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Client Alert
Commentary

Latham & Watkins Financial Regulatory Practice 27 February 2020 | Number 2600

MiFID Refit — Commission Consults on Review of MiFID II Framework

The consultation provides a key opportunity for market participants to provide feedback on the regime.

Key Points:

- The consultation covers a broad range of MiFID topics and, while framed as a questionnaire, contains various implicit and explicit policy proposals for change.
- As well as examining how certain areas of the existing regime could be better calibrated, the consultation considers how the MiFID framework might need to adapt to address new developments and concerns, such as digitalisation and climate change risk.

On 17 February 2020, the European Commission launched a public consultation on its review of the MiFID II framework. The MiFID II Directive and MiFIR both contain various mandatory review provisions, requiring the Commission to report to the European Parliament and the Council on many aspects of the regime during 2020. As part of this process, ESMA has already launched a number of consultations on specific areas, which will feed into the Commission's reports. This consultation is complementary to ESMA's work, and will also inform the Commission's reports, which could ultimately lead to legislative change. The consultation will run until 20 April 2020.

The Commission divides its paper between priority areas and non-priority areas for review, as well as including some general questions on the overall functioning of the MiFID framework and offering market participants the opportunity to provide feedback on any other areas that they consider require review.

A large section of the priority areas part of the consultation is dedicated to the proposal to create a consolidated tape, but other priority areas include various investor protection topics and the commodity derivatives regime. As well as using the paper to consider well-known areas of MiFID that have attracted criticism and debate, the Commission also opens up discussions on how MiFID II might need to be modernised. For example, the Commission considers how some of the MiFID II provisions need to be updated to accommodate the EU's Digital Finance and Sustainable Finance workstreams.

The consultation is not a full review of MiFID, but it is an extensive exercise that is likely to lead to important changes. In some areas, it proposes rolling back some of MiFID's more controversial provisions, but such changes tend to be at the margins. In other areas, the consultation focuses on continuing the MiFID II project: applying protections to professional investors, improving transparency (especially in non-equity markets), and looking at the regulation of new products and technologies.

Investor protection

Proportionate investor protection

The consultation picks up on the December 2019 European Council conclusions on the deepening of the Capital Markets Union, which invited the Commission to consider introducing new categories of clients, improving direct access to simple financial instruments (*e.g.*, plain vanilla bonds, index ETFs, and UCITS funds) when proportionate and justified, and ensuring adequate investor protection for retail clients in relation to complex products. The Commission is now seeking to understand the challenges that different categories of investors are confronted with when purchasing financial instruments in the EU, in order to evaluate where adjustments would be needed.

The Commission is exploring which requirements might be amended to facilitate direct access to simple financial instruments, focusing on product governance, costs and charges requirements, and conduct requirements. This includes considering whether the product governance regime is inhibiting access to products and could be applied in a more proportionate way, particularly to non-complex and non-retail focused products. The Commission is also exploring whether enhanced investor protection measures are needed in the case of complex products sold to retail clients.

Ex-ante cost disclosures

The Commission is exploring the usefulness of the ex-ante cost disclosures in the case of professional and ECP clients. The Commission notes that a “wide range of stakeholders” consider these disclosures to be a mere administrative burden, given they are aware of the current market and pricing conditions. The Commission is therefore consulting on whether clients could opt out unilaterally from ex-ante cost information obligations and whether there should be conditions attached to this.

Sustainability transition

The Commission is revisiting its rules requiring the provision of information in a “durable medium”, based on its Green Deal and Sustainable Finance agenda and the fact that access to financial markets is typically via online tools. The rules currently allow the use of electronic formats (*e.g.*, email), but also permit paper-based information. The Commission is seeking views on the phase-out of paper-based information and feedback on how this could be implemented (*e.g.*, a general phase-out over a 5-10 year period and/or explicit opt-outs for retail clients).

EU-wide database of investment products

The Commission is seeking feedback on the introduction of an EU-wide database for investment products to address a perceived desire from retail investors to compare product information (namely costs) in a transparent way. In this context, the Commission is seeking views on which products it should prioritise for inclusion in an EU-wide database (*e.g.*, all transferable securities, PRIIPs, and/or UCITS).

