



European Commission Consultation on the Review of MiFID

The Markets in Financial Instruments Directive (“MiFID”)¹ came into force in November 2007 and made significant changes to the regulatory framework of financial services within the EU, introducing a harmonised regime for the regulation of investment services. On 8 December 2010, the European Commission (the “Commission”) published its long awaited consultation paper (the “Consultation”) setting out a review of MiFID.² The proposals are intended to tie in with other recent international developments in the regulation of financial markets since the onset of the financial crisis, including the Dodd-Frank legislation in the U.S.³ and proposals in the EU in relation to the regulation of OTC derivatives and packaged retail investment products (“PRIPs”). The Consultation has been influenced by the Committee of European Securities Regulators (“CESR”) which conducted a number of consultations on specific aspects of MiFID and published resulting reports and technical advice.

We summarise below the Commission’s main proposals. Of particular note, the Commission proposes to introduce mandatory exchange trading requirements for standardised OTC derivatives, to extend the transparency and transaction reporting regimes and to make adjustments to the client classifications provisions. The proposals also envisage empowering supervisory authorities to ban certain investment services and activities in certain financial instruments and to intervene in derivative contracts.

Developments in Market Structures

Organised trading facilities

A number of the MiFID provisions, particularly in relation to transaction reporting and pre- and post-trade transparency requirements, currently apply to financial instruments admitted to trading on regulated markets, multilateral trading facilities (“MTFs”) and systematic internalisers (“SIs”). The Commission seeks to widen the scope of these provisions by introducing a new concept of an organised trading facility (“OTF”). This would encompass any facility or system operated by an investment firm or market operator that brings together buy and sell orders in relation to financial instruments on an organised basis. It is envisaged that this would capture

¹ The Markets in Financial Instruments Directive consists of the Directive 2004/39/EC of 21 April 2004 on markets in financial instruments, http://eur-lex.europa.eu/LexUriServ/site/en/oj/2004/l_145/l_14520040430en00010044.pdf, Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive, http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/l_241/l_24120060902en00260058.pdf and Commission Regulation (EC) No. 1287/2006 of 10 August 2006 implementing Directive 2004/39/EC as regards record-keeping obligations for investment firms, transaction reporting, market transparency, admission of financial instruments to trading, and defined terms for the purposes of that Directive, http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/l_241/l_24120060902en00010025.pdf.

² EU Commission public consultation: Review of the Markets in Financial Instruments Directive (MiFID) (8 December 2010), http://ec.europa.eu/internal_market/consultations/docs/2010/mifid/consultation_paper_en.pdf (comments deadline: 2 February 2011).

³ Dodd-Frank Wall Street Reform and Consumer Protection Act, <http://www.sec.gov/about/laws/wallstreetreform-cpa.pdf>.

broker crossing systems and interdealer broker systems but would exclude bilateral trades carried out on an ad hoc basis between counterparties that are not under an organised facility or system. The proposal to bring broker crossing systems within the MiFID transparency provisions is likely to be particularly controversial.

The Commission envisages that OTFs will become subject to certain general requirements as to authorisation, reporting, transparency, conflicts of interest, trade monitoring and other supervisory rules. It also proposes to introduce a new sub-regime for broker crossing systems under OTFs which would apply to all relevant financial instruments.

OTC derivatives

A key element of the Commission's proposals is the requirement that all trading in sufficiently liquid derivatives (likely to be determined by the European Securities and Markets Authority ("ESMA")) that are eligible for clearing be effected through a regulated market, MTF or OTF. This is consistent with the September 2009 G20 summit requirement that all standardised OTC derivative contracts be traded on exchanges or electronic trading platforms, where appropriate. Such a requirement is already included within the Dodd-Frank legislation in the U.S., but was not specified in the recent Commission consultation in relation to the regulation of OTC derivatives ("EMIR"),⁴ although that did, however, contemplate that most standardised OTC derivatives be cleared through central counterparties.

This is likely to be an area subject to a certain amount of discussion during the consultation process. Concerns have already been raised by some market participants that mandating exchange trading for certain instruments may have an adverse effect on availability and liquidity.

