

## THE MIFID-REVIEW

### INTRODUCTION

The European Commission is currently drafting the revision of its Markets in Financial Instruments Directive, the MiFID. The existing version of MiFID was adopted in 2004 – applied as of 2007 – and has established a regulatory framework for the provision of investment services in financial instruments (such as brokerage, advice, dealing, portfolio management, underwriting etc.) by banks and investment firms, as well as for the operation of regulated markets by market operators. It has also established the powers and duties of competent national authorities in relation to these activities. MiFID has contributed to further the integration, competitiveness, and efficiency of EU financial markets. In concrete terms, MiFID has abolished the possibility for Member States to require all trading in financial instruments to take place on specific exchanges and enabled Europe-wide competition between traditional exchanges and alternative venues. It also granted banks and investment firms a strengthened "passport" for providing investment services across the EU subject to compliance with both organisational and reporting requirements as well as comprehensive rules designed to ensure investor protection.

### REVISION

With the revision of MiFID, the European Commission now proposes to:

- Implement G20 commitments in the EU, such as mandating trading of OTC derivatives on trading venues to which end a new category of trading venue is introduced, the Organised Trading Facility or OTF. Many of these requirements are implemented in the US in the Frank - Dodd act;
- Implement supervisory reform in the EU, in the wake of the financial crisis, to make the financial system more resilient. This is done by strengthening powers of supervisors (for example introducing powers to set position limits or ban certain practices or products), harmonising rules in the EU (through the creation of a 'single rule book') and enhancing supervisory cooperation and coordination, partly by assigning powers to ESMA;
- Address downsides of MiFID I, such as fragmentation of data due to enhanced competition between trading venues by establishing the conditions for a consolidated tape;
- Catch up with technological developments such as high frequency trading;
- Enhance competition in post-trading by mandating non-discriminatory access;
- Widen the scope of transparency requirements regarding in MiFID;
- Widen the scope of application to a broader range of financial instruments such as commodity derivatives and structured bank deposits;
- Introduce a framework for third-country firms to provide investment services in the EU.

### WHO WILL BE AFFECTED?

The MiFID review will be of great interest to all institutions that are active in trading and post-trading of financial instruments: issuers, investors, investment firms and banks, trading venues, post-trading infrastructures and specialised institutions such as high frequency trading firms.

### FORM

The Commission proposal is expected around mid-October 2011 and will consist of two parts:

- A Directive (legal text that requires implementation into national legislation of EU Member States)
- A Regulation (legal text directly applicable in all EU Member States)

#### About FTI Consulting

FTI Consulting, Inc. is a global business advisory firm dedicated to helping organisations protect and enhance enterprise value in an increasingly complex legal, regulatory and economic environment. With more than 3,700 employees located in 22 countries, FTI Consulting professionals work closely with clients to anticipate, illuminate and overcome complex business challenges in areas such as investigations, litigation, mergers and acquisitions, regulatory issues, reputation management and restructuring. The company generated \$1.4 billion in revenues during fiscal year 2010. More information can be found at [www.fticonsulting.com](http://www.fticonsulting.com)

The Directive (MiFID) amends specific requirements regarding the provision of investment services, the scope of exemptions from the current Directive, requirements for investment firms on their organisation and the conduct of their business, organisational requirements for trading venues, powers available to competent authorities, sanctions and rules applicable to third-country firms.

The Regulation (MiFIR) sets out requirements in relation to the disclosure of trade transparency data to the public and transaction data to competent authorities, the authorisation and ongoing obligations applicable to providers of data services, the mandatory trading of derivatives on organised venues, and specific supervisory actions regarding financial instruments and positions in derivatives.

## PROCESS

This analysis is based on a draft version of the European Commission's upcoming proposal. Before the Commission adopts the final version of its proposal, internal Commission discussions (between the different Commissioners, each from one Member State) will take place. After adoption of the proposal, the Council of EU Member States and the European Parliament will have to discuss the texts (and are likely to change the proposals substantially) through the legislative procedure. It will become legislation once all three institutions agree on the same text.

## FOR MORE INFORMATION PLEASE CONTACT HANS HACK:

E: [hans.hack@fticonsulting.com](mailto:hans.hack@fticonsulting.com)

T: +32 2 289 08 75

M: +32 479 182 955

Below you will find an initial overview of the directive and of the regulation. The most noteworthy requirements, or those that are surprising, are highlighted in yellow.

**Page 3 - MiFID**

**Page 6 - MiFIR**

## MiFID (II)

### SCOPE (1-4)

- Scope is extended to:
  - i) conduct of business and conflicts of interests rules to apply to own products of banks/investment firms (advised and non-advised)
  - ii) structured bank deposits (which will be followed up by the Packaged Retail Investment Products (PRIPs) proposal with probably the life insurance products).
- Restriction of national regime regarding advice of institutions who among others do not hold clients assets – more articles of MiFID analogously applicable to these institutions and they need to be member of an Investor Compensation Scheme (11).
- Limiting and clarifying exemption for dealing on own account. Market makers, members of Regulated Markets (RM) and Multilateral Trading Facilities (MTF) and High Frequency Trading (HFT) firms are now covered as well as institutions that deal on their own account but execute clients orders (including underwriting).

