November 16, 2017

MiFID II: Share Trading Obligation

Bulletin 1

What has happened?

On November 13, 2017 ESMA issued a press release attaching its long awaited Q&A concerning the Share Trading Obligation (**'STO'**). We understand the Q&A and accompanying press release confirmed three things – i) Association for Financial Markets in Europe's (AFME) interpretation of the rule (more widely known as the 'undertakes approach') is dismissed and replaced with contrary guidance, ii) the EC continues to work on 'equivalence' decisions, and iii) shares from countries where 'equivalence' determinations are not being considered are exempt from the STO; therefore, firms can conduct their operations based on the understanding that "*the Commission has currently no evidence that the EU trading in shares admitted to trading in that third country's regulated markets can be considered as systematic, regular and frequent".*

In this note we shall look at the evolution of this rule and how we understand the latest Guidance to apply.

The Background

In a bid to ensure that more share trading takes place on regulated lit trading venues, MiFIR introduced the STO for investment firms. In view of the wide terms in which it is drafted, and the expectation that the vast majority of equivalency determinations would not be available before the go-live date, the STO has been a cause of concern for European investment firms, particularly for its extraterritorial footprint.

The STO obligates investment firms to trade shares tradable on European trading venues (TOTV shares) only on European trading venues (Regulated Markets and MTFs), with systematic internalisers ('SI'), or on 'equivalent' third country venues. A literal interpretation of this rule in the absence of equivalence determinations would prohibit investment firms from accessing material pools of liquidity in TOTV shares normally traded outside the EEA. The comments in ESMA's press release provide a very welcome interpretational direction which, in our opinion, removes some of the potential wide reaching territorial ambit of the STO.

The Impact

European trading venues enable trading in over 10,000 shares from approximately 120 countries[1] (**'non-EEA shares'**). However, the primary liquidity for non-EEA shares is normally only available

[1] https://www.esma.europa.eu/file/20507/download?token=1tPpNG5C

on non-EEA venues. Following a literal interpretation of the STO (in the absence of 'equivalency' determinations) would have had the bizarre result of European firms having to trade non EEA shares like Apple, IBM, or Google only on European venues.

In the absence of 'equivalency' determinations, it was anticipated that the STO would create adverse trading conditions for European firms; thereby hampering their competitiveness and the ability to deliver best execution, particularly with regard to non-EEA shares. The comments in the accompanying press release, therefore, come as a welcome reprieve in this regard. See later sections for details.

Prior Understanding

On September 6, 2017 the AFME published their approach to implementing the STO. Their approach was hinged upon the interpretation of the term 'undertakes' appearing in the text of the rule.

AFME argued that in a chain of intermediaries between the client order and the execution venue, only the last investment firm which interacted with or behaved as the execution venue was 'undertaking' the trade. All other intermediaries in the chain either 'transmitted' or 'received' the client order from other links in the chain. Therefore, the obligation to comply with the STO was understood to be only upon the investment firm that was the last link in a chain of intermediaries.

Given that the STO is only applicable to MiFID investment firms, if the last link in the chain is a non-MiFID firm then the execution of the order would not be constrained by the STO. This interpretation removed some of the concerns about trading non-EEA shares for which primary liquidity is observed outside the EEA.

The New Approach

Based on ESMA's press release and Q&A, investment firms now have a new approach to interpreting Article 23(1)[3].

- ESMA on AFME's Approach: ESMA rejected AFME's 'undertakes' approach. ESMA have now confirmed that in a chain of transmission of orders each participating MiFID investment firm is obligated to ensure that the ultimate execution of orders complies with the STO. We set out the relevant extract of the Q&A below:

  "Where there is a chain of transmission of orders …. all EU investment firms that are part of the chain…. should ensure that the ultimate execution of the orders complies"

- ESMA on the scope of affected 'Shares': Based on ESMA's comments in the press release, we are now led to understand that the list of shares subject to the STO is reduced because exception to the STO set out in Article 23(1)(a), MiFIR can apply to trading in non-EEA TOTV shares in jurisdictions for which no 'equivalence' determination is made. ESMA said that:

  "…the absence of an equivalence decision taken with respect to a particular third country's trading venues indicates that the Commission has currently no evidence that the EU trading in shares admitted to trading in that third country's regulated markets can be considered as systematic, regular and frequent."

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[3] *23(1). 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 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 their characteristics include that they:*
(a) are non-systematic, ad-hoc, irregular and infrequent; or
(b) are carried out between eligible and/or professional counterparties and do not contribute to the price discovery process.

- EC on third country equivalence: ESMA have indicated that the EC are working on equivalence of third countries. Our hope is that equivalence decisions for at least US, Canada, Australia, South Africa and Switzerland will be communicated in December.

Open Questions

- Until we have seen the final published equivalence decisions, the ability of MiFID investment firms to access OTC markets in equivalent non-EEA jurisdictions is still unclear.

Global Market Structure- EMEA

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