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AN ERA OF COMPETITIVE GOVERNANCE

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There has been some debate about whether regulatory divergence between the financial sectors of the European Union (EU) and the United Kingdom (UK) following Brexit is ante portas. Since the UK and the EU didn't achieve progress on mutually aligned financial sector regulation between June 2016, the date of the Brexit referendum, and the end of the Brexit transition period that ended on 31 December 2020, a joint declaration on the willingness to work together on regulatory aspects was all that could be found in the 1,276-page Trade And Cooperation Agreement, adopted around Christmas of 2020.

Although a Memorandum of Understanding on regulatory cooperation was signed at the end of March this year, details were missing and the EU's refusal to grant Britain ***"equivalence"*** (a concept under which the EU recognises certain regulations of another jurisdiction as equivalent to their own) has been seen as an indicator for the irreconcilability of positions. Where this may lead is unclear yet – why that matters, is not.

Recently, as a result of a capital markets review it has been carrying out together with HM Treasury[1], the British Financial Conduct Authority (FCA) said it intends to apply changes to the rules on investment research and best execution reporting applicable in the UK. The changes in the course of this review which has identified market structures, pre- and post-trade transparency for equities, bonds and derivatives and market data cost as ***"priority areas"***, are similar to those introduced by the European Union (MiFID II ***"Quick Fix"***)[2]. Some go far beyond. As the British government has meanwhile confirmed, it plans to loosen requirements for systematic internalisers (SIs), to abolish the share trading obligation (STO), to remove restrictions on the volumes firms may trade outside regulated venues and allow MTFs[3] to execute transactions in a matched principal capacity.

In the field of investment research, the EU contented itself with exempting research from the MiFID regime on research and inducements that is done into companies with a market capitalisation below EUR 1 billion for the 36 months preceding the research. The FCA has decided to set this cap at GBP 200 million, however, exempts fixed income, currencies and commodities research entirely from the rules on research and inducements. Also, research provided by independent research firms and research made openly available will be no longer subject to these rules. Effectively, this leaves just those research providers in the UK exposed to the MiFID requirements that also offer execution or brokerage services.

Given the initial motivation of the rules on research as an inducement, the FCA's decision is not incomprehensible – as these rules aimed at preventing brokers from ***"paying"*** investment managers with equity research for getting order flow in return.

As far as best execution is concerned, the EU has suspended the obligation to publish execution quality reports for two years until 28 February, 2023. The reports which have to be provided free of charge and downloadable in a machine-readable format, the so-called RTS 27 reports, must usually be published on a quarterly basis, three months after the end of each quarter.

> **On 31 March 2021, ESMA[4] commented that:**
> "These reports are rarely read and do not enable investors and other users to make any meaningful comparisons on the basis of the information they contain[5]".

The FCA, which had announced earlier it would not enforce compliance with RTS 27 reporting obligations for the remainder of the year, plans to abolish the RTS 27 reporting obligation once and for all. What's more, the FCA has also put the permanent removal of RTS 28 reporting up for discussion during its market-wide consulting on these topics. RTS 28 refers to the obligation to publish annual reports that list the top five execution venues in terms of orders a firm has used in the previous year (the EU did not eliminate these reports).

While the FCA's stance on RTS 27 is consistent and understandable, it seems less so for RTS 28. RTS 27 obliges trading venues, SIs, market makers and liquidity providers to report details on the price, cost, speed, likelihood of execution, settlement size and nature for each class of financial instrument based on daily trading data. However complex or laborious their compilation may have been for firms, the simple fact that they're ineligible for retail investors and that professional investors said they don't read them, is reason enough to abandon them.

In contrast, the transparency provided by the publication of RTS 28 reports may be of more value to investors. RTS 28 reports are annual lists of the five most important execution venues that firms who execute client orders must publish. For each execution venue used, the total number of orders and the total volume of these orders must be shown, separated by instrument type and, thereunder, separately for retail clients' and professional clients' orders. But in addition to this quantitative data there is some qualitative information in the RTS 28 reports, too. Among other things, firms must publish, whether there are close links between them and the top five execution venues they have used (and which they are), whether there are common ownership structures, specific arrangements with execution venues regarding payments made or received, discounts, rebates or non-monetary benefits received or any other potential conflicts of interest.

Transparency over these details can help retail investors to autonomously assess whether their brokers put clients' interests first and provided them the most favourable execution available. It is a straightforward means to monitor if, for instance, a broker uses just one execution venue or none at all and intermediaries instead and how the flow of fees is arranged in such cases.