### HIGH FREQUENCY TRADING (HFT) REQUIREMENTS (13)

- Organisational requirements relating to investment firms' algorithmic trading and firms offering access to HFT traders (including a binding written agreement).
- Risk controls and supervision: effective systems need to be in place so that trading systems are resilient, are subject to appropriate trading thresholds and limits and prevent the sending of erroneous orders or the system otherwise functioning in a way that may create or contribute to a disorderly market. Such a firm must also employ effective systems and risk controls to ensure the trading systems cannot be used for any purpose that is contrary to either the Market Abuse Regulation or the rules of the trading venue to which it is connected. The firm shall have in place effective continuity business arrangements to deal with any unforeseen failure of its trading systems and shall ensure its systems are fully tested and properly monitored to ensure they meet the requirements.
- There must also be an annual report to home supervisor.

N.B. Here the term 'Algorithmic trading' refers to trading in financial instruments where a computer algorithm automatically determines the individual parameters of orders such as whether to initiate the order, the timing, price or quantity of the order or how to manage the order after its submission, with limited or no human intervention. This definition does not include any system that is used solely for the purpose of routing orders to one or more trading venues or for the confirmation of orders.

### ORGANISED TRADING FACILITY (OTF) (4, 14, 14A, 14B, 26A, 26B, 26C, 41, 41A)

- Introduction of a new 'catch-all' category of trading venues, OTFs, OTF will be everything except Regulated Markets (RM) or Multilateral Trading Facilities (MTFs). OTFs is a trading venue operated by investment firm or market operator, in which multiple third party buying and selling financial instruments are able to interact in a system in a way that results in a contract (...)
- RM/MTF have non-discretionary execution of transactions and non-discretionary access to the system. This means that a transaction will be executed according to a predetermined set of rules. It also means that the platform needs to offer access to everyone willing to trade on their system.
- OTFs on the other hand may, within the best execution requirement, have discretion over how the transaction is executed, such as routing it over another platform. An OTF may also refuse access to clients. An OTF may not trade against his own proprietary capital. An OTF is where third party buying and selling interests meet.
- Requirement to explain why the OTF cannot work as an RM, MTF or SI.

### CORPORATE GOVERNANCE (9, 10, 37)

- The requirements are the implementation of the communication on corporate governance in financial sector.
- Management bodies (in essence, the board – both endowed with supervisory and managerial functions with ultimate decision-making authority and empowered to set strategy) are required to have sufficient knowledge and skills. They must not combine more than a maximum number of high level jobs: they are limited to no more than 1 executive function and 2 non-executive functions, or alternatively 4 non-executive functions. All management body members will be notified to a supervisor.

- **Diversity** – as in CRD IV the company will need to use diversity as a criterion in appointment process of the management board.
- ESMA will develop more detailed requirements on knowledge, skills, etc.
- Acquisition directive integrated in MiFID. ESMA will develop regulatory standards on what information needs to be provided to the competent authorities during acquisitions.

### INVESTOR PROTECTION (19, 21, 23, 24 ANNEX II)

- More focus on objectivity; increased transparency as to the remuneration of advisors. In cases of **independent advice and portfolio management there are to be no fees or commissions by third party.**
- Periodic information to client about services must be provided.
- In execution only, minimal duties of protection.
- Basic principles to apply to eligible counterparties. Local authorities dealing with public debt at national level are excluded from eligible counterparties.

### TRADING VENUES REQUIREMENTS (21,47A, 47B)

- Yearly report by trading venue on quality of execution (number of orders cancelled, speed of orders) and positions (aggregate data, category of client)
- Mandatory coordinated action between supervisors of RMs, MTFs and OTFs in suspension or ban on trading of a financial instrument. ESMA to develop regulatory standards on this matter.
- Mandatory exchange of information between trading venues.
- RMs to have: i) **measures on resilience and adequate capacity of the system, ii) conditions for when trading should be halted in cases of significant price movements, iii) position limits, minimal amount of unexecuted orders and minimum tick size, iv) controls on direct access, v) non discriminatory co-location policy.** All the above to be elaborated through delegated acts.
- All venues to set appropriate **commodities position limits or alternative arrangements** and settlement conditions for physically delivered commodities
- Weekly information on aggregate positions to be made public (above a certain threshold) and more specific information to be sent to regulators (including category and identity of end client)

### SME GROWTH MARKET (26D)

- Creation of a specific MTF with an SME label to raise visibility and create better funding possibilities for SMEs. MS may allow a network of linked SME MTFs.

