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The Impact of the MiFID Review, MAD Review and EMIR on Regulated Investment Firms

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On 20 October 2011, the European Commission (the **Commission**) published its legislative proposals for the review of the Markets in Financial Instruments Directive (**MiFID**) and the Market Abuse Directive (**MAD**). This followed the publication, in September 2010, of a draft European Market Infrastructure Regulation (**EMIR**), which is currently being negotiated through the trilogue process.

Set out below is a high level review of the impact of the Commission's legislative proposals on regulated investment firms. For a discussion of the effects of the MiFID and MAD reforms on energy and commodity traders, see our previous alert *Replacements for MiFID and MAD - key issues for commodity and energy traders*.

MiFID II

The Commission's proposals comprise a draft Directive (**MiFID II**) and a draft Regulation (**MiFIR**), which together will replace MiFID. The proposals aim to increase the efficiency, resilience and transparency of financial markets and to strengthen the protection of investors. Whilst the details of the reform package are subject to further amendment, it is clear that MiFID II and MiFIR will have a significant impact on investment firms.

Organised Trading Facilities (OTFs)

MiFID currently covers multilateral trading facilities (**MTF**s) and regulated markets. The proposals introduce Organised Trading Facilities (**OTF**s) as a third category of trading venue, designed to catch dark liquidity pools - trading systems which are not subject to pre-trade transparency requirements. Investment firms operating OTFs will need to be authorised under MiFID II and MiFIR.

The definition of an OTF is very broad. It is designed to cover broker-crossing systems, inter-dealer broker systems which bring together third party interests, dark pools and other currently unregulated organised trading systems. Although the proposals aim to create a level playing field for the regulation of all organised trading, there will be some differences in the treatment of OTFs compared to other kinds of trading venue. Whereas regulated markets and MTFs are characterised by the non-discretionary execution of transactions and are therefore subject to pre-determined rules, operators of OTFs will have a degree of discretion over how a transaction will be executed. However, OTFs will be subject to investor protection, conduct of business and best execution requirements.

To avoid conflicts of interests arising in OTF transactions, MiFID II introduces the following requirements which apply to OTFs only:

- Investment firms operating as OTFs will not be authorised to use proprietary capital when executing client orders.
- An investment firm will be unable to act as a systematic internaliser in an OTF operated by itself.
- Firms which operate OTFs will need to ensure that the OTF does not connect with another OTF in a way which enables orders in the respective OTFs to interact.

Transparency

The proposals extend the existing transparency rules under MiFID to instruments admitted to trading on OTFs. The rules are also extended to cover additional asset classes such as bonds and structured finance products admitted to trading on a regulated market or for which a prospectus has been published, emission allowances and derivatives admitted to trading or which are traded on an MTF or OTF. The application of the transparency rules will be calibrated to the particular asset class and type of trading undertaken by an investment firm. Specific transparency rules for firms trading over-the-counter (**OTC**), such as systematic internalisers, are also proposed.

MiFIR will require investment firms to make public trade reports through a new Approved Publication Arrangement (**APA**). Furthermore, investment firms which operate regulated markets, MTFs or OTFs, will be required to make post-trade information available free of charge 15 minutes after the execution of the transaction and to offer pre- and post-trade data separately. It is hoped that the new system will reduce the overall cost of data consolidation and improve the quality of OTC data.

Transaction reporting

Under MiFIR, investment firms which execute transactions in financial instruments will be required to report details of such transactions to the regulator as quickly as possible, and no later than close of business the following working day. Such firms will also need to maintain records of all transactions in financial instruments which they have carried out, for a five year period.

The reporting obligation is extended to catch all financial instruments except for those (i) not admitted to or traded on an MTF or OTF, (ii) whose value does not depend on the value of a financial instrument admitted to or traded on an MTF or OTF, and (iii) which cannot have an impact on an instrument admitted to or traded on an MTF or OTF. Records must include details of the names and numbers of instruments bought or sold, the quantity, date and time of execution, the identity of the investment firm's clients and of the persons responsible for the execution of the transaction (e.g. the traders) and the transaction price. Provision is made to avoid double reporting under MiFID and EMIR.

