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MiFID II

An update

July 2014

There is much within MiFID II, which was finally officially published on 12 June, beyond the scope of a simple briefing paper. Here we seek firstly to give you an update on progress regarding its contents and the timetable for its implementation, and secondly to highlight some issues which are of particular note/ interest.

Background

When MiFID I was introduced from 2007, it was an acknowledgment that markets had moved on since the original Investment Services Directive (or ISD) had been introduced. Now we are moving on to the next stage where there is a recognition that there is a need to promote the integration and competitiveness and efficiency of EU financial markets yet further.

Steven Maijoor, ESMA Chair, indicated that the recently launched MiFID II/MiFIR consultation process is an important step in "*the biggest overhaul of financial markets regulation in the EU for a decade. The reform of MiFID is an integral part of the EU strategy to address the effects of the financial crisis and aims to bring greater transparency to markets and to strengthen investor protection. These changes are key to restoring trust in our financial markets.*
We appreciate the magnitude of this exercise to stakeholders …"

The two main areas concern:

- financial market structure transparency regulation and
- investor protection.

What does MiFID II comprise?

In April 2014 the EU Parliament voted on MiFID II. It comprises two linked pieces of legislation:

MiFID II Level 1

MiFID II http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:JOL_2014_173_R_0009&from=EN amends rules on the authorisation and organisational requirements for providers of investment services and investor protection. The Directive also introduces a new type of trading venue – the organised trading facility (OTF). Standardised derivative contracts are increasingly traded on these platforms which are currently not regulated.

The Markets in Financial Instruments Regulation (MiFIR)

MIFIR http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:JOL_2014_173_R_0005&from=EN improves transparency and competition of trading activities by limiting the use of waivers on disclosure requirements and by providing for non-discriminatory access to trading venues and central counterparties (CCPs) for all financial instruments and requiring derivatives to be traded on organised venues.

In addition there will be a series of implementing measures – Level 2 legislation which takes the form of:

- delegated acts drafted by the Commission on the advice of ESMA and
- also technical standards drafted by ESMA and approved by the Commission.

MiFID II/MiFIR contain over 100 requirements for ESMA to draft regulatory technical standards (RTS) and implementing technical standards (ITS) and provide technical advice to the Commission to allow it to adopt delegated acts.

ESMA have, on 28 May, published a Consultation regarding technical advice and a Discussion Paper on the draft RTS/ITS which will provide the basis for a further Consultation Paper in late 2014/early 2015. The closing date for responses on both May 2014 papers is 1 August 2014.

We therefore now have a large number of documents from which to take a more focused view as to the consequences of the introduction of MiFID II.

What is the timetable?

In attachment 1 to this briefing paper you will find the expected timeline for implementation of MiFID II in diagrammatic form. It shows the plans from the EU perspective and also, so far as we are aware of it, the plan from the UK perspective for its implementation (which we will update from time to time as it develops).

A key point to note is the vast quantity of work which is expected of ESMA in preparing the Level 2 measures mentioned above. A concern might be that firms are expected to work through potential implications without having the full results of the ESMA work at an early stage. You are encouraged to dip in where appropriate to the documents which ESMA published on 22 May because they do give a comprehensive view of how ESMA plan to approach matters – albeit that on the RTS/ITS you also need to await the further Consultation Paper.

From the UK perspective, the FCA have now started to publish its commentaries which are designed to help keep market participants, firms and consumers informed of developments related to MiFID II and firms can register to receive regular email updates at http://www.fca.org.uk/firms/markets/international-markets/mifid-ii/register.

Note that much of MiFID II takes the form of regulations which are directly applicable and so will not require UK implementation specifically.

The MiFID II/MiFIR texts were published in the Official Journal on 12 June 2014 and entered into force 20 days later, on 2 July 2014.

The changes under MiFID II will take effect from 3 January 2017 (i.e. 30 months after they enter into force).

What changes are being made?

The changes are numerous, lengthy and detailed. Whilst not wishing to dodge generating our own summary, perhaps the most helpful starting point is to review the second attachment to this briefing paper which is the FCA's own details of "What is changing?" which it published on its website on 2 May – and a copy appears in Appendix 2 to this Briefing Paper. Most readers of this briefing paper will have UK authorised firms and the FCA have helpfully started to try and categorise the types of amendments and the impact they will have on a UK regulated business and on existing UK regulatory measures and so this is probably the most helpful starting point.

In the following paragraphs, we draw out below some key points to note – on an anecdotal rather than on a summary basis.

Derivatives regulation

- ### Trading Obligation

  MiFIR allows for a class of OTC derivatives which is subject to the clearing obligation under EMIR (or a subset of such a class) to be made subject to a 'trading obligation', requiring that such OTC derivatives are concluded on an EU regulated market, an EU multilateral trading facility (MTF), an EU organised trading facility (OTF) or, subject to certain criteria being satisfied, a third-country trading venue. The trading obligation will apply to covered OTC derivatives concluded between FCs and NFC+s (to use the EMIR terminology) or between a FC/NFC+ and an equivalent non-EU entity.

