MiFID II – an overview of the new regime

Executive Summary

Following the European Commission’s review of the Markets in Financial Instruments Directive (Directive 2004/39/EC) (MiFID), the MiFID II Directive (2014/65/EU) and the Markets in Financial Instruments Regulation (Regulation 600/2014) (MiFIR) will enter into force on 3 January 2017. MiFID II contains new EU-wide rules governing investment firms, trading venues and market structures, as well as third-country firms providing investment services or activities in the EU.

Some key elements of the new regime are:

- the introduction of a new category of trading venue – the Organised Trading Facility (OTF) – which will bring additional trading activity within the scope of regulation;
- a requirement for OTC derivatives contracts subject to the EMIR clearing obligation to be traded on certain types of trading venues;
- a general increase in scope, with additional financial instruments and fewer and/or narrowed exemptions;
- the extension of pre- and post-trade transparency requirements to non-equities;
- changes to the transaction reporting regime;
- new rules for High Frequency Trading (HFT);
- a new distinction between ‘independent’ and restricted financial advice, with a ban on third-party inducements in relation to the former;
- new corporate governance requirements equivalent to those applied under CRD IV (the Capital Requirements Regulation (Regulation (EU) No 575/2013) and the Capital Requirements Directive (Directive 2013/36/EU)); and
- new product intervention powers for the European Securities & Markets Authority (ESMA).

Background

MiFID was implemented on 1 November 2007, and, at the time of writing, is still the legislation currently in force. MiFID II reforms and replaces MiFID, in response to technological developments in the markets since MiFID’s implementation, concerns arising out of the financial crisis, such as investor protection and specific issues requiring resolution, such as the commodity regime and exemptions.

This report provides a high level overview of the main elements of MiFID II.

Scope

MiFID II substantially broadens the scope of MiFID by bringing new activities into scope, removing or narrowing exemptions and covering new financial instruments and a wider range of products.

Some firms that are currently unauthorised or outside the scope of MiFID will need to apply for authorisation or become investment firms, whilst existing authorised investment firms will find that MiFID II rules apply to a broader range of activities and financial instruments.

Commodity derivatives and emission allowances

Under MiFID, there were a broad range of exemptions used by commodities market participants. These exemptions have been deleted (in the case of the commodities dealer exemption) or narrowed (in the case of the own account dealing exemption and ancillary business exemption). Commodities market participants will now need to rely on the narrowed ancillary activity exemption for commodity derivatives trading (although this could be combined with the own account dealing exemption for other investment activities such as treasury risk management). Commodities firms that rely on the on the ancillary activity exemption must make an annual notification to the relevant competent authority.
Commodity derivatives contracts that can be physically settled and that are traded on OTFs (see below) are now ‘financial instruments’ falling within the scope of MiFID II. This is with the exception of wholesale energy products (as defined under REMIT (Regulation 1227/2011)), e.g. electricity and gas contracts, traded on an OTF that must be physically settled.

Emission allowances are also now ‘financial instruments’ covered by MiFID II in their own right. Physically settled derivatives relating to emission allowances have also been brought within scope (in addition to cash-settled derivatives which were previously caught).

**Structured deposits**

Structured deposits (i.e. deposits with a non-interest rate linked rate of return, e.g. linked to the performance of indices, financial instruments, commodities or foreign exchange rates) are brought within the scope of certain requirements under MiFID II. MiFID II rules will apply to investment firms when selling or advising in relation to structured deposits; and structured deposits will be covered by the ‘execution only’ regime (see below).

**Own account dealing**

The exemption in MiFID for persons dealing on their own account, but not otherwise providing investment services (and with certain other restrictions), has been amended, and will not be available to:

- persons dealing on own account in commodity derivatives, emission allowances or related derivatives;
- members of and participants in a Regulated Market or MTF;
- persons with direct market access to a trading venue; and
- persons engaged in high-frequency trading (HFT).

**Market regulation**

The original MiFID introduced a new hierarchy of trading venues:

- Regulated Markets, including the major stock exchanges, which are subject to the highest regulatory standards (e.g. for listing) and can only be run by dedicated market operators;
- Multilateral Trading Facilities (MTFs), which can be either primary or secondary trading venues, and which can be operated by investment firms; and
- Systematic Internalisers (SIs), an off-market trading platform for liquid shares offered by an investment firm on an organised, frequent, systematic and substantial basis (as identified based on quantitative criteria).

