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MiFID II key proposals and impacts

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The European Commission (EC) today published its proposals to amend the Markets in Financial Instruments Directive (MiFID), referred to as MiFID II, along with its proposed revisions to the Market Abuse Directive (MAD), referred to as MAD II.

The proposals introduce a range of measures which seek to address issues raised by the financial crisis, such as improving investor protection, as well as the commitments made by the G20 to improve the transparency and regulation of more opaque markets, such as derivatives.

The full impact of the changes will not be clear until the legislation is passed, by which time some controversial points could be omitted, and there is sight of the Level 2 and Level 3 proposals for both MiFID and MAD. However, firms should start to assess the potential market and business specific impacts of the proposals, for instance on the electronic trading of derivatives, and use these to inform their business plans. Similarly, they should look at the linkages between the various regulatory reforms in the EU and elsewhere, such as the Dodd-Frank reforms, to identify potential opportunities and synergies, thereby minimising the cost of implementing the amendments.

As the near final drafts of the MiFID II and MAD II proposals were widely circulated before their official release, the content is largely as expected. However, it is essential that the industry does not lose sight of the far-reaching nature of the changes to market structure and both retail and wholesale conduct regulation that flow from these proposals. The proposals include a Regulation and Directive for each of MiFID II and MAD II. This represents a major change in the level of direct European regulation for firms.

This briefing note sets out the key changes in the proposals and looks at the challenges now facing firms.

Key areas of impact in the MiFID II proposals include:	
Scope	• The scope of MiFID will be extended to m such as certain commodity firms, data prov third country firms. • Additional instruments will be brought into the MiFID, such as structured deposits and allowances.
Electronic trading	• Derivatives, which are sufficiently liquid and e clearing, will need to be traded on eligible plat • New category of trading venue, called Trading Facilities (OTFs), will be introduced. • Requirements will be imposed on operators and the operation of OTFs will be introdu separate permission.
Transparency and transaction reporting	• Transparency requirements will be exte additional instruments, such as bonds and de • Trade reports will need to be published Approved Publication Arrangement (APA) fir will also be subject to authorisation an organisational requirements. • Transaction reports will need to capture information.
Third country firms	• An equivalence decision will need to be ma EC in respect of third countries before firms f jurisdictions can request to provide services. • As a minimum, third country firms seeking the retail market will be required to establish b
Investor protection	• Receipt of monetary inducements by cert such as portfolio managers and firm independent investment advice, will be banne • Advice must meet certain criteria in ord classified as 'independent' and additional in will need to be provided to clients.

		• Definition of non-complex instruments will be updated to remove 'structured UCITS', which will prevent these funds from being sold on a non-advised basis.
Product intervention		• National regulators will have powers to permanently ban products, in coordination with ESMA, and ESMA will also be able to temporarily ban products. • Position limits for products, such as commodity derivatives, will be introduced. This will include powers for regulators to require existing positions to be reduced.

Further details of the key changes can be found in section 1 below.

1. Key changes

The majority of key changes proposed were initially set out in the consultation paper issued in December 2010. The key changes proposed today include:

Scope

The proposals expand the scope of MiFID, both in terms of the types of firms and instruments (e.g. structured deposits and emissions allowances) captured.

This will also introduce authorisation and registration regimes for additional firms, such as data reporting providers and third country firms. Current exemptions will be narrowed to bring more commodities firms into the scope of MiFID. This will result in increased regulatory scrutiny and more extensive compliance obligations for firms which are not currently captured by MiFID.

Electronic trading

The proposals introduce specific requirements in respect of electronic trading, including the trading of certain derivative types on eligible platforms in order to fulfil the G20 commitment. However, the derivative types to which this will apply will be defined by ESMA.

Other changes include the introduction of OTFs as a third category of trading venue. The MiFID provisions already extended requirements to regulated markets and Multilateral Trading Facilities (MTFs). However, the addition of OTFs will bring into scope additional trading venues which have been established since MiFID was originally implemented. OTFs have been defined very broadly to ensure that they capture future technological developments. Firms operating OTFs will require a separate permission, and they will be restricted from executing trades against their proprietary book to ensure that operators of trading venues remain unconflicted. More firms which execute client orders against their proprietary books may need to be classified as systematic internalisers, however this is subject to further clarification.

