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Brexit – the regulatory challenges

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Ladies and gentlemen,

"There are only two tragedies in life: one is not getting what one wants, and the other is getting it."

I will not attempt a literary analysis of Oscar Wilde's words but this example of human thinking resonates with some familiarity in the situation we find ourselves today.

Next month the United Kingdom will leave the European Union in what is an unprecedented event in modern European history. We are presented with a myriad of challenges that cannot be overcome simply by looking in a manual.

The UK's decision will sadly, but inevitably, move Europe's biggest capital market outside of the Union. This is a major operation as, supported by the progress of the single market in the past decades, the EU27 and UK capital markets have become very interconnected. Carving out the UK capital market requires preparations for all circumstances, by all participants concerned, including for the real possibility that the UK leaves the Union without a deal. As negotiations continue, protecting investors, the stability and orderly functioning of the EU's financial markets remain paramount. To this end, ESMA continues to monitor closely the associated risks and, if needed, to identify possible mitigating actions while taking into account that everyone must step up preparations for all scenarios and take responsibility for their specific situation.

In my remarks today, I will address the topic from two angles. First, I will give an overview of

ESMA's preparations for the UK's withdrawal, particularly in the areas of trading, clearing, and supervisory cooperation. Second, I want to look beyond the short term and share some views on the EU's capital market after Brexit and the improvements needed to ensure regulation and supervision continue to be as effective as possible.

ESMA's preparations for a no-deal Brexit

Let me first focus on our Brexit preparedness work on secondary markets. The implementation of MiFID II, as you will know, has introduced major changes to market structures and substantially increased the volume of market data provided to market participants and to supervisors.

The MiFID II transparency framework is founded on a number of thresholds to be specified at ESMA level, to introduce a transparent regime for trading all types of asset classes on a level playing field in the Union. One specific example is the double volume cap, which limits the share of trading in dark pools and is meant to preserve the quality of the price discovery mechanism in EU markets. ESMA is at the centre of determining breaches of these volume caps which is a task that has kept us busy in MiFID II's first year of application.

A no-deal Brexit will not only result in UK market participants losing their passports for accessing the EU, but there will be no further legal basis for the current extensive and granular daily data reporting from the UK to ESMA's systems under MiFID II. So, in no-deal Brexit, from that date, no new UK data will be collected by ESMA.

We also have to consider how UK data submitted before the Brexit date should be treated for future calculations. To provide clarity to market participants, we have explained in a public statement last week that in general we will gradually phase out the UK data over time. For the double volume cap example this means that UK data will remain part of ESMA's calculations for a period of twelve months but its impact will gradually decrease as time passes. We are aware that this is not a perfect solution but we believe it is the least disruptive and most certain for the market in a situation which does not allow for perfect solutions.

Given the importance of the UK financial market within the EU, a no-deal Brexit may also have some significant effects on the thresholds set by ESMA in implementing measures of MiFID II. I appreciate that some of the MiFID II thresholds may need recalibration in the new EU27 environment. However, this is something ESMA will look at once there is more clarity about the future relationship with the UK and once the effect of, for instance, UK trading venues setting up subsidiaries in the EU27 on overall liquidity has become clearer.

As an example of potential effects Brexit may have let me mention that last year in the first days of trading under MiFID II, it became evident that the new tick size regime, based on liquidity in the EU, did not work properly when applied to shares that have their main pool of liquidity outside of the EU. We reacted quickly and proposed changing the relevant technical standard to ensure that an adequate tick size can be set. In my view, it is a good example of the type of initiatives ESMA may take when there is a need to address new level playing field issues arising between the EU and third country trading venues, in particular, from the UK.

Like the tick size regime, there are other MiFID II provisions where third-country trading venues play an important role. One of those provisions which has raised concerns among market participants in case of a no-deal Brexit, is the trading obligation for shares. EU investment firms are only allowed to trade shares subject to this trading obligation on venues and systematic internalisers in the EU, and on third-country trading venues declared equivalent by the European Commission. To date no such equivalence decision exists for the UK.

