ASIFMA: How Asia is Dealing with Mifid II

Vijay Chander, Executive Director of Fixed Income at the association tells IFLR's Lizzie Meager how its members are adapting to new far-reaching European rules

The effects of European regulation on European banks and financial institutions are well-documented, but for firms in the rest of the world it can sometimes be a different story. That might be out of a (sadly false) perception that rules set in Brussels couldn't possibly apply in Shanghai or New York – but the world has changed, as have both the now-global nature of banks, and the rules that supervise them.

So Asian firms will not escape the grip of the EU's second iteration of the Markets in Financial Instruments Directive (Mifid II), though the extent to which this is true will differ wildly depending on their business model and client base. With around two months to go until Mifid II, IFLR spoke to Vijay Chander, Executive Director of Fixed Income at the Asia Securities Industry & Financial Markets Association (ASIFMA) to find out some of the key changes for Asia-Pacific firms, and how they are reacting to them.

On the whole, how prepared are Asian banks and financial institutions for Mifid II?
I would say the degree of preparedness varies almost in direct proportion to the extent of the impacts. For instance, based on the grid that ASIFMA has developed, the non-EU branches of EU firms face the greatest extraterritorial impacts, followed by the EU branches of non-EU firms and finally, the impacts would tend to be the least for non-EU firms that do not have a branch presence in the EU – though again, this is just an approximation at a very broad level.

As a practical matter, if you are a bank that's headquartered in the EU, Mifid II/Mifir is a topic that's been a senior management preoccupation for the better part of the last three to five years and for that reason, I am certainly aware that the resource commitments to Mifid II, both in the form of in-house staff and external professional advice, is quite substantial for these firms.

Are there many Asian firms that will not be compliant with Mifid II on January 3 and beyond, and what are the implications of that?
Asian firms, to the extent they are impacted by Mifid II, have little choice but to be compliant. And I do believe all firms, including those in Asia, have made substantial strides in this direction. My concerns are centred on the indirect impacts – particularly the fact that a number of member firms' clients have not yet adopted LEIs (or legal entity identifiers). That's for a variety of reasons, one of the key reasons being that several Asian jurisdictions do not require LEIs – although some do.

But as the European authorities have made clear, no LEI, no trade. To the extent that a number of clients/counterparties do not have LEIs, this is likely to severely curtail these clients' abilities to face our European member banks or indeed trade in instruments on European venues where the trades are carried out or booked in Europe. In a nutshell, I would say the extremely slow pace of LEI take-up in Asia is a definite concern, but it's an indirect one, impacting not so much our members as our members' clients.

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Do you anticipate Mifid II forcing fundamental changes to the business models of international firms in the coming years, and how?

Changes in business models are of course at the forefront of our members' considerations as they come to grips with Mifid II implementation, and look for ways to mitigate impacts in terms of costs and compliance. Obviously, this is a sensitive area and the approaches taken by each firm (which in some cases might be unique to that firm) is seen as a competitive advantage, which firms are understandably reluctant to share. But I can certainly highlight approaches that are being taken, and which have also been well-flagged or publicised and are in the public domain, in no particular order of importance:

1. Changing booking models: moving the booking of trades from Europe to Asia could mitigate some of the transaction reporting impacts.
2. Operating through a subsidiary instead of a branch in a non-EU location: firms may be considering this although again, the capital charges for maintaining a separately-capitalised subsidiary have to be weighed against any potential mitigation of Mifid II impacts.
3. Becoming systematic internalisers (SIs): firms may opt to do this to ensure that they continue to protect their market share or prevent trades moving to so-called venues.
   For certain types of products, transaction recording and reporting may be more streamlined if you are an SI. It's also worth noting that it is the SI that is required to perform transaction reporting, thereby relieving their buyside clients of any reporting obligations.

<u>Transaction reporting</u>

What are non-EU firms' transaction reporting obligations, and how do you know if you have them?

As with many areas of Mifid II, the answer is "it depends". A non-EU firm with a branch in Europe will be treated "no better" than another EU-domiciled firm's branch in that country. In this instance, the non-EU firm definitely has to comply with transaction reporting obligations for trades executed or booked within the EU. Even if the non-EU firm is conducting trades outside the EU, but faces an EU-based counterparty in an instrument that has a trading obligation within the EU, the non-EU firm has to meet certain requirements.

Sure, the non-EU firm has no direct transaction reporting obligations in this instance, but even so, it must make data available to its EU investment firm counterparty to allow the EU firm to accurately report transactions in the appropriate format. So even here, there is an indirect impact.

