

ERA Conference
The MIFID II Legislative Proposal

**Crucial changes in the reform of MiFID: distinction
between MiFID obligations and MiFIR requirements**

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A. The general context

The Markets in Financial Instruments Directive 2004/39/EC (MiFID)

- in force since November 2007
- a core pillar in EU financial market integration
- it was adopted in accordance with the “Lamfalussy” process
- it consists of:
 - a framework Directive (Directive 2004/39/EC),
 - an implementing Directive (Directive 2006/73/EC), and
 - an implementing Regulation (Regulation No 1287/2006)

A. The general context

MiFID repealed **Council Directive 93/22/EEC** on investment services in the securities field, which:

- sought to establish the conditions under which authorised investment firms and credit institutions could provide specified services or establish branches in other Member States on the basis of home country authorisation and supervision

To this end, Directive 93/22/EEC aimed to harmonise:

- the initial authorisation and operating requirements for investment firms including conduct of business rules, as well as
- some conditions governing the operation of regulated markets

B. The building blocks of MiFID

MiFID brought substantial amendments to Directive 93/22/EEC. The overarching objective was to further the integration, competitiveness, and efficiency of EU financial markets. More specifically:

- (a) it 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,
 - the operation of regulated markets by market operators, and
 - the powers and duties of national competent authorities in relation to these activities

B. The building blocks of MiFID

- (b) it abolished the possibility for Member States to require all trading in financial instruments to take place on traditional exchanges (abolition of the concentration rule) and enabled Europe-wide competition between those exchanges and alternative venues
- (c) it granted banks and investment firms a strengthened “passport” for providing investment services
- (d) it provided for a classification of investors to retail, professional investors and eligible counterparties based on concrete criteria
- (e) it upgraded investment advice to an investment service and it added to investment services the operation of MTFs

B. The building blocks of MiFID

MiFID introduced comprehensive rules on:

- (i) the **authorisation conditions and procedures** of investment firms* as well as on the withdrawal of authorisation
- (ii) the **operating conditions for investment firms**, including:
 - the organisational requirements with which they should comply,
 - the identification and management of conflicts of interest, and
 - the obligation to establish adequate policies and procedures sufficient to ensure compliance of the firm with its obligations under the Directive

** The provisions applying to credit institutions providing investment services are expressly specified in the Directive*

B. The building blocks of MiFID

MiFID introduced comprehensive rules on (cont.):

(iii) the **conduct of business obligations when providing investment services to clients** including:

- the information to be provided to clients at the precontractual stage as well as at the conclusion of the contract,
- the obligation of investment firms to execute the suitability or appropriateness test before providing investment services to the client,
- the obligation to execute orders on terms most favourable to the client (best execution), and
- client order handling rules

B. The building blocks of MiFID

MiFID introduced comprehensive rules on (cont.):

(iv) the **transparency requirements** including:

- the obligation of investment firms to keep at the disposal of the competent authorities the relevant data relating to all transactions in financial instruments which they have carried out and to report details of such transactions,
- **pre-trade transparency requirements** by investment firms, regulated markets and MTFs *in respect of shares*
- **post-trade requirements** by investment firms, regulated markets and MTFs *in respect of shares*,
- the obligation of systematic internalisers to publish a firm quote in those shares admitted to trading on a regulated market for which they are systematic internalisers and for which there is a liquid market

B. The building blocks of MiFID

MiFID introduced comprehensive rules on (cont.):

- (v) rules on the **freedom to provide investment services and activities**,
- (vi) rules on the **regulated markets**, including:
 - the authorisation and organisational requirements as well as requirements for the management of the regulated markets,
 - rules on the admission of financial instruments to trading, and
 - rules on the access to the regulated markets,
- (vii) rules on the **competent authorities** and the cooperation between competent authorities of different member states and third countries, and
- (viii) rules on the **administrative sanctions**

C. The reform of MiFID

The reform of MiFID after around 4 years in force was, according to the European Commission, necessary mainly for four reasons:

- the benefits from the more competitive landscape, as a result of MiFID, have not flowed equally to all market participants and have not always been passed on to the end investors; the trading environment became more complex, especially in terms of collection of trade data,
- market and technological developments have outpaced various provisions in MiFID,
- the rapid innovation and growing complexity in financial instruments underlined the importance of up-to-date, high levels of investor protection

