Deloitte.

MiFID II and the new trading landscape
Transforming trading and transparency in EU capital markets

EMEA Centre for Regulatory Strategy

Contents

Executive summary

Trading and transparency in EU capital markets will be transformed under new rules agreed in the revision to the Markets in Financial Instruments Directive and new Regulation (MiFID II/MiFIR). The reforms have been a long time in the making and are ambitious in scope; they will trigger a shift to a new trading landscape. Many of the new requirements are intended to be positive for the market as a whole through promoting competition, transparency, financial stability and the orderly functioning of markets. However, they will also create strategic and operational challenges for individual firms.

Where and how market participants execute their trades are set to change. The biggest changes will be felt in derivative markets, where the reforms seek to implement the commitments made by the G20 in 2009 to move more over-the-counter (OTC) derivative trading on to trading venues. Systematic Internalisers (SIs) will become more important as the regime is broadened and the reforms also seek to eradicate broker crossing networks for equity trading. OTC trading will be reduced significantly and, where it endures, will be typically characterised by less liquid and more bespoke products. Competition in trading and clearing markets is also expected to increase due to rules on access to trading venues and central counterparties (CCPs). Investment firms[1] that provide execution services will need to assess their business models in light of the new rules. End-users will also need to consider how they access the market in future as the types of trading venues available and the firms that offer them change.

Reforms intended to increase transparency and curb speculative trading in commodity derivative markets will bring extensive new disclosure and reporting requirements for both investment firms and operators of trading venues. These are likely to require significant systems changes. Robust data governance will be imperative. Rules designed to address the financial stability risks posed by high-frequency algorithmic trading will also require investment firms and operators of trading venues to enhance their systems, processes and controls.

The expectation is that MiFID II/MiFIR will enter into force in June/July 2014 and firms will need to comply with the new rules from around Q1 2017. While the recent endorsement of the package by the European Parliament is an important milestone, much of the detail still needs to be filled in through delegated acts and technical standards, to be developed by the European Commission (the Commission) and European Securities and Markets Authority (ESMA) respectively. Firms should monitor these developments closely and make sure their voices are heard. As the detail becomes clearer, firms need to consider the strategic implications of the reforms and undertake a gap analysis to identify where operational changes are needed. Firms cannot afford to sit back and wait; there is much to do before the go-live date.

While MiFID II/MiFIR also introduce further rules relating to investor protection, governance and third country firms,[2] this paper focuses on the capital markets aspects of the reforms.

Where and how market participants execute their trades are set to change. The biggest changes will be felt in derivative markets …

New requirements seek to extend some of the benefits that MiFID brought to equity markets to a wider range of asset classes, while addressing the problems caused by market fragmentation and dark trading.

Introduction

MiFID was implemented in 2007 and changed the market place for equities significantly. It increased transparency and opened up competition between trading venues through the introduction of the Multilateral Trading Facility (MTF). This led to lower transaction costs, reduced bid-ask spreads and faster trading times in equity markets.[3] However, the increase in trading venues also led to fragmentation in equities trading across the EU and a growth in so-called dark trading.[4]

A review of MiFID was always on the cards but legislators have extended the review beyond what was initially envisaged. New requirements seek to extend some of the benefits that MiFID brought to equity markets to a wider range of asset classes, while addressing the problems caused by market fragmentation and dark trading. Significantly, MiFID II/MiFIR are the vehicle to implement the 2009 G20 commitment in relation to venue trading for OTC derivatives. The package also seeks to address new risks that have emerged since 2007 due to technology advances, notably the growth in high-frequency algorithmic trading.

Key capital markets reforms:

- Move more OTC trading to trading venues through a trading obligation for certain equities and derivatives and establishing a new type of trading venue for non-equities – the Organised Trading Facility (OTF). SIs will also become more important as the regime is broadened; bond trading is likely to take place on SIs.

- Increase transparency through expanding the pre- and post-trade transparency regime to equity-like instruments (e.g. depositary receipts, exchange traded funds and certificates) and to non-equity instruments (e.g. bonds, structured finance products, emission allowances and derivatives), expand the scope of transaction reporting and establish a regime for the provision of an EU consolidated tape.

- Promote orderly markets by introducing specific provisions for algorithmic and high-frequency algorithmic trading.

- Improve oversight and transparency of commodity derivative markets by introducing position reporting and seek to reduce systemic risk and speculative activity through quantitative limits on positions.

- Promote competition in trading and clearing markets through requiring trading venues and CCPs to provide non-discriminatory and transparent access to one another.

Page 8 sets out further detail on the MiFID II/MiFIR requirements relating to capital markets.

Which firms are subject to the requirements?

The scope of MiFID will be broadened under the new rules.

