14 September 2020

The International Swaps and Derivatives Association

Brexit: Impact on the derivatives trading obligation and the characterisation of OTC derivatives in the EU and the UK

INTRODUCTION

The International Swaps and Derivatives Association (ISDA) considers that it is critical that the EU and the UK recognise the equivalence of each other's derivatives trading venues in order to mitigate the impact of the UK's withdrawal from the EU. If appropriate equivalence decisions are not in place by the end of the transition period provided for in the Withdrawal Agreement between the EU and the UK (the transition period), there will be significant issues for counterparties subject to the derivatives trading obligation (DTO) and other requirements under derivatives legislation in both the EU and the UK. The lack of such equivalence decisions is also likely to exacerbate the fragmentation of liquidity in OTC derivatives markets between the EU and the UK resulting from Brexit.

This paper discusses the impact of the failure to make these equivalence decisions by the end of the transition period and the potential other mitigating actions available to the EU and the UK.

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 925 member institutions from 75 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org. Follow us on Twitter, LinkedIn, Facebook and YouTube.

EXECUTIVE SUMMARY

A. The derivatives trading obligation

The EU and the UK should make equivalence decisions in relation to their respective derivatives trading venues to ensure EU and UK counterparties can continue to trade with each other.

In the absence of appropriate equivalence decisions, EU counterparties subject to the DTO applicable in the EU (the EU DTO) and UK counterparties subject to the DTO as it applies in the UK (the UK DTO) wishing to trade derivatives with each other after the end of the transition period will face conflicting requirements where the derivatives fall within the scope of the EU and UK DTOs (in-scope derivatives), i.e., the most liquid EUR, USD and GBP interest rate swaps and index credit default swaps (CDS).

This conflict will arise where those EU and UK counterparties wish to trade with each other in in-scope derivatives on a cross-border basis. It will also arise where such an EU counterparty wishes to trade in in-scope derivatives through a branch in the UK with a UK counterparty or such a UK counterparty wishes to trade in in-scope derivatives through a branch in the EU with an EU counterparty.

In the absence of appropriate equivalence decisions, those counterparties would, in practice, only be able to trade with each other in in-scope derivatives on US swap execution facilities (SEFs), as these are venues eligible under both the EU and UK DTOs which allow trading in in-scope derivatives. However, even if counterparties are able to trade with each other in in-scope derivatives on US SEFs (or to trade with different counterparties) where the DTOs conflict, this would involve a significant increase in operational complexity and unpredictable implications for effective market functioning.

Therefore, this conflict between the EU and UK DTOs would significantly exacerbate the fragmentation of liquidity in OTC derivatives markets between the EU and the UK that will in any event result from Brexit.

The best way of mitigating the impact of this conflict is for the EU and the UK to recognise the equivalence of their respective legal and supervisory frameworks for their trading venues. Given that UK and EU trading venues will operate under substantively the same regulatory frameworks at the end of the transition period, there are no technical reasons why these equivalence decisions should not be made.

In the absence of appropriate equivalence decisions, the EU and the UK could take other steps to mitigate the impact of the conflict between their respective DTOs but these steps are unlikely to fully resolve the conflict and may involve practical challenges for both firms and regulators.

First, the EU and the UK could restrict the territorial application of their DTOs so that they do not apply to trading conducted by their counterparties through branches outside their territories (when trading with local counterparties in the branch jurisdiction or with third-country counterparties). However:

- Changing the territorial application of the DTOs in this way may require changes to MiFIR in the EU and an Act of Parliament in the UK and thus may require measures to provide interim relief if the changes are not in effect at the end of the transition period.

- The EU and the UK would need to have a common approach to determining when a trade should (and should not) be regarded as executed through a branch and firms would need to be able to implement that approach.

- The jurisdiction in which the branch is located would also likely wish to apply its DTO to trades in in-scope derivatives executed through the branch (the UK already does this) and to decide whether its clearing obligation should also apply to those trades.

- Another solution would be needed to address the conflicts that arise when EU and UK counterparties wish to trade with each other on a cross-border basis.

Secondly, the EU and the UK could restrict the product scope of the derivatives covered by their respective DTOs at least to reduce the overlap between their DTOs. For example, the EU might determine that there is insufficient liquidity in GBP or even USD interest rate swaps in the EU to warrant the inclusion of these derivatives within the scope of the EU DTO after the transition period. The UK might perform a similar assessment of the liquidity in the UK in EUR interest rate swaps or other in-scope derivatives after the transition period.

However, this approach may not eliminate or significantly reduce the overlap between the scope of the derivatives covered by their respective DTOs in particular if the UK concludes that there is sufficient liquidity in the UK to warrant the continued inclusion of EUR interest rate swaps within the scope of the UK DTO after the transition period. Another solution would be needed to address the conflicts that arise when EU and UK counterparties wish to trade with each other in the in-scope derivatives that remain subject to both DTOs.