  In order for a class or a subset of a class to be subject to the trading obligation, there must be at least one trading venue on which that class / subset is traded and there must be sufficient liquidity. Intra-group transactions are exempt from the trading obligation, as are those which are subject to the EMIR transitional provisions in respect of the clearing obligation.

  This trading obligation is broadly in line with the swap execution facility (SEF) requirement in the US under Dodd-Frank.

- ### Commodity Derivatives

  MiFID II brings in a new regime of position limits for commodity derivatives, covering both those traded on trading venues and economically equivalent OTC contracts, in each case both physically- and cash-settled. These limits (to be set by national authorities, but in line with methodologies determined by ESMA) will set a clear maximum size of a position that can be held by an entity or on its behalf at an aggregate group level.

  Crucially, though, positions of a non-financial entity which are objectively measurable as reducing risks directly relating to its commercial activity are not covered. ESMA is required to draft technical standards setting out, amongst other matters, how positions will qualify as "risk-reducing" and when positions are to be aggregated on a group basis.

  Further, commodity derivatives trading venues are required to apply position management controls, including the monitoring of open positions and requiring entities to terminate or reduce their positions or to provide liquidity back to the market.

Market and regulatory developments

- ### Introduction of the Organised Trading Facility (OTF)

  Alongside regulated markets and multi-lateral trading facilities (MTF), MiFID II/MiFIR introduces a new category of trading venue for certain non-equity instruments, the organised trading facility (OTF).

  An OTF is defined as a "multilateral system in which multiple third-party buying and selling interests interact" in bonds, structured finance products, emission allowances or derivatives, and which is neither a regulated market nor an MTF. The operators of an OTF have discretion as to how to execute orders. Such trading venues have to date fallen outside the regulated market and MTF categories under MiFID I and so were consequently not subject to the MiFID I pre-trade transparency requirements. Operators of OTFs will be required to disclose pre-trade transparency information, and will be subject to various conduct of business requirements.

- ### Commodity derivative dealers

  The supervision of commodity markets will be strengthened under MiFID II by the tightening or removal of certain exemptions for commodity dealers that are currently in place. In particular the current exemption for firms whose main business is dealing on their own account in commodities and commodity derivatives is removed. The general effect is to limit the exemptions for firms trading commodity derivatives to those whose main business in not financial services and where dealing in commodities derivatives is ancillary to their main business.

- ### High-Frequency Trading and algorithmic trading

  It is perceived that the increased use of algorithmic trading and high-frequency trading has introduced new potential risks that may create a disorderly market, such as the risk such trading practices may overload a trading venue or that an algorithmic trading model may malfunction.

  New rules will require investment firms undertaking algorithmic trading and operators of trading venues to enhance their systems, processes and controls. In particular

algorithmic trading firms will be required to have effective systems and risk controls, business continuity arrangements, and systems which are fully tested and properly monitored.

Firms employing market making strategies through algorithmic trading will be subject to further requirements. These firms must carry out market making activities continuously during a specified proportion of a trading venue's trading hours so that liquidity is provided on a regular and predictable basis to the trading venue. ESMA regulatory technical standards will clarify what the specified proportion will be, which will be based on the liquidity, scale and nature of the specific market and the characteristics of the financial instrument traded.

"Clarifications"

As usual with the UK, we already have some relevant provisions which cover the territory now encompassed by MiFID II provisions. The MiFID II provisions will add, expand or change them – and some of the MiFID II provisions "clarify" MiFID I.

- ### Suitability

An established point is that investment firms providing investment advice or portfolio management have to provide suitable recommendations. Under MiFID II investment firms providing investment advice or portfolio management have to provide suitable personal recommendations to their clients or have to make suitable investment decisions on behalf of their clients. ESMA's recommendation is that Article 35 of the MiFID Implementing Directive is expanded for certain clarifications. Clearly though they think that further work is necessary to expand the Implementing Directive text itself. This would for example clarify:

- the responsibility to undertake the suitability assessment lies with the investment firm;
- the assessment should not be limited to recommendations to buy but every personal recommendation given to the client;
- where the investment firm has an ongoing relationship e.g. for ongoing advice or portfolio management service, the firm has to have and be able to demonstrate appropriate procedures to maintain adequate and update information about the client so that it can fulfil the Article 35(1) MiFID Implementing Directive requirements.

In relation to suitability reports, ESMA provide draft technical advice about what they should include. This is not explicit under MiFID I and ESMA's proposals will strengthen requirements here – on top of the provisions of some members states' requirements.

- ### Client agreements

The requirement to enter into written agreements currently applies for retail clients to an investment firm began providing services after the date of application of the MiFID Implementing Directive i.e. new retail clients. In the UK we are used to formal written agreements not only for regulatory reasons but also for good practice. ESMA still note in their recent consultation paper that it is sometimes considered burdensome and unnecessary to require the investment firm to conclude a written agreement with its professional clients but I think in the UK we would think that this is part of the ordinary course of having the formal relationship documented.