MiFID broadly applies to regulated markets (RMs), investment firms[5] and credit institutions[6] when providing investment services or performing investment activities in the EU e.g. stock exchanges, investment banks, broker-dealers, investment managers and operators of MTFs.

The scope of MiFID will be broadened under the new rules. Operating an OTF will be added to the list of investment services/activities in scope of the Directive, meaning that investment firms engaging in this activity will need to extend their authorisation requirements. The operation of Approved Publication Arrangements (APAs), Approved Reporting Mechanisms (ARMs) and Consolidated Tape Providers (CTPs) will be classed as data reporting services and need to meet authorisation requirements.

More rules will apply to a wider range of financial instruments, for example, with the expansion of the transparency regime to equity-like and non-equity instruments. The list of financial instruments has also been broadened to include emission allowances, derivatives of emission allowances and physically settled commodity derivatives traded on OTFs (with a carve-out for wholesale energy products defined in the Regulation on Wholesale Energy Market Integrity and Transparency (REMIT)).

Due to a narrowing of exemptions from the Directive with respect to dealing on own account, all firms that employ high-frequency algorithmic trading techniques will be in scope and need to comply with more stringent requirements. Users of direct electronic access, who currently rely on this exemption, also risk being caught under new requirements. Some additional entities that trade commodity derivatives may also be brought into scope, although this will depend on firms' precise activities and how exemptions apply. Commodity firms should assess how the changes to exemptions will affect them.

While not needing to be authorised under the Directive, CCPs[7] and persons with proprietary rights to benchmarks (e.g. where firms use their own data to establish benchmarks which are used by trading venues to develop contracts) will need to comply with the rules on non-discriminatory clearing access for financial instruments. Some corporates[8] will also need to comply with the derivative trading obligation.

A new trading landscape

The MiFID II/MiFIR reforms are not about incremental changes. They will trigger a shift to a new trading landscape. Many of the new requirements are intended to be positive for the market as a whole through promoting competition, transparency, financial stability and the orderly functioning of markets. However, there is a risk that the introduction of the OTF may lead to short and potentially medium-term fragmentation in non-equity markets, similar to the experience in equity markets following the implementation of MiFID. The effect of the reforms on liquidity, particularly in relation to transparency and high-frequency algorithmic trading, is also a big unknown.

A move away from OTC to trading venues

Where and how market participants execute their trades are set to change fundamentally. There will be significantly less OTC trading, with more trading taking place on one of the three regulated trading venues (i.e. RMs, MTFs or OTFs) or on SIs. The biggest changes will be felt in derivative markets. Under the trading obligation, a significant portion of this trading will move to a multilateral environment and specifically to OTFs. Some may also move to RMs, MTFs or equivalent third country venues. OTFs will be similar to MTFs in many respects: they will be multilateral (i.e. a system which brings together multiple buyers and multiple sellers); subject to the same pre- and post-trade transparency requirements; and operators will not be permitted to use proprietary capital (with certain exceptions). However, the key differences are that the OTF operator will be required to exercise discretion in the execution of client orders[9] and only non-equity instruments will be permitted to trade on this type of venue.

The exact volumes of derivative trading that will move to trading venues will depend upon how many derivatives meet the ESMA two-pronged test: (i) that they are classed as clearing eligible as per the European Market Infrastructure Regulation (EMIR); and (ii) that they are considered 'sufficiently liquid' – the definition of which will be defined by ESMA in technical standards. Indeed, we do not yet know the proportion of OTC derivatives that will be eligible for clearing, but the direction of travel is clear and is likely to be a significant proportion. Over time it is expected that around 70%[10] of all OTC derivatives will be centrally cleared, although this will vary by asset class. This differs from US rules, where the trading obligation applies to all clearing eligible swaps that are offered for trading by a swap execution facility (SEF) or designated contract market.

While the SI regime did not take off for equities following its introduction in MiFID,[11] more firms are expected to be treated as SIs in future as there will be a more robust SI definition (including the introduction of specified thresholds[12]) and the regime will be extended to a wider range of asset classes. By virtue of the fact that bonds predominantly trade on a bilateral basis with firms acting as a principal, it is expected that in future, a significant proportion of bond trading will be captured by the SI regime. Some OTC derivative trading that is not subject to the trading obligation is also expected to trade on SIs.

Equities subject to the trading obligation will no longer be able to trade on broker crossing networks. Instead, this business will need to move to RMs, MTFs, SIs or equivalent third country venues. However, this does not represent the same shift in equity markets as it does in derivative markets, as only about 4%[13] of equity business is currently traded on broker crossing networks.

All this means that OTC trading will be reduced significantly. Where it does endure it will be typically characterised by less liquid and more bespoke products.

