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**BRIEFING PAPER**

**MARKETS REGULATION: THE EXTRATERRITORIAL IMPACT OF THE DERIVATIVES TRADING OBLIGATION (DTO) IN MARKETS IN FINANCIAL INSTRUMENTS DIRECTIVE (MiFID) 2**

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The EU Asia Financial Services Round Table (EUAFSRT) looks to support authorities in delivering regulations that help facilitate efficient markets and cross-border financial services flows between the European Union and Asia.

**Introduction**

One area where there is an extraterritorial impact on Asian firms is the Derivatives Trading Obligation (DTO) in the Markets in Financial Instruments Directive (MiFID) 2 package. As currently interpreted it is unclear whether trades booked by an EU entity, but carried out in a non-EU jurisdiction (such as Asia) and in a non-EU product falls under the DTO. Also further clarity is required for trades that are carried out outside of European hours.

There is an additional complication in the fact that access to compliant venues in Asia is limited, as they are not approved in the same way that Multilateral Trading Facilities (MTFs) are in Europe or Swap Execution Facilities (SEFs) are in the US.

The uncertainty leads to problematic trading scenarios and unintended consequences of the DTO rules, some examples of which are set out below. We believe these examples are unintentionally extra-territorial as they have no bearing on the operation on the European markets.

We would be delighted to discuss the issues further and engage policymakers in seeking to identify possible remedies to these.

**Example 1: Asian client access**

The application of the DTO potentially restricts market access for Asian clients. This consequence does not appear to be the intended application of the EU rule set so ideally the application to other regions would be carved out of the rules through guidance.

For example global entities that operate a round the clock US\$ interest rate swap trading book may have traders in Tokyo, London and New York. As it currently stands an Asian client trading a US\$ IRS booked to an EU entity of a bank can be interpreted as being required to join an MTF or SEF. Although some have access to SEFs; none today have MTF membership. The application of this rule means business has to be turned away.

For one globally active firm that has meant by May 2018 over thirty Category 1 or 2 clients in Asia have been impacted and that will increase significantly when Category 3 (smaller financial services firms) and Category 4 (non-financials) clients come into scope in 2019 and later in 2018 respectively.

### **Example 2: Order handling / overnight orders**

As an extension to example 1, the venue list published on 9th January 2018 by ESMA contained only two client-to-dealer venues (Tradeweb MTF and Bloomberg MTF) and both are RFQ based venues. Clients are thus restricted to two venues, and RFQ trading only.

Given the global nature of the markets a typical trade for Asian clients is to leave orders in Asian time to be traded in the \$ market in the US time zone. As the RFQ protocol is a two way interaction, and the Asian client and the US trader are not operating in the same time zone, this business cannot be facilitated.

OTF licences are held by Inter-Dealer Brokers, and broadly do not service non dealer clients so this is not a feasible option to resolve this.

### **Example 3: Packages**

There is no specific exemption for packages from the DTO, despite published guidance. However this does not address the core principle that a package is traded (by definition) as a single instrument and,

therefore, can only be traded on venue if the entire package can be traded on venue. Guidance that a part of the package is in scope of the DTO goes against the nature of what a package is.

### **Example 4: Delta hedges on swaptions expiry**

The expiry of a swaption can lead to one of two outcomes: a physical delivery of an IRS as a lifecycle event, or a cash settlement.

- ➔ The physical delivery is not a new trade subject to the DTO.
- ➔ The cash settlement scenario is likely to lead to a new IRS as hedges are adjusted. There is the option to exchange the delta with the original counterparty with rate agreed via the ICE Fix, or to seek alternative counterparties for the delta. These are all referenced to the ICE Fix, and most but not all counterparties understand that even though these are IRS, ICE Fixing trades are not subject to the DTO.

### **Example 5: Re-coupon trades**

Whilst the final aspect refers only to par coupons, the DTO rules are not entirely clear. Liquidity assessment was only conducted on par coupons, and there is guidance that EU rules are not intended to go beyond the reach of the US approach. As such, this would seem that non par swaps are not part of the DTO, but clarity is required for market participants.

Additional possible scenarios cover ones which are not tradable on platform. For example for a Middle Eastern bank establishing an IRS hedge could in return be required to set up USD swaps with Middle Eastern holiday calendars. This business cannot be traded on a venue.

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*It supports regulators in developing an appropriate and balanced regulatory framework that enables long-term growth in both Europe and Asia, whilst identifying areas where regulation impedes the international flow of capital or creates unnecessary barriers to doing business. It supports the development of regulatory best practice, and a level playing field in financial services regulation in Europe and Asia, whilst promoting open and stable financial markets.*