Thirdly, the EU and the UK could use the mechanism to avoid duplicative and conflicting rules in Article 33 MiFIR as it applies in the EU and the UK by recognising the equivalence of each other's DTOs. Such an equivalence decision would have a more limited impact than a decision recognising the equivalence of EU or UK trading venues because it would only facilitate trading between EU and UK counterparties. However, this mechanism may be better suited to a case where one of the EU or the UK is unilaterally deferring to the other's DTO and would not fully resolve the conflict between the EU and UK DTOs where those DTOs apply in relation to trading through local branches with third-country counterparties.

Irrespective of whether equivalence decisions are made or other action is taken to mitigate the impact of the conflict between the EU and UK DTOs, the UK should address additional conflicts that are created by the way in which the UK DTO will apply to trading by EU counterparties.

ISDA urges the UK to address these additional conflicts by taking the following steps:

- The UK should remove the extraterritorial requirement on firms in the UK's temporary permission regime (TPR) to comply with the UK DTO when trading with UK counterparties from outside the UK.

- The UK authorities should also make clear that the UK DTO does not apply to EU firms in the TPR when those firms are trading from offices outside the UK with EU or third-country counterparties.

- Unless and until the EU and the UK adopt a revised common approach to the territorial application of their DTOs to trading conducted through branches, the UK should remove the requirement that branches of EU and other third-country firms comply with the UK DTO.

B. Characterization of UK and EU exchange-traded derivatives

The EU and the UK should also make appropriate equivalence decisions with respect to each other's regulated markets so that UK and EU exchange traded derivatives (ETDs) are not recharacterized as OTC derivatives for the purposes of EMIR as it applies in the EU and the UK.

The inclusion of positions in these ETDs in the counterparty classification assessment required under EMIR may lead to the reclassification of some counterparties and the imposition of more burdensome regulatory requirements.

THE DTO IN THE EU AND THE UK

The EU DTO

Under the EU Markets in Financial Instruments Regulation (MiFIR[1]):

- The EU DTO applies to counterparties established in the EU that are financial counterparties (FCs) and non-financial counterparties that exceed the clearing threshold (NFC+s) under the European Market Infrastructure Regulation (EMIR) when trading with one another in derivatives that are subject to the DTO.

- The EU DTO also applies to FCs and NFC+s when trading with third-country entities that would be subject to the EU DTO if they were established in the EU.

- The EU DTO applies to an FC or NFC+ when it is trading through its EU head office, a branch in the EU or a branch in a third country.[2]

- The EU DTO only applies in limited circumstances to third-country entities trading with one another, but it does apply to trades between EU branches of third-country entities that would be FCs if they were established in the EU.[3]

- The Commission has adopted regulatory technical standards (RTS) specifying that the most liquid standardised derivatives, including EUR, USD and GBP interest rate swaps and index CDS, already subject to the clearing obligation under EMIR are subject to the EU DTO.[4]

- A counterparty subject to the EU DTO can satisfy its obligations by executing the relevant transaction on an EU regulated market, multilateral trading facility (MTF) or organised trading facility (OTF) or on a third-country trading venue which is the subject of a European Commission equivalence decision.

- The Commission has adopted equivalence decisions with respect to US designated contract markets and SEFs regulated by the CFTC and certain derivatives trading venues in Singapore. However, in practice, counterparties only consider trading on US SEFs as eligible venues that allow the trading of in-scope derivatives.

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1 Articles 28, 32 and 33 MiFIR.

2 See below.

3 The EU DTO only applies to trading between third-country counterparties where their derivative contracts have a direct, substantial and foreseeable effect in the EU or where it is necessary or appropriate to apply the EU DTO to transactions to prevent the evasion of any provision of MiFIR. As explained further below, one circumstances in which trading between third-country counterparties is considered to have a direct, substantial and foreseeable effect in the EU is where two third-country counterparties enter into an in-scope OTC derivative contract through their EU branches and both counterparties would qualify as FCs if they were established in the EU. In addition, an in-scope OTC derivative contract traded between two third-country counterparties will also be considered to have a direct, substantial and foreseeable effect within the EU if all or part of the liabilities of one third-country counterparty resulting from the OTC derivative contract are guaranteed by an EU FC and the guarantee meets certain conditions.

4 Commission delegated regulation (EU) 2017/2417.

- The Commission has not yet adopted an equivalence decision with respect to UK trading venues.