Significant extension to the transparency regime

Transparency is set to increase significantly. The extension of the post-trade transparency regime to equity-like and non-equity instruments will see the number of instruments caught under the regime expand from about 6,000[14] equities to 100,000s[15] of financial instruments. The scope of the pre-trade transparency regime will also extend beyond equities. In practice this will mean that operators of RMs, MTFs and OTFs will need to make public current bid and offer prices as well as the depth of trading interest in a wide range of instruments. SIs will also need to make public firm quotes on a wider range of instruments. Waivers from the equity pre-trade transparency regime have also been narrowed and use of some of the waivers will become subject to a volume cap, limiting the extent to which they can be used. While potentially challenging in practice, use of the negotiated transaction and reference price waivers will be limited to 4% on a single trading venue, and 8% on all EU trading venues, of the total volume of trading in that financial instrument in the EU in the previous 12 month period.

After grappling for a number of years with how best to address the fragmentation in EU equity markets that resulted from MiFID, industry and regulators are now a step closer to a solution with the introduction of a regime for data reporting services providers to establish and run CTPs. CTPs will consolidate post-trade data from RMs, MTFs, OTFs and APAs and are intended to provide market participants with a better view of post-trade data across markets. However, while this sets the path for data service providers to follow, it doesn't deliver the end result. CTPs won't exist from day one and it will take time for data reporting services providers to work through all the practical challenges. Providers are expected to focus first on equity markets and learn the lessons there before moving on to the more challenging non-equity markets. If take-up by firms is not of the quality envisaged by the Commission, it may appoint a CTP through a public procurement process. Until CTPs are up and running, issues related to market fragmentation are likely to continue.

Promotion of financial stability and orderly markets

The rules on high-frequency algorithmic trading and commodity derivatives are designed to promote financial stability and orderly markets. While some argue that high-frequency algorithmic trading has had some benefits for the market in terms of increased liquidity, narrower spreads and reduced short term volatility, regulators are of the view that it poses risks to orderly markets, for example, through the overload of systems or overreaction to market events. Legislators and regulators in the United States have also recently raised concerns relating to market integrity in high-frequency algorithmic trading.

Similarly, legislators have become increasingly concerned that speculation in commodity markets has increased market volatility. To reduce systemic risk and promote orderly markets, competent authorities will be required to impose limits on the size of the net positions held in commodity derivatives (with exemptions for non-financial entities for hedging purposes) and ESMA will be granted position management powers.

Increased competition in trading and clearing markets

In a break-up of the so-called 'vertical silos', where trades executed on a venue are cleared by a CCP within the same group, rules on access to CCPs, trading venues and benchmarks are expected to drive competition in trading and clearing markets. This may improve services to market participants and reduce fees in both trading and clearing. The ability to execute transactions in similar instruments on different trading venues, but then clear them via a CCP of the counterparty's choice, may also minimise the costs of clearing due to benefits from the netting of off-setting margin payments. However, the ability of trading venues, CCPs and competent authorities to deny access in certain circumstances, as well as transitional arrangements, could potentially hinder the development of the regime.

The introduction of the OTF is also likely to drive competition in non-equity markets, as seen with the introduction of the MTF for equity markets under MiFID. The new OTF venues will compete with RMs and MTFs for the increased volumes of derivatives business that will move on to trading venues.

Liquidity: the price to pay?

While many of the reforms in MiFID II/MiFIR are expected to be largely positive for the market as a whole, all this may come at the price of reduced liquidity.

Increased transparency can be positive for investors, but too much transparency in less liquid markets can have a negative impact on liquidity. Consequently, it will be important that ESMA, tasked with calibrating the transparency regime in technical standards, is able to strike the right balance between ensuring investors receive the information they need and preserving liquidity.

Pooling trading on venues is intended to reduce the risk of liquidity drying up, as was seen in derivative markets during the financial crisis. However, bringing more trading on to venues does not automatically mean guaranteed, let alone increased, liquidity. In addition, the prohibition on operators of OTFs executing trades against their proprietary capital will remove this source of liquidity from the venues.

Rules that require operators of trading venues to ensure that algorithmic trading doesn't contribute to disorderly trading through, for example, limiting the ratio of unexecuted orders to transactions or slowing down trading, could potentially dampen this activity, reducing liquidity. Legislators have sought to address this through requiring that firms engaging in algorithmic trading as part of a market making strategy carry out market making continuously during a specified proportion of the trading day. This is in order to provide liquidity on a regular and predictable basis (except under exceptional circumstances). However, it is not yet clear the circumstances in which a firm will be deemed to be pursuing a market making strategy. This will be determined in ESMA technical standards.

Limiting positions held in commodity derivatives could also reduce trading activity in this market, with a potentially negative effect on liquidity. However, again, much will depend upon the methodology set out by ESMA to determine the limits.