Other proposals in relation to market structures

- *Automated trading.* The Commission expresses concerns about the increasingly wide use of automated or algorithmic trading, in particular high frequency trading which it believes can pose threats to the orderly functioning of markets. It proposes to amend MiFID to define automated trading widely and to require that all high frequency traders over a specified minimum threshold be authorised and subject to regulatory supervision and specific organisational requirements including appropriate risk controls and arrangements.
- *Systemic Internalisers.* SIs are firms that are required under MiFID to publish firm quotes in shares admitted to trading on a regulated market. The Commission proposes to make the definition of SIs more objective with clear quantitative thresholds and non-discretionary criteria. SIs will be required to publish two-sided quotes (i.e., both buy and sell) and maintain a minimum quote size of at least 10% of the standard market size of any liquid share.
- *Alignment of organisational requirements.* The Commission proposes to further align the organisational requirements for MTFs with those for regulated markets and to require operators of regulated markets, MTFs and OTFs trading in the same financial instruments to cooperate and exchange information.

Pre- and Post-Trade Transparency

The pre-trade transparency requirements are aimed at providing investors with information about current trading opportunities. Post-trade transparency provides information for concluded trades helping market participants facilitate price formation and comply with their execution duties.

⁴ See Morrison & Foerster client alert Draft EU Regulation on OTC derivatives, CCPs and trade repositories (20 September 2010), <http://www.mofo.com/files/Uploads/Images/100920-Draft-EU-Regulation-on-OTC-Derivatives.pdf>.

Equity markets

In relation to pre-trade transparency, the Commission states that it is concerned with the increasing use of “dark pools” (trading systems where price and volume of orders are not displayed before the transaction is executed) which could undermine the quality of the price discovery mechanism. It therefore proposes to tighten existing waivers from the pre-trade transparency markets and have their uses monitored by ESMA.

In relation to post-trade transparency, the Commission proposes to reduce the maximum permitted delays to “as close to instantaneously as is technically possible” and to reduce the real-time reporting deadline from 3 minutes to 1 minute and, for the deferred publication regime of large transactions, to no later than the end of the trading day.

The Commission proposes to extend the MiFID transparency regime to shares admitted to trading on an MTF or OTF (in addition to those admitted for trading on a regulated market), with some calibration for those operating SME markets.

Equity-like instruments and non-equity markets

The Commission believes the pre- and post-transparency regime should be extended to several other financial instruments which are similar to shares, including depository receipts, exchange traded funds and company securities certificates.

It is also considering applying the pre- and post-transparency regime to all trades in bonds and structured products which have a prospectus or are admitted to trading on a regulated market or an MTF and all derivatives (including those traded OTC or on an OTF) which are eligible for central clearing or are reported to trade repositories under EMIR. The requirements are likely to be similar to that for shares but calibrated for specific asset classes and instruments, in particular in relation to post-trade transparency, timing of reporting obligations and thresholds. The Commission acknowledges that concerns have already been raised that increasing transparency in these areas could have a detrimental impact on liquidity.

To improve information on the trading levels outside regulated markets and MTFs, it is proposed that post-trade transparency reports should identify trades executed on OTFs and OTC.

Transaction Reporting

The Commission notes that MiFID currently applies transaction reporting requirements to all transactions in financial instruments admitted to trading on a regulated market (regardless of execution venue). To reflect likely changes to the Market Abuse Directive (“MAD”),⁵ it believes the MiFID transaction reporting and data storage obligations should be extended to transactions in financial instruments admitted to trading or traded on an MTF or OTF and depository receipts related to them or financial instruments whose value correlates thereto.

The Commission proposes extending the definition of “transaction” for reporting purposes to any agreement with a counterparty to buy and sell financial instrument(s) and to seek a common EU transaction reporting format and content. It would also require firms receiving, transmitting or otherwise handling orders but not executing transactions to transmit order details to the receiving investment firm and require reports to identify the person who made the investment decision (“client identifier”) and the trader within a firm who executed the transaction (“trader ID”).

