

MANAGING COMPLEXITY

Preparing for the impact of MiFID II and MiFIR



What are the main changes under MiFID II and MiFIR?

Scope

- ▶ The application of the MiFID regime is extended in the commodity markets by reason of the deletion, and restriction of, exemptions for commodity traders. An exemption will only remain for firms where their MiFID activity is 'ancillary' to their main business and their main business is not financial services.
- ▶ Emission allowances will be categorised as financial instruments for the purposes of MiFID II and structured deposits will be brought within scope.
- ▶ A new regime providing for harmonised rules for access by third country firms to the EU's financial services markets.
- ▶ Restriction on the circumstances when firms may provide execution-only services, with the effect that investment firms will need to carry out an appropriateness test when providing investment services relating to certain products such as structured UCITS.
- ▶ Additional information will need to be provided in relation to the best execution obligation. More generally, there will be challenges in connection with the development of metrics for execution quality which are appropriate for a very diverse range of financial instruments and market models.
- ▶ Title transfer collateral arrangements will no longer be available when firms are providing services to retail clients with regard to financial instruments. Firms will be required to treat all retail client funds as client money. Further, restrictions are introduced in relation to such arrangements for professional clients.

Conduct of Business Rules

- ▶ Restrictions on independent advisers and portfolio managers receiving commissions or non-monetary benefits. In its final technical advice, ESMA proposes that the MiFID II implementing measures should permit investment firms to accept third party research only where they pay for it directly or from a ring-fenced research account that is funded by a specific charge to their clients (subject to certain conditions). The proposal makes clear that there should be no payment for third party research linked to the payments made for execution of orders.

Organisational Requirements

- ▶ Investment firms to update their organisational arrangements to comply with enhanced product governance and remuneration requirements, including a requirement that staff incentives do not cause conflicts of interest.

- ▶ Management bodies to consist of high calibre individuals as the management body will be held responsible for effective governance arrangements.
- ▶ Definition of client money widened to cover all monies belonging to retail clients.

Commodity Derivatives

- ▶ In commodity derivatives, the widened scope of MiFID II will bring a greater number of commodity market practices onto the regulators' radar and, as a consequence, long standing commercial practices in commodities could come under scrutiny and fall foul of regulation in the future.
- ▶ In particular, MiFID II introduces pre- and post-trade transparency and commodity position reporting requirements, and a system of position limits. Regulators will be able to impose position limits on the net position that a person can hold in contracts traded on a trading venue and economically equivalent contracts. Details of positions will need to be reported to trading venues on a daily basis. Once a week this information will need to be sent by the trading venues to ESMA. Trading venues will also be subject to position management and reporting requirements.

Algorithmic and High Frequency Trading (HFT)

- ▶ New authorisation and supervisory requirements will be imposed on firms engaged in algorithmic trading and HFT to ensure that such trading does not adversely effect market quality or integrity.

Market Structure

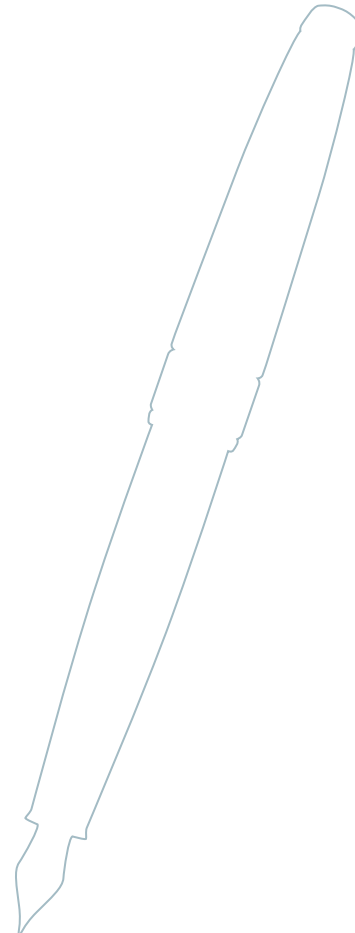
- ▶ A new type of trading facility will be introduced; the Organised Trading Facility (OTF) for the trading of non-equity instruments, such as bonds, structured finance products, emissions allowances and derivatives. In contrast with Regulated Markets (certain regulated exchanges listed on the ESMA website http://mifiddatabase.esma.europa.eu/Index.aspx?sectionlinks_id=23) and Multilateral Trading Facilities (MTFs), OTFs will be able to exercise discretion in order execution, and as such, may play a role in negotiations between market participants i.e. bringing buyers and sellers together with attendant conduct of business requirements. In regulating these venues; MiFID II is attempting to create and ensure safer and more resilient markets following the financial crisis whilst ensuring a fair playing field between OTFs and MTFs in terms of transparency and access requirements.

