

# Widening the net

Recently announced EU reforms introduce yet another set of compliance considerations for traders, and the possibility of greater regulatory intervention

**O**n January 14 2014, the European Parliament and European Council reached agreement in principle on the revised Markets in Financial Instrument Directive (Mifid II). The announcement signaled an important milestone in a long and difficult road to a major overhaul of a pillar of the EU financial regulatory framework.

Mifid II will mark a significant change in the mindset of EU regulatory authorities. Its scope will be expanded to cover a greater range of products and entities, there will be a much greater focus on investor protection, and a more intrusive and interventionist approach to regulation. There will also be significant changes affecting organised trading of financial instruments, pre- and post-trade transparency (among other aspects of market infrastructure), and a greater focus on enforcement and supervision by national regulators.

## What is Mifid II?

Mifid I became effective in November 2007 and represented a significant overhaul of the previous Investment Services Directive. It provides a framework for the authorisation of investment services and activities in the EU and created a so-called passport. This enables firms authorised in one EU member state to carry out relevant services and activities in other EU member states without further authorisation.

From the early days of Mifid, the European Commission contemplated a review of its provisions and impact on financial markets. The onset of the financial crisis had a major

result, it has sometimes been overshadowed by other developments including the European Market Infrastructure Regulation (Emir) relating to derivatives.

Mifid II comprises two distinct elements: a recast Mifid Directive and a new Markets in Financial Instruments Regulation (Mifir) which deals, in particular, with provisions relating to market infrastructure, including transparency and exchange trading requirements. Unlike Mifid, Mifir will be directly applicable in member states without the need for implementing legislation, limiting the ability of legislators and regulators in individual jurisdictions to put their own interpretation on the requirements and therefore representing greater centralisation of power within the EU.

## Market infrastructure

A key element of Mifid II is the extension of trading and reporting provisions to a much wider range of organised trading. Today, Mifid is limited to: transactions listed or traded on regulated markets or multilateral trading facilities (MTFs); and transactions executed by investment firms acting as so-called systematic internalisers, which execute client orders by dealing on their own account on an 'organised, frequent and systematic' basis outside a regulated market or MTF. Mifid II will introduce a new form of regulated organised trading platform referred to as an organised trading facility (OTF).

The definition of OTF will cover any system or facility (other than a regulated market or MTF) in which third-party buying and selling interests in financial instruments interact to result in a contract within the scope

Mifid II such as best execution and investor protection provisions. OTF operators will also be prohibited from executing trades against their own proprietary capital, and will not be permitted to act as systematic internalisers in an OTF that they operate. The OTF rules will only apply to non-equity instruments (including derivatives) traded on such platforms. Investment firms operating an internal matching system for executing client orders in shares, depositary receipts, exchange-traded funds and similar instruments will need to be authorised as a MTF.

Mifid II also gives effect to the commitment of the G20 leaders at Pittsburgh in 2009 for standardised derivative contracts to be traded on exchanges or electronic trading platforms where appropriate. Under Mifir, all derivatives subject to a clearing obligation under Emir must be traded on a regulated market, MTF or OTF subject to the European Securities Market Authority (Esma) determining the class to be subject to a trading obligation. Esma will determine whether a class is sufficiently liquid to be subject to the trading obligation taking into account factors such as the average frequency and size of trades, and the number and type of market participants.

A particularly controversial aspect of the Mifid II negotiations was the proposal by certain jurisdictions, including the UK, to require non-discriminatory access to trading venues and central counterparties, and benchmarks for trading and clearing purposes. Other jurisdictions, including Germany, raised concerns as to the impact on liquidity and possible market fragmentation. Mifid II will include provisions for open access but this will be subject to a 30-month transitional period. This is likely to challenge the existing vertically integrated model operated by many exchanges and require trading houses to clear trades transacted on other markets.

Mifid II will also seek to address concerns in relation to algorithmic and high-frequency trading, with a focus on the opaqueness of the market and its potential to create systemic risks. Algorithmic traders will be subject to regulation under Mifid and will be required to provide liquidity when pursuing a market making strategy. Firms providing direct electronic access to a trading venue must have systems and controls in place that are designed to prevent trading that could give rise to market abuse or a disorderly market.

## Extension of transparency requirements

Mifid II will greatly expand the requirements for pre- and post-trade transparency – the provision of information about trading opportunities, and prices and details of completed trades. Today these are limited to

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impact on the review and resulted in much more comprehensive proposals for reform than had originally been contemplated. In this regard, the review of Mifid has been carried out against the backdrop of a complete overhaul of EU financial regulation. As a

of Mifid. This will include a wide range of organised trading activities including broker crossing systems and swap execution facilities. OTF operators will retain some discretion over transaction execution and will therefore be subject to conduct of business rules under

## More on Mifid II

See p17 for the results of last month's Market Poll which asked readers which aspect of Mifid II is of greatest concern

shares admitted to trading on a regulated market. Mifid II extends these rules to shares and equity-like instruments (including depositary receipts and exchange-traded funds) traded on a regulated market, MTF or OTF.

