Group Regulatory Strategy

The Brexit process and its impact on financial markets

The Brexit process

The UK officially triggered the EU withdrawal process on 29 March 2017, starting the two-year period during which the EU and UK have to negotiate and ratify the precise terms of Brexit. The formal Article 50 negotiations have started on 19 June 2017 – and will continue. The clock towards 29 March 2019 is still ticking, when the UK leaves the EU with or without an agreement. For market participants the outcome of the negotiations is still uncertain. They need to be prepared for a number of different possible scenarios, including a no-deal scenario.

Post-Brexit EU – potential UK cooperation models

One of the key risks resulting from the short two-year period of negotiations and the ratification process as well as the complexity of the issues in question is that it may not be possible to negotiate all of the relevant issues during this time and that EU-UK ties (from withdrawal through to achieving a renegotiated relationship) will not be realigned until an indeterminate future date. The scenario of a cliff edge – the UK leaving the EU after the formal negotiation period in March 2019 without withdrawal agreement let alone any transitional period – is possible and could have fundamental implications for cross-border financial activities between the UK and the EU-27. This scenario means that the UK would completely leave the EU single market, and trade relations between the UK and the EU would consequently revert to WTO rules. Until Brexit, EU law fully applies for the UK.

How does the process up to Brexit work?

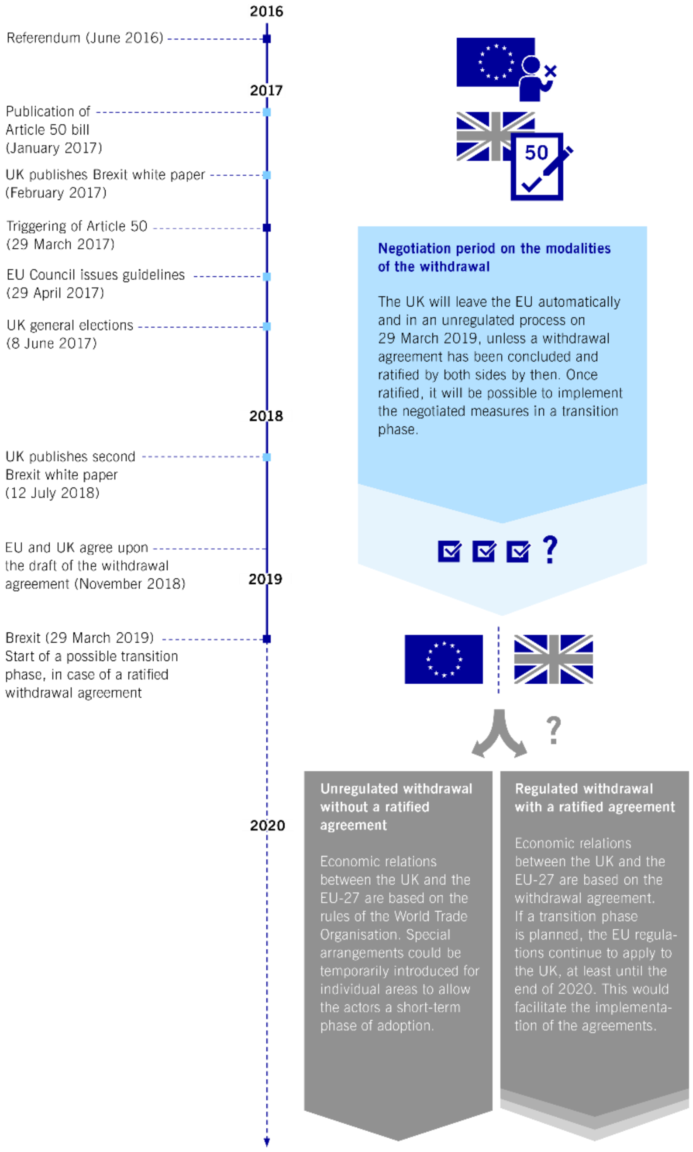

Figure 1: timeline for the Brexit process

The danger of a cliff-edge scenario raises also because, as of to date, the UK has ruled out conceivable and existing models for a cooperation between the EU and non-Member States (for further information on potential existing post-Brexit scenarios see below).

