MiFID II/MiFIR Primer - Part 1

Regulatory Update
January 2015

axxsys

This white paper, 1 of 2, provides an overview of the scope of the recast Markets in Financial Instruments Directive and Regulation

Introduction

The financial regulatory landscape has changed significantly over the last few years. The impact on all financial market participants during this time has been considerable, both in terms of the resources needed to monitor and assess new regulatory developments but also in the costs of adapting business models to ensure compliance.

Going forward, it is painfully clear that the regulatory process will remain dynamic for some years to come and will continue to put significant strains on all market participants and companies offering services to the sector. They will all need to find a way to manage these changes.

MiFID II/MiFIR

The Markets in Financial Instruments Directive (MiFID) is one of the cornerstones in the regulation of financial markets in the European Economic Area (EEA - the 28 European Union member states plus Iceland, Norway, and Liechtenstein). The original legislation came into force on April 30th 2004 and became effective on November 1st 2007, see [MiFID] for details. As a directive, it is up to the individual countries to implement it.

Motivated by lessons learnt from the financial crisis in 2008 and significant developments in the market such as dark pools, a more significant role of high frequency trading (HFT)/algorithmic trading, and increased trading in the lightly regulated commodity derivatives market, a review of the original MiFID directive was initiated.

It has been a prolonged process; the first consultation papers were issued in early 2010.

The new framework, consisting of a Directive (the recast MiFID, also known as MiFID II, see [MiFID_II]) and a Regulation (Markets in Financial Instruments Regulation (MiFIR), see [MiFIR]) were finally adopted by the European Parliament on April 15th 2014 and by the Council on May 13th 2014. It was then published in the Official Journal on June 12th 2014, entered into force on July 2nd 2014 and is expected to apply to firms by January 3rd 2017.

Where European Market Infrastructure Regulation (EMIR) is primarily concerned with improving the stability of the financial markets by imposing regulation on financial derivatives, MiFID has a broader scope

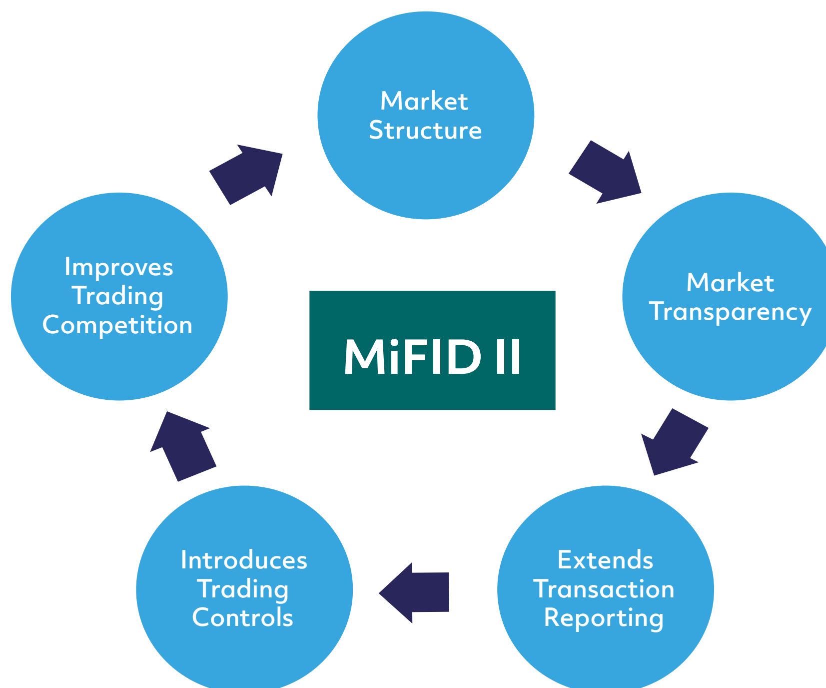
in terms of instruments. MiFID focuses primarily on putting in place a market infrastructure that protects market participants against market abuse and encourages pricing transparency.