- ### Conflicts of interests

We are well used to conflicts of interest regulation and indeed the Commission Consultation indicates that current MiFID Rules on conflict of interest are regarded as constituting "an effective and proportionate framework for the identification and management of such conflicts". There is though consideration of implementing clarifications designed to ensure a more consistent application of the requirements across Europe. Specifically, the Commission and now the ESMA Consultation focus on making specific reference to the disclosure requirements so as to clarify that disclosure should only be a measure of last resort and not a means for managing conflicts. This started with MiFID I but clearly just thought it necessary to provide more specifics to clarify and supplement the existing regime – and require a periodic review at least annually of conflicts of interest policies.

- ### Investment advice and use of distribution channels

The exemption from the definition of advice covering distribution channels (pursuant to Article 52 of the MiFID Implementing Directive) only applies when the recommendation is actually addressed to the public in general and the use of a distribution channel cannot automatically exclude the provision of investment advice under MiFID. Situations where, for example, email correspondence is used to provide personal recommendations to a specific person rather than address information to the public in general can amount to investment advice. Reference to distribution channels is therefore a point which ESMA recommend should be removed from Article 52 of the Implementing Directive.

Strengthening of MiFID I provisions

- ### Fair clear and not misleading information

Level 1 of the MiFID II Directive in Article 24(3) is to require that "*All information including marketing communications addressed by the investment firm to clients or potential clients should be fair clear and not misleading*". Also the point is now made that marketing communications should be clearly identifiable as such.

Whilst this basic principle has long been enshrined in the UK's regulatory approach, the challenge has always been to interpret quite how this should be applied in all circumstances. It might be preferable if, in each individual circumstance, what is fair clear and not misleading might be assessed by the firm so hopefully the making of detailed

provisions under this section should hopefully be limited?

This is one of the interesting areas where MiFID II extends the treatment not only to retail clients but to non-retail clients – professional investor and eligible counterparties. ESMA's guidance is taking this into account in order to propose targeted improvements to the regime applicable to non-retail clients where appropriate. For example, under its draft technical advice, information for professional clients should not give any reference to potential benefits without also giving a fair and prominent indication of relevant risks, should not disguise, diminish or obscure important items statements or warnings and should be accurate and up to date relevant to the method of communication used. Whilst this consistent approach should have been axiomatic for all firms in all instances for all types of clients, it is now to be specifically required.

One new aspect of the MiFID II provisions when compared with MiFID I is that one of the objectives of the MiFID review was to improve where appropriate the treatment of non-retail clients – i.e. professional clients and eligible counterparties – and in this respect the general principles applying to the provision of investment services – to act honestly, fairly and professionally and to provide fair, clear and not misleading information as well as some specific conduct of business rules in the area of information and reporting, have been extended to eligible counterparties.

The general information requirements under Article 24(4) are also being similarly improved for retail and non-retail clients.

- **Inducements**

The restrictions on legitimacy of inducements is a well-known concept pursuant to MiFID I. MiFID II aims to strengthen the current MiFID requirements for third party payments and benefits. It distinguishes between the rules that apply to investment services of portfolio management and investment advice on an independent basis, and for all other investment services.

The basic position will be that all fees commissions and monetary benefits paid or provided by a third party must be returned in full to the client as soon as possible after receipt of those payments by the firm and the firm should not be allowed to offset any third party payments from the fees due by the client to the firm. Firms providing independent advice or portfolio management must also set up a policy to ensure that third party payment received are allocated and transferred to the client.

Only minor non-monetary benefits should be allowed provided that they are clearly disclosed to the client and that they are capable of enhancing the quality of the service provided and that they do not or could not be judged to impair the ability of investment firms to act in the best interests of their clients. ESMA believes that the minor non-monetary benefits exemption should be interpreted strictly such that non-monetary benefits likely to influence the behaviour of the recipient should not be allowed.

ESMA also think that the receipt of minor non-monetary benefits should be permitted in respect of all MiFID investment and ancillary services, not only for independent advice or portfolio management, in accordance with the same conditions. Again this seems to be ESMA extending the precise terminology in the MiFID I level 1 provisions.

Firms should review ESMA's draft technical advice on what might constitute minor non-monetary benefits carefully. It is intended that the Commission will introduce an *exhaustive* list of non-monetary benefits that can be considered to be minor and therefore acceptable. Their initial comments on what might be included in the list includes participation in conference seminar and other training events and the benefits and features of the specific financial instrument investment or service; hospitality of a reasonable de minimis basis which for example might include food and drink during a business meeting or a conference seminar or other training event – and provision of information or documentation relating to a financial instrument (including financial research) or an investment service which could be generic in nature or personalised to reflect the circumstances of an individual client. These examples are, as you can see, very limited in their scope.

Any such benefits which are so identified should only qualify as minor when they are reasonable and proportionate and of such scale that they are unlikely to influence recipient's behaviour in any way that is detrimental to the interests of the relevant client. ESMA is advising the Commission to introduce a *non exhaustive* list of circumstances and situations that NCAs should consider in determining whether the quality enhancement test is not met. A fee is generally not to be regarded as designed to enhance the quality and service if it is used to pay for goods and services that are essential to the recipient firm in its ordinary course of business, does not provide for a higher or additional quality of service above the regulatory requirements provided to the end user client, directly benefits the recipient firm shareholders or employees without tangible benefit or value to its end user client or, in relation to an ongoing inducement, it is not related to the provision of an ongoing service to the end user client.

