Preparatory measures by ESMA in the context of the United Kingdom withdrawing from the European Union. February 2019.

On 29 March 2017, the Prime Minister of the United Kingdom (UK) – Theresa May – in a letter addressed to the President of the European Council – Donald Tusk – announced the UK's intention to leave the European Union (EU).

As a result of this notification and the implications that this decision might have in the area of financial markets, ESMA decided to allocate part of its resources to identifying and monitoring the risks that might result from the United Kingdom withdrawing from the European Union, the process of which is known as Brexit.

In addition, ESMA has adopted a series of measures in the framework of the functions entrusted to it – such as investor protection, the proper functioning of markets and financial stability – with the aim of limiting, as far as possible, the negative effects that might result from a sudden interruption of the participation of different operators from the British financial industry in EU27 capital markets, in particular if the UK does not ratify a withdrawal deal prior to 29 March 2019.

The most important measures adopted by ESMA up to 5 February 2019 are described below.

Measures taken in the area of supervisory convergence

ESMA's activities include promoting supervisory convergence between national competent authorities (NCAs). With this objective, ESMA adopted four opinions between May and July 2017 in the context of Brexit.

The aim is to promote the greatest possible consistency in the processing of requests for authorisation by UK entities that decide to relocate in the EU27 in order to prevent national competent authorities (NCAs) accepting the establishment of letter-box entities in their respective jurisdictions. Moreover, for effective application of these principles, a network has been set up within ESMA called the Supervisory Coordination Network, through which NCAs may discuss cases anonymously.

Similarly, in February 2019, ESMA published a MiFID II Supervisory briefing on how NCAs should supervise non-EU branches of EU firms providing investment services and activities. The issues covered by this document are the requirements necessary for authorisation, ongoing supervision – including compliance with reporting and collection of information obligations – and cooperation with non-EU competent authorities.

Furthermore, in July 2018, ESMA published a Statement in which it requested UK entities to submit their requests for authorisation to the corresponding NCAs sufficiently in time so that they may be processed before 29 March 2019, i.e., in the event of a no-deal Brexit.

Finally, it should be noted that in February 2019, ESMA published that the NCAs of the EU27 and the UK's national authority – the Financial Conduct Authority (FCA) – had reached a commitment with regard to the Memoranda of Understanding necessary so that both parties may carry out effective supervision of the entities that will provide cross-border services, which would become effective in the event of a no-deal Brexit.

Measures taken in the area of secondary markets

In its initial analysis of the possible risks that Brexit might pose in this area, ESMA identified certain gaps or inefficiencies in European legislation that it reported to the European Commission (EC) by means of a letter in November 2017.

Firstly, it referred to the lack of a fully harmonised third-country regime through which the entities from those countries will be subject to a similar level of requirements to that which markets in financial instruments

legislation, MiFID II/MiFIR, establish for entities established in the EU. In particular, the letter highlights that this legislation did not make clear whether or not the provisions relating to dealing on own account when this service is provided by high-frequency traders through direct electronic access, as a member or participant of the trading venue or as a market maker, were applicable to third-country firms. In addition, ESMA highlighted that non-EU firms that access our markets through branches established in any Member State might be subject to less stringent requirements than EU investment firms.

Secondly, ESMA recommended that the EC should introduce a harmonised EU framework governing the placing of trading screens by third-country venues.

Finally, ESMA informed the EC of its support for the proposal to allow to temporarily suspend the clearing obligation of derivatives under certain circumstances, such as a significant drop in liquidity and, in addition, it proposed extending the suspension to the trading obligation of derivatives.

Measures taken in the area of clearing

The main risk identified in this area in the context of Brexit relates to the importance of central counterparties authorised in the United Kingdom for our financial markets as a very significant part of derivatives trading cleared in the EU takes place on said CCPs, in particular interest-rate swaps in euros.

Given the importance of this issue, in November 2018, ESMA published a Statement setting out its support for the EC Communication of 13 November 2018, which indicated that one of the measures of its Contingency Action Plan for the withdrawal of the United Kingdom from the European Union will consist of adopting a temporary and conditional equivalence decision in order to ensure that the CCPs continue to provide services in the EU27. ESMA also indicated in this Statement that it had already started engaging with UK CCPs that had declared their intention to be recognised.

Subsequently, in December 2018 it published a second Statement in which it reported on the status of its plan for the recognition of CCPs. Specifically, it reiterated its commitment to complete this by 30 March 2019 in the event of a no-deal Brexit and unless it is eventually agreed to extend the two-year period referred to in Article 50 of the Treaty on the European Union, providing the requirements established by legislation are met. These include: (i) prior adoption of an equivalence decision by the EC, (ii) the UK CCPs that request recognition being authorised and subject to effective supervision and enforcement, (iii) the establishment of cooperation arrangements between the Bank of England and ESMA, and (iv) the UK complying with legislation on combating money laundering and terrorist financing.