To reduce systemic risk and promote orderly markets, competent authorities will be required to impose limits on the size of the net positions held in commodity derivatives …

Key MiFID II/MiFIR requirements relating

Pre-trade

Equities*

- **Pre-trade transparency regime:** extended to equity-like instruments (e.g. depositary receipts, exchange traded funds and certificates). RMs, MTFs and OTFs required to publish current bid and offer prices and depth of trading interest at those prices continuously during normal trading hours (including actionable expressions of interest).
- **Volume cap:** a cap is introduced for use of the negotiated transaction and reference price waivers. The use of the waivers is limited to 4% on a single trading venue and 8% on all EU trading venues of the total volume of trading in that financial instrument in the EU in the previous 12 month period.
- **SI pre-trade transparency:** extended to equity-like instruments. SIs must make public firm quotes where there is a liquid market.

Non-equities

- **Pre-trade transparency regime:** extended to non-equities (e.g. bonds, structured finance products, emission allowances and derivatives), with exemption for derivative transactions of EMIR non-financial counterparties for risk management purposes. RMs, MTFs and OTFs required to publish current bid and offer prices and depth of trading interest at those prices continuously during normal trading hours (including actionable expressions of interest). Pre-trade transparency waivers will be available for: (i) large in scale orders or orders held in an order management facility; (ii) actionable indications of interest in request-for-quote and voice trading systems above a certain size, which would expose liquidity providers to undue risk; and (iii) illiquid financial instruments (details to be specified in ESMA technical standards).
- **SI pre-trade transparency:** extended to non-equities. SIs must make public firm quotes where there is a liquid market if prompted by the client and SI agrees.

Execution

- **SI regime:** investment firms that meet the SI definition, including on new quantitative thresholds, will be required to register as SIs. The role will also be expanded to equity-like and non-equity instruments.
- **Algorithmic and high-frequency algorithmic trading:** investment firms must have effective systems and risk controls; notify competent authorities and relevant trading venues upon engaging in algorithmic trading; have in place effective business continuity arrangements; and ensure systems are fully tested and properly monitored. Investment firms engaging in high-frequency algorithmic trading must record all placed and executed orders, cancellations and quotes, to be made available to authorities upon request. Investment firms using algorithmic trading to pursue a market making strategy will also be subject to additional obligations.
- **Direct electronic access:** investment firms providing direct electronic access to trading venues will need to have effective systems and controls to monitor client trading and to ensure clients comply with MiFID II rules and the rules of the trading venue.
- **Trading venue systems:** operators of trading venues must ensure systems are resilient, have sufficient capacity, can ensure orderly trading and are fully tested. They must be able to temporarily halt or constrain trading (if there is a significant price movement) and, in exceptional cases, cancel, vary or correct transactions. There are also additional obligations in relation to algorithmic trading.
- **Trading venue fees:** operators of trading venues can impose higher fees for cancelled orders; on participants with a high ratio of cancelled to executed orders; or on those who engage in high-frequency algorithmic trading.
- **Minimum tick sizes:** operators of trading venues will have to adopt minimum tick sizes for equities, equity-like and other financial instruments (details to be specified in ESMA technical standards).
- **Market surveillance:** operators of trading venues will be subject to enhanced requirements in relation to market surveillance.
- **Best-execution:** rules strengthened to improve protection of interests of retail clients; increased disclosure requirements for investment firms.

* Includes equity-like instruments

to capital markets

Post-trade

- **Equity trading obligation:** shares admitted to, or traded on, trading venues must be traded on an RM, MTF, SI or equivalent third country venue (with some exemptions).

- **Internal matching systems:** internal matching systems executing client orders for equities and equity-like instruments on a multilateral basis must be authorised as MTFs.

- **Introduction of a new trading venue – OTF – for non-equities:** it captures all multilateral trading systems that are not RMs or MTFs. OTFs can execute orders on a discretionary basis, but cannot execute client orders against proprietary capital (except as 'matched principal' trading). OTFs are subject to investor protection obligations (e.g. best execution). An OTF and SI are not permitted within the same legal entity.

- **Derivative trading obligation:** financial and some non-financial counterparties must trade clearing eligible and sufficiently liquid derivatives on an RM, MTF, OTF or equivalent third country venue.

- **Transaction reporting:** investment firms will need to report on more financial instruments as scope has been broadened to include (i) instruments admitted to trading or traded on a trading venue; or (ii) where the underlying is an instrument traded on a trading venue; or (iii) is an index or basket composed of instruments traded on a trading venue. They will also need to include a wider range of data fields in their transaction reports. These may be reported to competent authorities directly, through an ARM or by a trading venue on its behalf. ARMs must be authorised. Operators of trading venues must report to competent authorities details of transactions which are executed through their systems by firms not already subject to transaction reporting obligations.

- **Consolidated tape providers:** CTPs required to consolidate data from RMs, MTFs, OTFs and APAs for specified instruments, into a continuous electronic data stream, as close to real time as possible. CTPs must be authorised.