The proposals also include specific systems and control requirements for firms which undertake algorithmic trading and firms which provide clients with direct electronic access to trading venues for execution purposes. The proposals seek to ensure that systems are suitably resilient and include appropriate risk controls, such as preventing systems from sending erroneous instructions and the ability to slow down the flow of orders, in order to improve the stability of financial markets.

The proposals also include a provision for a market making obligation for algorithmic trading strategies. The impact of this is likely to be particularly significant given the broad definition being applied to algorithmic trading. Although this provision could be omitted from the final legislation, it represents a signal of intent from the EC.

Electronic trading infrastructure will be a key area of focus for implementation work and, due to the associated IT spends, is likely to result in significant investment by firms to ensure their trading infrastructure is compliant.

Transparency and transaction reporting

The transparency and transaction reporting requirements are contained in the Regulation, which should increase the consistency with which they are implemented.

The proposals extend transparency requirements to additional asset classes that are not currently in scope, such as bonds, structured finance products, derivatives and emissions allowances. They also extend requirements to different trading venues, such as OTFs. However, their application will be calibrated to each type of asset class and type of trading undertaken.

The proposals include additional requirements in respect of transaction reporting, including the extension of reporting requirements to instruments admitted to trading on OTFs. The type of information required in transaction reports will also be amended to include additional information, such as the identification of individuals (or computer algorithms where relevant) responsible for the investment decision.

Third country firms

The proposals, which are contained in both the Directive and the Regulation, introduce a harmonised approach across Europe to the treatment of third country firms. Third countries will need to be deemed as being equivalent by the EC before access to firms from the third country is provided. ESMA will maintain a central list of the relevant countries.

Third country firms will have to establish branches in order to provide services to retail clients, however they may continue to provide services to eligible counterparties provided they are supervised in their own countries and are registered with ESMA. However, it is not clear how this regime will apply to clients categorised as 'professionals' and whether firms supervised outside the EU would also be subject to checks by regulators local to the markets they are seeking to operate in. Existing third country firms will have four years to comply with new requirements set out in the Regulation from its 'entry into force' date.

Currently, the regime applied to third country firms is at the discretion of national regulators, which means that the impact on firms will vary by country depending on the current arrangements implemented. The impact on third country firms, including those providing services to retail clients and eligible counterparties, will depend on further requirements drafted by ESMA.

Investor protection

In order to enhance investor protection, the proposals restrict the receipt of monetary inducements, for both portfolio managers and providers of independent advice. The proposals also state that when providing investment advice, clients should be informed of whether the advice is independent and whether the firm will provide an ongoing assessment of the suitability of products provided. Firms will need to specify how the advice given meets the personal characteristics of the client. Firms will also be required to provide additional information, including pre and post trade information, to clients regarding advice, inducements and complex instruments.

The conduct of business proposals also set out additional best execution requirements (e.g. firms will be required to disclose their top five execution venues for each class of financial instrument, at least on an annual basis). The proposals also include amendments to client asset requirements in order to increase the level of protection afforded to retail clients.

Product intervention

The proposals set out powers for national regulators, in coordination with ESMA, to ban products permanently, while giving ESMA the ability to also ban products temporarily. These proposals seek to enhance investor protection and to also improve market stability. However, further amendments to the new product approval process, such as stress testing new products, which were originally included in the consultation paper, could still be introduced as part of implementation measures.

The product intervention proposals also include the introduction of position limits in respect of commodity derivatives and emissions allowances (including spot contracts and derivatives). This will require trading venues to impose limits and to inform the national regulators of them. National regulators and ESMA will have powers to force positions to be reduced and have the ability to impose limits in exceptional circumstances (e.g. to ensure market stability). Restricting regulators' ability to impose limits in this way should minimise the risk of firms routinely being required to comply with several different limits in similar instruments.

