AFME Equities

Share Trading Obligation: Scope of the Obligation

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In our view, the Share Trading Obligation applies only to a MiFID investment firm when it is the final entity in the chain of execution in any given trade flow. Whereas a MiFID investment firm that places an order with or transmits an order to a third party (being another investment firm or a non-EEA firm) for execution, or is a passive intermediary in a chain of execution, should not be caught by the obligation, as it does not *undertake* the relevant trade.

1 Background

Directive 2014/65/EU ("**MiFID II**") and the accompanying Regulation (EU) 600/2014 ("**MiFIR**"), both coming into effect on 3 January 2018, introduce the concept of a "**Share Trading Obligation**", that applies to MiFID firms which "undertake" trades in shares admitted to trading on a regulated market or traded on a trading venue ("**In-Scope Shares**"). The Share Trading Obligation, set out in Art. 23 of MiFIR states that:

> *"An investment firm shall ensure the trades it undertakes in shares admitted to trading on a regulated market or traded on a trading venue shall take place on a regulated market, MTF or systematic internaliser, or a third-country trading venue assessed as equivalent in accordance with Article 25(4)(a) of Directive 2014/65/EU, as appropriate, unless their characteristics include that they:*
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> *(a) are non-systematic, ad-hoc, irregular and infrequent; or*
>
> *(b) are carried out between eligible and/or professional counterparties and do not contribute to the price discovery process."*

The intended purpose of the Share Trading Obligation is to move more over-the-counter trading in shares onto platforms providing market transparency (e.g. regulated markets, multilateral trading facilities ("**MTFs**") and systematic internalisers).

2 Industry Concerns

AFME are supportive of the overall objectives of the Share Trading Obligation. However, as the MiFID II legislative framework does not include a definition of "undertakes", the scope of the obligation is currently unclear and many in the industry are concerned that it could be read to apply broadly to any investment firm involved in any stage of a transaction involving In-Scope Shares. As considered below, such an interpretation would impose a severe restriction on European brokers and investment managers' ability to access global liquidity for the benefit of their clients, which does not appear to be the intention of the rules.

By reference to its intended purpose, we believe that the Share Trading Obligation applies only to the firm in the final part of the execution chain, for the reasons set out below:

- This interpretation is consistent with the approach CESR has previously taken in the best execution context, where it considered that the "*execution of a client order or a decision to deal is always carried*

out when an investment firm is the last link in the chain of intermediaries between the client order and an execution venue".[1]

- MiFID firms earlier on in the chain transmitting / placing orders, would have selected the final executing entity in accordance with their obligations to obtain best execution and to act in their clients' best interests, which should mitigate any anti-avoidance concerns regulators may have.
- The concern of an overly broad interpretation of the Share Trading Obligation is heightened if we consider that it would also apply to shares that have their primary liquidity outside of the EEA, but are traded just once on a European trading venue. Preventing MiFID firms from passing trades in such instruments to non-EEA brokers, would undermine some of the key principles underpinning the MiFID II regime and would result in disadvantageous outcomes for EEA clients (versus the more favourable outcomes for non-EEA investors who, accessing markets via non-EEA investment firms, would be able to obtain better results through their ability to access the primary pools of liquidity at better prices).
- An overly broad reading of the Share Trading Obligation is also likely to compromise the ability of firms transmitting / placing orders to obtain best execution or act in their clients' best interests, as they will be limited in the brokers they instruct.
- The Share Trading Obligation does not apply to non-MiFID EEA regulated entities such as AIFMs and UCITS managers. A broad interpretation of the Share Trading Obligation will therefore result in an uneven playing field across the industry, with some participants being significantly disadvantaged in their ability to access non-EEA liquidity and venues compared to others.

In light of the above and the noted regulatory uncertainty on this topic, we have decided to publish our interpretation of the scope of the Share Trading Obligation, and our supporting rationale. We hope that members of the industry will consider this interpretation when implementing the organisational and other changes they need to make to comply with MiFID II and MiFIR. In the absence of further regulatory guidance on this topic, we believe this interpretation is a reasonable and appropriate one for members of the industry to adopt.

The Annex to this memo includes some worked examples of how this interpretation would apply within a chain of execution.