- ▶ Where a share is *admitted to trading* on a Regulated Market or traded on a trading venue it will be required to be traded on a Regulated Market, MTF or SI (or equivalent third country trading venue) unless certain criteria apply, for instance, if the transaction does not involve a retail client and does not contribute to the price formation process.
- ▶ MiFIR complements the compulsory clearing obligation for OTC derivatives in EMIR by implementing the G20 commitment to mandate the trading on-exchange of standardised derivatives. In consequence, ESMA will have the power to determine a subset of derivatives subject to the EMIR clearing obligation which will become subject to this “trading obligation”.
- ▶ Wider definition of Systematic Internaliser (SI) based on a quantitative criteria taking into account the frequency and scale of trading. SIs will not be able to have an OTF in the same legal entity which may cause issues for some larger banking groups.
- ▶ New obligations for all trading venues, including systems and controls, circuit breakers and rules relating to minimum tick. Trading venues will be required to publish annual data on execution quality.
- ▶ Access to clearing and trading venues and benchmarks will be non-discriminatory.

Reporting and Transparency

- ▶ In general terms, MiFID II / MiFIR will introduce multiple new and expanded reporting requirements:
 - ▶ Transparency of market activity to the public;
 - ▶ Reporting to regulators;
 - ▶ Position reporting for commodity traders;
 - ▶ Best execution data to be published by the trading venue;
 - ▶ Irregular reporting/publications in relation to algorithmic trading;
 - ▶ Other irregular reporting e.g. arrangements to facilitate access to information etc.
- ▶ More specifically:
 - ▶ Pre and post trade transparency regime for shares is to be extended to equity-like instruments, such as: bonds, structured finance products, derivatives and emissions allowances.

- ▶ Trade transparency waivers are being limited with the aim of bringing trading out of the “dark pools” etc. and into the light, with a cap on so-called dark trading for equities, set at 8% of total trading in the EU and 4% of total trading per venue in any one stock.
- ▶ Quantitative thresholds will be imposed on SIs trading in shares, in addition to the qualitative ones currently in place. Furthermore, SIs will be subject to a minimum quote obligation.
- ▶ There will be an extension of the scope of the transaction reporting requirements to all financial instruments to ensure that the MiFID requirements mirror those of MAR.
- ▶ Consolidated tape for trade reports of shares, depository receipts, ETFs, certificates etc. and subsequently for non-equity instruments will lead to improved quality and availability of trade data.
- ▶ So as to maintain liquidity while increasing transparency, care will need to be taken in the calibration of thresholds for large in scale, appropriate publication delays and the definition of ‘liquid’ instruments, which will determine the remit of transparency requirements.



Who is affected and how?

Firms need to start planning for the changes which affect their business in readiness for the finalisation of the EU's implementing legislation and the subsequent changes to be made by HM Treasury to UK financial services legislation and the FCA to its Handbook.

Investment firms

As well as governance impacts and indirect markets-related impacts, there will be multiple impacts from amended conduct of business rules through to new organisational requirements; extension of scope to cover new financial products (such as structured deposits) and services.

Enhanced conduct of business requirements will provide additional protection to investors, including: new requirements for advisers wishing to describe themselves as “independent”; restrictions on independent advisers and portfolio managers making or receiving fees commissions or non-monetary benefits (which will impact the provision and receipt of investment research); enhanced information disclosure to different categories of client, including eligible counterparties; additional best execution obligations; and limiting products that can be sold on an execution-only basis.

These enhanced protections will apply to a wider range of entity, for instance, local authorities will no longer qualify as eligible counterparties but rather retail clients.