Client categorisation

The Commission is considering the introduction of a new client category of “semi-professional”, which would capture high net worth or sophisticated investor types. The rationale is that this may make it easier for those categories of retail investors to participate in the capital markets, which could involve a tailor-made investor protection regime for these clients. The Commission provides the following examples in this regard: (i) suitability and appropriateness; (ii) costs and charges; and (iii) product governance. It would also be interesting to see whether this client type would be exempt from some of the more onerous retail-driven requirements under the PRIIPs KID Regulation.

The Commission is consulting on lowering the quantitative threshold for a professional client's investment portfolio from €500,000, which may be an alternative to creating a new regime for semi-professional investors.

The creation of a new (fourth) category of client is likely to create interest amongst private banks and online investment firms, but it is difficult to see how much of an advance this will be unless the application of rules such as costs and charges and product governance to professional investors is also addressed.

Product governance

The Commission is consulting on a number of proposals to simplify the MiFID II product governance regime, including restricting the scope of the regime to carve out high denomination products and products that are only eligible for distribution to qualified investors, and expressly permitting distribution of products to retail clients in the negative target market on the basis of express client instructions. The Commission is also considering limiting the application of the regime to complex products only.

Taken together, the Commission's focus is clearly on increasing retail client access to products. However, these proposals are also relevant for wholesale business, as they have the potential to de-scope certain non-retail and non-complex products from the regime.

Investment advice

Akin to the UK's regime that came into force under the Retail Distribution Review, the Commission is consulting on an outright ban on inducements paid to independent investment advisers, since feedback from consumer associations indicates that the inducements regime is not sufficiently dissuasive to prevent conflicts of interest in the distribution process.

The Commission is also considering a new, potentially exam-based, certification requirement for staff providing investment advice, to address the issues resulting from diversified national educational and professional systems.

Distance communications

The Commission picks up on the practicalities of sending clients ex-ante costs and charges information prior to executing an order that is placed over the phone, which delays the immediate execution of the order. The Commission highlights that this, together with the telephone recording requirements, has led to some banks ceasing telephone-based services altogether. The Commission is therefore considering a rule change to allow the provision of costs and charges information after the execution of a transaction in the case of distance communications (via telephone, in particular).

Best execution

The Commission is seeking market feedback on the quality of best execution reports to assess whether the provision of information (*e.g.*, on top five trading venues) is useful to investors. There has been significant criticism from the industry about the (lack of) benefit this information provides.

Research

MiFID II brought in new rules on research unbundling, requiring asset managers to pay for research separately from execution costs. The Commission is particularly focused on an apparent consequential decline in research coverage of small- and medium-size enterprises (SMEs), which it states have suffered a reduction in coverage with potential knock-on impact on liquidity and the number of European IPOs. Accordingly, the Commission is consulting on a number of ways to overhaul the MiFID regime as it applies to SMEs, including:

- Carving out SME research providers and independent research providers from the unbundling rules
- Introducing rules to prevent under-pricing and ensure research is paid for on a reasonable commercial basis
- Amending the rules on free trial periods
- Encouraging public or market operator financing of SME research production
- Considering the use of artificial intelligence to assist in generation of SME research
- Creating an EU database of publicly available SME research, potentially developed by ESMA
- Liberalising the rules on issuer-sponsored research

If adopted, these proposals would represent a substantial relaxation of the regime as it applies to SME research. Interestingly, many of these proposals pick up on those published by the French regulator, the Autorité des Marchés Financiers (the AMF), in January of this year, which also presented a number of substantial amendments and relaxations to the regime targeted at supporting the French research industry. The MiFID II research regime was heavily influenced by the FCA, and so the Commission's proposals represent continued increasing potential for divergence in this area in the wake of Brexit.

The consolidated tape

MiFID II contemplated the creation of an EU consolidated tape, but one has not emerged. Therefore, the consultation describes how one could be created. Drawing on previous ESMA recommendations, and a recent European Commission workshop, the key aspects of the proposals include:

- Using a competitive appointment process to select an exclusive provider for a 5-7 year period
- Making contributions from trading venues mandatory and Approved Publication Arrangements free of charge, in return for a revenue share from contributing entities judged on the basis of price forming trades
- Mandatory consumption of the consolidated tape by users (without any clarity as to which users) to ensure that the project is properly funded
- An assumption that the tape should consolidate all transactions in all asset classes, subject only to limited targeted exceptions

The consultation draws strongly upon the experience in the US, whilst recognising that there are some differences between the Regulation National Market System and National Best Bid and Offer approach (partly driven by the non-existence of an equivalent order protection rule in the EU). However, the European Commission clearly sees this as evidence that a centrally organised data service can be made to work.