- Article 33 MiFIR also allows the Commission to make a decision that a third country's legal, supervisory and enforcement arrangements are equivalent to the EU DTO where certain conditions are met. If the Commission makes such a decision, then the EU DTO will not apply to transactions where at least one of the counterparties is established in the relevant third country and the counterparties are in compliance with the legal, supervisory and enforcement arrangements of the relevant third country. The Commission has not yet adopted any equivalence decisions under this provision and has stated that it does not intend to adopt such a decision with respect to the UK in the short or medium term.[5]

The UK DTO

Under the UK Government's Brexit plans, existing EU legislation and domestic implementing rules in effect at the end of the transition period will continue to apply in the UK subject to limited modifications made by secondary legislation to remedy deficiencies arising from the UK's withdrawal from the EU.[6]

As a result, UK trading venues will continue to be subject to all the rules adopted under the UK implementation of MiFID as well as MiFIR and other EU legislation, such as the Market Abuse Regulation, as they form part of UK law after the end of the transition period. Therefore, the regulatory and supervisory regimes for UK and EU trading venues will be fully equivalent to each other.

In addition, the DTO under MiFIR will apply in the UK as follows:

- The obligations under the UK DTO will apply to FCs and NFC+s if they are established in the UK.

- As described below, the obligations under the UK DTO will also apply to EU banks and investment firms that benefit from the TPR and to UK branches of EU and third-country firms authorised in the UK under the Financial Services and Markets Act 2000 (FSMA).

- Transactions with EU counterparties will be treated in the same way as transactions with counterparties established in third countries.

- The Commission's existing equivalence decisions with respect to US and Singaporean venues will become part of UK law so that counterparties subject to the UK DTO will be able to comply with the UK DTO by executing trades on those venues where they allow trading in in-scope derivatives.

5 Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, Getting ready for changes: Communication on readiness at the end of the transition period between the European Union and the United Kingdom (9 July 2020).

6 Under the European Union (Withdrawal) Act 2018 (EUWA) as modified by the European Union (Withdrawal Agreement) Act 2020.

- HM Treasury has been given the power to adopt equivalence decisions with respect to EU trading venues (and will have this power in relation to third-country trading venues after the end of the transition period). However, HM Treasury has not yet made an equivalence decision with respect to EU trading venues.

- HM Treasury has also been given the power to adopt equivalence decisions with respect to the DTO under Article 33 MiFIR as it applies in the UK (and will have this power in relation to third-country DTOs after the end of the transition period). HM Treasury has not yet made an equivalence decision with respect to the EU DTO.

After the transition period, EU banks and investment firms will generally be treated in the same way as other third-country firms doing business in the UK for the purposes of the UK's authorisation regime under FSMA. They will cease to benefit from their passport under MiFID or the Capital Requirements Directive (CRD) which currently enables them to do business in the UK without the need for authorisation under FSMA.

To mitigate the impact of this, the UK has created a TPR that will be available after the transition period to EU banks and investment firms that previously have used their passport to do business in the UK, either through a UK branch or on a cross-border basis.[7] Under the TPR, these firms can elect to be treated as having corresponding temporary permissions to do business in the UK. EU firms that enter the TPR may then seek full authorisation in the UK during a specified period, failing which they will exit the TPR and be treated in the same way as other unauthorised third-country firms for the purposes of the UK authorisation regime (although they may benefit from a run-off regime for existing contracts).

An EU firm in the TPR will be subject to an obligation to comply with the UK DTO, both when conducting derivatives business from a UK branch and, extraterritorially, when conducting derivatives business with UK counterparties from outside the UK.[8] On its face, this obligation also extends to cases where the EU firm is trading from offices outside the UK with EU or third-country counterparties, although the UK FCA has indicated that this was not the intention.

Furthermore, third-country firms authorised under FSMA are subject to the rules of the FCA. These rules currently require those third-country firms to comply with the requirements of MiFIR as if they were UK investment firms in relation to business conducted from their UK branches.[9] The FCA has indicated that it considers that these rules require third-country firms, including EU firms after the transition period, to comply with the UK DTO with respect to derivatives business conducted from their UK branches.

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7 Part 3 of the EEA Passport Rights (Amendment, etc., and Transitional Provisions) (EU Exit) Regulations 2018 (SI 2018/1149).

8 New Article 1(2A) MiFIR added by regulation 25(3) of the Markets in Financial Instruments (Amendment) (EU Exit) Regulations 2018 (SI 2018/1403).

9 GEN2.2.22A in the FCA handbook.

POST-BREXIT CONFLICT OF DTOS: CROSS-BORDER TRADING

After the transition period, EU and UK dealer banks will wish to continue to access liquidity in OTC derivatives across the Channel by trading with each other on a cross-border basis. In addition, both EU and UK dealer banks will wish to continue to service the OTC derivatives requirements of their institutional counterparties across the Channel on a cross-border basis (and those counterparties will wish to continue to access a broader range of OTC derivatives counterparties to the extent possible).