MiFID II adds a new category: Organised Trading Facilities (OTFs) (see below).

**Organised Trading Facilities (OTFs)**

The new category of trading venue, an OTF, is intended to capture certain existing trading arrangements between authorised firms such as broker crossing networks which, at present, exist outside formal trading venues such as MTFs and SIs, as well as systems for trading liquid derivatives which are subject to the EMIR clearing obligation (see below). OTFs are limited to trading in bonds, structured finance products, emission allowances and derivatives. Like MTFs, they can be operated by either a market operator or an investment firm which must be authorised for this purpose. Unlike Regulated Markets and MTFs, OTF operators will be able to exercise discretion in order execution. They are prohibited from executing orders against proprietary capital, except for trades in illiquid sovereign bonds, or in matched principal trading in some cases.

**OTC derivatives trading**

For more information on EMIR and the clearing obligation, please see the RegZone [EMIR page](#).

Any OTC derivatives contract which is

- subject to the EMIR clearing obligation (as specified by ESMA); and
- sufficiently liquid

must be traded on a Regulated Market, MTF or OTF.

ESMA will determine which classes of derivatives are subject to the trading obligation. There are certain exemptions for intragroup transactions and portfolio compression.

In addition, there is a new requirement for transactions in all centrally-cleared derivatives – not just those subject to the EMIR clearing obligation – to be accepted for clearing as soon as is technologically practicable, using automated systems.

There are provisions in both EMIR and MiFIR requiring that market participants be granted non-discriminatory access to central counterparties (CCPs) for the purposes of central clearing of OTC derivatives contracts.
Algorithmic and high-frequency trading (HFT)

Firms using algorithmic trading must notify this to their home state competent authority and that of the trading venue. Firms must put in place appropriate systems and controls to ensure that their trading systems are resilient and have sufficient capacity, are subject to appropriate thresholds and limits, and prevent erroneous orders or other malfunctions that could contribute to market disorder. They must also have systems and risk controls to ensure their trading systems cannot be used for any purposes contrary to the market abuse regime or the rules of a trading venue to which they are connected. Systems must be tested and monitored, and firms must have business continuity arrangements in place.

Firms engaging in algorithmic trading for market-making will be required to enter into a written agreement with the trading venue, and have in place systems and controls to ensure they fulfil their obligations under that agreement.

Investment firms and trading venues should ensure robust measures are in place to ensure that algorithmic trading or HFT does not create a disorderly market and cannot be used for abusive purposes.

Firms engaging in HFT must keep time sequenced records of all placed orders, including cancellations, executed orders and quotations on trading venues, and must make them available to regulators on request. Regulators may also require information from firms about their algorithmic trading strategies, which may be communicated to the regulators of the trading venues involved.

Pre- and post-trade transparency

Pre- and post-trade transparency requirements are extended to a wider range of instruments beyond equities. The requirements will now also apply to equity-like instruments such as depository receipts and exchange-traded funds (ETFs), as well as non-equity instruments such as bonds, structured finance products, emission allowances & derivatives; and will apply to Regulated Markets, MTFs and OTFs (SIs will be subject to a specialised pre-trade transparency regime).

The reference price waiver remains available for equities, and a negotiated price waiver has been added; however both are limited by volume caps of 4% per trading venue and 8% overall across the EU. Where a waiver is granted in the case of non-equities, indicative pre-trade bid and offer prices must still be published on a continuous basis during trading hours. Waivers will also be available for large-in-scale orders and orders held pending disclosure, derivatives not subject to the trading obligation and in certain other circumstances. Regulators may withdraw waivers for non-equity instruments in certain circumstances, and may temporarily suspend pre-trade transparency requirements for non-equities if liquidity falls below a certain threshold.

Non-financial counterparties entering into derivatives contracts for hedging purposes will be exempt from pre-trade transparency requirements.

There is a new requirement for trading venues to make pre- and post-trade transparency data available to the public on a reasonable commercial basis and to ensure non-discriminatory access. The information must be made available free of charge 15 minutes after publication.

Investment firms will have to publish post-trade transparency data through an ‘approved publication arrangement’ (APA). In certain circumstances, the publication of post-trade data may be deferred.