'MiFID focuses primarily on putting in place a market infrastructure that protects market participants against market abuse and encourages pricing transparency.'

Naturally there will be overlap between the two regulatory initiatives as both, for example, introduce a transaction reporting obligation.

However, at the time of writing, many technical implementation details are yet to be published so it is too early to draw precise comparisons.

From a high level, MiFID II/MiFIR contains five key areas of financial market regulation:



Below, we will discuss each of these items in more detail.

Introduction of a New Market Structure (Market Regulation)

MiFID II/MiFIR has a multitude of electronic multilateral (many to many) trading venue classifications: Regulated Market (RM), Multilateral Trading Facility (MTF) and Organised Trading Facility (OTF). For completeness, MiFID/MiFIR also operate with two bilateral trading classifications, namely Systematic Internalisers (SI) and traditional OTC trading (OTC).

The aim of having these separate platform classifications and forcing specific trading onto specific platforms is at least twofold:

i. To increase transparency in equity-like markets by imposing restrictions on the part of the market currently hidden in dark pools.

ii. To force standardised derivatives that were previously bilaterally traded on to electronic trading platforms, thereby increasing transparency and making the markets easier to monitor.

Reviewing each classification in turn:

Regulated Market is a multilateral system operated and/or managed by a market operator, which brings together or facilitates the bringing together of multiple third-party buying and selling interests in financial instruments. Examples of trading venues falling into this category are stock exchanges such as the London Stock Exchange.

Multilateral Trading Facility can be considered a kind of "exchange lite" as they share many of the operational features and obligations of an exchange. They have fewer restrictions surrounding the admittance of financial instruments for trading; for example they do not have a listing process and cannot change the regulatory status of a security. MTFs therefore allow participants to exchange more exotic assets than RMs. Examples of trading venues falling into this category would be Bats Chi X.

Organised Trading Facility is a new category of multilateral venues under MiFID II. OTFs will only be able to trade non-equity instruments. It is designed to capture bilateral standardised derivative trades and offer slightly more discretion on pricing, transparency, and order execution (that is having discretion over how orders are filled). Generally speaking, an OTF operator is not allowed to commit its own capital to trades (prop trading).

Systematic Internalisers, also called market makers, are investment firms who execute orders against its own books instead of sending orders to a central exchange. They are subject to transparency requirements and have to show a price before a trade is made. Post trade, they are required to make trade information public - just like a conventional exchange. Trading is bilateral and the SI can use own capital for its trading activity.

Over-The-Counter Trading is done directly between two parties. Products traded this way are typically less standardised or have unusual quantities. As this form of trading is bilateral and largely unregulated, the terms of the trades can be bespoke, in particular with regards to the collateral arrangement following the trade. Price transparency is, also, typically low.

Overall, the goal is to move OTC activity to OTF and SI. In particular, transactions in derivatives that are subject to the clearing obligation under EMIR, see [PR], will be required to be executed on an RM, MTF, or OTF (should there be sufficient liquidity in the instrument).

Firms will not be allowed to run an OTF and an SI under the same legal entity. This seems to be meant as a strong encouragement for firms to separate proprietary trading from the rest of their organisation.

Increasing Transparency (Market Regulation)

Equities

MiFID introduced pre and post-trade transparency requirements and they are now being extended to cover equity-like instruments such as ETFs, certificates, and depositary receipts traded on a RM, MTF or OTF.

Pre-trade transparency includes continuous publication of up-to-date bid-offer prices and market depth during normal business hours. Various pre-trade price transparency waivers exist primarily for large orders.

Post-trade trading venues have to publicise executed price, volume, and time in as close to real-time as practically possible. To further promote transparency it is envisaged that a service provider authorised by national competent authorities should set-up a consolidated tape service across trading venues, such that information about all equity-like trades is publicly available and free of charge 15 minutes after publication.

Presumably information will also be available in real-time for a fee. The aim is for this service to be available when MiFID II/MiFIR goes into force in early 2017.