### THIRD COUNTRY REGIME (35A-35D)

MIFID will for the first time regulate the conditions under which non-EU institutions can be active in the EU market:

- Through a branch: If a non-EU firm wants to become active in a MS of the EU, it can do that **via a branch in the EU** with mandatory (EU) authorisation.
- Through provision of services: If a non-EU firm wants to become active in a MS of the EU, it can do that through **provision of services.**
- Authorisation is granted by the relevant EU national competent authority. **Compliance with requirements of key articles of the MiFID and MiFIR is required in both cases (authorisation, capital, organisational requirements)**
- The third country firm **must be regulated in his own country** for the relevant activities and the firm must also comply with national requirements regarding, for example, the management board, ICS, and capital.
- **Cooperation agreements** between the EU supervisor and the supervisor in the third country are required.

### HARMONISATION OF POWERS OVER DERIVATIVES (50,50A, 56)

- Supervisors can act at any time during a derivative's lifetime.
- Possibility to set **ex-ante non-discriminatory positions limits** for supervisors.
- Notified to ESMA.

## HARMONISATION OF SANCTIONS (51-51E)

- All supervisors are to have the same 'toolkit' (withdrawal of authorisation, public statements, dismissal of management, administrative pecuniary sanctions, required cessation of any practice or conduct that is contrary to MiFID, removal of certain instruments from trading).
- National maximum of sanctions should exceed benefits.
- Maximum sanction in all national laws must be at least 10% of the annual turnover or 10% of the income in the case of natural person.
- All sanctions must be published.
- Whistle blower rules.

## REVIEW CLAUSE

- Two years after the application of MiFID (II) there will be a report on: OTF requirements, the SME label, HFT rules, bans on certain products, derivatives measures.

## EMISSIONS TRADING SCHEME (ANNEX I, SECTION C)

- Application of MiFID and MAD to spot secondary markets.

## MiFIR

### TRANSPARENCY ON TRADING VENUES (3-8)

- Transparency to be the same in RM, MTF, OTF, but calibrated per instrument.
- Pre- and post-trade transparency rules on equity-like instruments as shares, ETFs, deposit receipts, certificates, actionable indications of interest (3, 5), are different than pre- and post-trade transparency rules on bonds, structured finance, derivatives (4,6) for example.
- On a national level competent authorities may allow a waiver for both types of pre-trade transparency in cases specified in delegated acts. This intention needs to be notified to ESMA at least 6 months in advance. ESMA will decide on compatibility with MiFIR.
- Pre and post-trade data will need to be separated in disclosure to the public with COMM able to make delegated acts on level of disaggregation.
- Trading venues obliged to make post trade data available free of charge 15 minutes after trade and earlier against reasonable commercial terms with COMM to determine in delegated act what this is.

### TRANSPARENCY SYSTEMIC INTERNALISERS (SI) (9-12)

- SIs to publish pre-trade information: firm quotes. Requirements differentiated between i) shares, ETFs, deposit receipts, certificates, actionable indications of interest and ii) bonds, structured finance, derivatives.
- Post-trade also differentiated in a similar manner.
- Both minimum quote size and two way quotes are required.

### TRANSACTION REPORTING (13)

- All transactions to be reported and stored for 5 years by RM, MTF, OTF. Scope of transaction reporting is to be broadened, with the only exception being instruments not traded on RM, MTF, OTF. Broadened client ID.
- More information must be sent by investment firms to other investment firms in order to make transaction reporting possible.
- Trade repositories to report to competent authority.
- If not successful, all transaction reporting to ESMA appointed system after two years.

### MARKET DATA / CONSOLIDATED TAPE (14-21)

- All trade reports are to be published through approved publication arrangement.
- Sets conditions for emergence of consolidated tape.

### TRADING OF DERIVATIVES (22-25)

- Financial and non financial counterparties shall trade classes of derivatives (as determined by ESMA) on RM, MTF or OTF.
- The RM shall make sure that the derivatives traded on it are also cleared in a CCP.

### NON DISCRIMINATORY ACCESS (26-28)

- CCPs to accept clearing of financial instrument on a non-discriminatory and transparent basis regardless of where the instrument is traded.
- Trading venues to give non-discriminatory access to data streams and information on benchmarks and indices to CCPs.

### SUPERVISION (29-33)

- National supervisors to be able to impose permanent bans on certain products or activities. Strong coordination with ESMA in such cases.
- ESMA to be able to temporarily ban products or activities.
- ESMA will coordinate position limits set by national competent authorities.
- ESMA can gather information on positions and set limits to those positions.

**REVIEW (36)**

- 18 months after the application of MiFID II there will be a review (with ESMA input) concerning the consolidated tape.
- After 2 years there will be a review on transparency issues, transaction reporting and moving OTC derivatives to trading venues.