ESMA's Consultation Paper 2014/549 and Discussion Paper 2014/548

INTRODUCTION

The final legislative texts of the new Markets in Financial Instruments Directive (**"MiFID II"**) and the Markets in Financial Instruments Regulation (**"MiFIR"**) were adopted by the European Parliament on 15 April 2014 and by the European Council on 13 May 2014. MiFID II and MiFIR (together **"MiFID II/R"**) will enter into force on 2 July 2014[1] and become applicable at the earliest during 2016[2]. The final texts are still to be published in the Official Journal by the European Commission (the **"Commission"**).

On 22 May 2014, the European Securities and Markets Authority (**"ESMA"**) launched its Level 2 consultation process for implementation of MiFID II/R with the publication of two papers covering over 800 pages in total:

Consultation Paper[3]

Discussion Paper[4]

The Consultation Paper addresses key issues to enable ESMA to produce technical advice to the Commission which assist in making the delegated acts required by several provisions of MiFID II/R. ESMA's technical advice on these issues has been sought by way of formal request and needs to be submitted to the Commission by December 2014. The Consultation Paper represents issues on which ESMA has developed a fairly settled view. This will be the industry's only real opportunity to respond.

The Discussion Paper seeks views on elements of future ESMA regulatory technical standards (**"RTS"**) and implementing technical standards (**"ITS"**). The responses are intended to provide the basis for ESMA's further consultation paper, which is expected to be issued late 2014/ early 2015 and will include the draft RTS and ITS for submission to the Commission. As a discussion paper there is further scope for industry dialogue with ESMA on issues covered in the paper but it will nonetheless be important to respond compellingly to the paper with any proposed changes to ESMA's views.

The issues covered in the Consultation Paper and the Discussion Paper can be divided into two categories:

- the structure, transparency and regulation of financial markets (the **"Markets Category"**); and
- the strengthening of investor protection (the **"Investor Protection Category"**).

The consultation period for both papers ends on 1 August 2014. In advance of that deadline, ESMA will host public hearings on the topics of secondary markets, investor protection and commodity derivatives on 7 and 8 July 2014, with DLA Piper attending both.

Regulated firms and markets should take note of all ESMA proposals as early as possible because now is the time to raise views and concerns. As the details become clearer, firms need to consider the strategic implication of the reforms and undertake a gap analysis to identify where operational changes are needed.

While numerous reforms are introduced by MiFID II/R and considered in the consultation papers in the context of the Markets Category and the Investor Protection Category, this briefing focuses on the creation of organised trading facilities, the extension of the trading transparency regime to non-equity markets and investor protection measures.

CREATION OF ORGANISED TRADING FACILITIES

MiFID II/R creates a new type of trading venue within the regulatory framework: the organised trading facility (**"OTF"**). OTFs are multilateral discretionary trading platforms that are not currently regulated, but have an increasingly important role, for example, in the trading of standardised derivatives contracts. The operation of an OTF becomes a regulated activity and investment firms engaging in this activity will therefore need to extend their authorisation requirements.[5]

1 20 days after publication in the Official Journal of the European Union. The legislation was published in the Official Journal on 12 June 2014.

2 30 months after entry into force

3 CP ESMA/2014/549 "MiFID II/MiFIR"

4 DP ESMA/2014/548 "MiFID II/MiFIR"

5 Article 5(2) MiFID II and Annex 1, section A(9)

OTF is defined as "*a multilateral system which is not a regulated market or an MTF [multilateral trading facility] and in which multiple third-party buying and selling interests in bonds, structured finance products, emission allowances or derivatives are able to interact in the system in a way that results in a contract in accordance with Title II of this [MiFID II] Directive*".[6]

The broad definition of OTF encompasses all forms of organised trading that do not match existing categories including sufficiently liquid derivatives. The new category aims to ensure that all organised trading is conducted on regulated venues that are transparent (both pre- and post- trade) and subject to similar core organisational requirements.[7] OTFs will be subject to the same transparency rules as other trading venues to improve trading transparency in equity markets. ESMA is of the view that the inclusion of OTFs as trading venues should provide a more complete and reliable picture of trading of non-equity financial instruments and, therefore, allow regulators to limit computation to the transactions carried out on trading venues.[8]

Operators of OTFs will have a discretion over how a transaction is executed, unlike regulated markets (**"RMs"**) and multilateral trading facilities (**"MTFs"**) who execute transactions according to a pre-determined set of rules. This means that they are subject to investor protection, conduct of business and best execution requirements towards clients using the platform. Existing provisions on the trading process and finalisation of transactions applicable to MTFs are extended to apply to OTFs.[9] This includes a new requirement that OTFs (and MTFs) put in place arrangements for the sound management of the technical operations of the facility, including establishing effective contingency arrangements to cope with systems disruption.[10]