While these changes introduced by the FCA are clearly within the limits of what can be described as a natural policy discourse between jurisdictions that are not or no longer sharing a common lawmaking process, the British government's proposed changes – of which I just want to discuss two – deserve the predicate 'radical'.

According to the plans, MTFs shall be allowed to execute transactions on a matched principal basis, which simply means they would be allowed to interpose themselves between trading counter-parties' buying and selling interests. The basic concept of an MTF under MiFID II is that it is NOT allowed to apply any discretion over whether an order is being executed. That is, when a buy and a sell order match, they must be connected with no possibility for the MTF to decline them or to interpose itself to the trade to benefit from taking either position. MTFs are also obliged to publish current bid and offer prices for instruments traded on a continuous basis and to report the portion of the market ready to trade at these quotes. As such, the on-venue trading through an MTF is not only significantly increasing transparency around every aspect of the execution, it also supports the price formation process. Any deviation from these rules would mean thwarting the entire concept of an MTF.

Another major disruption would be a decision to remove the double volume cap (DVC) mechanism, thereby opening up dark pools to unlimited order flow. The DVC was introduced under MiFID II, aiming at limiting the amount of trading under certain waivers (the RPW and NTW[6]). It caps the transactions that are allowed to be executed under the RPW and NTW at 4% in an instrument at a venue level and at 8% in that instrument for all venues throughout the European Union. If those thresholds are reached, competent authorities must make sure that dark pools suspend trading for a period of six months.

Last year, after a period of intense industry lobbying against the DVC, ESMA has proposed to remove the 4% cap – only to even tighten the 8% total volume cap to 7%. In addition to introducing this ***"Single Volume Cap"***, the use of reference price waivers to large orders shall also be restricted. Moreover, ESMA said that periodic auctions should be defined and labelled as ***"non-price forming"*** systems, subject to pre-trade transparency requirements adding a call for more transparency for orders submitted during the auction call.

In contrast, the British government is now proposing to entirely withdraw any automated mechanism that could curtail the volume of trading in dark pools. Instead, the FCA shall be entitled to monitor dark trading volumes and intervene on the basis of other parameters.

Looking at such differences – and those that can be expected in the future, should influential voices such as the one from the UK Taskforce for Innovation, Growth and Regulatory Reform[7] be heard – it could be concluded that there might be two divergent streams of financial market regulation, each competing for the best mix of customer protection, market stability and integrity and fair, lively competition. Plus, it seems obvious that this must end up in a race to the bottom of regulatory standards since both jurisdictions are also in competition with one another over attracting Big Finance as well as over providing the most fertile ground for innovation and young entrepreneurs to design future technologies in, e.g., payments, trading or post-trading services or other areas. The proposed dark pool regulation in particular suggests that London might be tempted to recuperate some of the trading volume it lost to the continent as a result of leaving the European Union.

Then again, I would argue that there are factors limiting the leeway for an untamed loosening of standards. One being that the industry generally dislikes the applicability of different standards for the same service. Banks have adapted to servicing different client bases from different headquarters as a result of Brexit, however, different standards entail a significant administrative burden for internal processes to remain efficient. In a trade-off between enjoying lower standards for one part of the business while accepting higher ones for another part against accepting higher standards for the larger market at the cost of retreating from the smaller market entirely, many companies could opt for the latter scenario.

Another important aspect is the maturity level of the client base, i.e., the question of how much clients are accustomed to standards they don't want to miss or general public expectations on the enforcement of standards for the purpose of protecting their interests.

In this context, it is conceivable that the UK will adopt a regulatory regime that is more flexible to react to short-term changes and that is less restrictive towards smaller entities whose activities are less impactful or that may need certain exceptions during the start-up phase of their businesses. The EU, by the way, is trying to adopt a similar approach as regulatory proposals such as its DLT pilot regime[8] show. Hence, as far as regulation is concerned, a general trend towards more flexibility, proportionality and the appreciation of new technologies and global trends is more a likely outcome, in my view. This phenomenon, when actors in politics, law and economics aim at creating the most sophisticated environment for businesses, is called ***"Competitive Governance"***. I would call it a race to the top.

1 Her Majesty's Treasury, the United Kingdom's Ministry of Finance
2 Directive (EU) 2021/338 amending Directive 2014/65/EU ("MiFID II")
3 Multilateral Trading Facilities
4 The European Securities and Markets Authority
5 https://www.esma.europa.eu/sites/default/files/library/esma35-43-2632_statement_suspension_rts_27.pdf
6 RPW=Reference Price Waiver; NTW= Negotiated Transaction Waiver
7 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/994125/FINAL_TIGRR_REPORT__1_.pdf
8 Proposal for a Regulation on a pilot regime for market infrastructures based on distributed ledger technology

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