From a licensing perspective, it will be possible for some of this cross-border trading to continue after the transition period even though both EU and UK banks and investment firms will be subject to new restrictions on their cross-border business as a result of the loss of their MiFID and CRD passports. This is because the licensing regimes of the UK and many EU Member States permit third-country firms to transact derivatives business with local counterparties under exemptions or cross-border licences. In addition, many EU banks and investment firms will be able to rely on the TPR (for a period) to transact derivatives business with UK counterparties. If equivalence decisions are made for the UK and the EU under their respective third-country regimes under MiFIR (as it applies in the UK and the EU), it will be possible for EU and UK firms to register with the FCA and ESMA in order to conduct business with UK and EU eligible counterparties and *'per se'* professional clients.

In addition, after the transition period, EU banks and investment firms will continue to trade with EU asset managers acting on behalf of UK funds. Similarly, UK banks and investment firms will continue to trade with UK asset managers acting on behalf of EU funds.

Conflict between the EU DTO and the UK DTO

However, the absence of equivalence decisions by the EU and the UK with respect to each other's OTC derivatives trading venues will prevent cross-border trading after the transition period because, where an EU and a UK counterparty subject to their respective DTOs wish to trade with each other in a derivative within the scope of both DTOs:

- the EU DTO will require that the transaction is executed on an EU trading venue (or a qualifying third-country venue); and
- the UK DTO will require that the transaction is executed on a UK trading venue (or a qualifying third-country venue).

As a result, those EU and UK counterparties will not be able to trade with one another in the most liquid standardised contracts unless they can execute their trade on a US SEF. Similar issues will arise where EU banks and investment firms subject to the EU DTO are trading in-scope derivatives with EU asset managers acting on behalf of UK funds that are subject to the UK DTO and where UK banks and investment firms subject to the UK DTO are trading in-scope derivatives with UK asset managers acting on behalf of EU funds that are subject to the EU DTO.

Some EU and UK counterparties may seek to address this conflict by trading in-scope derivatives on US SEFs but in many cases this will not be a practical solution. Many EU and UK asset managers and other counterparties that are not dealer banks are not participants in US SEFs. These counterparties may not wish to trade on venues operating under a different legal framework and in a different time zone and may not be operationally equipped to trade on US

SEFs in any event. Even where both counterparties are able to trade on US SEFs, there are features of the venues' trading protocols which may inhibit trading (for example, the requirement on US SEFs for the request for quote to be addressed to at least three counterparties – 'RFQ-to-3').

Some EU and UK counterparties may seek to address this conflict by trading in-scope derivatives with counterparties in the EU and the UK respectively (and executing those trades on venues in the EU and the UK respectively) while continuing to trade other products with UK or EU counterparties on a cross-border basis. However, this would involve a considerable increase in operational complexity.

In addition, this conflict may affect the ability of some EU asset managers to continue to manage the assets of UK funds that are subject to the UK DTO where the manager is unable to trade in-scope derivatives on US SEFs. In that case, the conflict between the EU and the UK DTO would prevent EU banks and investment firms from trading in-scope derivatives with the EU asset manager where it is acting on behalf of the UK fund. The EU asset manager may not be able to access a UK bank or investment firm as an alternative as licensing requirements may prevent UK banks and investment firms from trading with the asset manager where it is located in a Member State that does not have an available national regime permitting such cross-border business, even if the manager is acting on behalf of a UK fund.

Therefore, this conflict between the EU and UK DTOs would significantly exacerbate the fragmentation of liquidity in OTC derivatives markets between the EU and the UK that will in any event result from Brexit. Lack of action by the EU or the UK could ultimately harm investors in EU funds managed by UK managers (or vice versa) due to fragmentation of liquidity and disruption in the derivatives markets used by such funds, affecting consumers' interests in the UK and the EU for little foreseeable benefit to them.

Key recommendation

The best way of mitigating the impact of this conflict is for the EU and the UK to recognise the equivalence of their respective legal and supervisory frameworks for their trading venues. Given that UK and EU trading venues will operate under substantively the same regulatory frameworks at the end of the transition period, there are no technical reasons why these equivalence decisions should not be made.

ISDA therefore urges both the EU and the UK to make these equivalence decisions before the end of the transition period.

Possible other steps to mitigate the conflict

In the absence of appropriate equivalence decisions, the EU and the UK could take other steps to mitigate the impact of the conflict between their respective DTOs but these steps are unlikely to fully resolve the conflict and may involve practical challenges for both firms and regulators.

Restricting the product scope of the DTOs

The EU and the UK could restrict the scope of the derivatives products covered by their respective DTOs at least to reduce the overlap between their DTOs (or temporarily suspend their respective DTOs in relation to particular classes of derivatives to reduce that overlap).

For example, the EU might determine that there is insufficient liquidity in the EU in GBP or even USD interest rate swaps to warrant the inclusion of these derivatives within the scope of the EU DTO after the transition period. In his speech at the ISDA 2019 Annual Conference in London, Mr Robert Ophèle, the Chairman of the French *Autorité des Marchés Financiers* (AMF) suggested that, after Brexit, there may be insufficient liquidity in the EU to support the effective operation of the EU DTO in relation to GBP or even USD interest rate swaps.

