TRAVERS SMITH

Financial Services and Markets

MiFID 2 and MiFIR: Reforming EU Financial Markets

The Markets in Financial Instruments Directive ("MiFID") was implemented in most European Member States in November 2007. Partly as a result of the financial crisis, the European Commission has decided that MiFID "exhibits the need for targeted but ambitious improvements". On 20 October 2011, it published a proposed replacement Directive ("MiFID 2") and a new Regulation ("MiFIR"). The measures must now be agreed between the European Council and the European Parliament. It is unclear when the measures are expected to take effect but it could be in 2013.

This proposal has significant implications for many different types of market participant. We highlight the following as some of the areas of significant change which will be relevant to many firms.

More powers for European Union bodies

The provisions minimise the discretions available to Member States, with the aim of creating a single EU rule book. In addition, the drive to centralise power in the hands of the European Securities and Markets Authority ("ESMA") and the European Commission continues. Extensive powers are conferred on the European Commission to make delegated legislation and to decide whether non-EU States ("third countries") meet the "equivalence" test necessary for their firms to provide services into the EU (see below), whilst ESMA will draft the regulatory and implementing technical standards.

More powers for regulators

UK firms are already used to a regulator with extensive supervisory and enforcement powers. The UK Government will extend these through the new Financial Services Bill. MiFID 2 and MiFIR will strengthen the powers of regulators in all Member States, in part to reduce regulatory arbitrage. In addition to requiring all regulators to have a range of general supervisory and enforcement powers, they will also have specific powers to:

- prohibit and restrict the marketing, distribution or sale of certain types of financial instruments and types of financial activities and practice, subject to certain conditions. The UK is already introducing a product intervention regime. It is not clear what impact the new EU regime will have on the UK proposals;
- demand information from any person regarding the size and purpose of a position in or exposure entered into via a derivatives contract related to commodities and to request that person to reduce the size of the position or exposure; and
- limit the ability of any person or class of persons to enter into a commodity derivative, including by introducing limits on positions or the number of such derivative contracts per underlying which any given class of persons can enter into over a significant period of time. This power reflects the significant concerns about excessive commodity price volatility and its impact on society.

Sanctions

MiFID 2 and MiFIR require Member States to have appropriate administrative sanctions for breach of their requirements, and for publication of sanctions. Member States are required to ensure that the measures include at least the possibility of fines of up to 10% of the total annual turnover of a legal person in the preceding business year and in the case of a natural person, sanctions of up to €5 million (or its equivalent). In addition, there must be fines of up to at least twice the benefit derived from the breach.

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Firms established outside the European Union

- At present each Member State has its own rules as to whether, and if so on what basis, a firm established outside the EU (a "third country firm") may provide services in or into its jurisdiction. The UK has what is known as the "overseas persons" regime which has successfully enabled the UK professional markets to operate on a global basis.

- MiFID 2 and MiFIR will impose significant restrictions on the ability of third country firms to access EU markets. More seriously for the EU, it also has the potential to make it more difficult for EU firms to access the services they require outside of the EU and opens up the possibility of international trade disputes.

- The draft follows a theme that is familiar to those who have followed the Alternative Investment Fund Managers Directive. There is clearly a desire at an EU level to prevent Member States from operating their own "third country" regimes and to seek to export EU regulatory standards to the rest of the world. Unless third country firms are registered in accordance with the MiFID 2 / MiFIR regime they will only be able to provide services to anyone established within the EU if they have not solicited their business.

- Under transitional provisions existing third country firms may continue to provide services and activities in accordance with national regimes for four years after the new regime comes into force.

The key elements of the third country provisions are as follows:

Services provided to retail clients

- A third country firm which wishes to provide investment services or activities to a retail client must at least establish a branch in the EU. That branch must be authorised and subject to a significant number of MiFID 2 / MiFIR requirements. Once the branch is established and authorised it will be possible to "passport" services from the branch into other Member States.