ESMA is looking at this issue with a view to avoiding disruption in financial markets as far as possible while respecting the intention of the trading obligation as foreseen under MIFID II. We intend to provide more clarity on this matter sufficiently ahead of Brexit date.

Clearing and settlement

Let me now move to the area of central clearing of derivatives, which is generally considered to be the securities markets area to entail the highest stability risks in the event of no-deal.

To respond to those possible risks to the stability of EU financial markets, ESMA identified we need to ensure continued access to UK CCPs for EU clearing members and trading venues. Following the temporary equivalence decision issued by the Commission in December 2018, ESMA has started the process to recognise UK CCPs under EMIR's third country regime. We aim to adopt the recognition decisions well ahead of Brexit date, and so far, the recognition process has progressed without delay.

Regarding non-centrally cleared OTC derivatives, we have concluded, like the ECB and the Commission, that a no-deal Brexit would not entail a stability risk that would need a public intervention like the one for centrally cleared derivatives. However, we will facilitate the repapering of contracts by avoiding that moving contracts from the UK to the EU27 would result in new margin requirements or a central clearing obligation. The relevant amended draft technical standards were submitted to the Commission in December last year, and following their adoption by the Commission, we now await the conclusion of the scrutiny period by Parliament and Council for them to enter into force.

Regarding settlement, ESMA's Board of Supervisors supports continued access to the UK Central Securities Depository (UK CSD) in order to allow the UK CSD to serve Irish securities and to reduce the risk of disruption to the Irish securities market. As this is also an area where the Commission has issued a temporary equivalence decision, ESMA began a similar process to that for UK CCPs, for the recognition of the UK CSD as a third-country CSD in case of a no-deal Brexit.

Cooperation Agreements

Finally, in the context of preparedness for a no-deal Brexit, I want to mention regulatory cooperation agreements which are essential for supervision and enforcement in securities markets. They are also needed for continued access to UK CCPs and the UK CSD. In the case of a no-deal Brexit, NCAs and ESMA should have in place with our UK counterparts the type of Memoranda of Understanding (MOUs) that we have with a large number of third country regulators. These MOUs are essential to meet our regulatory objectives and allow information exchange for effective supervision and enforcement, for example for market abuse cases. ESMA has coordinated the preparations for such MOUs with the EU27 National Competent Authorities (NCAs).

As announced recently I am happy that we have agreed MOUs with both the Financial Conduct Authority (FCA) and the Bank of England. The agreement between the FCA and the EU27 NCAs concerns a Multilateral MOU (MMOU). The agreed cooperation agreements will first of all support continued access to market infrastructures in the UK, but also allow the continuation of the delegation model for, for example, the asset management sector. The MOUs and MMOU will come into effect on the day after the UK's withdrawal from the Union, but only in a no-deal scenario, thereby avoiding significant cliff-edge risks.

Beyond Brexit

In the remainder of my contribution I wish to look beyond the short term and share some views on the EU's capital market after Brexit and improvements needed to ensure regulation and supervision continue to be effective. With the UK becoming a third country, the need for the

EU to build bigger and better capital markets with diverse funding and investment opportunities is even more important. It should spur us on in our work on completing the Capital Markets Union (CMU). Effective regulation is a condition for a successful capital market.

In that context, it is vital to minimise the risks of regulatory arbitrage as a result of relocations from the UK to the EU27. ESMA is playing an active role in this area. Early in 2017, we published general and sectoral opinions to clarify our regulatory expectations and to address risks of regulatory arbitrage between the EU27 Member States receiving UK business. In the opinions, we have re-emphasised important regulatory principles aimed at fostering consistency in authorisation, supervision and enforcement related to relocation without questioning in any way the freedom of establishment, one of the main pillars of the EU. Financial centres in the EU27 should be free to compete based on the particular strengths they can offer relocating firms, like speed and efficiency, but in all cases the EU rulebook should be consistently applied and supervised.

