MiFID II/MiFIR: An Overview of Current Developments

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On 14th October 2014, Avantage Reply held its second Business Breakfast meeting in London on MiFID II, with speakers from the UK Financial Conduct Authority (FCA), White & Case, the British Bankers' Association and Avantage Reply.

This Briefing Note presents an overview of the key takeaways of the Business Breakfast, including:

- MiFID II timetable at Levels 1, 2 and 3: The next key dates and how the impending regulatory developments affect MiFID II projects within firms;
- Key 'Conduct' issues that arose during ESMA's consultation on Level 2 measures;
- Key 'Market' issues that arose during ESMA's consultation process on Level 2 measures; and
- Implementation issues: Some of the key takeaways for firms in terms of the implementation of MiFID II.

We also outline how we expect the final advice provided by ESMA to the European Commission to come out, based on the Consultation and industry responses.

Introduction

As noted in our previous Briefing Note, *MiFID II: Bringing Significant Volume of Change*, the Markets in Financial Instruments Directive (MiFID), applied across the EU since November 2007, sets out conducts of business and organisational requirements for investment firms; authorisation requirements for regulated markets; regulatory reporting to avoid market abuse; trade transparency obligation for shares; and rules on the admission of financial instruments to trading.

Recent events and market developments have demonstrated weaknesses in some of MiFID's underlying principles, exposing gaps in the regulatory framework and highlighting areas which need reinforcement or revision. MiFID II aims to close these gaps to bolster investor confidence and achieve MiFID's original objectives. The new framework legislation (known as "Level 1") consists of a Directive (the recast MiFID) and a Regulation (MiFIR), collectively referred to as MiFID II in this Briefing Note.

MiFID II Timetable

The high-level implementation timetable in Figure 1 below shows that regulators and firms alike have a large change agenda ahead of them. Adopted in June 2014 and due to be applied from 3 January 2017, MiFID II promises an unprecedented amount of change for the industry.

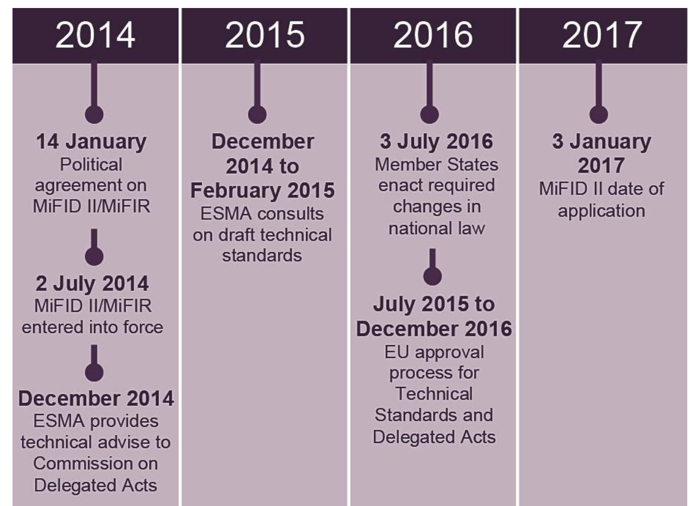

Figure 1: MiFID II Implementation Timetable

At Level 2 (i.e. detailed implementing measures), the industry will monitor closely the development of Delegated Acts and Technical Standards, which will set out the detailed rules for compliance. Change programs will want to establish without delay how requirements are 'shaping up' to drive MiFID II projects and work streams. In that context, Q1 and Q2/2015 will prove busy quarters as noted in Figure 2 below.

Delegated Acts:

Technical Standards:

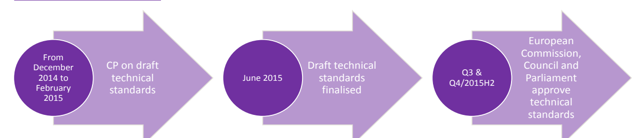

Figure 2: MiFID II Level 2 Timetable

For Level 3, we anticipate ESMA will begin the Frequently Asked Questions ("FAQ") process in late Q2 or early Q3/2015 for the 'Market Side' and potentially in early Q2/2015 for the 'Conduct Side'. This is particularly important for Change programs, so as to tackle detailed implementation issues in a compliant way. As noted with other regulations (e.g. EMIR), delays in the FAQ process (e.g. responses only provided a few hours prior to or just after the legislation comes into effect) result in regulatory uncertainty and additional costs. Despite best efforts, we anticipate this will also be the case for MiFID II.

Conduct Issues

The Business Breakfast discussed the issues highlighted during ESMA's consultation process on proposed Level 2 measures, including three key considerations:

The Use of Dealing Commissions

A recent paper by the UK FCA estimated that UK investment managers pay around £3bn of dealing commissions per year to brokers; around £1.5bn of this spent on research, a cost borne by investment managers' customers. Similar patterns are seen across the EU.

Level 1 legislation effectively mandated ESMA to address this issue, as policymakers and regulators have had ongoing concerns about investment managers' controls over the use of dealing commissions and the conflicts of interest it may create for them as agents to their customers.

