# MiFID II/MiFIR Primer - Part 2

Regulatory Update

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# This white paper, 2 of 2, provides an overview of the practical implications for the investment management industry 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 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.

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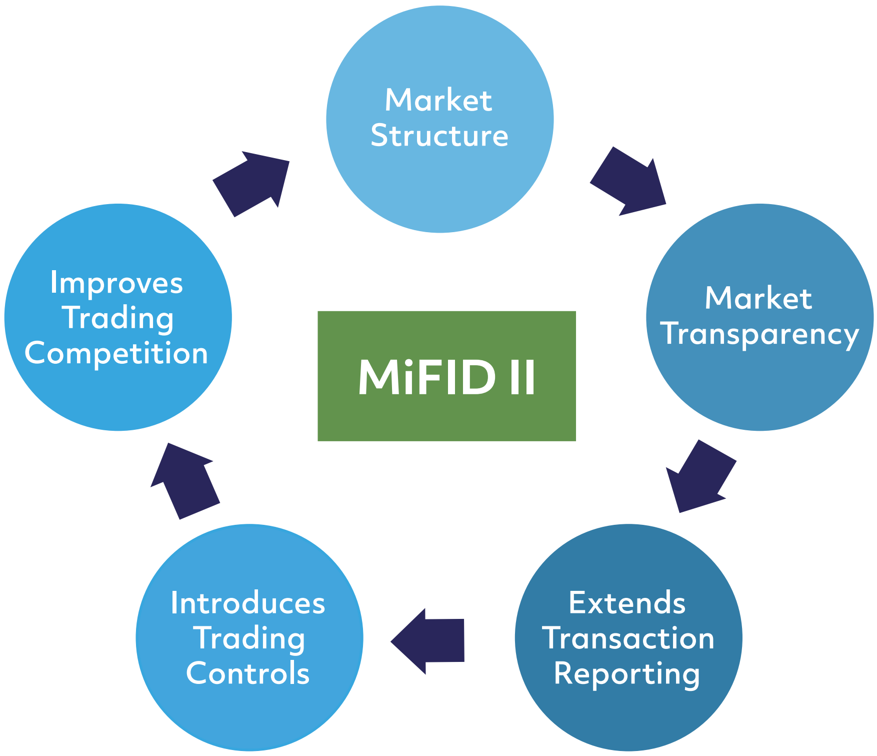
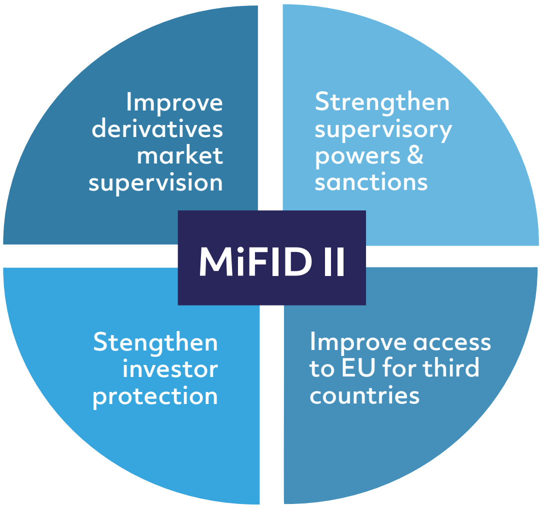
Naturally there will be overlap between the two regulatory initiatives as both, for example, introduce a transaction reporting obligation. However, at the time of writing, many technical implementation details are yet to be published so it is too early to draw precise comparisons.

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



In Part 1 of this white paper series we discussed the scope of the directive. In this paper we look at the scope in more detail focussing on the areas below:

MiFID II/MiFIR contains four key areas of regulation of financial firms:




## New Supervision Tools for Commodity Derivatives Firms (Firm Regulation)

Many commodity markets have limited liquidity and are therefore at risk of price manipulation, especially from derivatives usage where leverage magnifies the impact. This seems to have been one of the main reasons that commodity derivatives were the asset class which received the most attention in MiFID II/MiFIR.