The UK might perform a similar assessment of the liquidity in the UK in EUR interest rate swaps or other in-scope derivatives after the transition period.

However, this approach may not eliminate or significantly reduce the overlap between the scope of the derivatives covered by their respective DTOs in particular if the UK concludes that there is sufficient liquidity in the UK to warrant the continued inclusion of EUR interest rate swaps within the scope of the UK DTO after the transition period. Another solution would be needed to address the conflicts that arise when EU and UK counterparties wish to trade with each other in the in-scope derivatives that remain subject to both DTOs. In addition, this approach may still require counterparties to fragment their trading activity across different venues for different currencies.

Using the mechanism to avoid duplicative or conflicting rules

The EU and the UK could use the mechanism to avoid duplicative and conflicting rules in Article 33 MiFIR as it applies in the EU and the UK by recognising the equivalence of each other's DTO.

Such an equivalence decision would have a more limited impact than a decision recognising the equivalence of EU or UK trading venues:

- For example, such an equivalence decision by the Commission with respect to the UK would, like an equivalence decision with respect to UK trading venues, allow an EU counterparty trading with a UK counterparty to execute their trade on a UK venue even if the transaction falls within the scope of the EU DTO. However, unlike an equivalence decision with respect to UK trading venues, such a decision would not permit two EU counterparties entering into a transaction to execute their trade on a UK trading venue if the transaction falls within the scope of the EU DTO. It would also not permit an EU counterparty entering into such a transaction with a third-country counterparty to execute their trade on a UK venue.
- Similarly, such an equivalence decision by HM Treasury with respect to the EU would facilitate trading between EU and UK counterparties by allowing execution of their trades on an EU venue, without permitting two UK counterparties or a UK and EU counterparty to execute their trade on an EU venue if the transaction falls within the scope of the UK DTO.

However, a determination under Article 33 MiFIR may be better suited to a case where one of the EU or the UK is unilaterally deferring to the other's DTO. If both the EU and the UK use this mechanism to recognise each other's DTO, the EU and UK authorities would need to provide coordinated guidance on what requirements would apply to transactions between EU and UK counterparties and whether relevant parties to a transaction can simply choose whether to execute their in-scope transactions on a UK, EU or permitted third-country venue.

Mitigating additional conflicts under the UK DTO

ISDA also urges the UK to address the additional conflicts created by the way in which the UK DTO applies to trading by EU counterparties conducted from outside the UK:

- The UK should remove the extraterritorial requirement on firms in the TPR to comply with the UK DTO when trading with UK counterparties from outside the UK. This requirement is wholly duplicative of the compliance obligation that already applies to the UK counterparty to the trade.

- The UK authorities should also make clear that the UK DTO does not apply to EU firms in the TPR when those firms are trading from offices outside the UK with EU or third country counterparties. This extraterritorial requirement is inconsistent with the general approach that UK rules should only apply to EU firms when conducting regulated activities in the UK.

POST-BREXIT CONFLICT OF DTOS: TRADING VIA BRANCHES

After the transition period, some UK firms will conduct derivatives business through branches authorised in a Member State. In addition, some EU firms will conduct derivatives business through UK branches using the TPR or after obtaining full authorisation in the UK.

UK firms conducting derivatives business through EU branches

The EU DTO applies to counterparties established in the EU that are FCs or NFC+s, including their non-EU branches.[10] The territorial scope of this regime follows the territorial scope of the EU clearing obligation under EMIR and is not affected by the rules that apply to EU branches of third-country firms authorised under MiFID.[11]

The EU DTO only applies to third-country counterparties and EU branches of third-country counterparties where their derivative contracts have a direct, substantial and foreseeable effect in the EU or where it is necessary or appropriate to apply the EU DTO to transactions to prevent the evasion of any provision of MiFIR.[12] In particular, the EU DTO applies where two third-country counterparties enter into an in-scope OTC derivative contract through their EU branches and both counterparties would qualify as FCs if they were established in the EU.[13]

However, when a UK bank or investment firm conducts derivatives business through an EU branch, both the EU DTO and the UK DTO still apply to its in-scope transactions with EU counterparties. MiFIR will require an EU counterparty which is an FC or NFC+ to comply with the EU DTO when trading with the UK firm. In addition, the UK firm will still be subject to the UK DTO when trading through its EU branch. Thus the same conflict of DTOs will arise as discussed under above in relation to cross-border business. As discussed above, some EU and UK counterparties may seek to address this conflict by trading in-scope derivatives on US SEFs but in many cases this will not be a practical solution.