- **Access to CCPs:** CCPs shall clear financial instruments on a non-discriminatory and transparent basis regardless of the trading venue on which a transaction is executed (access can be refused in certain circumstances); transitional period for CCPs established for less that three years in relation to transferable securities and money market instruments.

- **Access to trading venues:** trading venues must provide data feeds on a non-discriminatory and transparent basis upon request to CCPs that wish to clear transactions in financial instruments (access can be refused in certain circumstances); small trading venues can apply to opt-out for exchange traded derivatives.

- **Access to benchmarks:** access to licences and information relating to benchmarks should be provided to CCPs and trading venues on a proportionate, fair, reasonable and non-discriminatory basis; transitional period for newly developed benchmarks.

- **Post-trade transparency regime:** extended to equity-like instruments. RMs, MTFs and OTFs must publish price, volume and time of transactions as close to real time as possible. Investment firms and SIs must also disclose post-trade information through an APA. There is deferred publication in certain circumstances. APAs must be authorised.

- **Post-trade transparency regime:** extended to non-equities. RMs, MTFs and OTFs must publish price, volume and time of transactions as close to real time as possible. Investment firms and SIs must also disclose post-trade information through an APA. There is deferred publication in certain circumstances. APAs must be authorised.

- **Reporting of commodity derivatives:** operators of trading venues, investment firms and members of venues have reporting requirements in relation to derivatives, emission allowances and derivatives thereof.

- **Position limits for commodity derivatives:** competent authorities must establish and apply position limits (methodology determined by ESMA), with exemptions for non-financial entities for hedging purposes. Operators of trading venues must apply position management controls and also meet disclosure requirements.

Opportunities and challenges

MiFID II/ MiFIR will affect the business models of firms that distribute financial instruments to investors …

End-users accessing markets

As outlined above, market participants are likely to see lower transaction costs, more information to aid price formation and a narrowing of bid-offer spreads as a result of MiFID II/MIFIR. They will need to consider how they access the market in future as the types of trading venues available and the firms that offer them change.

Investment firms providing execution services

MiFID II/MiFIR will affect the business models of firms that distribute financial instruments to investors via trading venues or on a bilateral basis e.g. investment banks or broker-dealers. There will be a restriction on the ability to provide OTC services as more trading activity is required to move to venues, reducing execution-related revenue. Profit margins may be squeezed further by potential pressure on transaction costs and a narrowing of bid ask spreads.

Investment firms dealing as principal will need to determine how they provide execution services to their clients. In future, clearing eligible and sufficiently liquid derivatives will have to be offered to clients via OTFs or MTFs. While the OTF is designed for derivatives, operating them may not be a viable option for an investment bank as OTFs will not be permitted to execute orders against proprietary capital (although matched principal trading will be allowed in certain circumstances). The same legal entity will also not be permitted to operate both an OTF and an SI, which is likely to be a hindrance to firms that provide a variety of execution services in the same entity. In the US, none of the 24 temporarily registered SEFs (or where registration is pending) is an investment bank.[16]

Investment firms will also need to determine whether they meet the more comprehensive definition of an SI, including specified thresholds, in relation to their dealing on a bilateral basis. They will also need to determine whether they are operating internal matching systems for equities and equity-like instruments on a multilateral basis which will require authorisation as an MTF under the new regime. Where they do meet these definitions, investment firms should assess the relative pros and cons of acting as an SI or seeking authorisation as an MTF, or changing or ceasing their trading activities in these areas.

Disclosure and reporting

MiFID II/MiFIR will bring extensive new disclosure and reporting requirements. With the expansion of the post-trade transparency regime to equity-like and non-equity instruments, operators of RMs and investment firms, including in their operation of MTFs and OTFs, will need to make public, as close to real time as possible, post-trade information on a much wider range of financial instruments. The scope of the transaction reporting regime is also widened from applying only to financial instruments admitted to trading on a RM to applying to financial instruments admitted to trading or traded on a trading venue. Investment firms will also need to include a wider range of data fields in their transaction reports to competent authorities, such as flags related to short sales, waivers and algorithmic trading. All this will require a re-design of existing systems.

Firms active in commodity markets will need to meet a number of new requirements. In particular, position reporting and disclosure requirements for commodity derivatives, emission allowances and derivatives of emission allowances are introduced for the first time. Operators of RMs, MTFs and OTFs will need to make public aggregated positions on a weekly basis and report a breakdown of positions to competent authorities on a daily basis. Investment firms will need to report positions to competent authorities on a daily basis in relation to trading outside of a trading venue, not only for positions held by the investment firm, but also those held by their clients and the clients of their clients until the end client is reached. Members of RMs and MTFs and the clients of OTFs will also have to report positions to the operators of trading venues for instruments traded on those trading venues, again also on behalf of clients until the end client is reached.