How do non-EU firms plan to manage their transaction reporting obligations with EU counterparties?

Clearly, a lot hinges on whether the non-EU firm is operating out of an EU branch or not – basically, for the transaction reporting obligation to apply, there has to be an EU presence. For a buyside non-EU firm dealing with an EU counterparty, there is the need to provide a lot more data – including things like trader IDs and passport numbers, the specific investing algorithm, instrument ISINs and the like, to the EU counterparty to enable the EU counterparty to report the trade.

Of course, the need for an LEI is paramount. These are all areas where the non-EU firms are directing their attention. Another way certain non-EU clients of EU firms could adapt is by requiring all the EU firms they deal with to be in a position to file reports through a so-called transmission of order mechanism – i.e. they delegate the filing of reports to the EU brokers on their behalf.

Yet another way to file transactions reports is to report to regulators directly via an ARM, or approved reporting mechanism.

How does equities transaction reporting differ from other asset classes for Asian firms?

Typically for equities, transactions are conducted either on-venue or on a regulated market. That means transaction reporting for equities is a bit more streamlined, since the trading venue has the obligation to transaction report when dealing with a non-EU firm.

On the other hand, non-equity products encompass a whole range of tradable instruments such as bonds and derivatives, and including those derivatives that have similar features to those listed on a venue, and are therefore considered to be traded on a trading venue (TOTV).

Moreover, a number of non-equity trades tend to be executed on an over-the-counter (OTC) basis. Where trades are on-venue and/or intermediated via an SI, Asian firms will for the most part not have an obligation to file the transaction report – this responsibility would lie elsewhere.

But on the other hand, for instruments that are traded OTC or through an ordinary counterparty/investment firm not acting in the capacity of an SI, there could be an obligation for Asian firms that have a presence in the EU to file transaction reports.

So the primary difference lies in the fact that equities are generally traded on-venue, while non-equities are not, meaning that in the latter case, there could be an increased onus on the Asian counterparty firms to report.

How are firms in Asia managing the balance of the need to report but not over-report?

This is a challenging exercise, especially for firms typically on the buyside with traders across multiple locations in Europe, Asia and elsewhere. These firms need to consider having systems in place to separate out the (reportable) EU legs of transactions from those transactions that are executed or booked out of non-EU venues.

Making the exercise more complicated is the fact that there are genuine ambiguities around whether certain OTC derivatives are in or out of scope for transaction reporting purposes. Thus, there is a good chance that during the initial stages at least, there could be some difficulties and inconsistencies in accurately distinguishing reportable trades from those that are not.

<u>Trading obligation</u>

How are Asian firms planning on managing their trading obligation for equities that are dual-listed on an Asian and EU exchange?

This particular issue is not so much an issue for Asian/non-EU firms per se as it is for the EU firms that are covered by Mifid II and are therefore subject to the trading obligation. Of course, if the Asian venue(s) where shares are dual-listed are deemed equivalent in time for the Mifid II, there really is no issue as orders can efficiently be transacted in Asia in compliance with the trading obligation.

Even if Asian venues with dual listings, thereby giving rise to the trading obligation, are not found equivalent in time there are workarounds, even for the EU firms. For instance, they could choose to be SIs, provided they of course meet the necessary conditions. The EU firm could ensure that the trades are transmitted outside of Europe through separately capitalised non-EU entities or subsidiaries.

Finally, if it can be demonstrated that a good faith effort was made to obtain best execution, another Mifid II obligation, and such execution is possible only on a non-EU venue (where say, the market in that particular share or stock is more liquid), the regulatory authorities could accept that explanation.

However it must be stressed that best execution per se cannot be used as an excuse to avoid the trading obligation altogether. Of course, as noted earlier, the trading obligation is more easily met if the non-EU/Asian venues with dual listings are indeed found to be equivalent in time, which I believe will be the case for at least a few of the major exchanges in the region.

How many Asian exchanges do you expect to be granted equivalence with the EU before January 3, and what happens to those dual-listed stocks if equivalence is not achieved?

As stated above, I do believe at least a few of the Asian exchanges will be found equivalent – I do not wish to speculate on the specific ones or the number of such exchanges which will make the grade in time, so to speak. Again, the issue as mentioned above (if equivalence is not obtained) is a more pressing one for EU-regulated firms/intermediaries – but even for such firms, there are ways they can continue to accommodate their clients in a Mifid-compliant fashion.

