Linklaters

ASIFMA Webinar

MiFID II / MiFIR

Share and Derivatives Trading Obligations

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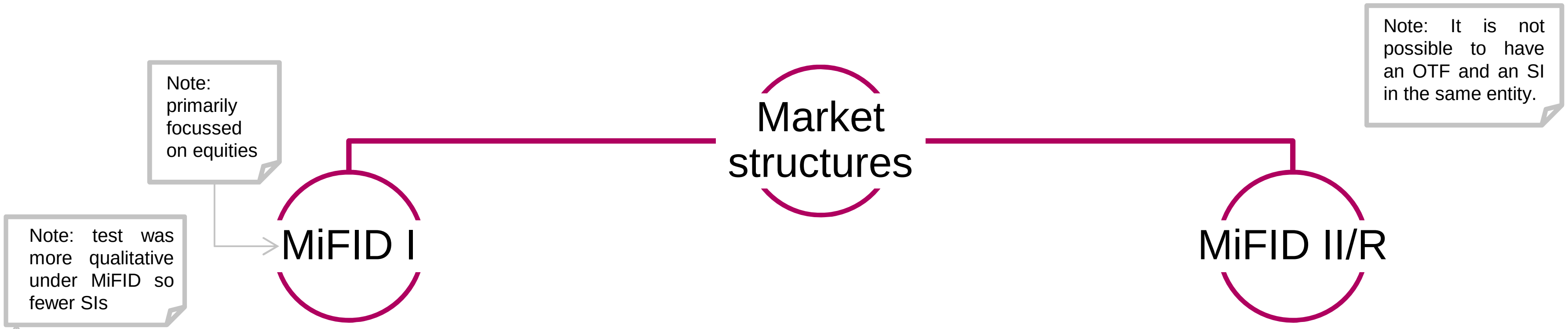
Aim of this session

Provide an overview of the:

- mandatory share trading obligation
- mandatory derivative trading obligation
- practical consequences and challenges resulting from the trading obligations
- Extra-territorial impact of the trading obligations

Market Structures

Market structures under MiFID I and MiFID II



Regulated Markets: for listed securities	**Regulated Markets:** for listed securities
Multilateral Trading Facilities (MTFs): alternative trading systems	**MTFs:** alternative trading systems (similar to MiFID I MTFs)
Systematic Internalisers (SIs): firms using own capital to make trades in respect of **equities only**	**SIs:** scope increased to cover equity-like & non-equity instruments (although limited for certain derivatives)
OTC	**OTC** (much reduced & further limited by trading obligation)
	Organised Trading Facilities (OTFs): new multilateral platform type for non-equity instruments

Overview of MiFID II market structures

Trading venues (**Multilateral**)

Regulated Market (“**RM**”)

Multilateral Trading Facility (“**MTF**”)

“… **a multilateral system**… which brings together… multiple third party buying and selling interests in financial instruments – in the system and in accordance with non-discretionary rules – in a way that results in a contract.”

Organised Trading Facility (“**OTF**”)

“… **any multilateral system** which is not an RM or MTF… in which multiple third party buying and selling interests in bonds, structured finance products, emissions allowances or derivatives are able to interact in the system in a way that results in a contract.”

Note: can’t have an SI and OTF in same legal entity

New for MiFID II

Other trading (**Bilateral**)

Systematic Internaliser (“**SI**”)

“an investment firm which, on an organised, frequent, systematic and substantial basis deals on own account when executing client orders outside of a regulated market or an MTF or OTF **without operating a multilateral system**.”

Expanded scope and application under MiFID II

Over the counter (“**OTC**”)

…no express definition… identified by… bilateral trading… carried out outside a trading venue or SI

Pre-trade transparency (subject to waivers)

More heavily regulated, more transparent

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Share Trading Obligation

Trading Obligation for Equities

Article 23 MiFIR

*An **investment firm** shall ensure the trades it **undertakes** in **shares admitted to trading on a regulated market or traded on a trading venue** shall take place on a:*

> *[European] regulated market;*

> *[European] MTF;*

> *[European] 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 their characteristics include that they:

> *are **non-systematic, ad-hoc, irregular and infrequent**; or*

> *are carried out between eligible and/or professional counterparties **and do not contribute to the price discovery process**.*

Who?: applies to EU entities only

What?: see next slides

When?: see next slides

Third-country venues: see next slides

Carve-outs: see next slides

Trading Obligation for Equities

What shares are in scope?

"shares admitted to trading on a regulated market or traded on a trading venue"

This includes shares dual-listed shares, where the EU listing is only secondary.

Practical Impact – where shares are dual-listed in the EU and the Hong Kong, an EU firm MUST trade them in the EU, unless an HK trading venue has been deemed equivalent, even if there is greater liquidity in Hong Kong

When does the obligation apply?