As regulators seek to get a better picture of activities and risks in financial markets, firms are facing increasing reporting and disclosure requirements from multiple pieces of regulation. Many investment firms are still getting to grips with the EMIR reporting regime for derivatives. And this won't be the end. Reporting requirements for securities lending and repos are also on the horizon under the proposed Regulation on reporting and transparency of securities financing transactions.[17] Experience from EMIR demonstrates that despite long implementation lead-times, the scale of the challenge can be under-estimated.

All this is likely to require significant systems changes. Rather than making changes in a piecemeal fashion, investment firms should use MiFID II/MiFIR implementation to step back and assess the data and systems changes that are being driven by all upcoming regulation, leveraging existing EMIR reporting infrastructure as much as possible. Robust data governance will be imperative.

Systems, processes and controls

Investment firms will need to meet enhanced requirements relating to algorithmic and high-frequency algorithmic trading, which build on existing ESMA Guidelines.[18] The definition of algorithmic trading is quite broad and will capture a significant number of electronic systems. Investment firms will need to have effective systems and risk controls, have business continuity arrangements in place and ensure systems are fully tested and properly monitored. There will be record-keeping requirements in relation to placed orders, cancellations, executed orders and quotes, and investment firms providing direct electronic access to trading venues will need to have effective systems and controls to monitor client trading and to ensure clients comply with MiFID II rules and the rules of the trading venue. Firms that pursue a market making strategy will face additional obligations. These requirements are likely to be particularly onerous for high-frequency algorithmic trading firms brought into scope of MiFID II/MiFIR.

Operators of trading venues will also need to enhance their systems, processes and controls to comply with the new requirements. They will need to ensure that systems are resilient, have sufficient capacity, can ensure orderly trading and are fully tested. They must be able to temporary halt or constrain trading (if there is a significant price movement) and, in exceptional cases, cancel, vary or correct transactions. There are also additional obligations in relation to algorithmic trading. Operators of trading venues will have to adopt minimum tick sizes for equities, equity-like and other financial instruments, for which further detail will be specified in ESMA technical standards. They will also face enhanced market surveillance requirements.

Market infrastructure

Operators of trading venues and CCPs will need to revise their systems and assess their business models in light of the rules on open access. However, transitional arrangements will mean that some firms will not need to do this from day one. They will need to consider how best they can retain and build market share once competition is opened up.

Changes to the post-trade transparency regime will provide opportunities for data reporting services providers. APAs will become increasingly important and there will be the opportunity for data reporting services providers to set up a CTP. More widely, trade repositories are fast becoming an important part of the market infrastructure due to EMIR reporting requirements and new reporting requirements proposed under the Regulation on reporting and transparency of securities financing transactions. Trade repositories will want to consider how they can take advantage of the new regime under MiFID II/MiFIR.

Authorisation

There will also be broadened authorisation requirements. Data reporting services providers will need to become authorised in their operation of ARMs, APAs and CTPs. Investment firms seeking to operate OTFs will need to extend their authorisation. Firms not currently authorised but engaging in high-frequency algorithmic trading will fall into scope of MiFID II/MiFIR and hence need authorisation, a lengthy and complicated process. Firms must be able to demonstrate that they meet the authorisation requirements and ensure that they provide accurate information to regulators within the expected timeframe. Failure to get it right could ultimately result in the firm having to cease performing some or all of its services/activities.

Figure 1. How the rules will affect different types of firms

		Investment firms and credit institutions when providing investment services and/or activities*	RMs and investment firms when they operate MTFs, OTFs and SIs	Data reporting services providers	CCPs and persons with proprietary rights to benchmarks	Non-Financial counterparties
Pre-trade	Pre-trade transparency	Indirect effect	Direct effect	Minor or no effect	Minor or no effect	Indirect effect
Execution	Algorithmic and high-frequency algorithmic trading	Direct effect	Direct effect	Minor or no effect	Minor or no effect	Minor or no effect
Execution	Enhanced requirements for RMs and MTFs	Indirect effect	Direct effect	Minor or no effect	Minor or no effect	Minor or no effect
Execution	Introduction of OTFs and increased requirements	Indirect effect	Direct effect	Minor or no effect	Minor or no effect	Minor or no effect
Execution	Best execution	Direct effect	Direct effect	Minor or no effect	Minor or no effect	Indirect effect
Execution	Equity trading obligation	Direct effect	Direct effect	Minor or no effect	Minor or no effect	Minor or no effect
Execution	Derivative trading obligation	Direct effect	Direct effect	Minor or no effect	Minor or no effect	Direct effect
Post-trade	Post-trade transparency	Direct effect	Direct effect	Direct effect	Minor or no effect	Indirect effect
Post-trade	Access to CCPs, trading venues and benchmarks	Indirect effect	Direct effect	Minor or no effect	Direct effect	Minor or no effect
Post-trade	Commodity derivatives	Direct effect	Direct effect	Minor or no effect	Minor or no effect	Minor or no effect

Minor or no effect   Indirect effect   Direct effect

*excluding where they operate MTFs or OTFs or act as SIs

What's next?