Article 20 of MiFID II sets out specific requirements relevant to an OTF which includes that:

- OTFs can execute orders on a discretionary basis, but cannot execute client orders against proprietary capital
- Transactions concluded on an OTF are subject to the requirements relating to investor protection such as best execution and client order handling obligations
- OTF operators may deal on own account other than on a matched principal basis only with regard to sovereign debt instruments for which there is not a liquid market
- OTFs must not connect with another OTF in a way that enables orders in different OTFs to interact

There is a risk that the introduction of OTF may lead to short and potentially medium-term fragmentation in non-equity markets, similar to the experience in equity markets following the implementation of MiFID. However, the concept is, in fact, recognising that these platforms already exist - and is bringing them within the boundaries of more "exchange-like" regulation which could make it less attractive to carry out the activity.

EXTENSION OF THE TRADING TRANSPARENCY REGIME TO NON-EQUITY MARKETS

MiFID II/R introduces a new pre- and post-trading transparency regime for non-equity markets, namely bonds, structured finance products, emissions allowances and derivatives.[11] The aim is to have real time transparency for secondary market trading of non-equity instruments.

The pre-trade transparency regime requires operators of RMs, MTFs and OTFs to make public current bid and offer prices as well as the depth of trading interest at those prices continuously during normal trading hours in a wide range of instruments including non-equity instruments. With regard to the post-trade transparency regime, investment firms which conclude transactions in non-equity products on a trading venue are under an obligation to make public the volume and price of those transactions and the time at which they were concluded.

ESMA clarifies that depository receipts with respect to bonds are to be treated as non-equity financial instruments for the purposes of transparency[12], but that securities issued in a non-EU country should not qualify as 'sovereign debt' under the transparency regime.

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6 Article 4(1)(23) MiFID II

7 Recitals 8-10, MiFIR

8 DP, section 3.6, para. 24

9 Article 18 MiFID II

10 Article 18(1) MiFID II

11 Articles 7 and 9 MiFIR

12 DP, section 3.5, para. 15

Categorisation

The transparency regime for non-equities is the same for all trading venues (RMs, MTFs and OTFs). However, the exact transparency regime will be tailored to the asset class in question and in some cases for the type of instrument within the asset class. This is an improvement over the one-size-fits all approach of the original Commission proposal that would have extended the equities regime without calibration.

ESMA enjoys wide powers for making proposals about how to calibrate the pre- and post-trade transparency regime, including the use of waivers and the conditions for deferred publication of trade information whereby it must strike the right balance between ensuring investors receive sufficient information and preserving liquidity.

ESMA proposes the following taxonomy of how to categorise and divide non-equity instruments into classes:

I) Bonds: Sovereign, corporate, covered and convertible bonds

II) Structured finance products: MBS, other ABS, CDO, ABCP, Others (WBS, etc.)

III) Emission allowances (no sub-categories)

IV) Derivatives:

- i) Securitised derivatives:
  - (a) covered warrants
  - (b) certificated derivatives (e.g. Kertificatz, certificats, etc.)
  - (c) negotiable rights
  - (d) warrants attached to bonds and medium term notes that track the performance of another asset
- ii) Derivative contracts:
  - (a) interest rate derivatives
  - (b) foreign exchange derivatives
  - (c) equity derivatives
  - (d) commodity derivatives (including energy derivatives, e.g emission allowances derivatives)
  - (e) credit derivatives (including single name and index credit default swaps)
  - (f) other derivatives (relating to environmental derivatives and other underlying classes of financial instruments)
- iii) Contracts for difference[13]

ESMA considers that the categorisation of financial instruments by class for transparency purposes should be assigned to market operators and investment firms which should be responsible for identifying the category to which particular non-equity financial instruments belong based on ESMA criteria, which still need to be determined.[14]

Waiver

Pre-trade transparency waivers will be available for:

(i) large in scale orders and orders held in an order management facility;

(ii) actionable indications of interest in request-for-quote and voice trading systems above a certain size, which would expose liquidity providers to undue risk; and

(iii) illiquid financial instruments.[15]

ESMA must be notified before the regulator uses the waiver[16].

The details of the above thresholds are to be specified by ESMA technical standards.[17] When determining whether a liquidity provider is exposed to undue risk under (ii), ESMA considers that the

13 DP, Annex 3.6.1

14 DP, section 3.5, para. 47

15 Article 9 MiFIR

16 Article 9(2) MiFIR

17 Article 9(5) MiFIR

ability to hedge risks at the specific sizes for an instrument shall be taken into consideration.[18]

In addition to waivers, firms can benefit from deferred, i.e. post-trade, publication if certain conditions are met[19] or a suspension of the publication obligations, for example, when the liquidity of a class of financial instrument falls below a certain threshold[20].