Fixed Income and derivatives

Pre and post-trade transparency requirements for fixed income and derivatives are new under MiFID II and are similar in spirit to those applying to equities.

The biggest difference appears to be in waivers to pre-trade price transparency. Here it is recognised that the relatively low liquidity of non-equity markets creates problems for “large” orders. The quantification of “large” is also more complex than for equities since relatively infrequent trading makes it hard to establish what a normal trading size is.

Post-trade, delayed publication of the trade information is allowed if it, by itself, can materially impact market prices (again recognising the relative shallow depth of these markets). The intention is also to provide consolidated tape services for more complex instruments but this is a project for the future.

Improving Conditions for Competition in Trading and Clearing (Market Regulation)

Another aim of MiFID II/MiFIR is to foster an environment of stronger competition between trading venues and clearing houses across EEA countries, for the ultimate benefit of investment firms and their clients. The hope is that this can be accomplished by requiring that:

– Trading venues provided transparent and non-discriminatory access to investment firms.

– Clearing houses provide transparent and non-discriminatory access to trading venues and act non-discriminatory in terms of collateral requirements and fees.

– Investment firms must have easy access to clearing and settlement systems throughout the EEA.

– Clearing houses must have the right to clear instruments traded at trading venues on a non-discriminatory basis, subject to being authorised.

All these requirements are to apply regardless of which member state the respective parties belong to.

This initiative is sometimes referred to as "Open Access". While there are good intentions here, it is worth remembering that credit risk still exists in the system and has to be paid for.

'While there are good intentions here, it is worth remembering that credit risk still exists in the system and has to be paid for!'

If CCPs are not allowed to differentiate between clients on fees, then the strong market participants will end up paying for the weak (everybody will be charged a fee corresponding to the average credit quality of the CCPs client pool). This will leave CCPs in a situation where they have a strong incentive to somehow keep weak clients off their platform to improve their competitive position against the other CPPs in terms of fees.

Overall, the problem is that all those involved are profit optimising commercial entities - but the regulation attempts to make them operate as if they were non- profit government organisations. It shall be interesting to see how this plays out.

Trading Controls for High Frequency Trading (Market Regulation)

High frequency trading has recently received a lot of attention from a regulatory point of view. This is not surprising given that the majority of trades these days are done by HFT firms both in terms of volume and number of trades.

This combines with a general level of discomfort around how these companies make money (and, in some cases, never seem to lose money). Such concern was exacerbated by Michael Lewis' latest book, Flash Boys, the so-called Flash Crash of 2010, and Knight Capital losing $440 million in 45 minutes due to an algorithm that had gone berserk.

Under MiFID/MiFIR the following initiatives are aimed at increasing the trading controls in the HFT corner of the financial markets:

Authorisation: Under MiFID II/MiFIR, HFT firms engaging in proprietary trading will have to be authorised.

Market making: HFT firms with algorithms that pursue a market making strategy will face requirements around their systems and control framework. They will also be required to enter into market making agreements with the venues to ensure they provide liquidity on a consistent basis.

Order to trade ratio: 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 actually undertake.

Operational issues: Trading venues where HFT/algorithmic trading takes place will have to have circuit breakers and minimum tick sizes in place, as well as controls to ensure that, among other things, venue pricing is transparent, fair and non-discriminatory. Trading venues should also have systems clever enough to recognise when a firm sends an excessive volume of order messages (or adopts other potential abusive order messaging tactics) so that penalties can be issued.

Bearing in mind that HFT firms will continue to be trading venues' biggest clients, it will be interesting to see how much policing they actually undertake against their golden goose.

Extension of Transaction Reporting (Market Regulation)

Under MiFID II/MiFIR, the obligation to report transactions is extended both in terms of qualifying instruments and the volume of reportable data.

The reporting is to be made on a T+1 basis to the national competent authorities but it is still a bit unclear if trading venues will end-up offering a reporting service and exactly what role Approved Reporting Mechanisms (ARM) will play (see below). In cases where a firm executing transactions on a trading venue is not subject to MiFID, the reporting obligation falls upon the trading venue.