The recent endorsement by the European Parliament is an important milestone and the expectation is that MiFID II/MiFIR will be published in the Official Journal in June. This will trigger the countdown to implementation; the so-called 'entering into force' of the legal text. But there is a significant amount of detail to come in the shape of technical standards. Indeed, ESMA has a big job ahead – signalled by the circa 400 references to ESMA in the legislative texts.

ESMA has indicated that the next stage in developing the rules will take two phases – split between delegated acts and technical standards.[19] At the end of May/early June we expect ESMA to release a discussion paper on the technical standards, with a more developed consultation paper to follow later this year/early 2015. The discussion paper will be accompanied by a consultation on the areas in MIFID II/MiFIR where ESMA must provide technical advice to assist the Commission in developing Delegated Acts.

Out of the 100 or so technical standards, technical advice and guidelines in which ESMA will flesh out the details of the regime, the following five areas should be closely monitored by firms:

1. **Transparency regime** – how ESMA calibrates the pre- and post- trade transparency regime, including the use of waivers and the conditions for deferred publication of trade information. Given the very different characteristics of the wide range of instruments captured by the new requirements, a one-size fits all approach should be avoided. ESMA will need to strike the right balance between ensuring investors receive sufficient information and preserving liquidity.

2. **High-frequency algorithmic trading** – implementing measures will set out the final shape of the regime, including further details on the organisational requirements, conditions where market making would be required, and the application of circuit breakers and other resilience requirements.

3. **Trading obligation** – ESMA will have the challenging task of defining when a market is considered liquid; the class of derivatives subject to the trading obligation; when equities may be excluded from the obligation; the dates of application; and the circumstances in which a trading obligation can be withdrawn.

4. **Reporting requirements** – the format and content of transaction reports will be of particular interest given the lead-time needed to make system changes.

5. **Commodities** – the methodology for calculating position limits and how they will be applied by the authorities in practice will be of key interest.

The current expectation is that firms will need to meet the new requirements from around Q1 2017. Figure 2 illustrates a timeline of key milestones in MiFID II/MiFIR implementation.

Figure 2. MiFID II/MiFIR timeline (estimated dates only)

2014	2015-2016	2017
• 14 January: political agreement reached. • 15 April: European Parliament vote. • May/June: ESMA discussion paper on technical standards and consultation on technical advice. • June/July: entry into force. • Q4: ESMA final technical advice. • Q4 2014/Q1 2015: ESMA consultation on technical standards.	• Q2/Q3 2015: ESMA final technical standards. • Q3 2015–Q1 2016: implementing measures finalised.	• Q1: MiFID II/MiFIR takes effect.

What should firms be doing now?

The increasing regulatory focus on data and reporting reinforces the need for firms to have streamlined and effective post-trade infrastructure as well as robust data governance arrangements in place.

While the go-live date may seem a long way off, the European Parliament vote is a key milestone. To date, largely due to the lengthy negotiation process, only investment banks with significant trading operations have needed to give much focus to MiFID II/MiFIR. This is set to change. The forthcoming ESMA consultation and discussion papers will give firms a much clearer view of the direction of travel and the likely approach. It goes without saying that firms should monitor these developments closely and make their voices heard when proposed rules would lead to real business and operational challenges. The detail from these papers will also provide firms with the basis for undertaking a gap analysis against their current implementation of MiFID to identify the areas that will likely cause challenges, as well as designing a roadmap towards implementation.

Larger institutions, particularly those with trading operations should, if they have not done so already, start to consider the strategic impacts of MiFID II/MiFIR. From a capital markets perspective, these are likely to focus on: (i) potential changes to business models; and (ii) changes to the provision of execution services. The restrictions on which products can be traded OTC in the new world will mean that firms will need to consider potential loss of margins on execution business and how products will be distributed to clients going forward. For example, whether a firm should become the operator of an MTF or act as liquidity provider to an OTF. Clearly, much will depend on the actual products caught in scope but banks currently operating a single dealer platform will need to change radically.

In the context of reporting, both from a transaction reporting and post-trade transparency perspective, the new requirements will lead to significant operational change. Firms currently undertaking systems changes in order to meet the EMIR reporting requirements should keep an eye on the extensive MIFID II/MiFIR II requirements that they will have to deal with in future. The increasing regulatory focus on data and reporting reinforces the need for firms to have streamlined and effective post-trade infrastructure as well as robust data governance arrangements in place.

Endnotes

1 In general, references to investment firms in this paper also include credit institutions when providing investment services/activities subject to MiFID II/MiFIR requirements.