C. The reform of MiFID

- the **financial crisis** has exposed **weaknesses** in the regulation of instruments other than shares, traded mostly between professional investors

More specifically, the financial crisis has exposed weaknesses:

- in the functioning and in the transparency of financial markets → need to strengthen the regulatory framework in order to increase transparency, better protect investors, reinforce confidence, reduce unregulated areas, ensure that supervisors are granted adequate powers to fulfil their tasks
- in corporate governance in a number of financial institutions, including the absence of effective checks and balances within them → need to enhance corporate governance in order to avoid excessive and imprudent risk taking, which may lead to the failure of individual financial institutions and systemic problems

C. The reform of MiFID

Directive 2004/39/EC is:

- partly recast as the new proposal for a Directive, and
- partly replaced by Regulation (EU) No .../... (MiFIR)

Together, both legal instruments should form the legal framework governing the requirements applicable:

- to investment firms,
- regulated markets,
- data reporting services providers, and
- third country firms providing investment services or activities in the Union

C. The reform of MiFID

A common characteristic of both the proposal for a Directive (MiFID II) and the proposal for a Regulation (MiFIR) is the key role provided for the European Securities and Markets Authority (ESMA). More specifically, ESMA:

- is entrusted with the elaboration of draft regulatory and implementing technical standards on various issues, which do not involve policy choices, for submission to the Commission in order to facilitate the implementation of the proposals, and
- is entrusted with specific powers of supervision under specific conditions expressly provided for in the proposals

C1. The proposal for a Directive MiFID II

Legal basis: article 53(1) of the TFEU

The Directive would replace Directive 2004/39/EC (MiFID) with regard to the harmonisation of national provisions for:

- the authorisation and operating conditions governing the provision of investment services by investment firms,
- the acquisition of qualifying holdings,
- the exercise of the freedom of establishment and of the freedom to provide services,
- the powers of supervisory authorities of home and host Member States and the sanctioning regime, and
- the authorisation and operating conditions for regulated markets and providers of market data

C1. The proposal for a Directive MiFID II

- The proposal for a Directive is **complementary** to the proposal for a Regulation [MiFIR]
- Most of the issues covered by the revision are already covered by the current MiFID legal framework
- However, action is required in order to update and modify the regulatory framework laid out by MiFID in order to take into account developments in financial markets since its implementation as well as the lessons drawn from the crisis
- According to the Commission *“The form of a Directive is appropriate in order to enable the implementing provisions in the areas covered by this Directive, when necessary, to be adjusted to any existing specificities of the particular market and legal system in each Member State”*

C1.1 The amendments to MiFID

(a) Extension of MiFID rules to like products and services

The proposal:

- extends MiFID requirements, and particularly conduct of business and conflicts of interest rules, to the advised and non-advised sale of structured deposits by credit institutions,
- specifies that MiFID also applies to investment firms and credit institutions selling their own securities when not providing any advice, and
- requires Member States to apply authorisation and conduct of business requirements analogous to MiFID in national legislation applicable to locally-based entities

C1.1 The amendments to MiFID

(b) Improvements to corporate governance

- As already mentioned, deficiencies in corporate governance in a number of financial institutions are considered to have contributed to the excessive risk taking
- In order to improve corporate governance mechanisms, MiFID II, in line with the proposal for a Directive, known as “CRD IV”, sets detailed rules in this area, and especially with respect to the management body of investment firms, aiming to strengthen the existing relevant provisions of MiFID

C1.1 The amendments to MiFID

(b) Improvements to corporate governance (cont.)

More specifically, according to the proposal for a Directive, members of the management body shall, in particular, fulfil the following requirements:

- they shall commit sufficient time to perform their functions,
- they shall not combine at the same time more than one of the following combinations:
 - (i) one executive directorship with two non-executive directorships
 - (ii) four non-executive directorships.
- the management body shall possess adequate collective knowledge, skills and experience to be able to understand the investment firm's activities,
- each member of the management body shall act with honesty, integrity and independence of mind to effectively assess and challenge the decisions of the senior management