Banks, building societies and insurers when providing investment services and/or performing investment activities

These institutions face multiple impacts subject to the extent of the investment business undertaken (see impact for investment firms). Many of these institutions, as MiFID firms, will be caught by the governance and organisational requirements.

Where the institutions are “manufacturers” of financial products, they will be subject to new product governance obligations including a new requirement to consider the target market for any particular product. Firms will need to consider how their product governance arrangements should change and consider whether their MiFID obligations sit at portfolio or component level and if responsibility for the sale of the products will remain with them or pass to any relevant distributor.

Central counterparties (CCPs)

Trading venues will have access to CCPs, and vice versa, subject to certain conditions, extending access rights granted under EMIR. Interoperability is likely to be extended.

Commodity firms

With the removal of the commodity dealer exemption and restriction of other exemptions, commodity firms and groups will need to review how they are structured and may need to

apply for authorisation and therefore comply with the FCA regime generally with attendant regulatory capital impact. In any event, even unregulated commodity market participants will be affected by other MiFID II changes such as position reporting and limits, and the obligation to trade standardised derivatives on an exchange.

Financial counterparties

EMIR Financial counterparties (defined by Article 2(8) of EMIR) such as banks, building societies, insurers, UCITS and their management companies will be subject to reporting requirements together with trading obligations for standardised derivatives.

Where an OTC derivative is subject to mandatory clearing under EMIR, ESMA has six months to decide whether to also propose mandatory on-exchange trading.

Market operators (including any trading venues they operate)

Market operators will see potential benefits from restrictions on OTC trading, but face increased competition from other trading platforms including OTFs for non-equities. There will be new obligations for trading venues such as annual publication of data on execution quality. In particular, market operators should be aware of the interaction with Dodd Frank's definition of limit levels and hedging to avoid being accused of regulatory arbitrage.

Non-financial counterparties (NFCs)

NFCs (defined under Article 10(1)(b) of EMIR) will be subject to reporting requirements together with trading obligations for standardised derivatives to the extent that their trading exceeds relevant thresholds and/or exemptions are not available.

Proprietary benchmark holders

Benchmark holders (very broadly defined) must provide CCPs and trading venues with non-discriminatory access to price and data feeds and a licence to use the benchmark etc.