Position reporting and limits

In an effort to support liquidity, orderly pricing and settlement conditions, and to prevent market abuse, the proposals require regulated markets, MTFs and OTFs to apply strict position limits on investment firms which enter into commodity derivatives contracts. Investment firms may be made to explain or reduce their position.

MiFID II requires that regulated markets, MTFs and OTFs which admit to trading or trade commodity derivatives or emissions allowances, report on a weekly basis to the competent authority on the positions held by different categories of traders, and provide further detailed position reports on request.

Exempt activities - commodities and commodity derivatives

Under the proposals, the exemption in article 2.1(k) for commodity and commodity derivatives traders who "deal on own account" has been removed. However, for investment firms, which are already regulated for other investment activities, the amendment will have a limited impact. The implications are greater for firms currently exempt from MiFID on the basis of article 2.1(k) who will either need to become authorised or find an alternative exemption to rely on.

The removal of article 2.1(k) and the narrowing of the exemptions in article 2.1(d) and (i) may have an impact on client classifications. Under the current system, investment firms are able to classify or "opt up" clients who fall outside MiFID as professional clients, with relative ease - clients are required to satisfy a qualitative test only. It is more difficult to opt up clients in respect of MiFID business, as this requires the fulfilment of both a qualitative test, based on number and volume of transactions, and a quantitative test. It is likely that more firms will be brought within the scope of MiFID II as a result of the proposals, and will therefore find it harder to opt up retail clients. Consequently, such firms will face higher compliance and risk costs in complying with the more burdensome conduct of business requirements relevant to retail clients.

Other changes under MiFID II

Other key changes introduced by MiFID II are set out below:

- ***Trading of derivatives***: Certain derivatives contracts, to be determined by the European Securities and Markets Authorities (ESMA), will need to be traded on a regulated market, MTF or OTF and will be subject to a clearing obligation. Firms must be given non-discriminatory access to clearing services.

- ***Supervision***: National regulators, in coordination with ESMA, will have powers to ban financial products and activities, for example where there are threats to the orderly functioning of financial markets.

- ***Custodianship***: Under MiFID II, the safekeeping and administration of financial instruments, and related services such as cash/collateral management, will be an investment service, rather than an ancillary service, under MiFID II.

- ***Third-country firms***: The proposals will harmonise the rules applicable to third-country firms providing services in the EU. Third-country firms will be able to provide services into or establish a branch in the EU provided that they pass an equivalency test, to be devised by ESMA. Non-EU firms will need to establish branches in order to provide retails services in the EU.

- ***Investor protection***: Investment firms will be required to provide certain information to clients when offering investment advice, and to specify whether the advice is provided on an independent basis according to criteria set out in MiFID II.

- ***Algorithmic trading***: Firms engaged in algorithmic trading will need to establish effective systems and risk controls to ensure that their trading systems are resilient, have sufficient capacity and are subject to appropriate trading thresholds to prevent the system from creating or contributing to a disorderly market.

- ***Eligible counterparties***: firms must act honestly, fairly and professionally in their relationship with eligible counterparties and must communicate in a way which is fair, clear and not misleading.

MAD II

The Commission's legislative proposals for the reform of MAD consist of a new Market Abuse Regulation on insider dealing and market manipulation (**MAR**) and a new Market Abuse Directive on criminal sanctions for insider dealing and market abuse (**MAD II**).

MAR aims to create a single, EU-wide rulebook for market abuse and to broaden the coverage of the EU rules. To this end, MAR extends the scope of the market abuse framework to cover financial instruments which are admitted to trading on an MTF or an OTF in at least one Member State, as well as other categories of behaviour.

Set out below is a summary of the principal changes proposed under MAD II and MAR.

Criminal sanctions for insider dealing and market abuse

MAD II would require Member States (with the exception of the UK and Ireland which have treaty opt-outs, and Denmark, to which MAD II does not apply) to introduce criminal sanctions for intentional insider dealing or market manipulation, and for inciting, aiding and abetting or attempting to commit either offence.

Insider dealing

MAR extends the definition of inside information to include a new category: non-price sensitive information. This will cover all non-public information which, if it were available to a reasonable investor who regularly deals on the market and in the particular financial instrument, would be regarded by that investor as relevant when deciding the terms of a transaction.