Scenario	Assessment	Attractiveness
EEA Agreement (e.g. Norway)	The UK could join the European Economic Area (EEA) and the European Free Trade Association (EFTA) and continue to have full access to the single market.	UK would have to adopt EU regulations and standards but it's ability to influence the rules will be limited. **UK Government has already expressed his reservation against such a model.**
Customs-Union (e.g. Turkey)	The UK could enter into a customs union with the EU. Goods could be exported to the EU without tariffs or customs restrictions, but the UK would be required to comply with various areas of EU regulation.	**Many sectors may be excluded from a customs union** and services, including **financial services, may not be covered** at all.
Free Trade Agreement (e.g. Switzerland[1])	The UK could agree on a free trade agreement with the EU in order to have a single comprehensive deal rather than piecemeal agreements. This could lead to a greater continuity of the single market at the cost of political autonomy.	**Swiss-Model[1]:** The UK would likely follow a sectoral approach by trying to "pick and choose" among policies beneficial for the country (such as full access to the single market) while at the same time rejecting commitments that are against UK's interest or unpopular among the British public. Such comprehensive relationship would come without the UK having a say on the adoption of new laws and at continued financial contribution. **This strategy has no real supporters among EU members.** For the UK to enjoy access to the single market, **the EU will insist on UK keeping up with common legislation to ensure a level playing field for all participants.**
Bilateral Agreements (e.g. Switzerland[1])	The UK could agree a set of bilateral agreements (BA) governing access to the single market, sector by sector. It would not get full access to the single market but would also not be required to comply with EU law except in relation to exports and investments into the EU. The UK could also become a member of EFTA.	
WTO (e.g. China)	The UK could rely on existing WTO rules and there would then be no negotiations for new agreements between EU and UK. The UK would gain full autonomy over its trade policy.	This scenario is not consistent with **UK's liberal approach to trade.** Financial services will not be covered.

Figure 2: potential post-Brexit process scenarios

1) The "Swiss-Model" is a bundle of sector-specific arrangements, which deals with each sector's specific requirements on a case-by-case basis but excludes financial services

The significance of Brexit for financial services

Even as EU law continues to apply in the UK during the ongoing negotiation period and the possible transition period (at least until the end of 2020), uncertainty for market participants continues until the terms of the UK's withdrawal are finalised and ratified.

This uncertainty poses a particular challenge in the context of financial services: The UK financial market currently acts as a wholesale hub for the EU and accounts for up to 80 per cent of EU activity in financial market segments.[1] UK-based financial firms will lose their existing EU passporting rights to conduct

1) According to the FESE European Equity Market Report 2016, around 54 per cent of the European equity trading was executed in the UK. The UK handles 77 per cent of euro-denominated derivatives transactions, according to the Bank for International Settlements data on over-the-counter trades. Around 78 per cent of European foreign-exchange (FX) trading, 74 per cent of European interest rate derivatives trading and 50 per cent of European fund management activities (by assets) take place in the UK.

business with EU-27-based clients, if the UK and EU do not agree on a withdrawal agreement including transitional provisions or treaties that would maintain these rights.

Market participants cannot afford to build their business on uncertainty. To reduce this uncertainty, some UK-based market participants are already establishing or even executing contingency plans to do business across the EU-27 post-Brexit (e.g. requesting respective licenses, relocating human resources etc.).

Importance of passporting for financial services

The impact of Brexit effects all parts of financial activities between the UK and the EU-27. As it stands, the "passporting" mechanism makes it possible to conduct financial services on a cross-border basis throughout the entire EU, without the need to establish a subsidiary or branch in the individual Member States. Simultaneously, passporting also means that EU trading venues, central counterparties (CCPs), trade repositories (TRs) and central securities depositories (CSDs) etc. are permitted to serve members from anywhere in the EU.[2] In case there are no treaties agreed between the UK and the EU that would maintain these passporting rights, UK-based financial firms will not be able to conduct business with EU-27-based clients – and vice versa.

Access to the European single markets for the UK after the Brexit

Essentially, there are two ways to retain access to the European single market. UK-based market participants can either establish a subsidiary in an EU-27 country and thus preserve their passporting rights, or ask for an equivalency decision by the European Commission that will make them subject to the third-country rules for financial services. But existing third-country rules are no adequate substitutes for the European passporting rights, as they do not cover the entire suite of financial services and there are too many uncertainties around some of the existing mechanisms with the European Commission having for example unilateral powers to withdraw equivalence decisions at very short notice.

The first scenario will involve a relocation of all or some parts of business into an existing regulated EU subsidiary or an application to the competent authority of a member state for authorisation of a local regulated subsidiary or branch. National supervisors have already made clear that they will not accept so-called letterbox companies.[3] [4] [5]

The second scenario for access to the EU single market is an equivalency decision by the European Commission according to the so-called third-country rules of the EU.

Third-country rules – access to financial markets

The EU, and thus the UK as well, follow international standards.[6] As a Member State of the EU since 1973, the UK has been transposing existing EU laws and is still in the process of transposing EU laws currently being implemented.