2 We will shortly publish a further paper that will focus on the implications of the MiFID II/MiFIR third country regime.

3 *Consultation on the review of MiFID*, European Commission, December 2010: http://ec.europa.eu/internal_market/consultations/docs/2010/mifid/consultation_paper_en.pdf.

4 *Impact of MiFID on equity secondary markets functioning*, Committee of European Securities Regulators (CESR), June 2009: http://www.esma.europa.eu/system/files/09_355.PDF.

5 MiFID defines an investment firm as any legal person whose regular occupation or business is the provision of one or more investment services to third parties and/or the performance of one or more investment activities on a professional basis (this definition has not changed under MiFID II/MiFIR).

6 Not all provisions apply to credit institutions and they do not need to be authorised under the Directive.

7 Instead CCPs must meet robust authorisation requirements as set out in EMIR.

8 Corporates classified as non-financial counterparties above the clearing threshold in EMIR (i.e. NFC+) will need to meet requirements stemming from the trading obligation for OTC derivatives.

9 An investment firm or market operator operating an OTF must exercise discretion in either or both of the following circumstances: (i) when deciding whether to place or retract an order on the OTF; or (ii) when deciding not to match a specific client order with other orders available in the system, provided it is in compliance with specific instructions received from the client and best execution rules.

10 *Macroeconomic impact assessment of OTC derivatives regulatory reforms*, Macroeconomic Assessment Group on Derivatives (MAGD), August 2013.

11 According to ESMA's database on SIs, there are currently only 12 SIs in the EU: http://mifiddatabase.esma.europa.eu/Index.aspx?sectionlinks_id=16&language=0&pageName=MiFIDSystematicSearch&subsection_id=0.

12 In MiFID II, SIs are defined as investment firms which, on an organised frequent, systematic and substantial basis, deal on own account when executing client orders outside a RM, MTF or OTF without operating a multilateral system. 'Frequent and systematic' basis and 'substantial' basis will be measured in relation to the number and size of OTC trades.

13 According to Thompson Reuters' monthly market share report (*Dark pool & broker crossing activity for all European equities* (February 2013 – February 2014)), on average about 4.4% of European equities out of % total order book were traded on broker crossing systems between February 2013 and February 2014.

14 ESMA database on shares admitted to trading on EU RMs: http://mifiddatabase.esma.europa.eu/Index.aspx?sectionlinks_id=14&language=0&pageName=MiFIDLiquidSearch.

15 *MiFID II and fixed income transparency*, the Association for Financial Markets in Europe, January 2013.

16 US Commodity Futures Trading Commission SEF database: http://sirt.cftc.gov/SIRT/SIRT.aspx?Topic=SwapExecution Facilities.

17 http://ec.europa.eu/internal_market/finances/docs/shadow-banking/140129_proposal_en.pdf.

18 *Systems and controls in an automated trading environment for trading platforms, investment firms and competent authorities*, ESMA, 24 February 2012.

19 Delegated acts are level two measures that supplement or amend technical elements of a directive or regulation. The European Commission prepares the act in conjunction with one of the European Supervisory Authorities (ESAs), typically through receiving technical advice, whereas technical standards are prepared by the designated ESA and submitted to the European Commission.

Glossary of acronyms

APA: Approved Publication Arrangement

ARM: Approved Reporting Mechanism

CCP: Central counterparty

Commission: European Commission

CTP: Consolidated Tape Provider

EMIR: European Market Infrastructure Regulation

ESMA: European Securities and Markets Authority

MiFID II: Markets in Financial Instruments Directive

MiFIR: Markets in Financial Instruments Regulation

MTF: Multilateral Trading Facility

NFC: Non-financial counterparty

OTC: Over-the-counter

OTF: Organised Trading Facility

RM: Regulated market

REMIT: Regulation on Wholesale Energy Market Integrity and Transparency

SEF: Swap execution facility

SI: Systematic Internaliser

Contacts

David Strachan
Partner & Head, EMEA Centre for Regulatory Strategy
dastrachan@deloitte.co.uk

Nikki Lovejoy
Partner, Risk and Regulation
nlovejoy@deloitte.co.uk

Manmeet Rana
Senior Manager, Risk and Regulation
mrana@deloitte.co.uk

Rosalind Fergusson
Manager, EMEA Centre for Regulatory Strategy
rfergusson@deloitte.co.uk

For more information on the EMEA Centre for Regulatory Strategy, please visit: www.Deloitte.co.uk/Centre

Deloitte LLP is a limited liability partnership registered in England and Wales with registered number OC303675 and its registered office at 2 New Street Square, London EC4A 3BZ, United Kingdom. Tel: +44 (0) 20 7936 3000 Fax: +44 (0) 20 7583 1198.

Designed and produced by The Creative Studio at Deloitte, London. 34380A