"*investment firm shall ensure the trades it **undertakes**…*"

AFME paper looks to limit the scope of the share trading obligation by looking at want amounts to "trade it undertakes" :

"*In our view, the Share Trading Obligation applies only to a MiFID investment firm when it is the final entity in the chain of execution in any given trade flow. Whereas a MiFID investment firm that places an order with or transmits an order to a third party (being another investment firm or a non-EEA firm) for execution, or is a passive intermediary in a chain of execution, should not be caught by the obligation, as it does not undertake the relevant trade*"

Practical Impact – taking the AFME interpretation, EU firms can transmit orders to Asian affiliates for execution. The Asian affiliate will not be subject to the trading obligation.

Trading Obligation for Equities

Third-country venues: equivalence

Art.25(4)(a) MiFID II

A National Competent Authority makes a request to the European Commission (EC)

EC adopts a decision stating the legal and supervisory framework of the third-country is equivalent to a regulated market, considering whether the:

- Markets are subject to authorisation and effective supervision and enforcement;
- Markets have clear and transparent rules regarding admission of securities, so securities are capable of being traded in a fair, orderly and efficient manner and are freely negotiable;
- Issuers are subject to ongoing information requirements ensuring a high level of investor protection; and
- Market transparency and integrity is ensured by preventing market abuse

Practical Impact – in the absence of an equivalence decision, EU firms will not be able execute in-scope shares transactions outside of the EU, even if that is where the most liquidity is.

We understand that the EC will be adopting a number of equivalency decisions before 3 January 2018

Trading obligation for equities

Carve-outs: what transactions are exempt?

Characteristics of the transaction are:

> *are **non-systematic, ad-hoc, irregular and infrequent**; or*

> *are carried out between eligible and/or professional counterparties **and do not contribute to the price discovery process**.*

Non- Price forming – A list of 9 types of transaction that are non-price forming are specified in RTS 1 Art.2:

(a) the transaction is executed by reference to a price that is calculated over multiple time instances according to a given benchmark;

(b) the transaction is part of a portfolio trade;

(c) the transaction is contingent on the purchase, sale, creation or redemption of a derivative contract or other financial instrument where all the components of the trade are to be executed only as a single lot;

(d) the transaction is executed by a UCITS management company or an alternative investment fund manager which transfers the beneficial ownership of shares from one collective investment undertaking to another and where no investment firm is a party to the transaction;

(e) the transaction is a give-up transaction or a give-in transaction;

(f) the purpose of the transaction is to transfer shares as collateral in bilateral transactions or in the context of central counterparty (CCP) payments;

(g) the transaction results in the delivery of shares in the context of the exercise of convertible bonds, options, covered warrants or other similar derivatives;

(h) the transaction is a securities financing transaction;

(i) the transaction is carried out under the rules or procedures of a trading venue, a CCP or a central securities depository to effect a buy-in of unsettled transactions.

Trading obligation for equities

What does this mean for Asian entities trading with EU in-scope firms?

Derivative Trading Obligation

Trading obligation: Derivatives

- The push onto trading venues also applies to standardised OTC derivatives.
- Strong interplay with EMIR
- MiFIR provides for a procedure for ESMA to designate derivatives that are subject to the clearing obligation under EMIR and which are sufficiently liquid, to be traded exclusively on RMs, MTFs, OTFs or non-EU trading venues deemed equivalent by the European Commission.
- ESMA will publish and maintain a register specifying the derivatives that are subject to the trading obligation, where they are admitted to trading or can be traded and the dates from which the obligation takes effect.

Trading Obligation for Derivatives

Article 28 MiFIR

FCs and NFC+s (including third-country entities who would be such if established in the EU) *shall conclude transactions*

(which are neither intragroup transactions as defined EMIR nor transactions covered by the transitional provisions in EMIR)

with other FCs and NFC+s in ***derivatives pertaining to a class of derivatives that has been declared subject to the trading obligation*** *only on :*

> *regulated market;*

> *MTF;*

> *OTF;*

or

> *a* ***third-country trading venue*** *assessed as equivalent*

Who?: wide scope. See next slides

Carve-outs

What?: see next slides

When?: see next slides

Third-country venues: see next slides

Trading Obligation for Derivatives

Who does the trading obligation apply to?

The trading obligation will apply to:

- Financial counterparties (“**FCs**”) and non-financial counterparties who exceed the threshold (“**NFC+s**”)
- FCs and NFC+s that enter into derivatives subject to the trading obligation with 3rd country financial institutions or other 3rd country entities that would be FCs and NFC+s if they were established in the EU; and
- 3rd country entities that would be subject to EMIR’s clearing obligation if they were established in the EU, which enter into derivatives subject to the trading obligation, provided that the contract has a direct, substantial and foreseeable effect within the EU or is necessary or appropriate to prevent evasion of MiFIR.

Parties may comply with equivalent 3rd country rules in lieu of EU requirements where one of the counterparties is established in that 3rd country (this reflects recent political agreement).

Therefore does not apply only to EU regulated entities

What is the process for determining which derivatives will be subject to the mandatory trading obligation?

ESMA to develop Regulatory Technical Standards to determine which classes of derivatives declared subject to EMIR's clearing obligation shall be subject to MiFIR's trading obligation.