ESMA also recognised in this Statement the need to allow continued access to UK central securities depositories (CSDs) so that they could continue to provide services to Irish securities and announced a plan for the recognition of these entities similar to that for CCPs.

The EC, for its part, adopted two Decisions on 19 December 2018 declaring an equivalence decision with regard to the regulatory and supervisory frameworks of the UK applicable to its CCPs and CSDs for a period of 12 and 24 months, respectively. Finally, in February 2019, ESMA published than it had reached an agreement with the Bank of England on the Memoranda of Understanding required in this matter, applicable only in the case of a no-deal Brexit.

Measures taken in relation to the continuity of contracts

Another of the issues that has generated a great deal of debate has been the effect of Brexit on the continuity of contracts, particularly in the area of derivatives. Specifically, with regard to non-centrally cleared OTC derivative contracts, ESMA has raised the issue of the impact resulting from UK counterparties no longer being able to provide services in the EU27 following Brexit. With the aim of preventing the novation of contracts by European counterparties that wish to replace the UK counterparty with a European counterparty triggering the clearing obligation, in November 2018 ESMA published a final report that included a proposal for regulatory technical standards, requesting the modification of the three Commission Delegated Regulations in the framework of the European Market Infrastructures Regulation (EMIR). The aim is to provide an exemption from the clearing obligation for a limited period of 12 months for novations that take place in these circumstances in the context of Brexit. In addition, the proposed amendments would only apply should a no-deal Brexit eventually take place.

Similarly, ESMA announced in a press release – also in November 2018 – that it is considering, together with the other two European supervisory bodies (EBA and EIOPA) to also provide an exemption from the application of bilateral margin requirements, in the context of Brexit, in order to facilitate the novation of OTC derivative

contracts with the aim of replacing the UK counterparty with a European counterparty.

These two measures, which have been set out in the EC's aforementioned December Contingency Action Plan, will be the only ones adopted to resolve the contract continuity problems resulting from Brexit.

In addition, various Member States, such as Germany and Italy, have recently adopted regulations to ensure the continuity of financial contracts in their respective territories when the service provider is a UK entity.

Measures taken in the area of investment firms

One of the positive consequences of Brexit is that it has served to reflect, at least at an EU level, on both the legal framework regulating the third-country regime and on its effectiveness with regard to certain aspects such as investor protection. In this regard, in September 2018, ESMA sent a letter to the EC informing it of a series of issues relating to MiFID II/MiFIR.

Firstly, ESMA requests that the EC reflect on the desirability of a higher level of harmonisation of the third-country regime provided for in MiFIR for providing investment services and performing investment activities to eligible counterparties and professional investors. For example, it proposed requiring foreign entities to comply with certain provisions contained in markets in financial instruments legislation. It also suggested that NCAs might exercise some type of direct supervision on them or that improvements be made to ESMA's registration system. In addition, with regard to the proposal that third-country entities submit an annual report on their activity to ESMA in the framework of the EC's initiative on the review of prudential requirements for investment firms, it proposed adding that it be specified in which Member States these entities are actually operating and also the possibility of gathering further information depending on the data provided. In this letter, ESMA also requested a strengthened cooperation framework rather than the optional cooperation agreements currently envisaged by MiFIR when third-country entities, using a branch established in a Member State, decide to provide investment services or perform investment activities to professional investors or eligible counterparties, following an equivalence decision and registration of the entity in ESMA's register.

Secondly, ESMA indicated that MiFID II regulates a fragmented framework of access for third-country entities that wish to provide investment services or perform investment activities to retail clients (and professional clients on request) in the EU given that this depends – except for the obligation to apply a limited number of harmonised requirements – on the provisions of the respective national legislations. In consequence, it proposed that the EC might reflect on the desirability of also adopting a more harmonised regime in this case, including addressing other situations in which it is the national regimes that are applicable.

Thirdly, with regard to the provision of investment services at the exclusive initiative of clients ("reverse solicitation"), ESMA requested that the EC review the legislation which allows this, particularly when it affects retail clients. It also provided specific proposals to limit its scope, such as (i) the burden of proof falling on third-country firms, (ii) in these cases, third country firms being subject to EU courts and dispute-resolution bodies, and (iii) clarifying that the reverse solicitation assessment should be assessed on a transaction-by-transaction basis.

Finally, ESMA suggested in its letter to the EC submitting the outsourcing of critical and important functions of entities that provide investment services or perform investment activities to third-country entities to a stricter regime than that provided for in MiFID II, proposing that it be aligned with the requirements set out in the Level 2 measures of the Alternative Investment Fund Manager Directive.

Similarly, in December 2019, ESMA published a Statement addressed to UK entities providing investment services or performing investment activities in the EU, as well as entities of the EU27 with clients in the UK – whether directly or through a branch in both cases – in which they were requested to inform their clients of the impact that Brexit might have on any contracts already signed with them or those that may be signed in the future, as well as the way in which they would be affected by the contingency plans adopted to mitigate the risks resulting from Brexit. The Statement also urges them to finalise and implement these plans within a suitable timeframe.