⁵ Market Abuse Directive (2003/6/EC), <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2003:096:0016:0025:EN:PDF>. See European Commission Public consultation on a revision of the Market Abuse Directive (25 June 2010), http://ec.europa.eu/internal_market/consultations/docs/2010/mad/consultation_paper.pdf (closed 23 July 2010).

To seek to avoid firms having to report to different competent authorities, the Commission proposes to facilitate direct reporting by investment firms to a permanent EU database accessible to competent authorities. It also proposes that third parties reporting on behalf of investment firms must be approved by competent authorities as an Approved Reporting Mechanism (“ARM”) but provisions should be included to avoid double reporting obligations.

Investor Protection and Provision of Investment Services

Scope of the Directive

The Commission believes that investors should be entitled to the same level of protection irrespective of the location or nature of the service providers. Whilst maintaining the ability of national regulators to grant MiFID exemptions to certain firms, it is considering requiring that such firms be subject to certain MiFID equivalent provisions, including authorisation requirements, providing information to clients, suitability assessments, inducements and client reporting.

Consistent with its consultation paper on PRIPs,⁶ the Commission proposes that the MiFID conduct of business and conflicts of interest rules be extended to advised and non-advised sales of structured deposits. It also proposes that MiFID should apply to investment firms and credit institutions selling their own securities even if on a non-advised basis.

Conduct of business obligations

- *Execution-only exemption:* An aspect of MiFID that has generated considerable debate, including in relation to the PRIPs consultation, is the classification of complex and non-complex financial instruments. This is relevant in the context of non-advised “execution-only” services that can be provided to a client without the requirement for an “appropriateness” assessment to be carried out as to the knowledge and experience of the investor. Article 19(6) of MiFID specifies the instruments that are eligible for such exemption, including shares admitted to trading on a regulated market, bonds or other forms of securitised debt (in each case not embedding a derivative), UCITs and other non-complex instruments. The meaning of “other non-complex instruments” is clarified by Article 38 of the MiFID implementing directive. These provisions have the effect that many structured products in the form of structured notes are regarded as complex with all structured products in the form of UCITs being automatically non-complex.

The Commission outlines two possible reforms in this area. The first option is that relatively minor amendments are made to Article 19(6). These would include bonds and other forms of securitised debt only being regarded as non-complex if, in addition to not embedding a derivative, they do not incorporate a structure which makes it difficult to understand the risk involved. The Commission also suggests complex portfolio UCITs structures could cease to be automatically treated as non-complex. Alternatively, it is considering the abolition of the execution-only regime so that in relation to non-advised financial services, an appropriateness test would always need to be carried out to assess the knowledge and experience of retail investors. The second option is a radical move and will impose additional due diligence requirements on providers of such services to retail investors. The first option is also likely to give rise to a number of issues, not the least of which is how it is to be determined whether a structure is difficult to understand.

⁶ Working Document of the Commission Services (DG Internal Market): Consultation by Commission Services on legislative steps for the Packaged Retail Investment Products initiative (26 November 2010), http://ec.europa.eu/internal_market/consultations/docs/2010/priips/consultation_paper_en.pdf. See also Morrison & Foerster client alert: EU Commission further consultation on PRIPs (17 December 2010), <http://www.mofo.com/files/Uploads/Images/101217-Structured-Thoughts.pdf>.

- *Classification of clients:* The Commission proposes maintaining the existing classification system but making some adjustments, including excluding complex products from the eligible counterparty regime. Non-financial institutions and certain financial institutions would be excluded from being eligible counterparties. It also suggests abolishing (at least in relation to complex products) the presumption that professional clients have the necessary experience and knowledge. This could potentially increase the due diligence obligations on firms, particularly considering the possible abolition of the execution only exemption referred to above.
- *Other:* Other Commission proposals relating to conduct of business requirements include
 - (a) Modifying disclosure requirements in relation to inducements, including removing the option to provide prior disclosure in summary form. Certain inducements including third party inducements in relation to portfolio management and those in the context of an intermediary providing financial advice may be prohibited;
 - (b) Requiring intermediaries to inform investors whether any investment advice is given on the basis of an independent and full analysis and to impose certain obligations if this is the case;
 - (c) Imposing additional requirements to provide clients with further information prior to and after buying complex products;
 - (d) Introducing civil liability for investment services providers, enabling clients to seek damages against investment firms infringing MiFID rules;
 - (e) Adjusting certain best execution requirements, including requiring trading venues to produce data on execution quality on financial instruments they trade and introducing measures to seek to ensure that firms provide clearer and more meaningful information to their clients; and
 - (f) Making certain adjustments to tighten up exemptions for dealing on their own account.