On the other hand, the EU DTO will not apply where a UK bank or investment firm conducts in-scope derivatives business with UK or third-country counterparties through an EU branch of the UK firm, except in the limited circumstances described above (e.g., when trading with other EU branches of UK or other third-country FCs). Instead, only the UK DTO will apply to those transactions.

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[10] Article 1(3) MiFIR. Also compare the territorial scope of the EU clearing obligation which applies to transactions executed by non-EU branches of counterparties established in the EU that are FCs and NFC+s and ESMA's Q&A on MiFID and MiFIR transparency topics which indicates that the pre- and post-trade transparency requirements in MiFIR apply to transactions executed in non-EU branches of EU investment firms (see Question 2 in Section 9 on Third country issues).

[11] Article 41(2) MiFID.

[12] Article 28(2) MiFIR. The DTO may also apply to third-country counterparties that are FCs because they are non-EU AIFs managed by an AIFM authorised or registered under the Alternative Investment Fund Managers Directive.

[13] Article 2(6) of Commission delegated regulation (EU) 2017/579. In addition, an in-scope OTC derivative contract traded between two third-country counterparties will also be considered to have a direct, substantial and foreseeable effect within the EU if all or part of the liabilities of one third-country counterparty resulting from the OTC derivative contract are guaranteed by an EU FC and the guarantee meets certain conditions.

EU firms conducting derivatives business through UK branches

In principle, the same result as described above should apply, *mutatis mutandis*, to EU banks and investment firms conducting derivatives business through UK branches:

- When a EU firm conducts derivatives business with UK counterparties through its UK branch, MiFIR as it applies in the UK should place the burden on the UK counterparty (not the EU firm) to secure compliance with the UK DTO, while the EU firm would be subject to the EU DTO.

- Similarly, where an EU firm conducts derivatives business with EU or third-country counterparties through its UK branch, the UK DTO should not apply except in the limited circumstances described above (e.g., when trading with other UK branches of EU or other third-country firms). Instead, only the EU DTO would apply to those transactions.

However, the TPR regime and the FCA rules, as interpreted by the FCA, will require an EU firm to comply with the UK DTO in all circumstances where it is conducting derivatives business through its UK branch, whether it is transacting business with UK, EU or third-country counterparties. This places an additional compliance obligation on the EU firm when it is transacting with UK counterparties through a UK branch which is wholly duplicative of the compliance obligation that already applies to the UK counterparty to the trade. In addition, it extends the impact of conflicting DTOs to cases where an EU firm is conducting business through a UK branch with other EU or third country counterparties, even though the UK clearing obligation does not apply to transactions with those counterparties. As discussed above, some EU and UK counterparties may seek to address this conflict by trading in-scope derivatives on US SEFs but in many cases this will not be a practical solution.

Key recommendation

As discussed above, the best way of mitigating the impact of this conflict is for the EU and the UK to recognise the equivalence of their respective legal and supervisory frameworks for their trading venues. Given that UK and EU trading venues will operate under substantively the same regulatory frameworks at the end of the transition period, there are no technical reasons why these equivalence decisions should not be made.

ISDA therefore urges both the EU and the UK to make these equivalence decisions before the end of the transition period.

Possible other steps to mitigate the impact of the conflict

In the absence of appropriate equivalence decisions, the EU and the UK could take other steps to mitigate the impact of the conflict between their respective DTOs but these steps are unlikely to fully resolve the conflict and may involve practical challenges for both firms and regulators.

The steps discussed above in relation to cross-border business could also mitigate the impact of the conflict between the EU and UK DTOs where business is conducted via branches but would not fully resolve the conflict of DTOs in that case.

Restricting the product scope of the DTOs

As discussed above, the EU and the UK could restrict the scope of the derivatives products covered by their respective DTOs at least to reduce the overlap between their DTOs. However, this approach may not eliminate or significantly reduce the overlap between the scope of the derivatives covered by their respective DTOs.

Mechanism to avoid duplicative and conflicting rules

As discussed above, the EU and the UK could use the mechanism to avoid duplicative and conflicting rules in Article 33 MiFIR as it applies in the EU and the UK by recognising the equivalence of each other's DTO. However, this mechanism may be better suited to a case where one of the EU or the UK is unilaterally deferring to the other's DTO.

In addition, even if the EU were to recognise the equivalence of the UK DTO, this would not resolve the conflict that arises between the EU and UK DTOs where an EU counterparty trades through a UK branch with third-country counterparties. This is because the mechanism under Article 33 of MiFIR only operates where at least one counterparty to the trade is established in the third country whose rules are recognised by the EU. Where an EU counterparty is trading via its UK branch with third-country counterparties, neither of the counterparties to the trade would be established in the UK and therefore the EU DTO would still apply to the trade – as would the UK DTO under the TPR and FCA rules.

