with which legislators are endeavouring to solve current technical challenges that could occur in the event of a no-deal or hard Brexit.

d. Equivalence

A separate equivalence agreement will likely necessitate a transitional period to be negotiated. The recent extension by the European Commission to equivalency negotiations with Switzerland to June 30th, 2019 could be a possible solution for the UK and EU to replicate. However, in the absence of equivalence:

- Firms will need to ensure that contracts with current counterparties are sufficient to respect their regulatory obligations or whether new contacts are required to continue to trade under the share trading obligation (STO) as well as to meet their best execution requirements.

- Where firms are facing new legal entities, they will have to incorporate new LEIs and adjust routing practices to ensure orders are reaching the appropriate counterparty. Where UK firms have direct membership to EU venues, they will have to ensure that this can continue in the event of a hard Brexit.

- This also impacts US venues. While US venues will be deemed equivalent from a UK perspective, UK venues are currently recognised as equivalent in the US, this is only under an agreement with the **EU**. New equivalence agreements will be required between the US and UK, of which negotiations are already underway.

2) Access and use of data

In the event of a hard Brexit and if equivalency is not granted, depending on the exact terms of the MMOU, a risk remains that EEA and UK firms will not be able to transfer personnel data to and from each other's jurisdictions without authorisation from a data protection authority, as the use of any EU data relating to personal information outside of the EU could be in breach of GDPR. The need for supervisory convergence in this area to improve data quality and ensure sufficient reporting is raised by both the FCA and ESMA[8] in their Brexit Paper.

This will also impact outsourcing or service provider agreements which will need to comply with applicable European legislation including data security and data protection rules. While under current rules the European Commission can recognise a third country's data protection standards as adequate and equivalent, such assessment can be lengthy making the probability of having the necessary equivalence agreements in place by 29th March 2019 unlikely.

3) Threshold Calculations

In the event of the UK becoming a third country, the FCA will no longer have access to ESMA's IT applications and databases and no new UK-related data will be received and processed by ESMA as of March 30th, 2019[9]. No longer including UK data will impact MiFID II/MiFIR transparency calibrations including the Double Volume Cap (DVC), Systematic Internaliser calculations and Large-in-Scale waivers.

[8] https://www.esma.europa.eu/convergence/supervisory-convergence
[9] https://www.esma.europa.eu/press-news/esma-news/esma-sets-out-use-uk-data-in-esma-databases-under-no-deal-brexit

Due to concerns about the temporary disruption of the ESMA IT applications and databases[10]. ESMA have agreed to freeze the following calculations for a two-month period in the event of a no-deal scenario:

- **quarterly calculations for the SI determination for equity instruments and bonds;**
- **quarterly determination of the liquidity status of bonds;**
- **and the monthly DVC publications for a period of two months.**

ESMA have agreed to use UK data for all financial instruments that remain available for trading in the EU ('non-terminated financial instruments') for which the FCA is currently the Relevant Competent Authority (RCA) to ensure that the data is incorporated in EU calculations. However, for UK single listed instruments, ESMA expects UK trading venue operators to establish venues in the EU and submit new reference data over time[11].

ESMA and the FCA have increased their efforts to improve the quality of the reference data used for EU financial instruments since the introduction of FIRDS[12]. The FCA is expected to make trade data public in a similar manner to the EU FIRDS., and the UK FIRDS is expected to be switched on April 1st while the UK FITRS replicating the EU FITRS[13] covering thresholds for liquid instruments, SSTI and LIS waivers should be made available April 3rd.

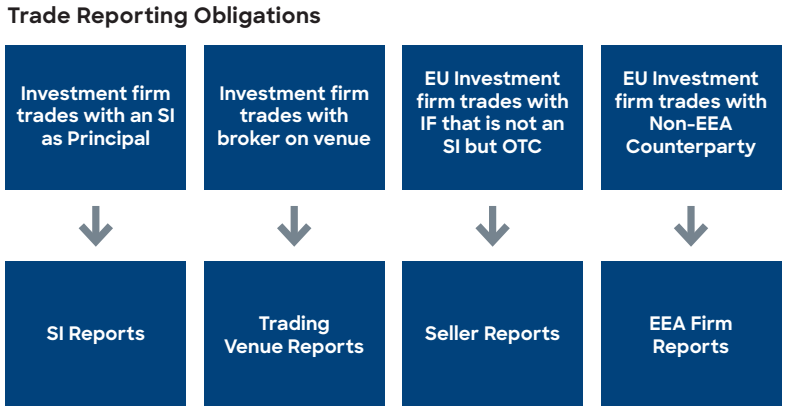
In the event of a no-deal Brexit, the UK will cease to be the Relevant Competent Authority (RCA) for EU-traded instruments and the EU will no longer incorporate data relating to single-listed UK instruments; but will incorporate data on dual-listed instruments for EU venues. Therefore firms will have to ensure they have relevant access to both the EU & UK FIRDS and FITRS databases. This potentially will mean eventually two sets of DVC data, inbound data streams from multiple SI streams, overloading already strained resources in importing accurate and complete datasets.

4) Trade and transaction reporting

The proposal to extend MiFID II/MiFIR obligations to third country firms includes trade and transaction reporting to ensure all trading activities taking place within the EU are correctly monitored, as well as ensuring the correct transparency, liquidity assessment and double volume cap thresholds are applied. This can only be possible with a comprehensive view of all trading activity within the EU. However, there is likely to be a duplication of reporting as firms have to meet both EU and UK regulatory requirements.

a. Trade Reporting

Where there is a chain and the execution occurs on a trading venue in that chain, the trading venue will trade report **provided there is no change in price or volume.** The challenge emerges when an EEA firm engages with a UK SI acting as principal to a trade. Dependent on the capacity in which the UK Seller has transacted will have a direct implication on who is responsible for reporting the trade.