Finally, the European Commission tackles the question of which types of instrument should be included. For example, in respect of shares, any consolidated tape is likely to include information related to shares admitted to trading on Regulated Markets and multilateral trading facilities (MTFs). The consultation accepts that the additional inclusion of shares that can be traded on an MTF, without previously having been admitted to trading with a prospectus (sometimes referred to as involuntary listings), is “more questionable”, and it is to be hoped that the consultation takes into account the many complexities of further extraterritorial impact in relation to involuntary listings.

Commodity markets

The introduction of the commodity position limits regime under MiFID II caused a large number of implementation challenges. The regime is extremely broad, requiring regulators to set position limits for all commodity derivatives contracts traded on trading venues, and their economically equivalent OTC contracts. This contrasts with the more targeted approach taken in other jurisdictions, for example in the US, and imposes significant monitoring and reporting obligations on trading venues and firms. Market participants will therefore welcome the fact that the Commission appears to be open to more fundamental reform of the commodities regime. This section of the consultation is complementary to the more technical ESMA consultation on position limits and position management, which was launched in November 2019 and closed on 8 January 2020. ESMA is due to provide feedback on its consultation by the end of March 2020 — both ESMA’s consultation and this consultation will inform the next steps.

The Commission’s main concerns relate to nascent and illiquid markets. The Commission acknowledges that the lack of flexibility within the position limits regime for commodity hedging contracts might have constrained the emergence of euro-denominated commodity derivatives markets that allow hedging against the increasing risk resulting from climate change. In contrast, the Commission considers that the position limit regime is working well for liquid markets.

As position limits are calculated as a percentage of “open interest” on a particular exchange, the limits applicable to smaller exchanges are much lower than those applicable on larger ones. Consequently, the Commission is concerned that the way in which position limits are calculated at present might inadvertently give an advantage to larger exchanges. Further, limits are often reached much more quickly in relation to illiquid or nascent contracts, limiting the trading opportunities in those contracts. Therefore, the Commission suggests that rules on pre-trade transparency waivers and on position limits for nascent contracts could be recalibrated, to help facilitate more commodity derivatives trading denominated in euros. The Commission also proposes that, as an alternative, trades negotiated OTC could be brought to an electronic exchange for post-trade publication in order to gradually familiarise commodity traders with the beneficial features of trade transparency inherent in electronic trading.

According to the Commission, some market participants also consider that a more finely calibrated system of pre-trade transparency applicable to commodity derivatives would encourage a swifter transition of these markets to on-venue trading. At present, there are concerns that the large-in-scale waiver calculations do not work effectively in relation to commodities contracts, making it difficult for trading venues to accommodate certain markets. This may mean that the offering of more niche instruments and the development of new and fast-moving markets is constrained. The Commission considers that more generous position limits and transparency waivers for smaller markets could allow more EU non-financial companies to hedge more of their business risk in euro-denominated markets, thus enabling euro commodity markets to grow.

The Commission seeks views on the scale and materiality of this issue, as well as on how it might be addressed. For example, it asks whether the scope of the regime ought to be amended to focus on a designated list of “critical” contracts, similar to the US regime, or whether a different scope would be more appropriate. Further, the Commission raises concerns about how position management controls are implemented by trading venues, and asks whether there is a need for additional clarification in this area.

Non-priority areas for review

Although the Commission is consulting on a number of additional topics detailed below, it notes that it has not identified any need to review the current legislation and therefore has not proposed any concrete policy options in these areas. It will, however, reassess its approach if sufficient responses to the consultation indicate a need for reform.

Derivatives trading obligation

MiFID II implements the G20 commitment to ensuring that standardised OTC derivatives are traded on exchanges, MTFs, organised trading facilities (OTFs), or an equivalent third-country venue. Currently, only certain IRS and CDS are subject to the derivatives trading obligation (DTO). The Commission is looking to understand the issues, if any, that firms are facing with the regime and, in particular, whether it is hampering access to in-scope derivatives and firms’ market-making.