Measures adopted in the area of direct supervision by ESMA

ESMA is the competent authority in the EU for credit rating agencies (CRAs) and trade repositories. However, as from the date of Brexit, these entities will no longer be registered with this Authority as the UK will become a third country. However, EMIR requires that transactions in derivatives subject to the reporting obligation should only be reported to entities that are established in the EU or in third countries but recognised in the EU. European legislation requires that for credit ratings to be used for regulatory purposes in the EU, they must have been issued by an entity registered in the EU and supervised by ESMA, except in the case of endorsement or prior

certification of the entity by ESMA. As a result, most UK-based CRAs and data repositories have opted, in their contingency plans in preparation for a no-deal Brexit, to continue providing their services to EU27 entities either by registering a new legal entity in one of those countries or by notifying ESMA of material changes in the organisation of entities already registered in the EU. Some have also decided to remove themselves from the register.

In November 2018, ESMA published a Statement in which it indicated that it was monitoring the level of implementation of the contingency plans of these entities with the aim of ensuring their full execution by 30 March 2019. ESMA also invited market participants to contact their trade repository to verify whether continuity of service will be ensured after Brexit. Finally, given the possibility that some counterparties may need to request their existing UK trade repository to port their data to an EU trade repository, it recommended adhering to the most recent reporting requirements.

Similarly, in February 2019, ESMA published that it had agreed with the FCA the Memoranda of Understanding required in this area in February 2019.

Measures taken in relation to data

If no withdrawal agreement is ratified by 29 March 2019, the FCA will stop sending data to ESMA as from 30 March 2019. Consequently, ESMA has been forced to design a strategy with regard to the impact that Brexit will have on its databases as they will not have data from the UK and the effect when performing the transparency calculations required by MiFID II/MiFIR – such as those relating to reference data, transparency of equity instruments, liquidity of bonds or for determining systemic internalisers. Specifically, the following databases will be affected: Financial Instruments Reference Database (FIRDS), Financial Instruments Transparency System (FITRS) and Double Volume Cap Mechanism Data (DVC system). This situation will also affect the data used for the annual calculation of whether an activity may be considered to be ancillary.

Links of interest:

Opinion – General principles to support supervisory convergence in the context of the United Kingdom withdrawing from the European Union (ESMA42-110-433)

Opinion to support supervisory convergence in the area of investment management in the context of the United Kingdom withdrawing from the European Union (ESMA34-45-344)

Opinion to support supervisory convergence in the area of investment firms in the context of the United Kingdom withdrawing from the European Union (ESMA35-43-762)

Opinion to support supervisory convergence in the area of secondary markets in the context of the United Kingdom withdrawing from the European Union (ESMA70-154-270)

MiFID II Supervisory briefing. On the supervision of non-EU branches of EU firms providing investment services and activities (ESMA35-43-1493).

PUBLIC STATEMENT. Timely submission of requests for authorisation in the context of the United Kingdom withdrawing from the European Union (ESMA42-110-998).

PRESS RELEASE. ESMA and EU securities regulators agree no-deal Brexit MoUs with FCA (ESMA71-99-1096).

Letter to the European Commission on MiFID II/ MiFIR third country regime, placing of trading screens in the EU and lack of temporary suspension regime for the trading obligation for derivatives (ESMA70-156-236)

PUBLIC STATEMENT. Managing risks of a no-deal Brexit in the area of central clearing (ESMA70-1511-948).

PUBLIC STATEMENT. ESMA is ready to review UK CCPs' and CSDs' recognition applications for a no-deal Brexit scenario (ESMA70-151-2032).

PRESS RELEASE. ESMA agrees no-deal Brexit MOUs with the Bank of England for recognition of UK CCPs and the UK CSD (ESMA 71-99-1107).

Final Report – EMIR RTS on the novation of contracts for which the clearing obligation has not yet taken effect (ESMA70-151-1854)

PRESS RELEASE. ESMA proposes a regulatory change to support the Brexit preparations of counterparties to uncleared OTC derivatives (ESMA71-99-1055).

Letter to the European Commission on MiFID II/MiFIR third country regimes, provision of investment services and activities at the exclusive initiative of the client and outsourcing of functions to third country entities (ESMA35-36-1442)

STATEMENT. Reminder to firms on their MiFID obligations on disclosure of information to clients in the context of the United Kingdom withdrawing from the European Union (ESMA35-43-1328).

PUBLIC STATEMENT. Contingency plans of Credit Rating Agencies and Trade Repositories in the context of the United Kingdom withdrawing from the European Union (ESMA80-187-149).

PRESS RELEASE. ESMA and EU securities regulators agree no-deal Brexit MoUs with FCA (ESMA71-99-1096).

PUBLIC STATEMENT. Use of UK data in ESMA databases and performance of MiFID II calculations in case of a no-deal Brexit (ESMA70-155-7026).