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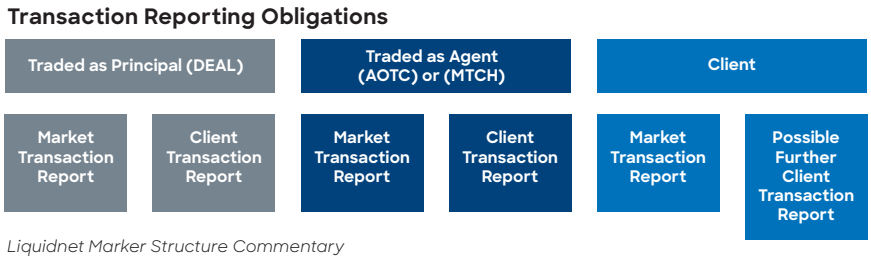
[10] https://www.esma.europa.eu/press-news/esma-news/esma-sets-out-use-uk-data-in-esma-databases-under-no-deal-brexit
[11] https://www.esma.europa.eu/sites/default/files/library/esma_70-155-7026_use_of_uk_data_in_esma_databases_in_case_of_a_no-deal_brexit.pdf
[12] The Financial Instruments Reference Database System is published by the European Securities and Markets Authority and lists meta-information to all financial instruments included in the scope of MiFID II. This reference data is necessary to find metadata on a given financial instrument, uniquely identified by a so-called International Securities Identification Number.
[13] From 3 January 2018, the Financial Instruments Transparency System (FITRS) displays information on transparency calculations, in particular for derivatives (at ISIN level) and new listed bonds and equities. From 1 May 2018 also the quarterly liquidity assessment for bonds (except ETCs and ETNs) admitted to trading before and until 28 February 2018 is provided through FITRS. These results are applicable from 16 May 2018.

b. Transaction Reporting
Similarly, with transaction reporting, where the broker acts as principal, they will be either a buy-or seller to the transaction (fields 7/16). The broker will have a market and client- side report and will need to specify that it is dealing as principal "DEAL" (field 29).

UCITS/AIFMD firms will not have a transaction reporting obligation (as they fall under MiFID II Article 2 Exemptions) but **UCITS/AIFMD firms who delegate management to a MiFID portfolio firm will have an obligation to transaction report** as a MiFID II firm. Portfolio management companies are different from UCITS and AIFMD firms and continue to have transaction reporting obligations.



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c. Branch Obligations
As it stands today, UK branches of EEA firms currently send transaction reports to their home EEA regulator rather than to the FCA. Yet, the Statutory Instrument published by the UK Government will require **UK branches of EEA firms** to report trades in financial instruments admitted to trading or traded on UK and EU trading venues to the FCA in the same manner as UK branches of non-EEA firms are currently required to do so.

Transaction Reporting Obligations – Branches & Instruments
MiFIR extends transaction reporting to branches of;

- EEA Investment firm based outside EEA which should report to the home state regulator; and
- Third Country investment firm based inside EEA should report to the host state regulator

This includes;

- **Instruments where underlying is an instrument, index or basket of instruments**
- **EEA Venue-Listed instrument traded on venue (TOTV)**
- **EEA Venue-Listed instrument traded off-venue**
- **Non-EEA Exchange-traded derivative with underlying in ESMA list**
- **Unlisted derivative with underlying in ESMA list**

d. Dual Reporting Risk
Firms looking to make use of the Temporary Permission Regime (TPR) will be subject to the UK trading obligation and the definition of a branch will fall under Article 2.22. Firms will be responsible to establish whether they are acting in the capacity of a branch or on behalf of the EEA Headquarters and report accordingly.

If the EU firm choses to utilise substituted compliance the firm can choose where to report. If it is an EU firm using a UK branch, it then depends whether the counterparty is a UK SI or not. As a registered venue then EU firm would need to report regardless. If the transaction is then reported on UK venue the activity would not contribute to SI volumes.

Continuing Politics

To solve the political impasse, an extension to Article 50 may yet be needed, however the terms on which this is arranged could yet up-end frustrating any successful conclusion. Some EU member states are now suggesting a minimum extension of a year, possibly even two, given the continued uncertainty of the UK's position. There is also the matter of the European Parliament elections in May and the departure of Juncker with a new European Commission and Commissioner; meaning that the UK Parliament may yet end up negotiating with a completely different team. While the Brexiteers are supporting May's renegotiation, they are unlikely to support any extension and may press ahead for a no-deal Brexit regardless. By February 14th, the UK could very well be back to the drawing board leaving firms with zero alternative than to continue planning for a hard Brexit.

Whatever the final political outcome, the regulators are now gearing up to deliver pragmatic solutions to the implementation and trading challenges that lie ahead in the event of a no-deal or hard Brexit. The issue for the industry will be staying abreast of the changes and their consequences – intended or otherwise.

About the author

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Rebecca is considered to be one of Europe's leading industry voices on market structure, regulatory reform, and financial services technology. She has authored a plethora of qualitative research reports and commentary covering the impact of market regulation on all asset classes, changing market structure and developments in dark pools, HFT, and surveillance. She joined Liquidnet in July 2016 to use her 20 years' experience to collaborate and deliver research and insights for both the European equities and fixed income markets. Rebecca is also Co-Chair of the FIX Trading Community's EMEA Regulatory Subcommittee, dedicated to addressing real business and regulatory issues impacting multi-asset trading in global markets. She has held prior roles at TABB Group, Incisus Partners, the British Embassy in Bahrain, Credit Suisse, Goldman Sachs International, and Bankers Trust International.

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