UK gold plating

A likely UK specific category of changes is where some UK provisions will remain as gold plating. Under MiFID I, countries can impose in limited circumstances requirements that go beyond those of MiFID. An example in the UK concerns the Retail Distribution Review (RDR) and this can be taken forward when MiFID II is introduced. The FCA expect the current RDR restrictions on payments to all investment advisers to be maintained – and the new MiFID II restrictions on inducements will most likely have an effect on portfolio managers who are not currently subject to the RDR unless they offer advisory services.

Area of focus

- **Costs and charges**

A key focus is on information to clients on costs and customer associated charges as required under Article 24(4)(c). ESMA is advising on the format and timing of disclosures and other detailed matters. The new focus under Article 33 is that the total price paid for the client including all related fees commissions and charges and expenses and all taxes payable via the investment firm should be provided to clients.

Note that Article 33 applies to retail clients only. ESMA in its consultation paper however considers that increased transparency on costs is relevant for all categories of clients including non-retail clients and therefore is proposing implementing measures in line with MiFID II text to all categories of clients.

The dichotomy between the different regimes becomes clear as between MiFID II and UCITS/PRIIPs in ESMA asking the Commission to consider further the issue in relation to costs and charges. The UCITS KIID for example does not include an obligation to provide information about transaction costs and the PRIPS regulation introduces a KIID to be produced for all packaged retail investment products (subject to the initial UCITS carve-out because they already have a KID document). ESMA identify that it is essential that there is some consistency because investment firms providing disclosure, in the context of MiFID investments, will need to be able to rely on the costs and charges disclosed in product KIID documents when aggregating the costs and charges according to MiFID II. Leaving aside consistency being a desirable object in any event, this is a practical issue for implementation of MiFID II by investment firms.

The UK IMA is making proposals for disclosure of fund costs in pounds and pence – and also seeking to develop a common standard for calculation of portfolio turnover rate. Hopefully the MiFID arrangements as developed might match with these which are being developed in advance in the UK. Note that ESMA considers that the increased transparency on costs, however it might be formulated, is relevant for all categories of clients including non-retail clients.

- **Appropriateness – and complex products**

One of the difficult areas of MiFID I has been the appropriateness provision, which includes a definition of non-complex instruments.

In 2009 CESR published a Q&A statement on MiFID complex and non-complex instruments and, with the development of instruments over recent years, this problem has been the focus of much attention. ESMA is now recommending adding two criteria to Article 38 of the MiFID implementing Directive which an instrument not included explicitly in Article 25(4)(a) of MiFID II would need to meet to be considered non-complex:

- it does not incorporate a clause, condition or trigger that could fundamentally alter the nature or risk of the investment of the investment or pay-out profile. This would include for example investments that incorporate a right to convert the instrument into a different investment; and
- it does not include any explicit or implicit exit charges that have the effect of making the investment illiquid even though technically frequent opportunities to dispose or redeem it would be possible.

ESMA is also recommending clarification of complex instruments described in Article 25(4)(a) of MiFID II which do not meet the specific requirements of any of the tests in 1 – 5 of that Article should be considered complex.

The debate on what should or should not be regarded as "complex" is likely to be a lively debate for some time. The focus on comprehensibility and understandability as indicating whether something is complex or not may not be the right way forward but it is a proposal which is being discussed in various member states. The final direction of travel on this issue will be an important one for determining how many of the more innovative products can be offered widely.

- **Responsibilities of manufacturers and distributors**

There is some interesting comment regarding product governance and the respective obligations of manufacturers and distributors. For those used to the UK established work in this area, you are likely to have some arrangements already in place but those now proposed in the ESMA draft guidance go further.

- Responsibilities of manufacturers

Article 24 will require that investment firms which manufacture financial instruments for sale to clients shall ensure that those financial instruments are designed to meet the needs of an identified target market of end clients within the relevant category of clients, the strategy for the distribution of the financial instruments is compatible with the identified target market and the investment firm takes reasonable steps to ensure that the financial instrument is distributed to the identified target market. An investment firm must understand the financial instruments they offer or recommend, assess the compatibility of those instruments with the needs of the clients to whom it provides investment services, also taking into account the identified target market of end clients and ensure that the financial instruments are offered or recommended only when this is in the interest of the client.