Similar issues would arise if the UK were to recognise the equivalence of the EU DTO where a UK counterparty trades through an EU branch with an EU branch of another third-country counterparty (where both parties would be FCs if established in the EU). In that case, neither of the counterparties to the trade would be established in the EU and therefore the UK DTO would still apply to the trade – as would the EU DTO.

Re-evaluating the territorial application of DTOs in relation to trading through branches

The EU and the UK could seek to mitigate the impact of the conflict of DTOs in relation to trading through branches by restricting the territorial application of their DTOs so that they do not apply to trading conducted by their counterparties through branches outside their territories (when trading with local counterparties in the branch jurisdiction or with third-country counterparties).

In his speech at the ISDA 2019 Annual Conference in London, Mr Robert Ophèle stated:

> "… [W]hile it makes sense to apply parent company rules to third countries branches when the branch serves an EU client – notably to avoid circumvention of EU rules - I am not convinced that –in the case of derivatives trading obligations - there is a proper rationale to apply the parent company rules when the branch is servicing local clients.
>
> In my view, it would seem much more logical to apply the Derivatives Trading Obligation to branches on a territorial basis, i.e. on the basis of the jurisdiction where they are established and not that of their parent company.
>
> This approach is far from new: the European Commission adopted a similar approach in a Q&A precisely regarding the application of MIFID1 to branches. Some may argue that this Q&A is now somewhat dated, but GDPR used and adopted the same logic: it doesn’t apply to third-country branches as long as it concerns a non EU client.

The territorial approach has another advantage: it puts market players on an equal footing regardless of whether it is a branch or an entity. The territorial application ensures equal treatment between market participants - in this respect, it is worth restating a key principle of MIFID, which is that third-country branches should not be granted more favorable treatment than local entities." [14]

However:

- Changing the territorial application of the DTOs in this way may require changes to MiFIR in the EU[15] and an Act of Parliament in the UK[16] and thus may require measures to provide interim relief if the changes are not in effect at the end of the transition period. For example, ESMA may recommend that EU competent authorities do not prioritise their enforcement action in relation to compliance with the EU DTO by non-EU branches of EU counterparties pending the adoption of changes to EMIR. The UK authorities may be able to use their powers under the European Union (Withdrawal) Act 2018 to provide temporary relief pending the making of amendments to EMIR as it applies in the UK.

- The EU and the UK would need to have a common approach to determining when a trade should (and should not) be regarded as executed through a branch and firms would need to be able to implement that approach.

  This is particularly important in the (very common) cases where transactions arranged by a firm's branch personnel are traded or booked in the firm's head office. In these circumstances, there is a risk that UK supervisors would regard a trade by an EU firm with a UK counterparty involving the EU firm's branch in the UK as subject to the UK DTO but EU supervisors would regard the trade as executed in the EU firm's head office and still subject to the EU DTO (which would then conflict with the UK DTO that applies to the UK counterparty to the trade). It would be critically important that firms are able operationally to identify when a transaction is regarded as executed in a branch in a way that ensures that the transaction is not subject to both the home and the host states' DTOs.

  Similar duplicative requirements can arise in relation to transaction reporting of trades executed wholly or partly through third-country branches. For example, where a trade

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14 See above.

15 It might be possible partially to implement the change relating to trading conducted through EU branches of third-country counterparties by amending the RTS deeming that trading to have a "direct, substantial and foreseeable effect" in the EU. The last sentence of the first sub-paragraph of Article 28(2) is not explicitly restricted to transactions between third-country entities that have a direct, substantial and foreseeable effect in the EU, although that might be inferred by reference to the corresponding provisions of Article 4(1)(a)(v) EMIR regarding the EU clearing obligation which are explicitly limited in this way. It might also be possible to implement the change relating to trading conducted through non-EU branches of EU counterparties by Q&A as there is no explicit Level 1 provision stating that Article 28 applies to non-EU branches of EU counterparties, although again that may be inferred from the corresponding scope of the EU clearing obligation and the transparency provisions in MiFIR referred to above.

16 Unless it was concluded that the proper interpretation of Article 28 MiFIR is that it already does not apply to non-EU branches of EU firms. HM Treasury can only use the powers under the European Union (Withdrawal) Act 2018 to amend EU legislation in order to remedy deficiencies arising from the UK's withdrawal from the EU not to make other policy changes.

involves an EU branch of a third-country firm, the supervisor of the EU Member State in which the branch is located may regard the trade as reportable to it - but the third-country firm's home state supervisor may also regard the trade as being reportable to it, especially where the trade is traded or booked in the home state (and this may result in dual reporting of the same trade). After the transition period, these issues may arise in relation to trades by a UK firm involving an EU branch or by an EU firm involving a UK branch. Before the end of the transition period, the RTS under MiFIR require the firm to report these trades once only to either the firm's home state regulator or, with the agreement of the home state supervisor, to the host state supervisor.[17] Therefore, firms would not be able to rely on their existing reporting arrangements to identify uniquely where a trade is regarded as executed for the purposes of the DTO.[18]

- The jurisdiction in which the branch is located would also likely wish to apply its DTO to trades in in-scope derivatives executed through the branch (the UK already does this) and to decide whether its clearing obligation should also apply to those trades.