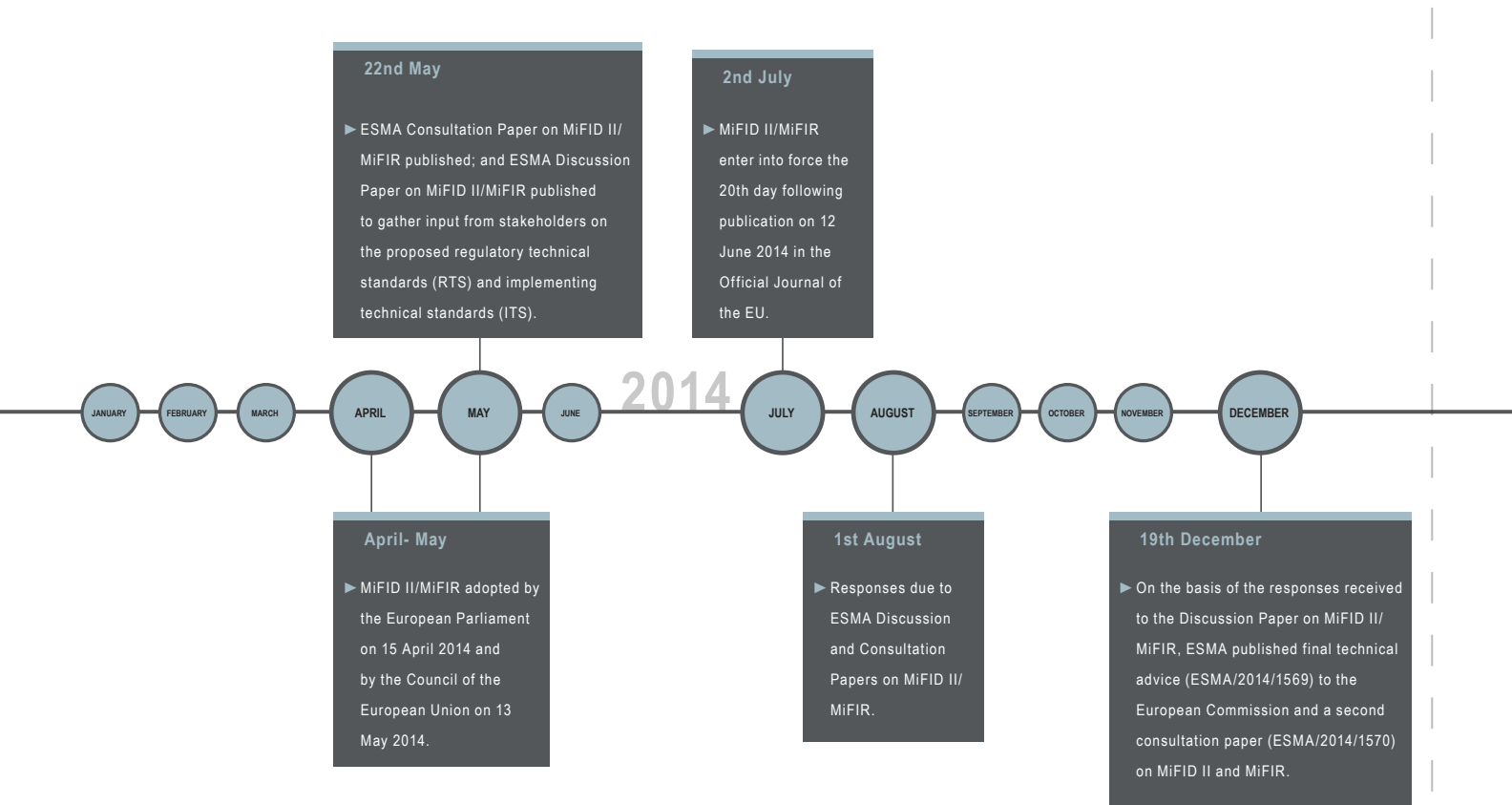
Third-country firms

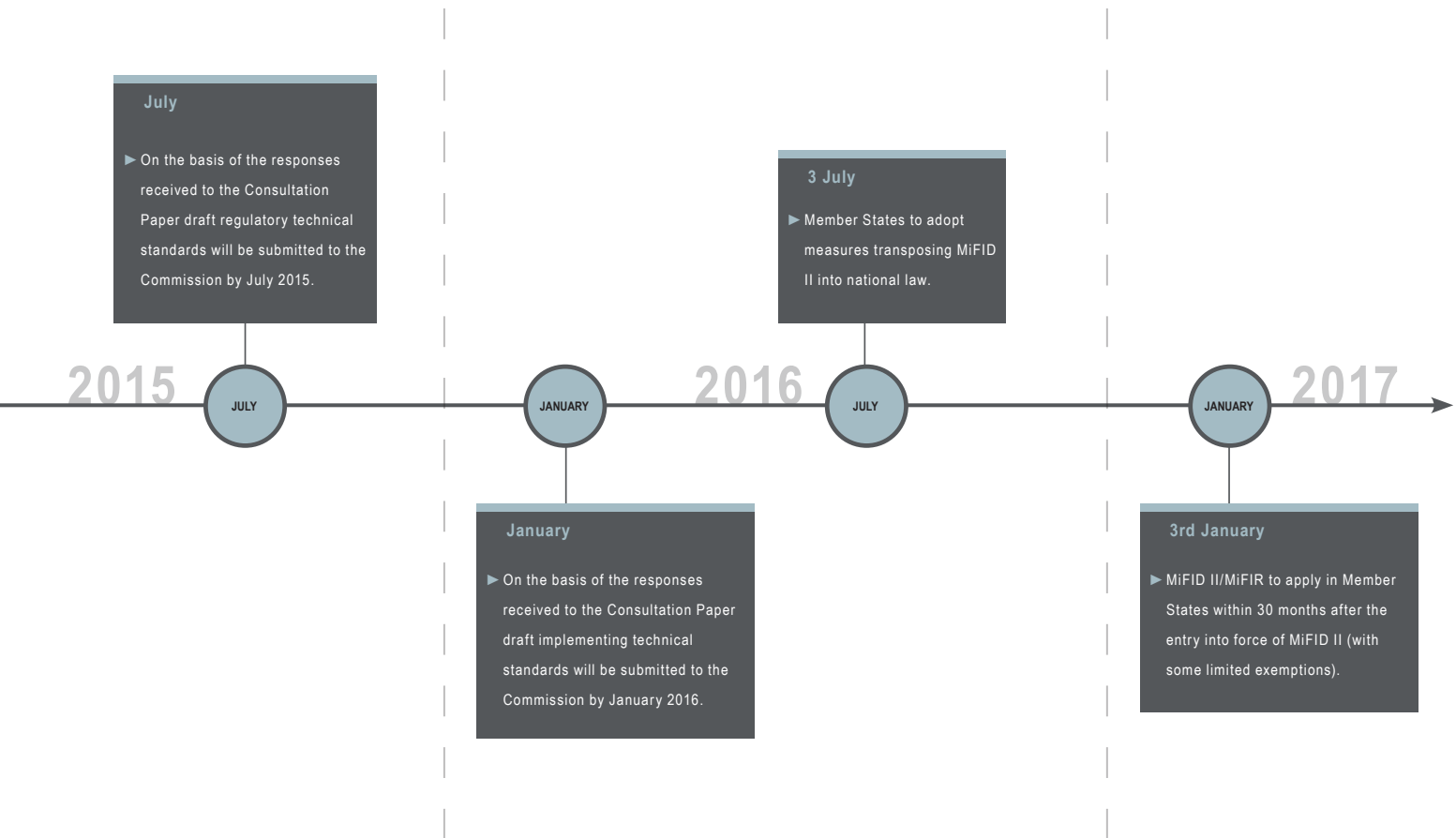
For the first time there will be a harmonised third country regime for the access of third country investment firms and market operators into the EU. There are potential benefits for third country firms which may be able to offer cross-border services to eligible counterparties and professional clients in the EU subject to equivalence and reciprocity requirements between the third country and the EU. Such non-EU firms wishing to provide investment services to retail clients may be required by a member state to do so through a branch.

Regulators

ESMA will gain dispute resolution and co-ordination powers and the ability to act in emergencies. Of greater relevance outside the UK, national regulators will gain product intervention and tougher enforcement powers.

Timeline MiFiD II





The obligations of MiFID and MiFID II / MiFIR at a glance

	MIFID	MiFID II / MiFIR
Commodity Derivatives	Various exemptions for firms trading commodity derivatives	Exemptions for commercial firms trading commodity derivatives significantly restricted Position reporting and position limits for commodity derivatives Regulatory intervention powers
Transparency & Reporting	Pre and post trade transparency for the equity markets Transaction reporting for equities	Extension of transparency regime to non-equities Extension and harmonisation of transaction reporting obligation Consolidated tape for trade reports Approved Reporting Mechanisms
High Frequency Trading	N/A	HFT firms require authorisation, systems and controls and controls on venue pricing
Market Structure	Regulated Markets (RM) Multi-lateral Trading Facilities (MTF) Systematic Internaliser (SI) Market Makers	Additional - Organised Trading Facility (OTF) New rules for trading venues Wider definition of SIs

	MIFID	MiFID II / MiFIR
Conduct of Business Rules	<ul style="list-style-type: none"> Client categorisation Suitability and appropriateness Information and documents Best execution rules Conflicts of interest and inducements Execution only – eligible product list Client money 	<ul style="list-style-type: none"> Trading venues to publish annual data on execution quality Additional information on best execution Execution-only exemption narrowed
Scope of Regime	<p>MiFID applies to a range of investment services and activities, in relation to MiFID financial instruments and subject to some limited exemptions</p>	<ul style="list-style-type: none"> Structured deposits, emissions allowances and benchmarks will come within scope Operation of an OTF becomes a new investment service MiFID exemptions are narrowed
Third-Country Firms	<p>National regimes – third country firms permitted providing they are not afforded more favourable treatment than EEA firms</p>	<p>Harmonised regime for services provided to eligible counterparties and professional clients</p>

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