↓

For the trading obligation to take effect:
(i) the class of derivatives must be admitted to trading or traded on at least one trading venue; and
(ii) there must be sufficient third-party buying and selling interests in the class of derivatives so that it is sufficiently liquid to trade only on the organised trading venues.

↓

Whether a derivative is sufficiently liquid will be determined by ESMA on a case-by-case basis, based on the average size and frequency of trades, the number and type of active participants and the average size of the spreads.

↓

Intra-group transactions, certain "transitional" transactions and portfolio compression exercises are exempted from the obligation.

Trading Obligation for Derivatives

What derivatives will be subject to the trading obligation?

Interest Rate Swaps with benchmark tenors
Fixed-to-Floating single currency IRS:
- EUR EURIBOR 3m and 6m
- USD LIBOR 3m and 6m
- GBP LIBOR 3m and 6m

ESMA published Final Report on RTS on 29 September 2017. RTS has not yet been adopted by the European Commission

Index Credit Default Swaps
Index CDS, on-the-run series, first off-the-run series:
- EUR 5Y iTraxx Europe Main
- EUR 5Y iTraxx Europe Crossover

When will the trading obligation for these instruments apply?

The Mandatory Trading Obligation for the above instruments will come into force on 3 January 2018, but will be phased-in for counterparties, depending upon the EMIR clearing categorisation.

Derivative	Category 1	Category 2	Category 3	Category 4
in-scope interest rate Derivatives	3 January 2018	3 January 2018	21 June 2019	21 December 2018
in-scope credit Derivatives	3 January 2018	3 January 2018	21 June 2019	9 May 2019

Trading Obligation for Derivatives

Third-country venues: equivalence

Art.28(4) MiFIR

EC adopts a decision stating the legal and supervisory framework of the third-country is equivalent to a trading venue, considering whether the:

- Markets are subject to authorisation and effective supervision and enforcement;
- Markets have clear and transparent rules regarding admission of securities, so securities are capable of being traded in a fair, orderly and efficient manner and are freely negotiable;
- Issuers are subject to ongoing information requirements ensuring a high level of investor protection; and
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We understand that the EC will be adopting a number of equivalency decisions before 3 January 2018

Trading obligation for derivatives

What does this mean for Asian entities trading with EU in-scope firms?

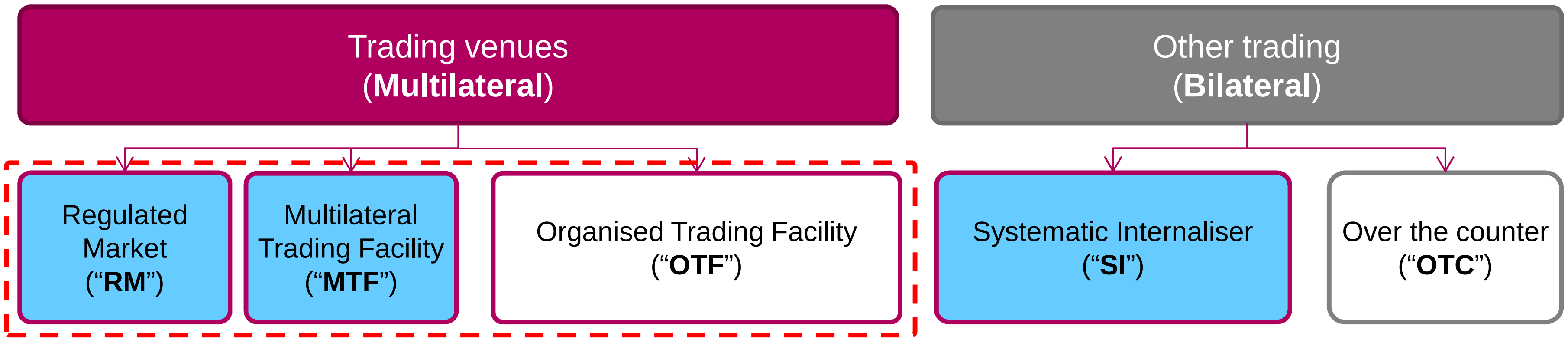
Trading obligations in a nutshell

Derivatives trading obligation (Art. 28 MiFIR)

What? Derivatives that are traded on a trading venue that are sufficiently liquid and declared subject to the trading obligation
Where? Regulated Market, MTF, OTF, equivalent third country trading venue
Who? Transactions between: FC and another FC; FC and an NFC+; An NFC+ and another NFC+; (and third country entities that would be subject to clearing obligation)

Equities trading obligation (Art. 23 MiFIR)

What? Shares admitted to trading on an regulated market or traded on an MTF
Where? Regulated Market, MTF, Systematic Internaliser, equivalent third country trading venue
Who? Transactions between: two Investment Firms, Investment Firm & a non-Investment Firm (only investment firms can be direct members of trading venues)
Exemptions for trading which is “non-systematic, ad-hoc, irregular and infrequent” (not defined) or trading which is between professional clients/ECPs and does not contribute to the price discovery process (exhaustive list in RTS 1)



Eligible for **derivatives** subject to trading obligation

Eligible for **equities** subject to the mandatory trading obligation

Questions?