Scope: All financial instruments available for trading at trading venues - that is RMs, MTFs and OTFs - fall under the reporting obligation. So do derivatives, where the underlying is a financial instrument available for trading at trading venues (including indices and baskets of such instruments).

Flags: As part of the reporting, in certain cases additional information must be submitted via flags. This is the case if a transaction is a short sale or has been executed under an applicable waiver.

ARMs: All reportable transactions are to be reported through systems that comply with the specific

requirements detailed in Article 12 of the MiFID Level 2 Regulation. Such systems are collectively referred to as Approved Reporting Mechanisms (ARMs) and must be authorised by the local national competent authority.

Firms will generally be responsible for the accuracy, timeliness, and completeness of the reporting, except in cases where it can be clearly demonstrated that an error has been introduced by a trading venue or ARM.

Supervisory Powers (Firm Regulation)

To improve investor protection, MiFIR introduces new and extensive regulatory powers regarding product intervention. MiFIR authorises the European Securities and Markets Authority (ESMA), the European Banking Authorities (EBA) and national regulators to impose bans or restrictions on firms' marketing, distribution, or sale of financial instruments. These powers extend to imposing sanctions on firms' financial activities or practices. Such powers will be available even before a financial instrument has been marketed to clients.

These new rules encourage a more harmonised approach to administrative sanctions across the different member states.

Axxsys™ Regulatory Practice

We help investment management businesses understand and meet the regulatory challenges they face. Axxsys' operational expertise and long track record of working with the buy-side community are supported by our strong regulatory network and long-standing relationships with trade repositories, system vendors, clearing houses and ARMs. As a result, our technical specialists are uniquely placed to see regulation from the point of view of the client business, providing tailor-made solutions that manage regulatory risk and create value within the operating model.

For more information about MiFID II / MiFIR and the strategic and operational impact they may have on your investment management business, please contact Axxsys Consulting on +44 (0) 20 7526 4900 or info@axxsysconsulting.com.

axxsys

References

[MiFID] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:02004L0039-20070921&from=EN

[MiFID_II] http://eur-lex.europa.eu/legal-content/EN/TXT/ PDF/?uri=CELEX:32014L0065&from=EN

[MiFIR] http://eur-lex.europa.eu/legal-content/EN/TXT/ PDF/?uri=CELEX:32014R0600&from=EN

[PR] http://www.esma.europa.eu/system/files/public_register_for_the_clearing_ obligation_under_emir.pdf

Further Reading

For more details, good summaries can be found in [CC] and [FCA].

[CC] http://www.cliffordchance.com/briefings/2014/06/mifid_2_and_mifir- whatyouneedtoknow.html

[FCA] http://www.fca.org.uk/firms/markets/international-markets/mifid-ii/what-is- changing

[CP] http://www.esma.europa.eu/system/files/2014-549_-_consultation_paper_mifid_ii_-_ mifir.pdf

[DP] http://www.esma.europa.eu/system/files/2014-548_discussion_paper_mifid-mifir. pdf

[COB] http://www.esma.europa.eu/system/files/2014-1485_peer_review_report_-_ mifid_-_conduct_of_business_fair_clear_and_not_misleading_information.pdf

Copyright © 2015 Axxsys Consulting. All rights reserved. This note is produced for information only on a best efforts basis, and does not constitute advice of any kind. You may publish, quote or reproduce this white paper on the condition that Axxsys Consulting is notified and properly credited (and linked to) as the source, including our URL: www.axxsysconsulting.com

New Broad Street House,
35 New Broad Street,
London,
EC2M 1NH,
United Kingdom

+44 (0)20 7526 4900

First Canadian Place,
100 King Street West,
Suite 5700, Toronto,
ON M5X 1C7,
Canada

+1 416 915 4186

616 Corporate Way,
Suite 2-4684,
Valley Cottage,
NY 10989,
United States

+1 845 459 2626

Fax: +44 (0) 20 7526 4901

axxsysconsulting.com

info@axxsysconsulting.com