Consolidated tape

MiFID II introduces the new concept of a ‘consolidated tape provider’ (CTP), which will consolidate post-trade data from all APAs and trading venues into a continuous electronic data stream and make the information available to the public as close to real time as is technically possible on a reasonable commercial basis. The information will be made available free of charge 15 minutes after publication by the CTP. MiFID II makes provision for a CTP for equities and equity-like instruments (non-equity financial instruments are not yet covered) to be appointed via a public procurement process, should no adequate private sector solution emerge.

Transaction reporting

MiFID II extends the scope of transaction reporting obligations and introduces an EU-wide system of Approved Reporting Mechanisms (ARMs). Transaction reporting requirements will now apply to transactions in all financial instruments admitted to trading on Regulated Market, MTF or OTF and in other instruments where the underlying is an instrument admitted to trading on a Regulated Market or traded on an MTF or OTF.

Firms that transmit orders must also include the relevant information in the transmission of the order.

Reporting may be carried out by a firm itself, a trading venue or via an ARM, e.g. trade matching or reporting systems and trade repositories. Regulated Markets, MTFs and OTFs will be obliged to report transactions on behalf of non-financial participants, if systematically traded.

Transactions reported in accordance with EMIR will satisfy the MiFID II reporting requirement, provided certain requirements set out in MiFID II are met.
**Position limits for commodity derivatives**

Commodity derivatives contracts traded on venues (and economically equivalent OTC contracts) will be subject to position limits set by the national regulators, based on a methodology to be designed by ESMA. There will, however, be exemptions for non-financial counterparties holding positions for hedging purposes.

Trading venues will be required to publish weekly reports of aggregate positions in commodity derivatives or emission allowances or derivatives thereof, and provide the reports to regulators and ESMA. In addition, trading venues must provide regulators with a breakdown at least daily of positions held by all persons including members or participants and their clients. Members or participants of Regulated Markets, MTFs and clients of OTFs must report to the trading venue on at least a daily basis their own positions and those of their clients and the clients of those clients through contracts traded on that trading venue.

Trading venues that trade commodity derivatives will be required to apply position management controls.

**Other changes to the regulation of trading venues**

- Systems requirements for MTFs have been aligned with those for Regulated Markets.
- Regulated Markets, MTFs and OTFs will all be required to have in place systems, procedures and arrangements to ensure trading systems are resilient, with sufficient capacity, able to ensure orderly trading under conditions of severe market stress and fully tested. They must also have in place business continuity arrangements.
- Further, all trading venues must be able to temporarily halt or constrain transactions should there be a significant short-term price movement. In exceptional circumstances, they should also be able to cancel, vary or correct transactions.
- Trading of shares admitted to trading on a Regulated Market or traded on a trading venue must take place on a Regulated Market, MTF or SI (or an equivalent third-country trading venue). This is unless certain criteria apply, e.g. transactions are non-systematic, ad hoc, irregular and infrequent.
- Firms providing direct electronic access to a trading venue must notify their home regulator and that of the trading venue, and must have systems and controls in place for the assessment and review of the suitability of clients, to prevent clients from exceeding appropriate pre-set trading and credit thresholds, the monitoring of trading and appropriate risk controls.
- Firms acting as clearing members must also have systems and controls in place to review the suitability of clients and to ensure that appropriate requirements are imposed on those clients to reduce risks.

**Investor protection**

**Independent and restricted advice**

Firms providing investment advice must inform a client whether their advice:

- is provided on an independent basis or not (see below);
- is based on a broad or on a more restricted analysis of different types of financial instruments (and, in particular, whether the range is limited to instruments issued or provided by entities “having close links” with the advisor); and
- will be followed by a periodic assessment of the continuing suitability of the financial instruments recommended.

In order to inform clients that investment advice is provided on an independent basis, a firm must assess a “sufficient” range of financial instruments available on the market that are sufficiently diverse in type and issuers or product providers. In particular, this assessment must not be limited to financial instruments issued or provided by the firm itself or entities with which it has close links or close legal or economic relationships as to pose a risk of impairing the independent basis of the advice provided.

Firms that provide independent advice are also subject to a ban on third party fees, commissions or any monetary or non-monetary benefits (see below).