ESMA refer to the Commission's Consultation from December 2010 and concludes that the final version of the MiFID II text is consistent with that original consultation – and ESMA also refer to the European Supervisory

Authority's joint position on manufacturers product oversight and governance processes of November 2013 and IOSCO work on the regulation of structured retail products, and finally ESMA's March 2014 opinion on structured retail products and good practices for their product governance arrangements. ESMA's May Consultation Paper goes on to set out details of proposals for amending the MiFID Implementing Directive which, for example for product manufacturers, will oblige manufacturers to devise requirements for the following:

- procedures and arrangements to ensure that conflicts of interest, including those related to remuneration, are properly managed as part of product design, creation and development process;
- governance processes to ensure effective oversight and control over the product design and manufacture process;
- the assessment of the potential target market for the products designed and developed to limit the risk of products being sold to investors that are not compatible with their characteristics, needs and objectives;
- the assessment of risks of poor investor outcomes posed by products in the circumstances that may cause these outcomes to occur;
- due consideration of the charging structure proposed for products and the extent to which this can impact the outcomes for the target market;
- the provision of adequate information to distributors to enable distributors to understand and sell the product properly; and
- the regular review of the investment product offered or marketed taking into account any event that could materially affect the potential risk to the identified target market to assess at least whether the product remains consistent or the needs of the identified target market and whether the intended distribution strategy remains appropriate. ESMA set out four possible options for the frequency of product reviews.

- Responsibilities of distributors

ESMA propose that obligations for distributors include:

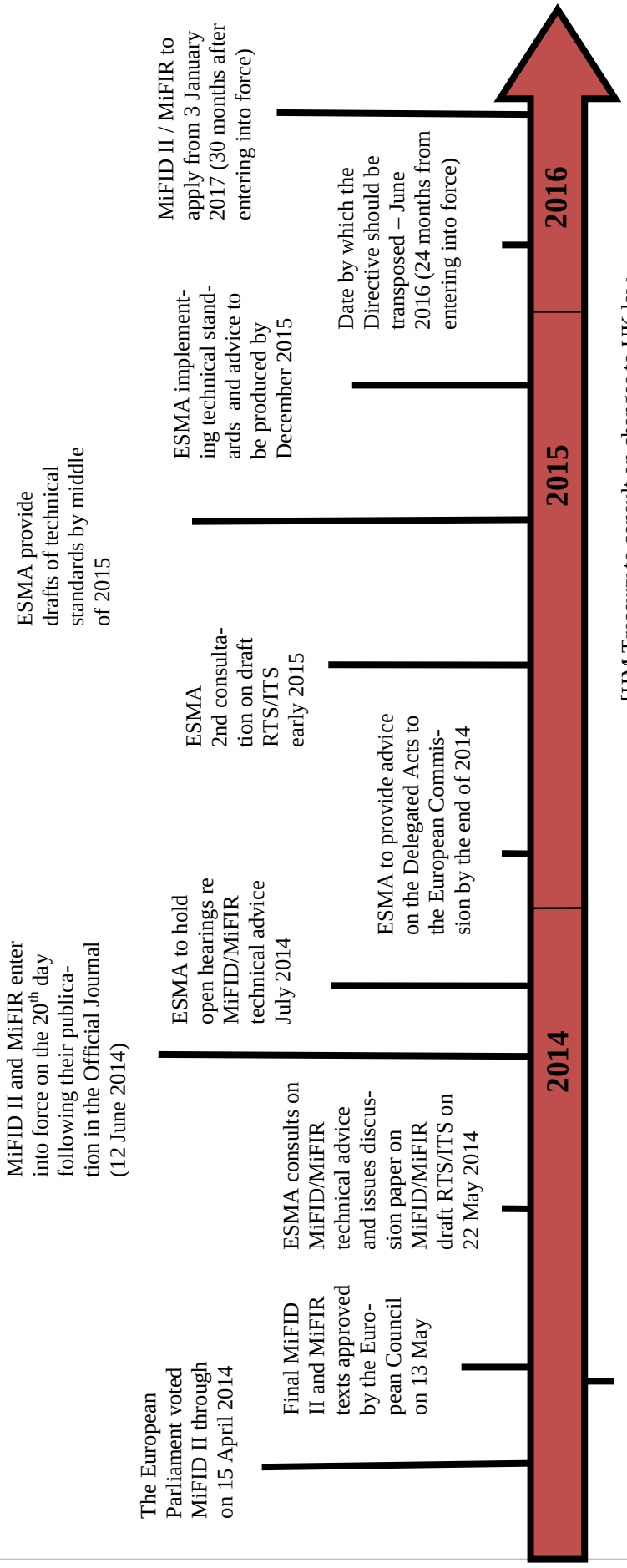
- product governance processes to ensure the products and services the investment firm intends to offer are compatible with the characteristics, objectives and needs of the identified target market;
- the periodic review of those arrangements to ensure they remain robust and fit for purpose;

