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An Introduction
to MiFID II



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This is the first part in a series of Legal Longs on the MiFID II Directive [2014/65/EU] and the Markets in Financial Instruments Regulation (MiFIR) (together, “MiFID II”), which will come into effect on 3 January 2017. This first part will provide a brief overview of the key changes which MiFID II will bring about and subsequent Legal Longs will focus on some of the most important changes affecting fund managers.

Introduction

MiFID II will repeal and recast MiFID [2004/39/EC] to form the legal framework governing the requirements applicable to investment firms, trading venues, data reporting service providers and third-country firms providing investment services or activities in the EU.

The general aim of the MiFID II proposals was to make the financial markets more efficient and resilient, to take account of technological developments since MiFID was implemented in November 2007, to increase transparency of both equity and non-equity markets, to introduce a stricter framework for commodity derivatives markets, strengthen investor protection and to reinforce supervisory powers.

The text of the MiFID II Directive and the text of MiFIR were published in the Official Journal of the EU on 12 June 2014 and came into force on 2 July 2014. A large number of elements need to be further specified in delegated acts to be adopted by the Commission (Level 2 Measures) and the European Commission has requested both ESMA and the European Banking Authority (EBA) for technical advice to assist it in making these acts.

To date, ESMA has published a discussion paper (ESMA/2014/548) and two consultation papers on MiFID II, in May 2014 and December 2014 respectively, as to which, please see further below.

Member states must adopt and publish the measures transposing the MiFID II Directive into national law by 3 July 2016 and (with some exceptions) must apply those provisions from 3 January 2017. The FCA envisages that its formal consultation on Handbook changes to implement MiFID II will commence towards the end of 2015 and expects to issue a discussion paper on various conduct of business issues towards the end of the first quarter of 2015. HM Treasury expects to consult on the legislative changes to implement MiFID II in the first quarter of 2015.

Key changes to MiFID

There are a considerable number of key changes to MiFID, the most important of which are as follows:

(i) Commodity derivatives markets

MiFID II introduces a new regime of position limits and position reporting. Reporting obligations will relate to the size and purpose of a commodity derivative contract and regulators will be empowered to monitor and intervene at any stage in trading activity in commodity derivatives (including imposing position limits where there are concerns about disorderly markets). Existing exemptions will be narrowed for commodity firms and in future such firms will only be exempt where their activity is ‘ancillary’ to their main business and their main business is not financial services.

(ii) Organised trading facilities (OTFs)

MiFID II will introduce a new category of venues, organised trading facilities (OTFs), alongside the existing categories of regulated markets (RMs) and multilateral trading facilities (MTFs), OTFs will only be able to trade non-equity instruments. They will be able to exercise discretion in order execution, such as playing a role in negotiations between market participants. OTF operators will be able to trade on a proprietary basis on their own platform in illiquid sovereign bonds and trade on a matched principal basis in all bonds.



(iii) High frequency algorithmic trading (HFT)

There will be new safeguards for high frequency algorithmic trading activities. Firms engaging in HFT must be authorised and high frequency traders must be properly supervised. Requirements will be introduced to strengthen systems and controls relating to risks associated with high frequency trading and systems to ensure that algorithmic trading systems cannot create disorderly trading systems.

(iv) Transparency

OTFs will be subjected to the same transparency rules as other trading venues in order to improve trading transparency in non-equity markets as well as equity markets. A new trading transparency regime for non-equity markets (that is bonds, structured finance products, derivatives and emissions allowances) will therefore be introduced and transparency requirements will be extended to “equity-like” transactions. The exact transparency regime will be tailored to the instrument in question.

(v) Systematic internalisers (SIs)

Currently firms dealing outside a trading venue in liquid shares on an organised, frequent, systematic and substantial basis (a ‘systematic internaliser’ or ‘SI’) are subject to certain pre-trade transparency requirements. MiFID II will clarify the criteria for determining when a firm is an SI, which will include replacing the “material commercial relevance test” with clear quantitative criteria based on the frequency and scale of their trading and clarifying the application in substance of the non-discretionary rules and procedures. MiFID II will also introduce a pre-trade transparency regime for SIs in other liquid financial instruments, requiring SIs to publish two sided quotes (to both buy and sell) and to establish a minimum quote size.

(vi) SME markets

There are provisions to facilitate access to capital for small and medium sized enterprises (SMEs) and to facilitate further development of specialist markets to cater for the needs of SME issuers (known as SME markets or growth markets).

(vii) Conduct of business requirements

The revised legislation seeks to enhance the levels of protection granted to different categories of clients. These include: (a) new requirements for advisors wishing to describe themselves as “independent”; (b) strict restrictions on independent advisers and portfolio managers making or receiving fees, commissions or non-monetary benefits; (c) enhanced information disclosure to different categories of client (in particular, eligible counterparties) especially where complex products are involved; and (d) limiting the circumstances when firms may provide execution-only services.

(viii) New requirements for trading venues

New obligations for trading venues will be imposed, including rules on systems and controls, circuit breakers and the requirement to publish annual data on execution quality.

(ix) Consolidation of market data

A consolidated tape for trade data to ensure data quality and consistency will be introduced. Investment firms will be required to submit post-trade data to Authorised Reporting Mechanisms (ARMs), who will report the details of transaction to regulators on behalf of investment firms to ensure the data is published in a way that facilitates its consolidation with data published by trading venues.

(x) Transaction reporting

The scope of the transaction reporting requirements will be extended to all financial instruments to ensure that the MiFID requirements mirror those of the Market Abuse Directive (2003/6/EC) (MAD). Double reporting of the same information under MiFIR and EMIR will be avoided (and EMIR will be amended to that effect).

(xi) Third-country firms

Harmonised rules for authorisation and conduct of business of EU branches of third-country firms will be implemented. Non-EU firms wishing to provide investment services to retail clients will



be required to do so through a branch. Such firms will be allowed direct access to eligible counterparties and professional clients, subject to ESMA registration and a third-country equivalence/reciprocity decision.

Other key changes to MiFID include:

- Reinforced supervisory powers
- The introduction of sanctions
- The introduction of rules on corporate governance and managers' responsibility for all firms
- The extension of the scope of MiFID to cover financial products (such as structured deposits), services and entities not currently covered
- Emissions allowances trading is to be brought within the MiFID framework

ESMA's first consultation paper (ESMA/2014/549)

In its first consultation paper, ESMA addressed the following issues:

- Investor protection
- Transparency
- Data publication
- Micro-structural issues, such as HFT and Direct Electronic Access (DEA)
- Requirements relating to trading venues
- Commodity derivatives
- Portfolio compression

The consultation closed to comments on 1 August 2014 and ESMA published the list of responses it had received on 5 August 2014.

ESMA's second consultation paper (ESMA/2014/1570)

In its second consultation paper, ESMA has proposed draft technical standards based on the responses it received to its discussion paper (ESMA/2014/548), which addressed the following issues:

- Investor protection
- Transparency
- Micro-structural issues
- Data publication and access
- Requirements relating to trading venues
- Commodity derivatives
- Market data reporting
- Post trading issues

The closing date for responses to the consultation is 2 March 2015. On the basis of the responses to the consultation, ESMA will update the draft technical standards and send the final report to the European Commission for endorsement by mid-2015.

In our next Legal Long in this series, we shall be looking in more detail at the revised conduct of business rules under MiFID II for investment firms.

If you would like to discuss this further, please contact Claire Cummings at Claire.Cummings@cummingslaw.com or on 020 7585 1406.

**This document is for general guidance only. It does not constitute advice
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