(This is, of course, in addition to the general MiFID rules about the need for investment firms to act honestly, fairly and professionally in the best interests of clients; assess the compatibility of financial instruments they offer and recommend with the needs of the client; provide information that is fair, clear and not misleading, etc., which apply to both independent and restricted firms.)

**Inducements**

MiFID II aims to strengthen the MiFID requirements on third party payments in relation to services provided to clients. Accordingly, it distinguishes between the rules for investment firms in general, and the rules for firms providing independent advice or portfolio management.
The general rule for firms is that any fees, commissions and non-monetary benefits provided to or received from third parties in connection with the provision of an investment service or ancillary service must be designed to enhance the quality of the service to the client and must not impair compliance with the firm’s responsibility to act in the client’s best interest. Any such payments or benefits must be disclosed to the client prior to the provision of the investment service or ancillary service.

Firms providing independent advice (see above) or portfolio management must not accept any fees, commissions, monetary or non-monetary benefits from third parties in relation to the service provided to the client. Minor non-monetary benefits that are capable of enhancing the quality of service provided to a client and are of a scale and nature such that they could not be judged to impair compliance with the firm’s duty to act in the best interest of the client are allowed, although they must be clearly disclosed.

ESMA proposes to introduce an exhaustive list of non-monetary benefits (although there is provision for this to be supplemented through ESMA guidelines). This has been widely criticised, as it will make the rules in this area extremely restrictive. The issue of payment for research is particularly contentious.

What about the UK Retail Distribution Review (RDR)?

MiFID II allows Member States “in exceptional cases” to ‘goldplate’ investor protection requirements by imposing additional requirements on investment firms where these are “objectively justified and proportionate so as to address specific risks to investor protection or to market integrity which are of particular importance in the circumstances of the market structure of that Member State” (Article 24 MiFID II).

The FCA has stated that it “expect[s] to maintain the current RDR restrictions on payment to all investment advisers” and 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”.

‘Execution only’ regime

MiFID II makes changes to the list of financial instruments which are covered by the ‘execution only’ regime. The following financial instruments are now excluded:

- shares in structured UCITS and non-UCITS funds;
- shares that embed a derivative;
- bonds not admitted to trading on a Regulated Market, MTF or third-country equivalent market;
- transactions involving a loan or credit to the investor*; and
- bonds and money market instruments whose structure makes it difficult for the client to understand the risk involved.

Structured deposits have been added to the ‘execution only’ regime, except for those with a structure which makes it difficult for a client to understand the risk of return or the cost of exiting the product before term.

Product governance

The organisational requirements of MiFID are expanded to include new product governance and distribution requirements. Firms that manufacture financial instruments must have in place an approval process before those financial instruments are marketed or distributed to clients, e.g. for identifying a specific target market for the product, ensuring that relevant risks to that target market are assessed and ensuring that the distribution strategy is appropriate. Financial instruments offered must be regularly reviewed.

Product governance arrangements will apply to both product manufacturers and distributors; the latter should be provided with information from the approval process, including the specified target market. Distributors offering financial instruments which they did not manufacture should have arrangements in place for obtaining this information.

Other investor protection issues

- Title transfer collateral arrangements (TTCA) involving retail clients are now prohibited. Firms will be required to treat all retail clients’ monies as client money. In the UK, the FCA already imposes strict limitations on how TTCA can be used for retail clients.
- Best execution’ for retail clients will be determined based on total consideration paid by the client, including all costs and expenses incurred. Firms may not receive any remuneration, discount or non-monetary benefit for routing orders to a particular venue, where this would be in breach of requirements on conflicts of interest or inducements.

* Although this will not apply to existing credit limits of loans, current accounts or overdraft facilities.
• Investment firms must inform clients where orders have been executed. Every year firms must publish, for each class of financial instrument, their top five execution venues in terms of trading volumes, along with information on quality of execution.

• When bundling products or services, firms must inform clients whether the individual components may be purchased separately, and provide individual costs for each component.

**Governance**

**Corporate governance**

MiFID II extends the corporate governance requirements for banks and certain investment firms under CRD IV to all other investment firms, operators of Regulated Markets and data reporting services providers. An investment firm’s management body must define, oversee and be accountable for the implementation of governance arrangements that ensure effective and prudent management of the firm, including the segregation of duties and the prevention of conflicts of interest. In addition, the management body of an investment firm, operator of a Regulated Market or data reporting services provider must:

- be of the requisite calibre;
- act with honesty and integrity;
- commit sufficient time to the firm;
- assess and challenge the decisions of senior managers;
- not take on more than a certain number of directorships at the same time;
- be sufficiently diverse;
- monitor and periodically assess the effectiveness of governance arrangements;
- have overall responsibility for the firm, its objectives, risk strategy, and internal governance arrangements that ensure effective and prudent management.