Market manipulation

The prohibition on market manipulation contained in MAD is reproduced in MAR. However, MAR extends the definition of market manipulation to cover not just orders and transactions, but "any other behaviour" that may give false or misleading signals or secure prices at artificial levels or which employs a fictitious device or other form of deception.

A new offence of attempting to manipulate the market has been introduced. The possibility of establishing a defence based on established market practices is removed. This is subject to a 12-month transitional period for previously notified practices.

Disclosure

The obligation on issuers of financial instruments to inform the public as soon as possible of inside information which directly concerns them will not apply to the new category of non-price sensitive inside information.

As under MAD, firms can delay the publication of inside information in order to protect their legitimate interests, but must inform the regulator of the delay immediately after the information is disclosed to the public.

Under MAR, the regulator will be able to authorise the delay of the publication of systemically important inside information where it is in the public interest to do so.

The disclosure obligation will not apply to issuers who have not requested or approved trading of their financial instruments on a regulated market, an MTF or an OTF.

Reporting managers' transactions

MAR will require the reporting of managers' transactions including the lending or pledging of financial instruments (shares, derivatives or other financial instruments linked to them, and emissions allowances) and transactions undertaken by or on behalf of portfolio managers. The information will need to be made public within two business days after the day on which the transaction occurred. Transactions totalling less than €20,000 over a calendar year will not need to be reported.

Other changes under MAD II

Other key changes introduced by MAD II are set out below:

- ***Scope***: EU emissions allowances and spot commodity contracts are brought within the scope of the market abuse regime.
- ***Suspicious transactions***: The duty on firms to submit suspicious trading reports is extended to cover suspicious orders.
- ***Insider lists***: The obligation on issuers of financial instruments to maintain insider lists will not apply to firms whose financial instruments are admitted to trading on SME growth markets (as defined under MiFID).
- ***Prevention of market abuse***: Firms which arrange or execute transactions in financial instruments will need to have in place systems to detect and report to the regulator transactions and orders that might constitute market abuse. Firms which operate regulated markets, MTFs or OTFs will be required to put similar arrangements and procedures in place.

European Market Infrastructure Regulation (EMIR)

EMIR proposes the following measures which would apply to investment firms:

- ***Trading of OTC derivatives***: All standardised OTC derivatives will need to be traded on exchanges and cleared through a central counterparty (**CCP**) by the end of 2012. ESMA would be responsible for the identification of contracts subject to the clearing obligation. Firms that enter into OTC derivatives contracts which are not cleared by a CCP will be subject to different risk management techniques, including the requirement to hold more capital.
- ***Reporting***: Investment firms will be required to report to a trade depository the details, including the parties, beneficiaries, and main characteristics, of any OTC derivatives contract they have entered into, no later than the working day following the execution, clearing or modification of the contract. If the trade repository is unable to record the details of the contract the firm must report the details to the regulator.
- ***Third countries***: CCPs established in a third country, and recognised by ESMA, may provide clearing services to firms established in the EU.

The following points were established during recent trilogue negotiations on the draft text of EMIR between the European Parliament, the Council of Ministers and the Commission.

- ***Phase-in***: Phase-in provisions will not be linked explicitly to frontloaded contracts but will determine 'the timeframe in which counterparties or categories of counterparties become subject to the clearing obligation'.
- ***ESMA eligibility determination***: It is possible that the final version of the Regulation will require ESMA to take account of the international consensus in determining the eligibility of contracts for the clearing obligation.
- ***Authorisation of CCPs***: The European Parliament is pushing for a more prominent role for ESMA in the process of authorising CCPs.

- ***Indirect clearing***: It seems likely that the existing definition of "client" will be retained, meaning that indirect clearing will not be possible under EMIR.

The next trilogue on EMIR is scheduled for 28 November 2011, although there is some suggestion that this may be brought forward. It is unlikely that this will be agreed before Christmas.

Implementation

The timeframe for the implementation of the MiFID and MAD reforms is unclear. The proposals will now pass through the Commission and European Parliament for negotiation and amendment, but are unlikely to apply until two years after their adoption and publication in the Official Journal, with the exception of certain provisions in MiFIR which will have effect on publication. The Directives will need to be transposed in the national laws of Member States which will delay full implementation of the reforms further. A final text of EMIR is expected in late-2012.

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