- No branch will be authorised unless, amongst other things:

    - the firm establishing the branch is authorised in the third country to provide the services covered by MiFID 2 / MiFIR. For example, if the firm wanted to provide investment advice, and that activity is not regulated in its own country, its European branch could not be authorised;

    - the Commission has issued a formal decision that the legal and supervisory arrangements in the third country impose legally binding requirements which have equivalent effect to the MiFID 2 / MiFIR requirements and the Capital Adequacy Directive;

    - there are co-operation arrangements between the Member State regulator and the third country regulator;

    - sufficient initial capital is at the free disposal of the branch.

These are potentially significant hurdles for any third country firm. The draft AIFMD legislation has already proposed onerous requirements for assessing the equivalency of third country laws and for the nature of the co-operation arrangements required between regulators. In practice this measure is likely to mean that third country firms which wish to provide services to retail clients will establish a subsidiary in a Member State to provide those services.

Services provided to eligible counterparties

- A third country firm need not establish a branch to provide the services or activities of dealing on own account, reception and transmission of orders or executing deals on behalf of clients with eligible counterparties, but the third country firm must be registered in a register kept by ESMA in order to do so.

- ESMA has 180 working days to advise the applicant whether or not its application for registration has been granted or refused.

- ESMA will only register a third country firm if certain conditions are met, including that:

    - the Commission has issued a formal decision that the legal and supervisory arrangements in the third country impose legally binding requirements which have equivalent effect to the MiFID 2 / MiFIR requirements and the Capital Adequacy Directive;

    - the firm is authorised in its own jurisdiction and there are co-operation arrangements between regulators.

Services provided at the initiative of the client: professional clients and eligible counterparties

- It appears that if a third country firm with no authorised EU branch wants to provide any investment services or activities to professional clients, or to provide any services other than dealing, reception and transmission of orders or execution of client orders with eligible counterparties, it can do so only if it has been contacted by the EU client "at its own exclusive initiative".

- The concept of the provision of services "at own exclusive initiative" of the EU person is very narrow. If the third country firm solicits clients in the EU, or promotes or advertises its investment services or activities in the EU, its services will be deemed not to be provided at the own exclusive initiative of the client. This is extremely restrictive and impracticable, for example, how will a firm show that its internet site does not constitute advertising in the EU when it can be accessed from the EU?

Conduct of Business

Clients

- Municipalities and local public authorities will not be "per se" professional clients, although they may be treated as professionals if they can be opted-up to that status, and each Member State can adopt specific criteria for assessing the expertise of these entities.

Order execution policies

- The Commission is critical of the current information provided by many investment firms to clients about their order execution policies. It considers that they are often generic and standard and do not allow clients to understand how an order will be executed or to verify the firm's compliance with best execution. The new law requires more detail to be provided and will require firms to make public annually their top five execution venues for client orders.

Recording communications

- There will be requirements to record telephone conversations and electronic communications involving client orders.

Advisers and managers

- There are a number of aspects where MiFID 2 / MiFIR imports ideas which are very similar to those which have been or are being introduced by the UK Financial Services Authority. For instance:

    - investment advisers will have to specify whether they are independent or providing restricted advice;

    - independent advisers cannot receive fees, commissions or any monetary benefits from any third party; and

    - portfolio managers will be prohibited from accepting or receiving fees, commissions or monetary benefits from a third party in relation to the provision of services to clients. This will rule out not only the receipt of distribution commissions but could also cover soft commissions and commission sharing arrangements.

Information requirements

- The Commission considers that the financial crisis has revealed that many non-retail clients are limited in their ability to appreciate the risk of their investments. As a result, MiFID 2 / MiFIR will extend some information and reporting requirements even to relationships with eligible counterparties.