- the provision of sales information to manufacturers to assist manufacturers in meeting their post sale product governance responsibilities – which might assist the current dilemma for manufacturers that they simply will not know what happens in the distribution chain;
- the involvement of the compliance function in the development and product review of product governance arrangements in order to detect any risk of failure by distributors to comply with their obligations;
- the endorsement of the management body or other corresponding governing body of the range of investment products and services that will be offered and their respective target markets and the provision of information to senior management in the compliance functions periodic reports to the management body; and
- when investments are manufactured or issued by third country firms or non MiFID firms, distributors must take all reasonable steps to ensure that the level of product information obtained for any manufacturer/issuer is of a reliable and adequate standard to ensure that products will be distributed in accordance with the characteristics, objectives and needs of the target market – given the lack of detailed due diligence, say, on some offshore fund products, this should hopefully increase the level of information of which some distributors appraise themselves before promoting them to their clients.
  Note that the final distributor in the chain, i.e. the firm with the direct client relationship, has the ultimate responsibility to meet these product governance obligations but the intermediate distributor firm(s) must perform certain limited functions to ensure that the relevant product information is passed to the final distributor and, in reverse, if the product manufacturer requires information on product sales to comply with its product governance obligations, the intermediate firm must enable them to obtain it – and apply the product governance obligations for manufacturers as relevant in relation to the service they provide.

It will be interesting to see how detailed the identification of target markets needs to be. The draft Technical Guidance indicates "*The target market must be specified at a sufficiently granular level to avoid the inclusion of any group of investors for whose needs, characteristics and objectives of the product is not compatible*". This seems a somewhat negative way of approaching matters and also manufacturers will often struggle to know the investors to whom distributors may be promoting products. For larger firms which can train and constrain their distribution channel activities in their likely new workstreams in this area, there may be a practical solution. The issue may well be particularly concerning though for smaller manufacturers who are simply not in a position to undertake such an exercise.

The scope of MiFID II is therefore wide ranging and will have an effect on all manner of activities of asset managers. Investment firms should ensure that they keep abreast of the detailed ESMA work on the MiFID II Level 2 measures in order that they can work out the implications for their businesses in good time before MiFID II takes effect in 2017.

Appendix 1: MiFID II: Expected timeline



Note:

1. MiFID I has been applied since 2007 and MiFID II should take effect from 3 January 2017.
2. MiFID II and MiFIR require ESMA to develop draft Technical Standards and implementing Technical Standards in several areas for submission to the Commission by respectively 12 and 18 months from the entry into force of the Directive and the Regulation.
3. Also note that much of MiFID takes the forms of regulations which are directly applicable and do not need to be converted into UK domestic law and regulation. The FCA is discussing with Trade Associations and HM Treasury the best way to implement MiFID II in the UK. Note it is not simply an implementation issue but also how to adapt domestic laws and regulation to the revised legislation.

Appendix 2: FCA publication: MiFID II: what is changing

MiFID II – what is changing?

Published: 02/05/2014

We summarise the significant changes proposed to the Markets in Financial Instruments Directive.

Commodity Derivatives

The revisions to MiFID are adapting some elements of the existing directive and introducing a new regime of position limits and position reporting. Key details of these provisions will be determined through 'Level 2' implementing measures

- **Exemptions:** The current broad exemptions for commercial firms who trade commodity derivatives are being narrowed. 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.
- **Financial instruments.** Emission allowances will be financial instruments under the revised MiFID. Physically settled contracts traded on Organised Trading Facilities, a new category of trading venues, will be financial instruments except for electricity and gas contracts.
- **Position limits.** Contracts traded on trading venues and economically equivalent contracts will be subject to position limits set by us using a methodology in an implementing measure. There will be exemptions for non-financial firms on positions which are objectively measurable as reducing risks directly related to their commercial activity
- **Position reporting.** Details of positions will need to be reported to trading venues on a daily basis. Once a week this information will need to be sent by the trading venues to the European Securities and Markets Authority (ESMA) who will publish aggregated reports distinguishing between positions held by commercial firms and financial firms. Investment firms will be required to report OTC positions to their competent authority.

Firms trading commodity derivatives who are not currently authorised under MIFID will need to examine whether they can continue to remain exempt from authorisation. Trading venues and members of trading venues (and their clients) will need to consider how the implications of the regime of position limits and position reporting.

Transparency

The existing pre and post trade transparency regime in MIFID applies only to shares admitted to trading on a regulated market. That regime is being revised and a regime will be applied to non-equities. The details of the equity and non-equity transparency regimes will be determined through 'Level 2' implementing measures.

- **Scope of regime for equities.** The pre and post-trade transparency regime for shares is being extended to cover depositary receipts, ETFs, certificates and other similar financial instruments traded on a RM or MTF.
- **Caps on equity waivers.** Trading under the reference price waiver and negotiated transactions made within the current weighted spread on the order book will not be able to exceed 8 per cent of total trading in a given share on all EU trading venues where the share trades. There is also a cap at 4 per cent for use of these waivers by an individual trading venue.
- **Non-equity pre-trade transparency.** Trading venues will need to make information about trading interest publicly available. This obligation will not apply where there is not a liquid market for an instrument, an order is large-in-scale compared with normal market size, is held in an order management facility or is trading interest above a size that that would expose liquidity providers to undue risk (as long as indicative prices are publicly disseminated).
- **Non-equity post-trade transparency.** Details of transactions conducted on trading venues will need to be made public as close to real-time as possible. Deferred publication will be possible for under certain circumstances including when a transaction is large in scale compared to normal market size. For sovereign debt instruments once the period of deferral ends, the volume of transactions can be published on an aggregated rather than transaction-by-transaction basis

Trading venues will need to implement the rule and systems changes necessary to comply with the transparency requirements. Members of trading venues will have to consider what impact the revised transparency regime will have on their trading activities

High frequency trading

The revised MiFID will introduce specific provisions designed to ensure that high frequency trading (HFT) does not have an adverse effect on market quality or integrity The details of the provisions will be determined through 'Level 2' implementing measures.