Like ESMA, the Commission notes that there is misalignment between the scope of counterparties subject to the DTO, and those subject to the EMIR clearing obligation (the CO) following the changes made by EMIR Refit (the DTO and the CO are, both from a practical and legal perspective, closely linked). Although the Commission notes that ESMA’s proposal to align the CO and DTO regimes received broad support from industry participants, it raises similar questions in its consultation.

Multilateral systems

Firms operating a “multilateral system” — *i.e.*, any system or facility in which multiple third-party buying and selling trading interests in financial instruments are able to interact in the system — must be authorised as a Regulated Market, MTF, or OTF. Inconsistencies in the interpretation of this definition prompted ESMA to issue Q&A on what constitutes a multilateral system in advance of MiFID II implementation. The Commission is now querying whether the current definition of multilateral system is sufficiently and uniformly understood by market participants. In particular, the Commission notes that there are certain electronic platforms that offer similar functionality to a multilateral system, but are not authorised on the basis that they match trading interests on a bilateral basis. Although not raised formally, the implicit query is whether these types of systems should be regulated (although why additional guidance or rule changes might be needed, on top of the existing body of work, is not clear).

Double volume cap

In similar vein to ESMA’s recent consultation on the equities transparency regime, the Commission is querying whether the double volume cap (DVC) (which limits the use of certain transparency waivers for shares when certain trading venue and EU-level thresholds are reached) is an overly complex regime that is also failing in its objective to reduce “pure” OTC trading in the EU (thereby hampering market transparency). The Commission is seeking stakeholder views on their experiences with the DVC and its impact on transparency.

Non-discriminatory access

MiFID II introduced an open access regime to allow market participants to trade and clear financial instruments on a non-discriminatory and transparent basis. The underlying rationale was that the open access provisions would facilitate competition between trading venues and central counterparties, as well as prevent discriminatory treatment. The Commission is seeking feedback on whether the requirements have caused any operational or technical issues for the market and its participants, as well as whether the regime has introduced cost efficiencies or other benefits in the trading and clearing areas.

Digitalisation and new technologies

Tech neutrality

The Commission reiterates its commitment to the principle of tech neutrality, a policy it has previously positioned as one of the guiding principles in its FinTech Action Plan. A tech-neutral approach to regulation aims to ensure that the regulatory treatment of products or activities is unaffected by the technological medium through which products are offered or activities are conducted. Accordingly, the Commission is seeking input as to whether there are particular elements of MiFID II that do not accord with the principle of tech neutrality. The Commission regards addressing any such elements as important to avoid obstacles to the adoption of financial innovation and to ensure that there are no gaps in the regime in relation to the risks that may be associated with particular innovations.

Broadly, the principle of tech neutrality in regulation has been adopted by most sophisticated financial regulators around the world on the basis that it best preserves their ability to regulate financial activities and outcomes, rather than the processes that achieve them. It is, therefore, unsurprising to see the Commission emphasising tech neutrality in the MiFID consultation and in its FinTech Action Plan. However, recent developments in a number of jurisdictions suggest that financial regulators may be modifying their application of the principle of tech neutrality in the face of the increasing rate of technological development and the emergence of a number of new technologies with transformative potential (*e.g.*, distributed ledger technology, cryptography-based security and validation mechanisms, machine learning, and artificial intelligence).

The FCA, for example, recently released specific regulatory guidance on the application of the UK financial regulatory perimeter to cryptoassets, and the US SEC recently floated a proposed safe harbour from US federal securities laws for qualifying cryptoasset projects. Furthermore, a number of jurisdictions (including, France, Gibraltar, Malta, and Japan) have implemented bespoke regulatory frameworks tailored to cryptoassets or virtual currencies. The question of whether regulation can remain tech-neutral likely will become more pressing for regulators as other technologies that are currently nascent in financial services mature.

The promise of decentralised finance or “DeFi” (using smart contracts and decentralised systems not run by any single operator to conduct financial activity) is a case in point. It holds the potential for financial services traditionally performed by centralised actors to be executed autonomously using smart contracts, which raises novel challenges for financial regulators. For example, if an application that runs on a decentralised network provides equivalent functionality to a traditional exchange but does not have a central operator, should it be subject to regulation as a trading venue? If so, who should be the person responsible for the operation of the system? What is the relevant jurisdiction of the system (and, in EU parlance, which regulator is the system’s home state regulator)? Alternatively, should a smart contract that provides exposure to an underlying reference asset equivalent to that provided by a derivative contract, but without a contractual counterparty against whom it can be “enforced”, be a regulated financial instrument?