The key areas of difference from the consultation paper include the addition of non-discriminatory access to clearing houses, which has the objective of increasing competition for clearing. There are also proposals to provide central counterparties and trading venues with access to licences for trading and clearing index based products, which would impact current practices relating to major equity indices.

2. Key challenges for firms

Cost of implementation	The EC's own cost estimates set the one-off compliance costs between €512 and €732 million and ongoing costs between €312 and €586 million. Although the costs are anticipated by the EC to be less than for the original implementation of MiFID, in practice these could be far more for some firms, particularly where significant IT changes are required. Firms should ensure that they have full sight of linkages between legislation (both pan-European and global) to ensure the full impact of regulatory reforms on different business areas is assessed and potential leverage opportunities are identified in order to minimise the cumulative cost of implementation.
Further changes to proposals	The release of the proposals clarifies some of the changes which MiFID II will bring. However, the full extent of changes required as a result of the revisions to MiFID will not be clear until there is sight of the Level 2 and Level 3 proposals. The proposals themselves are also likely to change, with some controversial points omitted, as the final text is negotiated between the EC, Council and Parliament. This presents an opportunity for firms to present key interest points for their businesses to regulators and

	law makers. For example, firms that have extensive OTC derivative trading operations will potentially face very significant changes to their business models and should understand and discuss potential issues.
Changing objectives of MiFID	The inclusion of emissions allowances within the scope of MiFID can be viewed as a desire to improve market stability in an area where there is currently little or no financial services regulation. However, a key issue identified in relation to the spot emissions allowances market is fraud. After the initial consultation, there were concerns raised by industry that the objectives of MiFID were no longer clear and that the legislation was increasingly being used to tackle issues which do not fit neatly into other pieces of legislation. The inclusion of emissions allowances appears to support these concerns and also represents a significant divergence from the treatment of spot trading in relation to other asset classes, such as commodities and FX.
Belgian regulatory framework	There are some overlaps with planned regulatory changes, such as the FSMA's initiatives with regard to particularly complex structured products, which could lead to implementation challenges for firms. For example, the MiFID II proposal requires that firms establish a policy to ensure that services and products are offered or provided in accordance with the risk tolerance of the firm or institution and the characteristics and needs of the clients to whom they will be offered or provided. A similar requirement will be part of the proposed FSMA Regulation on particularly complex structured products. As such care should be taken to ensure alignment between the MiFID II proposal (and any consequent Level 2 or Level 3 measures) and the FSMA Regulation. The same applies to measures regarding product intervention powers.

3. Linkages to MAD II

The MAD II proposals are more consistent with the MiFID II proposals than was the case in the original consultation. This includes the following areas:

- The scope of both MAD II and MIFID II has been updated to include instruments traded on MTFs and OTFs, as well as the trading of emissions allowances.
- There is specific reference to Small and Medium Enterprises (SMEs) in both proposals. MiFID II seeks to introduce a new category of SME markets to make funding easier to obtain for these firms, while the MAD proposals include exemptions for SMEs not to maintain insider lists in certain circumstances. These both complement pan-European initiatives to the support the SME sector.
- Both the MiFID II and MAD II proposals include minimum sanctions to be applied across different jurisdictions.

The MAD II proposals also introduce the criminal offences of insider dealing and market manipulation as a separate directive.

4. Expected implementation

The implementation timeline is still not clear. The proposals published today will pass to the European Parliament and to the Council for negotiation and adoption.

The requirements are not likely to apply until 2 years after they have been adopted and published in the Official Journal. However, there will be some exceptions to this. For example, there are a number of provisions in the Regulation which will apply immediately after publication. There are also provisions where ESMA's technical advice is only required by 2016.

Furthermore, the Directive will need to be transposed in the national laws of the Member States, which can be a lengthy process.

Given the timeframes set out it does not seem likely that the G20 deadline for the trading of standardised derivatives on electronic platforms by the end of 2012 will be met.

Should you wish to discuss the proposals in detail, please contact Caroline Veris or Bart Dewael.

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