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Insights

THE SHARE TRADING OBLIGATIONS – A NEW YEAR'S MESS

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SUMMARY

Diverging approaches to Share Trading Obligations from the FCA and ESMA pose challenges for investment firms in a post-Brexit Europe.

With 1 January 2021 creeping closer and the hope of securing an effective Brexit deal seemingly drifting ever further away, there is continued ambiguity when it comes to the future of financial services across Europe. How the Share Trading Obligation ("**STO**") will operate in practice in a post-Brexit world is no exception to this state of uncertainty.

The Current STO

Under Article 23 of the Markets in Financial Instruments Regulation ("**MiFIR**"), EU investment firms are only permitted to trade shares on an EU trading venue (i.e. regulated markets and multilateral trading facilities), an EU systemic internaliser ("**SI**"), or an equivalent third-country trading venue, where those shares are admitted to trading on an EU trading venue.

In the absence of a solution, when the Brexit transition period ends on 31 December 2020, the EU version of the STO will force EU investment firms to execute transactions in such shares on EU venues and EU SIs, which will by then exclude trading venues and SIs in the UK. The reverse would also be true under the UK's onshored version of the STO.

A significant volume of trading in shares, which are listed on EU venues, currently takes place on UK trading venues, even though the UK is not necessarily the jurisdiction where the primary listing has taken place, or even where the issuer is registered. This means that in a post-transition period world, without a solution to the STO problem, EU investment firms will be forced to execute trades on markets in the EU which, for some shares, will have lower liquidity and therefore potentially much less efficient price formation processes than is currently the case when those same firms have access to pools of liquidity in the UK.

Ultimately, this could result in worse outcomes for the underlying clients of these investment firms (including pension funds and retail investors). Therefore, the market has been hoping for an arrangement to emerge that will minimise disruption come 1 January 2021 and maintain access to trading venues in both the UK and the EU for all firms, regardless of the jurisdiction in which they are authorised.

The European Stance

On 26 October 2020, the European Securities and Markets Authority ("**ESMA**") published a statement[1] indicating that, in the absence of a decision as to equivalence by the European Commission in respect of the UK, we will see the same consequences as that of a no-deal Brexit. ESMA referred to its earlier statement of 29 May 2019, confirming that EEA shares with International Securities Identification Numbers ("**ISINs**") starting with EEA country codes will fall within the remit of the EU STO, whereas UK shares with GB ISINs will not. In other words, from ESMA's perspective, the application of the STO depends solely upon the jurisdiction where the issuer's shares are registered.

At the time of writing, the European Commission has not published an equivalence decision in favour of the UK in relation to the STO. Accordingly, ESMA's EEA-ISIN approach remains the current EU position.

The UK Stance

The FCA published a statement on 4 November 2020[2] ("**the FCA's Statement**") that it would use its Temporary Transitional Power ("**TTP**") to minimise impact on UK investment firms, allowing them to continue to seek the best pricing outcomes for themselves and their customers across all EU and UK trading venues and SIs. The FCA disagrees with ESMA's position that the ISIN and/or currency of a share should determine the applicability of the STO.

On 2 December 2020, the FCA published a draft transitional direction[3] and explanatory note[4], which codifies the FCA's Statement and reiterates the FCA's commitment to mitigating disruption.

It is important to note that the FCA's Statement did not grant equivalence from the UK to EU trading venues. Rather, it clarified that UK authorised firms will not be forced to execute on a UK venue if there is a better price obtainable on an EU venue. Practically, the outcome of this will be the same as if equivalence had been granted but the nuance of language speaks pertinently to the politicised power play we have seen dominate this and other discussions on the future relationship between the UK and the EU.

The FCA maintains that mutual equivalence between the UK and EU "*should be easy to agree and remains the best way of dealing with overlapping STOs*". To that end, we understand that the FCA

has not ruled out granting equivalence and remains open to discussions with ESMA on how best to minimise disruption.

Commentary

The FCA's approach is unsurprising given its views on market stability and the desire to minimise Brexit related market disruptions. Unfortunately, if ESMA's stance remains as it is, we will see fragmented pools of liquidity in the UK and EU, which fails to give proper consideration to the current high trading volumes in London for instruments that are registered all over the EU.

Suddenly restricting the number of venues where an instrument can be executed ignores the fact that trading throughout Europe (including the UK) has been open and relatively seamless for a significant period of time. Historically, the best price and venue across the EU has always been available to investment firms. In the absence of an arrangement that resembles some level of mutual equivalence, in the short term at least, we are very likely to see worse pricing outcomes for investment firms and clients across the EU (and potentially the UK).

The EU's position seems to be either oblivious to the adverse pricing realities that fragmentation will cause in the short term, or, as is more likely the case, is a deliberate strategy to create a "fortress Europe" for share trading in EU shares over the longer term, notwithstanding the shorter-term negative implications. Those short-term effects are likely to be un-competitive pricing available for shares registered all over the EU – something that EU pension funds, investment funds and investors generally cannot be happy about.

Whether the EU will grant some type of effective "equivalence" at the last minute on this issue remains an unanswered question at this time, but the signs are not promising.

While the UK FCA has so far taken the lead on seeking to minimise disruption in this space, it should not be ignored that the option to explicitly grant equivalence in STO context was available to it but not unilaterally exercised by the FCA. It is therefore worth noting that the FCA's Statement mentioned a willingness to discuss *"whether the MiFID II calibrations, which were designed for a pan-European market of 28 countries, remain appropriate for the UK in the absence of our current equivalence being recognised".* This suggests that a divergence from European standards would be readily considered if ESMA does not take steps to meet in the middle. Some have justifiably labelled these words a "threat"[5], as they reflect a stronger stance than we have come to expect from the UK regulator.

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[1] https://www.esma.europa.eu/press-news/esma-news/esma-sets-out-final-position-share-trading-obligation-0

[2] https://www.fca.org.uk/news/statements/fca-statement-share-trading-obligation

[3] https://www.fca.org.uk/publication/handbook/draft-transitional-direction-sto.pdf

[4] https://www.fca.org.uk/publication/handbook/draft-transitional-direction-sto-explanatory-note.pdf

[5] https://www.ft.com/content/365672d0-3bbb-46eb-93f7-68c72293f709

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