Scope

MiFID 2 / MiFIR will apply to a wider range of activities, services and instruments. Extensions of scope include:

- the extension to third country firms providing services or activities in the EU;

- the regulation, for the first time, of data reporting service providers (they operate approved publication arrangements, approved reporting mechanisms and the new consolidated tape);

- firms who are members of or participants in regulated markets or MTFs will be regarded as dealing on own account and require authorisation. This could include high frequency traders;

- firms specialising in trading commodities and commodity derivatives;

- a new activity of "operating an organised trading facility" is created (see below);

- custody of client assets becomes an investment service;

- emission allowances will become financial instruments so as to improve supervision of trading in them;
- structured deposits will be within scope. This does not include deposits linked solely to interest rates regardless of whether the interest rate is predetermined, fixed or variable;
- transparency requirements applicable to shares admitted to trading on regulated markets will be extended to a range of other instruments, including depository receipts and exchange traded funds;
- MiFID 2 / MiFIR introduces an entirely new concept of an SME growth market. The idea is to make it easier for SMEs to obtain financing by raising the visibility and profile of markets which are dedicated to SMEs. For this purpose, an SME is a company with an average year end market capitalisation of less than €100 million for the previous three calendar years.

Increased scrutiny of senior management

The changes represent a common view amongst international regulators that weak corporate governance was a contributory factor to the financial crisis. As a result, there will be far more intrusive and detailed regulation of management bodies of investment firms.

MiFID 2 will impose extensive requirements in relation to governance structures. These include that:

- members of the management body should commit sufficient time to perform their function. ESMA will develop draft regulatory standards to specify the notion of sufficient time but in any event no-one is to combine more than one of the following:
  - one executive directorship with two non-executive directorships;
  - four non-executive directorships.

  Intra-group directorships are treated as a single directorship. Local regulators may authorise someone to combine more directorships depending on the individual circumstances;
- investment firms must take into account diversity as one of the criteria for selecting members of their management body and shall have a policy which promotes gender, age, educational, professional and geographical diversity on the management body. The purpose of the diversity requirement is stated to be "to avoid group thinking and facilitate critical challenge".

Market infrastructure

MiFID 2 / MiFIR attempts to bring a more level playing field between different types of trading system, which are often fundamentally different in their scope and operation. The changes are designed to ensure that all "organised" trading is conducted on regulated trading venues and the same pre- and post-trade transparency requirements will apply to all of these venues.

Organised trading facility ("OTF")

- The OTF concept is intended to capture all types of organised execution and arranging of trading which do not correspond to the functionalities or regulatory specifications of regulated markets and MTFs. An OTF is defined as "any system or facility, which is not a regulated market or multilateral trading facility, in which multiple third party buying and selling interests in financial instruments are able to interact in a way that results in a contract".
- An OTF operator cannot execute client orders against its own proprietary capital.
- The definition is extremely broad and will catch many types of trading arrangement currently provided by brokers and investment banks, such as broker crossing networks, which have to date not been treated as subject to the same pre- and post-trade transparency requirements as apply to regulated markets and MTFs. It does not include facilities where there is no genuine trade execution or arranging taking place in the system, such as bulletin boards. However, the exact scope of the OTF proposal remains unclear.

Systematic internalisers

Any dealing on own account by investment firms with clients, including other investment firms, taking place outside a regulated market, MTF or OTF will be considered to be OTC trading activity. These firms will be treated as systematic internalisers unless they can show that such trading is non-systematic and irregular.

HFT, algorithmic trading and DMA

- The EU authorities have identified major regulatory concerns about the impact of trading technology on the integrity of the markets, in particular the use of algorithmic or high frequency trading and the provision of direct market access arrangements. These are considered to give rise to risks such as overloading trading venue systems, the creation of erroneous orders, malfunctioning that leads to disorderly markets and the exacerbation of volatility.

- Firms that engage in algorithmic or high frequency trading or provide direct electronic market access will be required to institute specific risk controls. Firms that provide direct market access will be required to have controls to assess and review the suitability of the clients for that service, to prevent them from exceeding pre-set trading and credit thresholds, and must monitor their trading and impose appropriate risk controls to prevent trading that could create or contribute to a disorderly market.

Links

The legislative proposal for MiFID 2 can be found here.

The legislative proposal for MiFIR can be found here.

Supporting documents, including press releases, FAQs and impact assessments can be found here.

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