Of course, one outcome could be that the EU-regulated entities will have to stop executing trades for clients on non-equivalent venues altogether, at least for a short period of time. While I do not wish to speculate on what regulators will or will not do in the event equivalence is not achieved, I do believe that as long as trades can be carried out in a Mifid-compliant manner using some of the routes described above, there won't be adverse consequences for firms that execute or book trades using one of these alternative avenues.

What are the possible unintended consequences of the trading obligation rules?

One unintended consequence could be market fragmentation, as trading somehow becomes more localised: Asians trade in Asia, while Europeans trade in Europe. This would be most inefficient and would most likely result in best execution not being obtained.

Another consequence, although it cannot strictly be labelled as unintended, is that Mifid firms that are in scope for the trading obligation yet somehow find themselves shut out of the more liquid non-EU markets due to a lack of equivalence could hold themselves out as SIs for their clients/counterparties, thereby ensuring compliance – even if the hedge leg of the transaction is then transmitted on to a non-EU venue.

How do you expect branches of Mifid firms to deal with article 39 which dictates that a non-Mifid firm cannot be treated better than a Mifid branch?

It is indeed possible that certain non-EU entities with a significant EU presence, such as the large and well-known US-headquartered financial institutions, could have a large market share in certain financial instruments in Europe which have a trading obligation. In some instances, this market share could be as large as, or even larger than the market share(s) enjoyed by other institutions that have their head office in the EU. For instance, large volumes of US dollar and euro swaps could well be handled by the London subsidiary of a large US bank.

So as to not have better treatment than other EU-based firms with branches in London – the US firm in London should be subject to the same transparency, reporting and other obligations as other EU firms in London – the US firm in London may well have to register as an SI.

More importantly, article 39 deals with the issue of third-country firms' access to a) professional clients and eligible counterparties versus b) elective professional clients and retail counterparties in individual jurisdictions within the EU. Under the provisions of article 39, a third-country firm, such as those from Asia, need not necessarily have a branch in a particularly country to deal with clients in category a) above. They would however need to establish a branch to deal with category b) clients in that country. Moreover, the third-country branch would have a passport to provide its services to category a) clients elsewhere in the EU, but not to category b) clients.

Furthermore, individual EU countries can choose *not* to opt in to article 39, like the UK. In this instance, that country's local laws regarding third-country access would apply. In the fullness of time, we do believe that even the countries that do not opt in would apply the Mifid II rules regarding third-country firms' access, so as not to favour them over EU-based firms.

<u>Pre and post-trade transparency</u>

How do Mifid II's pre and post-trade transparency rules apply to Asian firms?

The pre-trade transparency obligations generally do not apply to a non-EU firm. However, if the non-EU firm has an EU branch, the Mifid II rules will require EU branches of non-EU firms to undertake the SI calculations and be subject to the pre-trade transparency regime in relation to local branch business. Furthermore, for EU firms with a branch in Asia, the volumes the Asian branch undertakes in instruments with a trading obligation in the EU will have to be added to the volumes in the same instrument traded by the EU-located parent institution of the Asian branch, to determine the EU firm's SI status. With regard to post-trade transparency, recent level three guidance on the topic of trade reporting extended post-trade transparency to include trades conducted on similar third-country venues, or with third-country firms, when filling client orders from EEA branch locations.

Overall, it would be safe to say that Asian firms will for the most part not be impacted directly by the pre and post-trade transparency obligations, since such obligations for the most part fall to a) trading venues and b) SIs, and most Asian firms will likely not qualify for the SI designation in any case.

What is the general attitude in Asia towards the new pre and post-trade transaction reporting requirements?

It's true that the impact on Asia is arguably the greatest in the area of post-trade transaction reporting. Even in instances where the Asian firms facing European/in-scope Mifid II entities do not directly have to report, at the very least they must be in a position to support their counterparty's ability to accurately report transactions. That includes providing information pertinent to individual traders' names and passport numbers, along with other details. All these requirements have given rise to data privacy concerns. Again, it's worth keeping in mind that data that are transaction-reported as opposed to being pre or post-trade transparent are available to only a very small subset of people – typically the regulators and the regulators alone, so basically the people charged with oversight pertaining to the smooth and efficient functioning of markets.

On a separate note, one further point worth noting in relation to LEIs (which are a requirement under Mifid II) is that the information required to obtain an LEI is relatively less onerous than the KYC [know-your-customer] checks carried out by banks and broker-dealers when accounts are opened with these entities. Even so, the rate of LEI take-up has been limited for several reasons as pointed out above – including and especially the fact that it is not a requirement in Asia – unlike in Europe, where Mifid compliance requires LEIs.

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