- **Authorisation:** The revisions will require HFT firms engaging in proprietary trading to be authorised under MiFID
- **Market making.** In addition to systems and controls requirements on the use of algorithms, HFT firms who use market making strategies on trading venues will be required to enter into market making agreements with the venues. This is designed to ensure they provide liquidity on a consistent basis
- **Order to trade ratios.** Trading venues will be required to set limits on the maximum number of order messages that a market participant can send relative to the number of transactions they undertake.
- **Tick sizes.** Equity exchanges in Europe currently voluntarily set minimum increments, 'tick sizes', by which prices can change. Implementing measures will set minimum tick sizes in shares and other similar financial instruments.
- **Venue pricing.** There will be controls on venue pricing to ensure that it is transparent, fair and non-discriminatory and can be used to penalise excessive order messaging.

The HFT provisions build on ESMA's 2012 Automated Trading Guidelines. They have implications both for members of trading venues and for the venues themselves. They will require systems changes and, for firms, enhanced governance of HFT activities.

Market structure

The revisions to market structure are designed to produce comprehensive regulation of secondary trading that is fair, efficient and safe. Detail of these provisions will be set out in Level 2 implementing measures.

- **Organised Trading Facilities.** A new category of venues, alongside the existing categories of regulated markets (RMs) and multilateral trading facilities (MTFs), organised trading facilities (OTFs). 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.
- **Systematic internalisers (SIs).** Currently firms dealing outside a trading venue in liquid shares on an organised, frequent, systematic and substantial basis are subject to certain pre-trade transparency requirements. The revised MiFID will introduce a pre-trade transparency regime for SIs in other liquid financial instruments. Firms will be identified as SIs on the basis of quantitative criteria based on the frequency and scale of their trading.
- **Derivatives trading obligation.** In line with G20 commitments, transactions in derivatives subject to the clearing obligation under the so-called European Market Infrastructure Regulation (EMIR) will be required to take place on an RM, MTF or OTF where the instrument is sufficiently liquid.
- **Trading obligation in shares.** Where a share is admitted to trading on a trading venue it will be required to be traded on a RM, MTF or SI unless certain criteria apply, such as the transaction does not involve a retail client and does not contribute to the price formation process.

Firms currently operating multilateral trading systems will need to decide how they fit into the new trading landscape. This will include firms whose systems are not currently regulated as a trading venue, and firms operating MTFs which involve discretionary and non-discretionary trading processes. Firms currently operating bilateral trading systems will need to consider whether their activity will lead to them becoming SIs. Market participants will need to consider the impact of the two trading obligations on their trading activity.

Organisational requirements

The revised MiFID will introduce expanded requirements in respect of the management of firms, explicit organisational and conduct requirements relating to product governance arrangements and a prohibition on title transfer collateral agreements involving retail clients.

- **Management bodies.** Provisions which were imposed on banks in the Capital Requirements Directive are now being extended to investment firms. These require members of management bodies to be of the requisite calibre, to be limited in the number of appointments they take on and to act with honesty and integrity. Larger firms have to have nomination committees. The management body is to be held responsible for the firm having governance arrangements that ensure effective and prudent management of a firm
- **Product governance.** As part of organisational requirements and conduct rules firms will be expected to have explicit arrangements for product governance. Product governance arrangements will apply to firms who manufacture products and to those selling them and are designed to try and ensure that firms understand the nature of the products they are manufacturing and/or selling and that they are sold to clients for whom they are likely to be suitable.
- **Sales targets and remuneration.** Requirements on remuneration build on the European Securities and Markets Authority's Guidelines on Remuneration Policies and Practices (MiFID) and aimed at ensuring that the staff incentives do not cause conflicts of interest or cut across firms' obligation to act in the best interests of their clients.
- **Title transfer collateral arrangements.** We have restricted title transfer collateral arrangements in relation to retail clients' dealings in foreign exchange derivatives. The revised MiFID will extend this prohibition to all of retail clients' dealings in financial instruments. So firms will be required to treat all monies put up by retail clients as client money.

All investment firms will be affected by the provisions relating to management bodies and will need to consider how their existing governance arrangements match up to them. Most investment firms will be affected by the product governance and remuneration requirements and will need to review their existing arrangements in these areas.