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2) European Parliament (2017).

3) Esma (Mai 2017).

4) BaFin (February 2017).

5) Andreas Dombret (February 2017).

6) For example, the CPMI-IOSCO Principles for financial market infrastructures, which are implemented in the EU via EMIR.

Key legislations applying to operators of financial market infrastructure are:

- MiFID II/MiFIR[7] (was implemented in the EU and the UK by the start of 2018)
- EMIR[8] (already in force in the EU and the UK)
- CSDR[9] (currently being implemented in the EU and the UK)

There should therefore be a basis for an equivalence decision in favour of the British regulatory framework, at least by the time the UK withdraws from the EU. However, the European Commission has sole discretion when making an equivalence assessment. In this respect, equivalence is no substitute for the EU passport.

In any event, it is of considerable importance to ensure the comparability of UK regulations with EU regulations going forward, including in their technical implementation. Otherwise, the danger is that the high European standards would be undermined by less stringent third-party standards in the interest of regulatory arbitrage.

1. Trading venues (MiFID II/MiFIR)

Starting in 2018, the European regulatory framework for trading in financial instruments will be comprehensively governed by MiFID II/MiFIR. Key terms of MiFID II/MiFIR are the obligation for investment firms to use trading venues for the trading of certain financial instruments and comprehensive transparency requirements for trading participants (see chart below). MiFIR further imposes comprehensive governance and stability requirements on operators of financial market infrastructures.

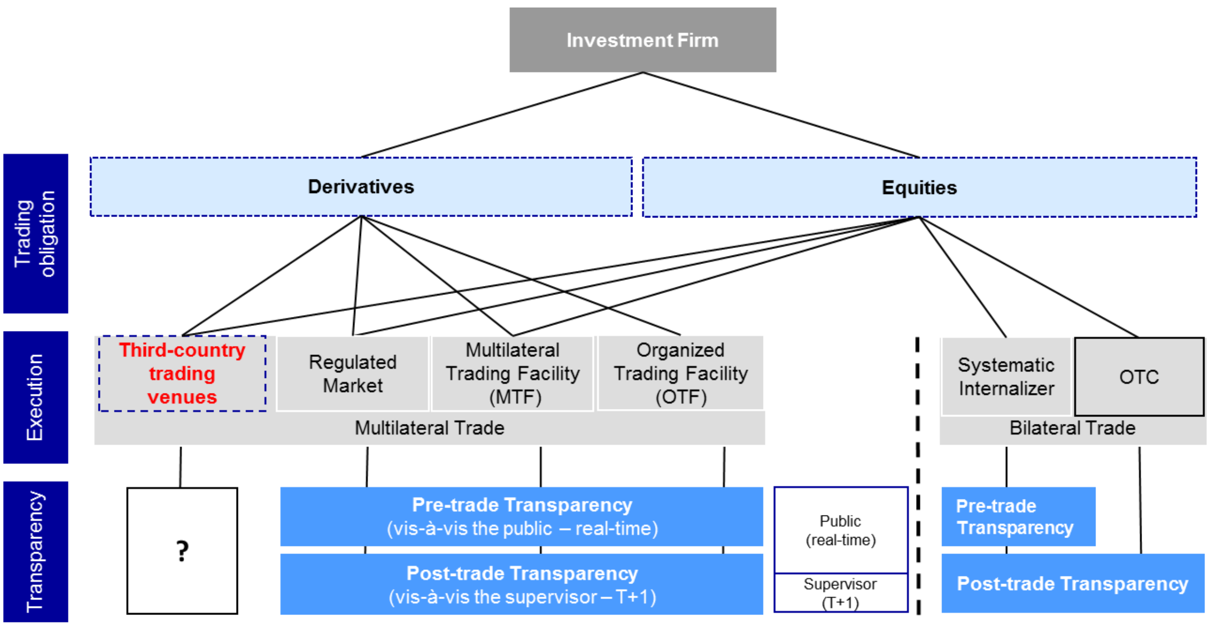

Figure 3: market participants' obligations under MiFID II/MiFIR (from 2018)

7) MiFID II: Revised Markets in Financial Instruments Directive (Directive 2014/65/EU); MiFIR: Markets in Financial Instruments Regulation (Regulation (EU) No 600/2014)

8) EMIR: European Market Infrastructure Regulation (Regulation (EU) 648/2012)

9) CSDR: Central Securities Depositories Regulation (Regulation (EU) 909/2014)

MiFID II/MiFIR provides a third-country regime for trading venues from non-EU countries via an equivalence regime. However, the regulator's objective is to increase market stability and transparency. To remove risk, continuous monitoring is required of whether the regulations in non-EU countries have been implemented in an equivalent manner, thus avoiding regulatory arbitrage between the EU and the UK.