Authorisation and organisational requirements

The Commission is contemplating strengthening a number of authorisation and organisational requirements, including extending the fit and proper criteria to all members of the board of directors, strengthening the involvement of the board in compliance, risk management and internal audit functions and imposing specific organisational requirements for portfolio management services. It also believes there should be a more consistent application of conflicts of interest rules across the EU. In view of some of the difficulties that have arisen in relation to establishing ownership of client assets during the financial crisis, it is seeking views on prohibiting title transfer collateral arrangements in relation to assets of retail clients and imposing additional requirements in relation to segregation of client assets. It is also considering more detailed and tailored requirements in relation to firms providing the service of underwriting and placing financial instruments.

Commodity Derivatives

To meet the G20 aim of improving the regulation, functioning and transparency of financial and commodity markets to address excessive price volatility, a separate chapter may be added to MiFID dealing with the functioning of the commodity derivatives market. To improve information available to regulators, organised trading venues admitting commodity derivatives to trading may be required to provide harmonised position information to regulators by type of regulated entity (and publicly disclose aggregated information). The requirement for publication of position information is likely to be controversial. Some exchanges are moving towards position reporting but others currently remain opposed to this move. Although firm position limits will

not be required, the additional supervisory powers referred to below could lead to competent authorities having the power to impose position limits.

The Commission also intends to review the existing exemptions from MiFID in relation to commodity firms dealing on their own account in financial instruments or providing investment services in commodity derivatives on an ancillary basis as part of their main business (where they are not a subsidiary of a financial group). It also seeks views on whether emissions allowances come within the definition of financial instruments under MiFID and believes a more in-depth study is needed on this issue.

Other Matters

The Consultation also considers the following matters:

- *Data consolidation.* To improve the quality and consistency of the publication of raw data, the Commission is considering requiring firms to publish post-trade reports through an authorised Approved Publication Arrangement. It proposes to establish a mandatory European consolidated tape to consolidate all trading data available in the EU and make it available at a reasonable price.
- *Regulatory framework and supervisory practices.* The Commission proposes abolishing, restricting or otherwise modifying the national discretion in relation to tied agents and their handling of client assets. It also proposes a common regime for telephone and electronic recording of client orders across the EU. It is also considering appropriate powers by member states to impose sanctions including criminal sanctions, whistleblowing programmes and public disclosures of sanctions imposed. The Commission also proposes a harmonised EU regime for the access of third-country investment firms and market operators to EU financial markets, subject to a strict equivalence regime.
- *Reinforcement of supervisory powers.* The Commission seeks views on introducing the power for it to ban certain investment services and activities in certain financial instruments to protect investors, market stability or integrity. It proposes to bestow competent authorities with power to intervene in a derivative contract, including commodity derivatives, and requiring reduction of the size of positions or imposing position limits. The extent of these powers arguably go further than those proposed in other jurisdictions, including under the Dodd-Frank provisions, and are likely to be controversial.

Next Steps

The consultation closes on 2 February 2011, and the Commission will use the responses to prepare a formal legislative proposal to be adopted in mid-May 2011.

The Commission's proposals are ambitious in scope and seek to extend the reach of the MiFID framework quite considerably to cover new trading venues, trading methods and financial instruments, with flexible definitions which are designed to capture future innovations. As such, the proposed changes are likely to further drive the transformation of trading in financial instruments, particularly those executed off the exchange. A great deal of regulatory coordination may also be needed to avoid potentially overlapping or conflicting requirements under various other EU directives including MAD, EMIR and the Prospectus Directive,⁷ which are also undergoing reviews or amendments.

⁷ Prospectus directive (2003/71/EC), <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2003:345:0064:0089:EN:PDF>.

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