INVESTOR PROTECTION MEASURES

Investor protection measures under MiFID II/R set out stricter standards for investment firms, with restrictions on certain types of fees and remuneration structures to ensure that advice is independent and impartial.

With regard to the UK, the investor protection proposals set out in the papers mirror those already introduced in the UK by the FCA's Retail Distribution Review (**"RDR"**) which will continue to apply. Some of the proposals will apply in the institutional market as well as in the retail markets.

While the Consultation Paper provides draft technical advice on many issues relating to investor protection, this article focuses on the incidental manner exemption, product governance requirements, product intervention powers, a ban on inducements and proposed rules for client agreements.

Incidental manner exemption

The original incidental manner exemption has been transferred to MiFID II/R which states that the legislation shall not apply to "persons providing an investment service where that service is provided in an incidental manner in the course of a professional activity (…)"[21]. Considering that the EU member states have developed diverging interpretations of the term "in an incidental manner" and that the exemption should be applied in a uniform manner, ESMA was asked to provide further clarification.

ESMA establishes the following strict conditions which need to be fulfilled for an investment service to be provided in an incidental manner:

(i) a close and factual connection exists, including in temporal terms, between the professional activity and the provision of the investment service to the same client, such that the investment service is regarded as accessory to the main professional activity; and

(ii) the provision of investment services to the clients of the main professional activity does not aim to provide a systematic source of income; and

(iii) the person providing the professional activity does not market or otherwise promote his/her availability to provide investment services.[22]

Our expectation is that this will lead to a revision of the exemption within article 67 of the Regulated Activities Order 2001, whereby certain activities carried out in the course of a profession or non-investment business are exempt from being viewed as FCA regulated activities. This is likely to be particularly relevant to a range of professional advisors such as consultants, accountants and lawyers who provide certain financial services as an incidental aspect of their main business.

Product governance requirements

The new product governance requirements aim to enhance investor protection by introducing specific oversight, control and governance obligations on investment firms that manufacture financial instruments and on investment firms that distribute such products. In addition to the existing point of sale requirements, the proposals will help to ensure that new products and services are marketed or provided to the right investors.

ESMA proposes the introduction of two sets of policy proposals for product governance arrangements for:

(i) investment firms to adopt when manufacturing products (i.e. manufacturers which create, develop and design investment products); and

(ii) investment firms to adopt when deciding the range of products and services they intend to offer to clients (i.e. distributors).

[18] CP, section 3.8, para. 9

[19] Article 11 MiFIR

[20] Article 9 (4) MiFIR

[21] Article 2 MiFID II

[22] CP, section 2.1

Investment firms that act as both, manufacturer and distributor of investment products, need to fulfil both the obligations set out for manufacturers and distributors.[23] ESMA suggests imposing a positive duty on firms to check that products function as intended, rather than only requiring them to react when detriment becomes apparent and sets out a list of key obligations for manufacturers and distributors.[24]

Key obligations for product manufacturers

- To specify the target market for each product to avoid the inclusion of any investor groups for whose needs the product is not compatible
- To consider the charging structure proposed for the product by checking that the product costs are compatible with the characteristics of the target market, that the charges do not undermine the product's return expectation and that the charging structure is appropriately transparent for the target market[25]
- To provide adequate information about the product to enable distributors to understand and sell the product properly which includes information about the appropriate sale channels, product approval process and target market assessment
- To review the products on a regular basis, taking into account any event that could affect the potential risk to the target market
- To conduct an analysis of potential conflicts of interest each time a product is generated
- To outline the responsibilities in a written agreement when collaborating with a third party based in a non-EEA Member State to create or manage a product[26]

Key obligations for product distributors

- To have in place adequate product governance arrangements to ensure that the offered products are compatible with the characteristics of the target market which includes identifying any investor groups whose needs the product is not compatible
- To ensure that the management body endorses the range of investment products that will be offered
- To review the products offered on a regular basis
- To provide manufacturers with sales information to support their product reviews[27]
- To maintain procedures and measures to ensure compliance with all applicable MiFID II/R requirements

These obligations even apply to those distributors selling products issued by entities which are not subject to MiFID II/R.

ESMA's approach to corporate governance is not overly prescriptive per se, but it is essential that flexibility is provided so as to take account of the diverse size, capacity and business models of the range of market participants.

Product intervention powers

MiFIR[28] introduces a framework for product intervention which gives ESMA, the European Banking Authority (**"EBA"**)[29] and the national competent authorities (**"NCAs"**) new powers to scrutinise products and services being offered.

These product intervention powers allow ESMA to temporarily ban or restrict the marketing, distribution or sale of certain financial instruments or financial instruments with certain features, or types of financial activity or practice if the following circumstances are met:

(a) There is a threat to investor protection, the orderly functioning and integrity of markets or to financial stability.

(b) Existing EU regulatory requirements do not address the threat.