With the introduction of MiFID II, new transparency mechanisms via data provision services (APA, ARM and CTP)[10] are introduced for financial firms. In addition, the reporting and transparency obligations, currently applicable only for shares, are extended to all financial instruments. However, by contrast to trading venues, MiFID II provides no third-country regime for data provision services. This means that such infrastructures would have to be authorised and supervised in the EU post-Brexit.

2. Clearing houses and trade repositories (EMIR)

EMIR implements the objectives of the G20 and the global CPMI-IOSCO Principles for financial market infrastructure at the European level. It has already been implemented in the EU, including the UK. The key regulations for market participants are mandatory CCP clearing, as well as the obligation to ensure bilateral collateralisation for transactions not eligible for clearing and reporting these via TRs (see the diagram below). EMIR also comprehensively governs organisational and operational requirements for CCPs. Further work on governing CCP recovery and resolution and the review of EMIR are already on its way.

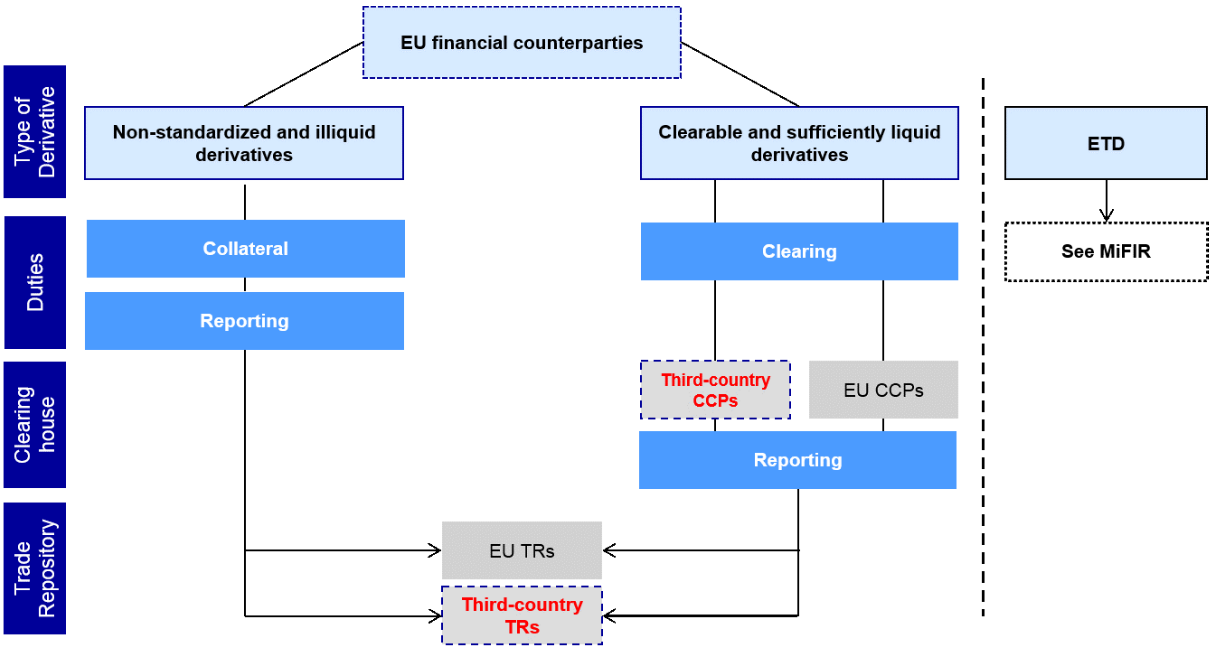

Figure 4: market participants' obligations in respect of CCP clearing and transaction reporting

EMIR provides a third-country regime for CCPs and TRs from non-EU countries. In this area, too, it must be ensured that EU CCPs and TRs are not competing against less stringently regulated CCPs and TRs from the UK (e.g. lower capital requirements for CCPs in the UK). The relevant areas of EMIR must be continuously monitored in detail as part of the equivalence decision to ensure that regulatory arbitrage is avoided. However, the European Commission has already presented legislative changes of EMIR.[11]

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10) APA: Approved Publication Arrangement; ARM: Approved Reporting Mechanism; CTP: Consolidated Tape Provider

11) European Commission (May 2017).

There are different approaches being discussed at European level:

- One of them is to extend the supervisory powers of EU regulators towards third-country entities. In this context, Steven Maijoor (ESMA) also called for more powers to directly oversee third-country CCPs.
- The other option is the location policy. This concept is not new. The European Central Bank has tried to limit euro-clearing activities to happen within the eurozone in 2011 due to stability concerns.