Trade reporting

The provisions in the revised legislation on trade reporting are designed to resolve problems with the quality and availability of data that have been observed since the original directive was introduced. Level 2 implementing measures will provide more detail on how these provisions will work

- **Consolidated tape.** The revised MiFID envisages that there should be a consolidated tape of trade reports for shares, depositary receipts, ETFs, certificates and other similar financial instruments from when the revised legislation takes effect at the end of 2016. Two years later it is envisaged that there will be a consolidated tape for non-equity instruments. The consolidated tape will be available free of charge 15 minutes after publication.
- **Consolidated tape providers (CTPs).** The consolidated tape will be produced by firms who seek authorisation as consolidated tape providers. They will have to meet certain organisational requirements and make the consolidated tape available on reasonable commercial terms. The model of having multiple CTPs will be reviewed after the legislation takes effect with a view to a single provider being appointed if the model of having multiple CTPs is not judged to have been a success.
- **Approved publication arrangements (APAs).** MiFID allowed trade reports to be published through trading venues, a third party or proprietary arrangements. We established a Trade Data Monitors (TDM) regime to ensure that third parties publishing data had adequate arrangements in place to ensure the quality of the data. The revised MiFID has a similar regime which requires third parties publishing data to meet certain organisational requirements and be authorised as APAs.

Firms who are currently offering consolidated data services will need to decide whether or not to become authorised under the CTP regime. TDMs will need to decide whether they wish to become APAs and investment firms will need to decide of those firms who become APAs which they want to use to publish their transactions.

Conduct of business rules

The revised legislation seeks to enhance the levels of protection granted to different categories of clients. A lot of the detail of the provisions, as is currently the case, will be provided in Level 2 implementing measures.

- **Inducements.** The existing legislation places restrictions on payments that firms providing services to clients can receive or make in relation to the provision of the service. The revised legislation goes beyond the existing provisions in prohibiting firms providing independent advice or portfolio management from receiving and retaining payments from third parties
- **Goldplating.** As under the existing legislation, countries will be able to impose, in limited circumstances, requirements that go beyond those in MiFID. As part of this existing notifications of additional measures, such as those the UK has made in relation to the Retail Distribution Review (RDR), can be carried forward when the revised legislation takes effect.
- **Execution-only.** Under the current directive firms can only allow clients to buy and sell a certain range of products on an execution-only basis. The revised legislation is narrowing the list of execution-only products, in particular structured UCITS will no longer be able to be sold on an execution-only

basis. Structured deposits – which are newly being brought into MiFID – will also be affected; no longer being allowed to be sold on an execution-only basis if, for example, it is difficult to understand the cost of exiting before term.

- **Best execution.** Additional information will need to be provided in relation to best execution. Brokers will need to provide details of the main 5 execution venues for each of the main categories of financial instruments they provide services in relation to.

We would expect to maintain the current RDR restrictions on payments to all investment advisers. The main impact of the new restrictions on inducements is therefore likely to be on portfolio managers, who are not currently subject to the RDR unless they offer advisory services. Firms offering execution-only services will need to review their offerings in the light of the changed list of products that can be sold on an execution-only basis. Brokers will also need to develop the systems to publish information on the execution venues they use

Transaction reporting

The scope of the transaction reporting obligation is being extended, the scope of the reports is being enhanced and an EU-wide system of Approved Reporting Mechanisms (ARMs) is being introduced.

- **Scope.** The scope of the MiFID transaction reporting obligation is being extended beyond instruments admitted to trading on regulated markets to include instruments trading on MTFs and OTFs and financial instruments which have instruments trading on trading venues as an underlying. Existing requirements in the UK go beyond those in MiFID but the revised legislation has an even wider scope.
- **Flags.** The revised legislation will require additional information to be included in transaction reports, in particular whether a transaction in shares or sovereign bonds is a short sale and whether a transaction took place under an applicable waiver.
- **Approved Reporting Mechanisms (ARMs).** The UK established a regime for ARMs in implementing the existing directive. The revised MiFID introduces an EU-wide ARMs regime under which investment firms can make transaction reports through firms authorised to act as ARMs and subject to certain organisational requirements to ensure they are organised to discharge their responsibilities.
- **Trading venues.** Operators of trading venues will have to report transactions executed through their systems by firms not subject to MiFIR.

Investment firms who execute transactions will need to review their transactions to understand whether they will need to report a wider range of transactions than they currently do and how, if necessary, to report the wider range of information required.

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Contacts

Kirstene Baillie
Partner - Financial Services

E: kirstene.baillie@fieldfisher.com
T: +44 (0)20 7861 4000

Nicholas Thompsell
Partner - Financial Services

E: nicholas.thompsell@fieldfisher.com
T: +44 (0)20 7861 4292

Guy Usher
Partner - Derivatives and Structured Finance

E: guy.usher@fieldfisher.com
T: +44 (0)20 7861 4209

Andrew Massey
Senior Associate - Financial Services

E: andrew.massey@fieldfisher.com
T: +44 (0)20 7861 4056

Edward Miller
Partner - Derivatives and Structured Finance

E: edward.miller@fieldfisher.com
T: +44 (0)20 7861 4205

John Dooley
Solicitor - Financial Services

E: john.dooley@fieldfisher.com
T: +44 (0)20 7861 4086

Daniel Franks
Partner - Derivatives and Structured Finance

E: daniel.franks@fieldfisher.com
T: +44 (0)20 7861 4205