(c) The regulator has not taken adequate action to address the threat.[30]

23 CP, section 2.7, para. 8

24 CP, section 2.7, para. 13

25 The charging structure should not be too complex to understand or disguise charges.

26 CP, section 2.7, draft technical advice

27 CP, section 2.7, draft technical advice

28 Articles 40-43 MiFIR

29 Note that the EBA will conduct a separate consultation on its product intervention powers on structured deposits.

30 Article 40 MiFIR

To assess whether the above conditions are met, a non-exhaustive list of factors has been proposed in the Consultation Paper[31] which should assist in determining whether to intervene. Factors to assess that there is a threat, for example, include whether the financial instrument would threaten the investors' confidence or pose a high risk of disruption to financial institutions deemed to be important to the financial system of the EU and whether the activities would significantly compromise the integrity of the price formation process. The factors should not apply cumulatively and depending on the severity of the issue, an intervention may be justifiable where only one factor is present.

ESMA's new product intervention powers are controversial in that there is no consensus about the degree to which ESMA should engage in direct regulation of the financial markets and it should only have the power to intervene in exceptional circumstances. However, ESMA states that it is essential that intervention powers are dynamic enough to deal with a range of different exceptional situations and to allow steps to be taken to address issues before they become widespread.[32]

Ban on inducements

Investment firms that provide advice on an independent basis or provide portfolio management will be banned from accepting or receiving fees, commissions or any monetary benefits paid or provided by any third party or a person acting on behalf of a third party (for example, issuers and product providers) relating to the provision of the service to clients.[33] Only minor non-monetary benefits will be allowed if they are capable of enhancing the quality of the service and do not impair the ability of investment firms to act in the best interest of their clients.[34]

ESMA proposes to introduce an exhaustive list of minor non-monetary benefits that are therefore acceptable[35] which include:

(i) information or documentation relating to a financial instrument (including financial research) or an investment service;

(ii) participation in conferences, seminars and other training events on the benefits and features of a specific financial instrument or an investment service; and

(iii) hospitality of a reasonable de minimis value (e.g. food and drink during a business meeting or a conference, seminar or other training events).

An investment firm is obliged to keep an internal list of all commissions, fees and non-monetary benefits accepted from third parties and to record how it uses the commissions and fees.

This issue of banning inducements has already been dealt with domestically in the UK by the FCA via its RDR which prohibits all payments in the form of commission.

Client agreements

ESMA proposes to extend the requirement to conclude a written client agreement with new retail clients to relationships with new professional clients provided that the firm and the professional client intend to establish an on-going business relationship.[36]

These written agreements would enable professional clients to better understand the nature of the services to be provided and to seek judicial recourse if the firm has not abided by the terms of the agreement. ESMA does not consider this requirement to be overly burdensome for the investment firms because their relationships with professional clients are often already documented in written agreements.[37]

ESMA provides guidance on the content of the written agreement which should contain the following:

- the nature and extent of any investment advice services to be provided
- the types of financial instruments and transactions that may be undertaken on behalf of the client as well as any instruments or transactions prohibited
- the main features of any custody services to be provided including the role of the firm with respect to corporate actions relating to client securities

[31] CP, section 2.24, draft technical advice

[32] CP, section 2.24, para. 6

[33] Article 24(7)(b) and (8) MiFID II

[34] Recital 75 MiFID II

[35] CP, section 2.15, draft technical advice

[36] CP, section 2.19, draft technical advice, para. 2

[37] CP, section 2.19, para.8

Other obligations for investment firms

In addition to the above, ESMA proposes to impose the following obligations on investment firms:

- Remuneration: to design the remuneration policy in such a way so as not to create incentives that may lead persons to favour their own interests or the firm's interest to the detriment of clients[38] and for the management body to approve the remuneration policy[39]
- Compliance: For the compliance function to conduct an assessment, to establish a risk-based monitoring programme and to report annually on the effectiveness of the control environment and the complaints-handling reporting to the management body[40]
- Safeguarding of client instrument and funds: To appoint a single officer with specific responsibility for matters relating to the firm's compliance with its obligations regarding the safeguarding of client instrument and funds[41]
- Recording: To record written notes of face-to-face conversations with clients and to tape record telephone lines[42]
- Complaints-handling: To publish the details of the firm's complaints handling process and for the management body to endorse the complaints management policy which must provide up-to-date information about the complaints-handling process[43]
- Information: to make information easily available to insolvency practitioners and those responsible for the resolution of failed institutions[44].

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38 CP, section 2.11, draft technical advice
39 CP, section 2.11, draft technical advice
40 CP, section 2.3, draft technical advice
41 CP, section 2.3, draft technical advice
42 CP, section 2.6, draft technical advice
43 CP, section 2.6, draft technical advice
44 CP, section 2.8, draft technical advice

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