3. Central secuirties depositories (CSDR)

Under the provisions of CSDR, CSDs authorised in the EU may provide services across the entire territory of the EU, inter alia through creation of a branch. As a rule, there is only one CSD in most Member States.

The third-country regime of the CSDR allows ESMA to authorise non-EU CSDs to provide services to EU market participants and establish links with other CSDs. A non-EU CSD will be recognised by ESMA if various conditions are met and approved by the European Commission, including that the non-EU CSD is subject to regulation that is equivalent to CSDR.

4. Further market infrastructures

The Benchmark Regulation[12)] (applicable from January 2018) also contains different possibilities for benchmark providers from third countries which provide their indices inside the EU. Besides the equivalence regime, the Benchmark Regulation provides temporary measures for the period leading up to an equivalence decision by the European Commission (namely recognition and endorsement) in order to prevent disruptions through a possible abrupt suspension of the use of benchmarks originating from a third country in the EU.

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12) Regulation (EU) 2016/1011 of 8 June 2016 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds

For on overview of third-country regimes with respect to relevant financial market legislations see table below.

Legislation	Type of EU firms / products	Passport right / mutual recognition	Third-country regime for non-EU equivalent
MiFID2 / MiFIR	Investment firms	Cross-border provision of investment services	Yes, but only for wholesale clients and counterparties*
	Investment firms	Establishment of branches to provide investment services	Optional for Member States*
	Investment firms	Right to remote membership of market infrastructure	No
	Trading venues	Right to provide terminals on Member State territory	No
	Trading venues	Permitted execution venue for shares and OTC derivatives subject to trading mandate	Yes*
	Trading venues CCPs	Non-discriminatory access to trading venues, CCPs, benchmarks	Yes*
	Data service providers	Single authorisation for EU	No
CRD	Banks	Cross-border provision of banking and investment services	No for banking services. See MiFID2/MiFIR for investment services
	Banks	Establishment of branches to provide banking and investment services	No for banking services. See MiFID2/MiFIR for investment services
EMIR	CCPs	Single authorisation for EU	Yes
	Trade repositories	Single authorisation for EU	Yes*
	CCPs, trading venues	Rights of non-discriminatory access to each other	No, but see MiFID2/MiFIR
CSDR	Central securities depositories	Cross-border provision of services and branches	Yes*
Prospectus Directive	Prospectuses	Prospectus approved in a Member State can be used across EU	No
UCITS Directive	UCITS funds	Distribution in other Member States	No
	UCITS management companies	Cross-border provision of management and advisory services (and branches)	No
AIFMD	AIFMs	Can market EU AIFs across EU	No
	AIFMs	When "switched on", can market non-EU AIFs across EU	Yes*
	AIFMs	Cross-border provision of management and advisory services (and branches)	No
Benchmark Regulation	Benchmark administrators	Single authorisation / registration for EU	Yes*

Figure 5: overview of third-country regimes with respect to relevant financial market legislation

*) New regime, no examples of use to date

Source: AFME 2016

Outlook

An efficient future relationship between the EU and UK is desirable in order to keep UK as a partner for a prospective and competitive Europe. At the same time, it is important for Europe to remain in competition with the US and Asia on an equal footing. To achieve this, the right regulatory framework is key. Unfortunately, uncertainty about the final arrangements between the EU and the UK still remains. Financial infrastructure providers like Deutsche Börse Group will play an important role during these times: they provide sound and stable trading and post-trading systems and assist their clients in adapting to the new environment before and after Brexit.

Deutsche Börse Group is closely monitoring and analysing the Brexit process. We are actively discussing the impact of Brexit with our clients, and are involved in industry association discussions. It is in our primary interest to ensure that our UK-based clients maintain access to our infrastructure. We are therefore committed to maintaining our UK market access post-Brexit, while supporting clients who seek to relocate their business to the EU.

As a service provider, we have established a Brexit Transition Team that is in close dialogue with our UK clients to assist them in taking any required preparations. We are also preparing ourselves to get ready for Brexit as a company. We therefore have established a Brexit Readiness Project. In order to prepare, we are in contact with the relevant UK authorities to ensure that our affected entities can offer their infrastructures and services post-Brexit in the UK.

Additionally, to support our customers to get prepared we have launched a partnership program through Eurex Clearing, as we believe that a market led solution can help to proactively address the regulatory concerns regarding financial stability.

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Published by

Deutsche Börse AG
60485 Frankfurt/Main
http://deutsche-boerse.com/dbg-en/about-us/public-affairs

December 2018

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