Mifid II will also extend the transparency regime to non-equity instruments including bonds, structured finance instruments, emissions allowances and derivatives traded on a regulated market, OTF or MTF. The requirements will, however, be calibrated for different asset classes.

National regulators can continue to grant waivers for publication of pre-trade data, but they must pre-notify Esma, which will issue an opinion as to the compliance of the waiver with Mifid II. For both debt and equity instruments, waivers can be granted for large scale transactions and orders held in a transaction management facility. For non-equities, regulators can grant waivers for: financial instruments for which there is not a liquid market; derivatives not subject to the trading obligation; and indications of interest in request-for-quote and voice trading systems above a specified size where liquidity providers would otherwise be subject to undue risk. For equities, waivers may be granted for certain reference price trading and negotiated transactions subject to a four percent venue and eight percent global cap. Subject to Esma monitoring, competent authorities may also permit deferral of the post-trade publication requirements based on the type or size of the transaction.

### Increase in scope of regulation

In addition to the new OTF rules and increased scope of the transparency requirements, Mifid's regulatory purview is increased in a number of important respects. Consistent with the European Commission's proposals regarding packaged retail investment products (Prips), advised and non-advised sales of structured deposits by credit institutions will be subject to conflicts of interest, conduct of business and other organisational requirements. Today's Mifid exemption in relation to dealing on own account in respect of an activity ancillary to an entity's main business (not being the provision of investment services) will not now apply to the execution of client orders, including those on a matched principal basis.

Regarding commodities dealers, the existing Mifid exemption for firms whose

main business consists of proprietary dealing in commodities and/or commodity derivatives will be deleted. Further provisions will result in greater regulation and supervision of commodity markets, including requirements for trading venues to adopt arrangements to support liquidity, prevent market abuse, and facilitate orderly pricing and settlement. Local regulators will be able to set position limits for commodities under a methodology to be published by Esma. Mifid will also now apply to secondary spot trading in emissions allowances.

### Product intervention

Mifid II gives Esma the power to take action to temporarily prohibit or restrict the marketing, distribution or sale of certain financial instruments (or instruments with certain features). It can do this if it's necessary to address a threat to investor protection, the orderly functioning and integrity of financial markets, or EU financial stability (taking into account possible detriments to market efficiency and the potential for regulatory arbitrage). Competent authorities will also have the power to restrict the sale or marketing of financial instruments in their member states on the same grounds as Esma, where such action is proportionate. Esma is also obliged to seek to coordinate action taken by competent authorities who must also consult with other authorities in jurisdictions likely to be affected by such action.

Esma will also have powers to intervene in relation to derivatives positions to address threats to the stability of the EU financial system, or the orderly functioning and integrity of markets. This may include information requests on the size or purpose of a position, requiring an entity to reduce the size of a position, or limiting its ability to enter into a commodity derivative.

It is not, however, clear that these provisions will grant national regulators significant new powers. A number of EU jurisdictions, including the UK under the Financial Services Act 2012, have introduced legislation that grants local regulators various powers regarding financial instruments, particularly those aimed at retail investors, including the ability to ban or restrict the sale of such products.

### Third country firms

Under the existing Mifid regime, there is no harmonised approach to the provision of investment activities in the EU by non-EU entities. The terms on which such firms can operate in individual member states are a matter for national regulators and there is no ability for services provided by a non-EU

entity in one member state to be passported into another.

After much contentious debate, it was agreed during Mifid II negotiations that in relation to the provision of investment services and activities by non-EU entities to professional clients and eligible counterparties in the EU, a harmonised regime will apply. Such services can be provided throughout the EU without the need for the entity to establish an EU branch, provided the European Commission has made a determination that the relevant non-EU jurisdiction has requirements equivalent to Mifid II. The new regime is subject to a transitional period of three years, during which time existing national regimes will continue to apply.

Investment services and activities provided to retail clients by non-EU entities will continue to be subject to approval by the relevant member state in which services are provided. No EU passport will apply in this case.

Concerns are likely to remain that the equivalence requirements could result in some non-EU firms providing investment services in the EU today, will be unable to do so after the end of the transitional period. This is coupled with concerns that some non-EU jurisdictions could impose reciprocal requirements that may deny EU firms access to some markets.

### Combined effect of Mifid II rules

Mifid II will herald a sea change in the regulation of investment services and activities in the EU. Its impact will be wide-ranging and the combined effect of the provisions outlined above is difficult to predict. Many welcome the prospect of greater transparency for a wider range of financial transactions and greater competition in relation to those providing trading and clearing services. Concerns remain, however, that widening the Mifid framework to a greater range of trading venues and financial instruments could have a negative impact on market liquidity and in some cases limit choice and increase costs for investors. Much of the detail remains to be filled in under level two legislation and Esma technical standards, and the full picture will not emerge until this process is complete. It seems unlikely that Mifid II will become fully effective until 2016. However, in many areas, including the requirement for exchange trading of derivatives, it will be necessary for firms to be taking steps at a much earlier stage to ensure compliance with the new regime.

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Read online at [iflr.com/MifidII](http://iflr.com/MifidII)