The main changes under the new rules are:

**Scope:** All commodity contracts traded on a RM, MTF, or OTF with physical settlement will be in scope under MiFID II. Certain electricity and gas contracts appear to be exempt.

**Exemptions:** The current broad exemption for commercial firms who trade commodity derivatives is being narrowed. Such activities must now be ancillary to the main business (which can't be financial services) if the firm is to maintain its exempt classification. As a result, many commodity dealers will lose their exemption and be impacted for the first time by the regulation.

**Position limits:** Contracts traded on trading venues and economical equivalent OTC contracts shall be subject to position limits. Limits will apply on both individual net position level and aggregate group level.

**Position reporting:** The legislation introduces a reporting obligation for trading venues to report aggregate positions on a daily basis to competent authorities, with a breakdown of positions between participants, clients, and client of clients. Once a week, the trading venues will have to send this information to ESMA who will report aggregated positions, separating out positions held by commercial and financial firms. Investment firms will be required to report OTC positions to their local authorities.

> **"Competent authorities get new supervisory powers allowing them to introduce temporary additional position limits or even force people to reduce their positions in commodity derivatives.'**

## Strengthened Investor Protection/Conduct of Business Rules (Firm Regulation)

MiFID II's conduct of business provisions are the primary attempt, within the new rules, to improve investor protection.  The main changes are:

**Conflicts of interest:** Stringent new rules around inducements and remuneration structures within firms will be introduced in an attempt to reduce potential conflicts of interests between a firm and its clients. Restrictions will be placed on payments that firms providing services to clients can receive or make for these services. Firms providing independent advice or portfolio management will be prohibited from receiving and retaining inducements from third parties.

**Product design:** A new, stricter process will be imposed upon both the manufacturers and distributors who introduce a new product to retail clients. This is clearly a response to all the mis-selling scandals we have witnessed over the last few years.

**Execution only:** Under the current directive, brokers can only allow clients to buy and sell a certain range of products on an execution-only basis. Under MiFID II this list is being further narrowed to exclude margin trading, complex structures, structured UCITS, embedded derivatives, and certain structured deposits (deposits where repayment is for example linked to an equity index or FX rate).

**Best execution:** Brokers will - on an annual basis - need to provide details of the top five execution venues by volume for each of the main categories of financial instruments used by the firm. Execution venues are further required to disclose information about the quality of the execution they provide (price, cost, speed, likelihood of execution, etc).

**Retail client rights:** The funds and ownership rights of retail clients must be sufficiently safe-guarded, particularly with respect to the firm's own accounts and status in case of a default. In particular, it is prohibited for investment firms to enter into title transfer financial collateral arrangements with retail clients.

## Harmonising Regulations of Third Country Firms (Firm Regulation)

Currently, the access of third country financial firms to EU markets is not harmonised and each member state can introduce its own third country regime.


It is the aim of MiFID II/MiFIR to harmonise these rules.

It is not the aim of MiFID II/MiFIR to prevent competition from third country firms within the EU; third country firms are free to establish a branch within the EU as long as they are compliant with EU regulation. This is just the reality non-EU companies will have to live with if they want to do business with retail clients.

However, if a third country firm chooses to trade only with professional investors, they will have the opportunity to apply for exemption from EU regulation so long as their home country passes the equivalence and reciprocity tests.

(Equivalence means that EU regulators would recognise a third country's regime as being of a "sufficiently" comparable standard. Reciprocity refers to the question of whether the third country treats the EU as equivalent in their third country rules. These definitions obviously leave a lot of room for interpretation and it is unclear what the current status is for non-EU countries).

Forcing companies to be compliant with both their local regulations and the regulation of a foreign regime is obviously a significant burden; indirectly, then, these rules do seem to limit competition, in particular from those smaller non- EU firms that would otherwise wish to operate within the EU.

Further, most of the progress in harmonising rules seems to have been accomplished for companies dealing with professional clients. The retail market is still left regulated largely by individual member states.

As and when more details emerge, we'll follow up with more commentary and observations.

## 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 +44 (0) 20 7526 4900 or info@axxsysconsulting.com.

## 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


## 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

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