The chairman of a firm may not also act as Chief Executive Officer unless justified by the firm and authorised by the regulators. Large or complex firms may be required to establish nomination committees.

Remuneration, including sales targets, must not cause conflicts of interest, interfere with the firm’s obligation to act in a client’s best interest, or create incentives for market abuse.

**New regulatory powers and penalties**

**Product intervention**

MiFID II seeks to harmonise the powers available to regulators across the EU.

In particular regulators will now be able to ban specific products, services or practices, where:

- the product, service or practice either:
  - give rise to significant investor protection concerns;
  - poses a threat to the orderly functioning and integrity of financial markets or commodity markets or to the stability of the financial system within at least one Member State; or
  - (for a derivative) has a detrimental effect on the price formation mechanism in the underlying market; and
- existing regulatory requirements do not sufficiently address the risks (and these cannot be addressed by conventional supervision or enforcement); and
- the action is proportionate and does not not have a discriminatory effect on services or activities provided from another Member State.

A regulator must also notify ESMA and other national regulators before it uses this power, in order that ESMA can co-ordinate action across the EU.

ESMA itself (and the EBA in respect of structured deposits) will also be able to temporarily ban a product, service or practice where:

- there is a significant investor protection concern or a threat to the orderly functioning and integrity of financial markets or commodity markets, or to the stability of the whole or part of the financial system in the EU;
- existing regulatory requirements do not address the threat; and
Sanctions and penalties

MiFID II also imposes greater consistency across the EU in relation to sanctions and penalties. Regulators will have certain specific sanctions available to them, including:

- public statements;
- withdrawal or suspension of authorisation;
- temporary or permanent bans of individuals;
- temporary or permanent bans on firms being members of certain trading venues; and
- maximum fines of up to 10% of annual turnover or at least €5m, and at least twice the benefit derived (where this can be determined).

Third country firms

MiFID does not currently set out a harmonised regime for the provision of investment services by third country firms (firms incorporated outside the EEA). These firms are therefore subject to varying rules in each Member State. MiFID II establishes a new harmonised regime which will govern the ability of third country firms to access the EU market.

The new regime for third country firms distinguishes between:

a) services provided to per se professional clients and eligible counterparties; and
b) services provided to elective professional clients and retail investors.

Third country firms will be able to provide investment services to persons falling within category (a) above without having to establish an EU branch, provided that their home state passes the Commission’s “equivalence test”, as set out in article 47 MiFIR. This stipulates that the third country’s legal and supervisory regime should be broadly equivalent to the EU regime in a number of respects. MiFIR also requires that there are cooperation agreements in place between ESMA and the relevant third country authorities. Third country firms will also have to be registered with ESMA.

In order for a third country firm to provide investment services to persons falling within category (b) above (except where this is at the exclusive initiative of the client), Member States may require the firm to establish (and obtain authorisation for) a branch in their jurisdiction.

Third-country firms that have a branch authorised in an EU Member State will be able to passport investment services/activities for persons falling within category (a) above throughout the EU from their branch.

Completion of the MiFID regime and timing

The complete MiFID II regime

The overview above is only a high-level summary of some of the key provisions in MiFID II. There are also changes in other areas, including benchmarks and client relationships.


ESMA launched consultations on MiFID II in May 2014, and on 19 December 2014 it published draft regulatory technical standards, its final report to the Commission on delegated legislation and a further consultation which closes on 2 March 2015. This material (which runs to over 1,500 pages) is outside the scope of this overview report but will be covered in more detailed RegZone publications on different aspects of MiFID II.

Timing

Member States must transpose the MiFID II rules by 3 July 2016.

MiFID II comes into force on 3 January 2017 (except for the regulations on non-discriminatory access to benchmarks and one provision on information dissemination by consolidated tape providers; these come into force later from 3 January 2019).

- a competent authority has not taken action to address the threat or the actions that have been taken do not adequately address the threat.
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