Indeed, the consultation suggests that, despite its reiteration of the principle, the Commission is also grappling with the question of whether EU financial regulation can remain completely tech neutral. For example, the Commission notes the potential impact of the particularities of the “online environment” on the provision of investment services through digital channels (citing robo-advice as an example) and seeks feedback on whether certain requirements in MiFID II (including product governance and distribution provisions) "should be adjusted to better suit the provision of services online". The questions in the consultation that reference decentralisation and new business models (discussed below) also suggest the Commission is considering how EU financial regulation should cater for the possible impacts of innovation in financial services over the longer term.

Decentralisation and new business models

The consultation seeks views from industry participants as to where they see the main developments in their sectors, in particular whether they anticipate the emergence of more "decentralised value chain services" or new business models. The Commission also asks respondents whether they consider that digitalisation and new technologies will significantly impact the role of EU trading venues in the next five to 10 years. This suggests that the Commission is considering not only the impact innovation might have in making existing processes more efficient or accessible, but also how it might impact the financial services landscape in a more fundamental way (*e.g.*, by encouraging the emergence of new market participants as has been seen, for example, in the payments space and which may follow in the investment space if the trend towards open data continues in financial services more broadly).

Foreign Exchange

Spot FX contracts are not currently classed as financial instruments under MiFID, and consequently they are also not within direct scope of MAR. ESMA raised the question of whether spot FX contracts should be brought within scope of MAR as part of the MAR review, which remains ongoing (ESMA's report on its findings is expected shortly). Given that the scope of MiFID and MAR is meant to align in terms of the instruments captured, the Commission raises the issue of whether spot FX contracts should be classed as financial instruments under MiFID.

In its consultation on the MAR review, ESMA appeared reluctant to recommend an extension of MAR to include spot FX, largely because of the practical difficulties in applying the relevant requirements to this type of instrument, but also because of the progress made following the introduction of the FX Global Code of Conduct as an alternative means of reducing concerns about behaviours in this market. The MiFID consultation does not give any indication about the Commission's views on whether the framework should capture spot FX, but the same issues arise as to how the existing framework might work in relation to spot FX. For example, who would be classed as the issuer, and how would pre- and post-trade transparency obligations apply.

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

David Berman
david.berman@lw.com
+44.20.7710.3080
London

Kishore Bhindi
kishore.bhindi@lw.com
+44.20.7710.4785
London

Sherryn Buehlmann
sherryn.buehlmann@lw.com
+44.20.7710.3043
London

Brett Carr
brett.carr@lw.com
+44.020.7710.4695
London

Charlotte Collins
Knowledge Management Lawyer
charlotte.collins@lw.com
+44.20.7710.1804
London

Becky Critchley
becky.critchley@lw.com
+44.20.7710.4519
London

Stuart Davis
stuart.davis@lw.com
+44.20.7710.1821
London

Carl Fernandes
carl.fernandes@lw.com
+44.20.7710.4777
London

Nicola Higgs
nicola.higgs@lw.com
+44.20.7710.1154
London

Markus E. Krüger
markus.krueger@lw.com
+49.69.6062.6641
Frankfurt

Gabriel Lakeman
gabriel.lakeman@lw.com
+44.020.7710.4645
London

Anne Mainwaring
anne.mainwaring@lw.com
+44.20.7710.1018
London

Sam Maxson
sam.maxson@lw.com
+44.20.7710.1823
London

Frida Montenius
frida.montenius@lw.com
+44.20.7710.1161
London

Rob Moulton
rob.moulton@lw.com
+44.20.7710.4523
London

Denisa Odendaal
denisa.odendaal@lw.com
+44.20.7710.1845
London

Jonathan Ritson-Candler
jonathan.ritson-candler@lw.com
+44.20.7710.1815
London

Katy Sanders
katy.sanders@lw.com
+44.20.7710.4548
London

Axel Schiemann
axel.schiemann@lw.com
+49.69.6062.6509
Frankfurt

Thomas Vogel
thomas.vogel@lw.com
+33.1.40.62.20.47
Paris

Sean Wells
sean.wells@lw.com
+44.20.7710.4662
London

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