ESMA, Consultation paper, MiFID II / MiFIR (May 2014) provides that "any research that involves a third party allocating valuable resources to a specific portfolio manager […] could be judged to impair compliance with the portfolio manager's duty to act in their client's best interest."

This proposal prompted much criticism by the industry, as it would actually result in the 'unbundling' of research from dealing commissions across the EU. However, we understand this ESMA proposal is likely to make it to the final text, as it is seen by policymakers and regulators as beneficial to end investors.

Inducements

We understand the European Commission had asked ESMA for 'strict advice' consistent with Level 1 legislation. Apart from a limited exception ("minor non-monetary benefit"), MiFID II Level 1 prevents portfolio managers from accepting and retaining fees, commissions or any monetary or non-monetary benefits.

ESMA's advice makes specific proposals on what will be permitted as 'minor non-monetary benefits', which is designed to be very narrowly construed, following the Level 1's intention of otherwise banning all inducements for portfolio managers.

Again, we expect the proposal to make it to the final text and the Commission to extend the regime to UCITS and AIFMD investment management activity.

Product Governance

The industry generally supported the development of MiFID product governance requirements to ensure fair treatment of customers, i.e. firms should consider the impact of their action (or inaction) on the customer through the product (and perhaps also service etc.) life cycle (design, marketing, sales and advice processes etc.). However, the industry—including the Buy Side and the Sell Side—expressed significant concerns about several proposals and a perceived lack of clarity (e.g. 'target market', 'manufacturer model', etc.).

We expect the final technical advice to address a number of the concerns around scope and lack of clarity.

Market Issues

The Business Breakfast discussed issues highlighted during ESMA's consultation process on proposed Level 2 measures, including four key aspects:

Equities (Liquidity, Transparency)

ESMA has been asked to provide advice on the criteria under which an equity should be considered to be liquid. This has implications for the transparency regime (shares, depositary receipts and equity-like instruments such as ETFs), the quoting obligations for systematic internalisers and so on.

In the consultation, ESMA recommended that an instrument must meet all four criteria listed under MiFIR (free float, average daily number of transactions, average daily turnover and daily traded) in order to be deemed to have a 'liquid market'. It is noted that ESMA's proposed thresholds are lower than under the existing regime.

Some actors on the Buy Side raised concerns regarding the reduced thresholds (e.g. the free float threshold being reduced from EUR 500 to 250 million) and recommended that ESMA should set an appropriate calibration for liquid shares, such that asset managers are still able to trade larger blocks without undue price detriment to their underlying clients.

Non-Equity Transparency

The scope of the MiFIR non-equity transparency framework explicitly includes bonds and structured finance products as financial instruments to which pre-trade and post-trade transparency requirements apply. Money-market instruments however are excluded from the scope.

ESMA has been asked to provide advice on a clear delineation between non-equity instruments within and outside

the MiFID II scope, so it is evident to all stakeholders whether trading in an instrument is subject to transparency obligations.

The industry responded that it is willing to have greater complexity to achieve more granularity. We would therefore expect the final paper to reflect such granularity and account for the call for consistency with other European Directives and Regulations made by the industry (e.g. as relates to the definition of money market instruments).

Position Limits (Commodity Derivatives)

Under MiFID II, mandatory position limits and position reporting will be introduced across the EU for the first time with a view to prevent market abuse and to support orderly pricing and settlement conditions.

The consultation responses show a 'surprising' degree of consensus on the approach ESMA took, while acknowledging some practical difficulties which firms will need to address over the coming months (e.g. lack of product codes for identifying commodity derivatives, likely differences in the position limits 'architecture' across jurisdictions etc.).

Algorithmic and High Frequency Trading (HFT)

ESMA was asked to help define what should be considered algorithmic trading as opposed to high frequency algorithmic trading to ensure a uniform application of the authorisation requirement for those who engage in high frequency algorithmic trading, taking into account the need to capture all genuine high frequency traders.

A large number of comments on the definition broadly welcomed the regulatory requirement to subject all market participants to the same rules and hence to require all High Frequency Traders to be authorised as investment firms. In particular, the industry noted that many HFT firms currently operate under a light regulatory framework.

However, most respondents worried that the proposed definition of HFT does not adequately capture all genuine high frequency traders. ESMA's final advice will no doubt need to improve on the current draft.

Implementation

While we await ESMA's final advice, firms and regulators are well aware of the implementation changes ahead:

- ***Processing regulatory change***, including achieving authorisations, approval of waivers and position limits, by 3 January 2017;
- ***Implementing systems changes***, including as relates to transaction and position reporting;
- ***Implementing changes without legal and regulatory certainty***, which reinforces the need for very regular discussion amongst firms and with regulators, while ensuring Senior Management is kept abreast of the magnitude and potential impact of such uncertainty;
- ***Dealing with the likely lack of consistency in supervision in the early days of the regime***;
- ***Dealing with third-country equivalence issues;*** and
- ***Understanding that MiFID II is meant to be a 'permanent revolution'*** at least when one considers that the Level 1 legislation requires more than 20 separate reviews to be completed between 2017 and 2020. Whether it will be more tidying up or more fundamental changes is unknown at this stage, but firms should recognise that MiFID II is essentially a six to seven year program of work.

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