  For example, if the EU DTO applies to all trading through EU branches of UK counterparties, this would result in the EU DTO applying to trades between the UK counterparty and other third-country counterparties transacted through the branch, even though those trades are not subject to the EU clearing obligation.

In any event, as already noted, even if both the EU and the UK implemented this proposal to re-evaluate the territorial application of the DTO in relation to trading conducted through branches, this would not resolve the issue of conflicting DTOs applying to cross-border business. Another solution would be needed to address the conflicts that arise when EU and UK counterparties wish to trade with each other on a cross-border basis. Therefore, ISDA urges both the EU and the UK to recognise the equivalence of each other's trading venues as the best way of resolving the issues of conflicting DTOs for both cross-border and branch business.

In addition, unless and until the EU and the UK adopt a coordinated approach to the territorial application of the DTO in relation to trading conducted through branches, ISDA recommends that the UK should remove its requirement that branches of EU and other third-country firms comply with the UK DTO. This would also ensure that the UK DTO is aligned with the UK clearing obligation.

[17] Article 14(1) and (2) of RTS 22 (Commission delegated regulation (EU) 2017/590).

[18] The existing transaction reports under MiFIR identify where a transaction was wholly or partly executed through a branch (see Article 14(3) of RTS 22), but this does not resolve the question of where the transaction should be reported if the transaction is also partly executed through the firm's head office.

CHARACTERISATION OF EXCHANGE-TRADED DERIVATIVES AS OTC DERIVATIVES

EMIR defines OTC derivatives as derivatives that are not executed on a regulated market or a third-country market determined by the Commission to be equivalent to a regulated market in accordance with the process specified in EMIR.[19] HM Treasury has similar powers to make equivalence decisions with respect to non-UK markets under EMIR as it will apply in the UK.

In the absence of such decisions:

- UK ETDs will be considered to be OTC derivatives for the purposes of determining whether EU counterparties are FCs over the clearing threshold (FC+s) or NFC+s[20] (and whether UK and other third-country counterparties are undertakings that would be FC+s or NFC+s if they were established in the EU).

- EU ETDs will be considered OTC derivatives for the purposes of determining whether UK counterparties are FC+s or NFC+s (and whether EU and other third-country counterparties are undertakings that would be FC+s or NFC+s if they were established in the UK).

The inclusion of positions in these ETDs may in some cases lead to the following adverse consequences:

- an FC being treated as an FC+ (or as a third-country entity that would be an FC+ if established in the EU or, as the case may be, the UK) resulting in its transactions being subject to mandatory clearing under the clearing obligation for the first time;

- a counterparty being treated as an NFC+ (or as a third-country entity that would be an NFC+ if established in the EU or, as the case may be, the UK) resulting in its transactions being subject to mandatory clearing under the clearing obligation, margin or other risk mitigation obligations under EMIR[21], the DTO or, when facing an institution subject to the Capital Requirements Regulation (CRR) in the EU or the UK, credit valuation adjustment (CVA) risk capital charges[22] for the first time (and, for entities established in the EU or the UK that become NFC+s, obligations to report the valuation of their positions for the first time[23]); and

- as a result of a counterparty being treated as an NFC+, the counterparty will not be able to rely on an FC to report transactions on its behalf.[24]

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19 Article 2(7) and Article 2a EMIR.

20 Articles 4a and 10 EMIR.

21 Article 11 EMIR.

22 However, an undertaking becoming NFC+ does not affect the CVA charge under CRR for exposures to the undertaking under existing contracts (see point (a) and the third sub-paragraph of Art 382(4) CRR).

23 Article 9 EMIR.

24 From 18 June 2020, EMIR requires FCs to report OTC derivatives transactions (but not ETDs) on behalf of non-financial counterparties that fall below all clearing thresholds (NFC-s) (new Article 9(1a) to (1e) EMIR added by EMIR REFIT).

In addition, treating these ETDs as OTC derivatives may result in counterparties being treated differently under the UK and the EU regime depending on the composition of their portfolio. For example, a counterparty currently treated as NFC- under EMIR may become treated as NFC+ under EMIR as a result of its and its affiliates' positions in UK ETDs but remain treated as an NFC- for the purposes of EMIR as it applies in the UK.

Key recommendation

ISDA urges both the EU and the UK to make appropriate equivalent decisions with respect to each other's regulated markets so that UK and EU exchange traded derivatives (ETDs) are not recharacterized as OTC derivatives for the purposes of EMIR as it applies in the EU and the UK.