3 Legislative Support

We believe that there is support from the wording of MiFIR itself for the view that the term "undertakes" is only intended to capture the final execution of trades in any given trade flow. Recital 11 of MiFIR provides further commentary on the Share Trading Obligation and states that it "*requires investment firms to undertake all trades including trades dealt on own account and trades dealt when executing client orders on a regulated market, an MTF, a systematic internaliser or an equivalent third-country trading venue*". The examples of "undertaking" activity provided in Recital 11 focus exclusively on activities comprising the actual execution of trades and do not include the placing or transmission of orders, which are the most common intermediate or initial steps in a trade flow. It therefore seems that the scope of the Share Trading Obligation is focussed on firms that actually execute the trade.

This conclusion is supported by earlier drafts of MiFIR. For instance, in the June 2013 Council of the European Union ("**EU**") draft of MiFIR[2], the predecessor to Recital 11 of MiFIR stated that the Share Trading Obligation "*requires investment firms to undertake all trades (i.e. trades dealt on own account and also trades dealt when executing client orders)*". Whilst this wording did eventually change in the drafting

[1] http://ec.europa.eu/internal_market/securities/docs/isd/letter-cesr-best-execution_en.pdf
[2] http://register.consilium.europa.eu/doc/srv?l=EN&f=ST%209710%202013%20REV%202

of MiFIR, we feel that the earlier drafting and the use of "i.e." does provide an indication that the original legislative intent behind the Share Trading Obligation was that it applies only to firms executing trades.

Other European publications on MiFID II also support this understanding. In both its May 2014 Discussion Paper on RTS under MiFID II and MiFIR[3] and its December 2014 Final Report on Technical Advice to the European Commission on MiFID II and MiFIR[4], ESMA mirrored the wording that originally appeared in the predecessor to Recital 11 of MiFIR (see underlined text above) when referring to the meaning of "undertakes" (defining it as "*i.e. on own account and on behalf of clients*"). This supports the interpretation that even though the wording has changed in MiFIR itself, the legislative and regulatory intent remains the same.

In addition, the June 2013 draft of the predecessor to Recital 11 of MiFIR stated that the Share Trading Obligation applied unless "*there is a legitimate reason for them to be concluded outside of one of these* [venues]". The use of the word "concluded" further implies that when the Share Trading Obligation was drafted it was envisaged to apply only to the final execution of a transaction and not the intermediate passing of trades in a trade flow. This interpretation is also consistent with the principles CESR has previously outlined in the best execution context, where it stated that the "*execution of a client order or a decision to deal is always carried out when an investment firm is the last link in the chain of intermediaries between the client order and an execution venue*".[5]

Furthermore, it is only when an executed client order is actively "dealt" that the trade is said to have been undertaken. This would appear to allow for a chain of execution in which a firm is regarded as having executed an order, rather than merely received and transmitted it or otherwise passed it on to another entity, without itself having "undertaken" the trade. Steps taken by investment firms prior to this stage would not necessarily result in a trade. Had the terms execute and undertake been synonymous there would be no need for the additional term.

4 Policy Considerations

4.1.1 Execution Entity

One must presume, from a logical perspective, that given the Share Trading Obligation is concerned with where a trade is executed, it can only apply to an investment firm that ultimately executes a trade (e.g. on a venue). In this regard, it appears to be illogical, for instance, to require a portfolio manager placing an order with a broker to be subject to this obligation. The portfolio manager may not have the appropriate expertise or trading venue access to execute an order for the In-Scope Share. Similarly, a MiFID firm receiving an order in an Asian security (which is also traded on an EEA trading venue) that passes the order to an Asian broker to better access the available liquidity would not itself be undertaking the trade - the trade is instead *undertaken* by the Asian broker (which faces the execution venue).

4.1.2 Best Execution and Clients' Best Interests

Intermediate MiFID firms in the trade flow must obtain best execution and act in their clients' best interests. A decision to pass on a trade to another entity for execution would therefore have been made by reference to these obligations. In the case of shares that are primarily traded outside the EEA, it is very likely that investment firms will be able to achieve a more reliable, faster and better priced result by passing trades on to a non-EEA firm (with access to the relevant non-EEA trading facilities) who then undertakes the trade.

[3] https://www.esma.europa.eu/sites/default/files/library/2015/11/2014-548_discussion_paper_mifid-mifir.pdf
[4] https://www.esma.europa.eu/sites/default/files/library/2015/11/2014-1569_final_report_-_esmas_technical_advice_to_the_commission_on_mifid_ii_and_mifir.pdf
[5] http://ec.europa.eu/internal_market/securities/docs/isd/letter-cesr-best-execution_en.pdf

Restricting an EEA firm's ability to pass orders on to non-EEA firms to access non-EEA sources of liquidity, would be highly detrimental to the interests of European clients and would contradict the objectives of other key parts of MiFID II and MiFIR, and therefore cannot be the legislative or policy intention.