Certainly, we plan further convergence work to continue in the coming months. ESMA and the NCAs will continue discussions regarding relocating entities, activities or functions from the UK to the EU27. We hold these discussions in a dedicated forum for this purpose: the Supervisory Coordination Network where ESMA brings together staff from the 27 NCAs involved in relocation supervision. Common approaches are fostered on arising convergence issues. For example, last week we published a supervisory briefing on the phenomenon of back-branching. The briefing is designed to help NCAs in their judgements during the authorisation and the ongoing supervision of firms that intend to establish (or have established) a branch in a non-EU jurisdiction. We also plan to launch a peer review of the supervisory practices of the EU27 NCAs regarding Brexit relocations towards the end of 2019.

I would like to stress that Brexit has increased the convergence challenges of European financial supervision as the structure of the financial market is changing. Financial market activity concentrated in London is relocating to a range of hubs across the EU27 including Ireland. So, financial activity is moving from one regulator to a range of regulators, increasing the need for consistency and additional and stronger convergence tools.

Therefore, I want to reiterate the importance of the Commission’s proposal on the ESAs review, notably on supervisory convergence. The proposal builds upon the finding that ESMA’s powers and instruments are currently insufficiently robust to deal with all cases of regulatory or supervisory arbitrage, such as ensuring consistent authorisation scrutiny and supervisory outcomes, and avoiding the associated risks to investor protection and stability.

I would like to make an additional point on the ESAs' review. The European Parliament, in its position on the ESA review, has made a proposal to give ESMA certain powers to issue so-called *no-action letters*. I welcome this proposal as, currently, we have limited ability to rapidly adjust regulatory requirements or allow for a temporary non-compliance with the rules, in view of new developments in financial markets. Brexit will make it even more important to have supervisory tools that enable us to act swiftly in response to market developments that pose a risk to the EU. As I said earlier, the new EU27 environment will be one where there will be a large, liquid and interconnected capital market next door, which is not part of, or subject to, its regulatory requirements. This creates the need to have tools to react rapidly to new developments.

Third country regimes

The prospect of a large financial market moving out of the EU, while continuing to be interconnected with EU financial markets, has also triggered a reconsideration of our third country arrangements. Of course, as the UK will continue to be an important capital market of the EU post-Brexit, it is also vital that an appropriate framework for third-country regulation and supervision is in place. Based on the current EU equivalence regimes, supervision of third country entities is conducted outside the EU, typically without the provision of any specific safeguards from an EU perspective. At the same time, many of these third country entities will continue to perform important functions in the EU financial system and affect its stability and how investors are protected.

This is something recognised by the ESAs review proposal, as well as the proposal for third country CCPs in EMIR 2.2. Equivalence assessments need to be conducted more frequently to detect changes on time, and we need to have the supervisory tools for third country CCPs that are systemically relevant for the EU. I understand that the legislative process of EMIR 2.2 is progressing well and, indeed, to prepare for Brexit it is essential that this file is completed soon.

Finally, regarding third country regimes I want to mention the positive developments in the Investment Firm Review. As ESMA has said before, the current third country regime for investment firms under MIFID II allows a patchwork of national regimes. This poses the risk of regulatory competition, inconsistent treatment of risks to investor protection and stability, and complicates the access of third country firms to the EU. We are supportive of an EU-wide passport but, at the same time, this cannot come without appropriate safeguards within the EU. Therefore, I am happy that in the legislative process measures have been introduced giving the EU better powers to regulate and monitor third country investment firms for wholesale investment services, once a third country's equivalence has been recognised. For the EU's Brexit preparations this is another issue that needs to be finalised soon.

Ladies and Gentlemen, it just remains for me to thank the European Financial Forum of Ireland for the invitation, and I look forward to further dialogue with you in the future.