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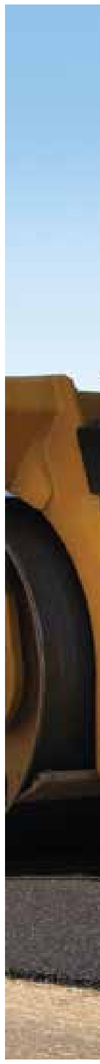

A new landscape for EU capital markets

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The landscape for EU capital markets is set to change radically 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.

Legislators are hoping that many of the benefits that MiFID brought to equity markets, such as lower transaction costs, reduced bid-ask spreads and faster trading times, will be extended to a wider range of asset classes. The reforms also seek to implement the commitments made to the G20 in 2009 to move more OTC derivative trading on to trading venues and to address the risks posed by the recent growth in dark trading and 'high frequency' algorithmic trading.

The investment management sector will face increased requirements under MiFID II/MiFIR, in particular relating to post-trade reporting, 'high frequency' algorithmic trading and investor protection. They will have new choices about where to execute their business and compliance costs are set to rise. But there is good news. Many of the new rules are designed to promote competition and support better price formation and should ultimately benefit the investment management sector and their clients.

New choices about where to execute business

Where and how investment managers execute their trades are set to change as regulators aim to bring more transparency to perceived opaque markets. A requirement to trade clearing eligible and sufficiently liquid derivatives on a trading venue will see large amounts of derivatives business move away from OTC execution to venues. Much of this business is expected to be executed on a new type of venue - the Organised Trading Facility (OTF). This will be available only for trading non-equities and is largely seen as equivalent to the U.S. swap execution facility.

Support for price formation

Changes to the transparency regime under MiFID II/ MiFIR are likely to be largely positive for the investment management sector, although much will depend upon how the regime is calibrated in the technical standards that will be developed by the European Securities and Markets Authority (ESMA). The pre- and post-trade transparency regime introduced for equities under MiFID will be expanded to equity-like instruments (e.g. depositary receipts and exchange traded funds) and to non-equities (e.g. bonds, structured finance products, emission allowances and derivatives traded on a trading venue). This is likely to promote price formation and narrow bid-ask spreads in these markets, as was observed in equity markets following the introduction of MiFID. The reforms also seek to limit dark trading in equities through introducing a cap on the use of some of the waivers from the equity pre-trade transparency regime.

However, while increased transparency is often positive for markets, too much transparency in less liquid markets can have a negative impact on liquidity. If market participants become concerned that others might be able to guess their investment strategies, they may be less willing to trade. This is particularly pertinent for asset managers when trading large orders on behalf of their clients. Consequently, it will be important that ESMA, in calibrating the transparency regime, is able to strike the right balance between ensuring investors receive the information they need, without harming liquidity. Investment managers will have a better view of post-trade data with the introduction of a regime for an EU consolidated tape. This is intended to be provided on a commercial basis, but if take-up by firms is not of the quality envisaged by the Commission, it may appoint a consolidated tape provider through a public procurement process. Investment managers will also need to comply with the expanded post-trade reporting regime. They will need to have streamlined and effective post-trade infrastructure, as well as robust data governance arrangements.

Competition driving improvements for market participants

In a break-up of the so-called 'vertical silos' between trading venues and central counterparties (CCPs), CCPs will be required to clear financial instruments on a non-discriminatory and transparent basis regardless of where the transaction is executed and, in return, trading venues will be required to provide trade feeds on a non-discriminatory and transparent basis upon request to CCPs wishing to clear transactions. For the investment management sector, the increase in competition between trading venues and CCPs may drive down transaction costs and improve services to market participants. However, the ability of trading avenues, CCPs and competent authorities to deny access in certain circumstances, as well as transitional arrangements, could potentially hinder the development at the regime.

Increased requirements for firms engaging in high frequency algorithmic trading

Firms engaging in high frequency algorithmic trading will need to have suitable systems and risk controls for trading systems and report certain information to regulators, including on their algorithmic trading strategies. They will need to test and monitor trading systems and have effective business continuity arrangements in place. Their trading activity will also be subject to greater scrutiny by trading venues, with venues able to limit high frequency algorithmic trading and charge higher fees for cancelled orders or for high frequency traders.

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Changes to distribution and focus on product governance

Designed to strengthen investor protection, a number of the reforms will affect how products are advised on and sold. Investment advisers will need to disclose increased information to investors on the services provided and on total costs and charges, with independent investment advisers banned from receiving and retaining third-party remuneration or benefits (with exceptions for some non-monetary benefits). Investment managers will need to consider how potential changes to independent investment advice business models in some EU countries may affect distribution of their products.

More products will be classed as complex and subject to the appropriateness regime, so that firms will need to apply additional checks when selling them. ESMA, the European Banking Authority (EBA) and competent authorities will also receive temporary product intervention powers. All this could potentially drive providers and distributors towards less complex products and dampen innovation.

Investment managers will also need to comply with extensive product governance requirements. They will need to have a product approval process that specifies an identified target market of end clients, with a compatible distribution strategy. Responsibility will not stop once the product is with the distributor. There will also be increased focus on conflicts of interest, in particular where they may be driven by third-party inducements or the incentive structures of staff.

What is next?

While the political agreement on MiFID II/MiFIR has set out the big picture of the reforms, the detail will still need to be filled in with ESMA technical standards and implementation of the Directive by Member States. The reforms are expected to enter into force in June/July this year and firms will then have until around Q1 2017 to comply.

To the **point**:

- The landscape for EU capital markets is set to change radically under new rules provisionally agreed in MiFID II/MiFIR
- The investment management sector will face increased requirements, in particular relating to post-trade reporting, high frequency algorithmic trading and investor protection. They will have new choices about where to execute their business and compliance costs are set to rise
- Many of the new rules are designed to promote competition and support better price formation, which should ultimately benefit the investment management sector and their clients. However, it will be important that ESMA, tasked with calibrating the pre-trade transparency regime in technical standards, is able to strike the right balance between ensuring investors receive the information they need, without harming liquidity
- The reforms are expected to enter into force in June/July this year and firms will then need to comply from around Q1 2017