4.1.3 Inconsistent Application to Regulated Entities

The Share Trading Obligation only applies to MiFID II investment firms. Our proposed interpretation of the term "undertakes" ensures that investment firms that pass orders in a chain of execution but do not themselves ultimately execute the trade will be treated in the same way as other non-MiFID firms (such as those regulated under AIFMD or the UCITS rules).

4.1.4 Legitimate Interactions with Non-EEA firms

Whilst MiFID II and MiFIR have some elements of extra-territoriality, it is clear that they are not intended to apply generally or broadly to non-EEA firms or to prevent the legitimate interaction of investment firms with non-EEA firms.

Our proposed interpretation will accordingly reflect this principle by enabling the legitimate interaction of investment firms with non-EEA firms, whilst recognising that MiFID firms cannot use this as an anti-avoidance measure because their order routing behaviour will be regulated by other MiFID obligations such as acting in their client's best interests and obtaining best execution for their clients.

AFME do not support a narrow interpretation of "undertakes" being adopted by investment firms where used to justify measures designed to avoid the application of the Share Trading Obligation.

4.1.5 Consistency with Policy Objectives

The policy arguments in favour of a narrow interpretation of "undertakes" are even stronger when one considers the scope of similar obligations under other EU legislation. Notably under Regulation (EU) 236/2012 (the "**Short Selling Regulation**"), which has similar market soundness objectives to the Share Trading Obligation, the requirement to notify competent authorities of a net short position and the restrictions in short selling in shares are disapplied with respect to shares admitted to trading in the EEA where the "*primary venue for the trading of the shares is located in a third country*". This means that the requirements of the Short Selling Regulation have a significantly narrower scope than the Share Trading Obligation, as they do not capture shares which have their primary liquidity pools outside of the EEA, and merely happen to be incidentally traded on EEA trading venues. Given that the obligations have a similar policy intent of market soundness, we think that similar restrictions on scope can be inferred from the wording of the legislation by interpreting the term "undertakes" as applying to the firm that does the final execution (as set out in section 3 above). This restriction in scope would assist in mitigating the unintended extra-territorial effects of the Share Trading Obligation, as outlined above in section 2.

5 Conclusion

As noted above, in our view, the Share Trading Obligation applies only to an investment firm when it is the final entity in the chain of execution in any given trade flow. For the reasons outlined above, we believe this interpretation of "undertakes" is consistent with the legislative wording, alleviates the relevant policy concerns and results in the Share Trading Obligation being applied in greater consistency with other obligations imposed under MiFID II and other EU legislation.

In light of these considerations, we believe that it would be fundamentally disproportionate to adopt an expansive interpretation of the meaning of "undertakes" in the Share Trading Obligation.

Annex – Worked Examples

As noted above, we believe that the correct reading of the Share Trading Obligation is that it applies to the firm in the final part of the execution chain.

For example:

- Where a French portfolio manager (authorised as a MiFID investment firm) wishes to invest in French shares, it may send its order to its French broker (also authorised as a MiFID investment firm). The French broker executes that order on Euronext. In this scenario, it is the French broker that "*undertakes*" the trade, and not the portfolio manager.
- Where the same French portfolio manager wishes to invest in Greek shares, it may again send the order to its French broker. The French broker (either because it does not have direct membership of the Athens exchange or it believes a third-party broker can obtain better execution), routes that order to a Greek broker that has access to the Athens Exchange. In this scenario, it is the Greek broker that "*undertakes*" the trade and not the portfolio manager or the French broker. In each case the portfolio manager and the French broker route the order in accordance with their best execution obligations.
- Where the French portfolio manager wishes to invest in Indonesian shares, it may send its order to its French broker. The Indonesian share is traded in the EEA but liquidity in the share within the EEA is 0.1% of average daily volume (and is therefore an In-Scope Share), whereas liquidity on the Indonesian exchange represents 99.9% of average daily volume. The French broker does not have direct membership of the Indonesian exchange. In accordance with the French broker's duty of best execution, it routes the order to an Indonesian broker (not a MiFID investment firm), and the Indonesian broker then executes the order on the Indonesian exchange. In this scenario, it is the Indonesian broker who "*undertakes*" the trade and not the portfolio manager or the French broker. In this scenario, we are assuming the Indonesian exchange has not been subject to a positive equivalence assessment.

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