MiFID II: The Deloitte perspective
Implications for capital markets participants

The European Commission (the Commission) has released its proposals to amend and extend the Markets in Financial Instrument Directive including the introduction of a new Regulation (known as MiFID II). Deloitte's Centre for Regulatory Strategy released a commentary on the proposals in their entirety which can be **accessed here**. In this paper Deloitte's Banking & Capital Markets practice highlights the headline issues we believe should be at the top of the agenda for senior management of market participants. These issues have ramifications for business models; and given the substantial use of delegated acts in the proposals, organisations will need to keep a watchful eye on the evolution of the final rules.

The trading obligation

Through the European Market Infrastructure Regulation (EMIR) the Commission is seeking to fulfil in part the G-20 commitment to push more derivative transactions through central counterparty clearing and increase visibility for regulators. MiFID II takes this one stage further through the introduction of a 'trading obligation' that will force certain derivative asset classes to be traded in multilateral exchange environments. In their current form, the proposals will see the end of bi-lateral 'over the counter' trading of these 'G-20' derivatives on single dealer platforms – a market in which London in particular has achieved global dominance.

This potentially momentous change means that firms will need to reassess the structure of their derivatives businesses. Whilst some derivative asset classes have been found suitable for exchange trading by the markets themselves, exchange traded funds (ETFs) being a notable example, there appears to be a clear political will to see the range of products trading on exchange extended.

However, most organisations will find that they are not yet in a position to start making assessments as to the scale of impact facing their businesses.

The proposed regulation leaves the scope of the trading obligation (i.e. which derivatives will in fact be G-20 derivatives) to be determined through technical standards, developed by the competent European supervisory authority, the European Securities and Markets Authority (ESMA).

The recitals to the proposed regulation are explicit that clearing eligibility and sufficient liquidity will be the criteria that ESMA should have regard to when developing technical standards. However, liquidity has proved itself to be a hotly debated concept; add to this the potential for debate over what constitutes a 'class of derivatives' and the fact that liquidity profiles change over the life of derivative instruments (as clearly illustrated in the corporate bond markets), and the scale of the challenge facing ESMA becomes apparent. It is encouraging that the Commission has recognised the significance of the proposals and included a requirement for ESMA to conduct a public consultation prior to releasing its implementing standards.

Trading venue categorisation and systematic internalisation

Central to MiFID II, is the organised trading facility (OTF) category of trading venue. This, alongside the revised concept of systematic internalisation (SI) and its application to non-equity markets, again necessitates that firms examine their business models and assess whether these remain viable under the proposed regulatory regime.

Yet again organisations will be struggling to make important judgements at this stage. This is because the detail of the proposals with the greatest potential impact on the industry – pre-trade transparency obligations and the associated waiver regime – are once again left to the Commission and ESMA's discretion. In addition, the scope of the trading obligation will also determine the relative importance of the OTF and SI categories.

Industry has been quick to defend certain existing trading models as both sufficient to support price formation and maintain liquidity whilst providing execution benefits for clients. Voice/electronic hybrid trading models and Request for Quote (RFQ) systems are examples.

Recitals to the proposed regulation suggest that such systems will be allowed to continue. Although the OTF category is described in terms of an exchange's electronic order book, the pre-trade transparency provisions talk of waivers based on a 'market model', supporting the recital that suggests calibration of the regime will accommodate hybrid and voice venues and quote-driven systems. The systematic internalisation regime is quote based but requires firm rather than indicative quotes. The determination of standard market size for instruments traded systematically will play an important role in determining how widely pre-trade quotes are publicly disseminated.

Reporting

The Commission's proposals signpost a significant increase in the reporting obligations of investment firms and trading venues. This will be both public reporting through post-trade transparency obligations and private reporting to regulators.

Again there are areas where the detail is yet to be specified but firms and venues can at least be certain that their data handling processes are going to come under pressure.

The G-20 commitments in response to the financial crisis had signposted this additional reporting requirement. Indeed, market participants have already responded in part with an industry-led initiative to agree a global standard for legal entity identifiers to be used in transaction reports. This is with a view to defining a standard that will meet the requirements not just of European regulations such as EMIR and MiFID II but also US and other jurisdictions' regulatory demands. This is representative of a broader concern that divergent standards across jurisdictions will end up imposing excessive compliance costs on global participants whose aim will be to implement uniform business processes to serve multiple regulators' purposes.

It may be that this type of initiative, seeking to front-run and gain acceptance from regulators, becomes increasingly important. In many cases where the broad needs of regulators are clear, participants may be well placed to design solutions that meet those needs in the most efficient manner thereby reducing compliance costs that are ultimately shared by end users in the real economy.

Conclusion

There is a long way to go before the Commission's proposals become reality but the direction of travel has been set. Now is the time for industry participants to make their views and supporting arguments clear to regulators as well as to member-states and European Parliamentarians who will shape the final legislation.

With an end-2012 deadline explicit in the G-20 commitments, political pressures could give rise to diminishing returns on well-reasoned arguments as that date approaches. Therefore, senior management teams need to ensure that their policy teams are asking the right questions of their business colleagues as to the implications of the proposals in the coming months.

It is imperative that firms are proactive in their response to these wide-reaching proposals. Given that important details of the new regulatory framework are yet to be determined, now is the time to assess the broader significance of the proposals and to identify the key areas that need to be kept under close review. Taking the time to understand the business lines and processes likely to be most strongly affected and the ease at which they will be able to evolve in line with regulatory developments is a key first step. Those firms that go through this exercise sooner rather than later will find that they are positioned to plan for the necessary changes to their operations, minimising business disruption and compliance costs. These firms will also find themselves well placed to identify the opportunities that will inevitably arise in a strengthened European single market ahead of their competitors.

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