C1.1 The amendments to MiFID

(b) Improvements to corporate governance

- investment firms should devote adequate resources to the induction and training of members of the management body
- obligation to establish a nomination committee to assess compliance with the above-mentioned requirements and to make recommendations, when needed, on the basis of their assessment. *The nomination committee shall be composed of non executive members of the management body*
- obligation of investment firms to take into account diversity as one of the criteria for selection of members of the management body (policies promoting gender, age, educational, professional and geographical diversity on the management body)

C1.1 The amendments to MiFID

(b) Improvements to corporate governance

- the management body of an investment firm should ensure that the firm is managed in a sound and prudent way and in a manner that promotes the integrity of the market and the interest of the its clients
- the management body shall monitor and periodically assess the effectiveness of the investment firm's organization and the adequacy of the policies relating to the provision of services to clients and take appropriate steps to address any deficiencies
- non executive members of the management body shall have adequate access to information and documents which are needed to oversee and monitor management decision-making

C1.1 The amendments to MiFID

(c) Enhancement of the investor protection framework

- the proposal strengthens the regulatory framework for the provision of investment advice and portfolio management and the possibility for investment firms to accept incentive by third parties (inducements)
- it introduces a framework to deal with cross-selling practices in order to ensure that investors are properly informed and that these practices are not detrimental for them

C1.1 The amendments to MiFID

(c) Enhancement of the investor protection framework

- it improves the information to clients in relation to the services provided to them and to the execution of their orders
- it enhances protection to be provided to non-retail clients

C1.1 The amendments to MiFID

(d) Data consolidation

- the area of market data in terms of quality, format, cost and ability to consolidate is key to sustain the overarching principle of MiFID as regards transparency, competition and investor protection
- the proposed provisions will improve the quality and consistency of data by requiring that all firms publish their trade reports through Approved Publication Arrangement (APA)
- the proposed provisions set also the conditions for the emergence of consolidated tape providers and define the organisational requirements that such providers will need to meet in order to be able to operate such a scheme

C1.1 The amendments to MiFID

(e) Powers of competent authorities

- competent authorities would be bestowed with explicit powers to demand information from any person regarding the positions held in the derivative instruments concerned as well as in emission allowances
- the supervisory authorities would also be able to intervene at any stage during the life of a derivative contract and take action that a position be reduced

C1.1 The amendments to MiFID

(e) Powers of competent authorities (cont.)

- Member States should provide that appropriate administrative sanctions and measures can be applied to breaches of the Directive. To this end, the Directive will require them to comply with minimum rules, such as the following:
 - the maximum level of administrative pecuniary sanctions laid down in national legislation should exceed the benefits derived from the breach,
 - the criteria taken into account by competent authorities when determining the type and level of the sanction to be applied in a particular case should include at least the criteria set out in the Directive (eg. benefits derived from the violation or losses caused to third parties, cooperative behaviour of the responsible person, etc)
 - sanctions and measures applied should be published, as provided in the Directive

C1.2 The new elements

(a) Level playing field between trading venues

- A central aim of the proposal for a Directive is to ensure that **all organised trading is conducted on regulated trading venues**:
 - regulated markets,
 - multilateral trading facilities (MTFs), and
 - (the new concept) organised trading facilities (OTFs)

- Identical pre and post trade transparency requirements will apply to all of these venues. *However, the transparency requirements will be calibrated for different types of instruments, notably equity, bonds, and derivatives, and for different types of trading, notably order book and quote driven systems*

C1.2 The new elements

(a) Level playing field between trading venues

- *Regulated markets and multilateral trading facilities* are characterised by non-discretionary execution of transactions. Transactions are executed according to predetermined rules.
- By contrast, the operator of an *OTF* has a degree of discretion over how a transaction will be executed. Consequently, the operator is subject to investor protection, conduct of business, and best execution requirements towards the clients using the platform.

C1.2 The new elements

(a) Level playing field between trading venues

- Organised trading may also happen by *systematic internalisation*
- A systematic internaliser (SI) may execute client transactions against his own proprietary capital
- However, an SI may not bring together third party buying and selling interests in functionally the same way as a regulated market, MTF or OTF, and is therefore not a trading venue
- Any trading on own account by investment firms with clients, including other investment firms, is thus considered over-the-counter (OTC). OTC trading activity which will not meet the definition of SI activity will have to be non systematic and irregular

C1.2 The new elements

(b) SME markets

- it is proposed to create a new subcategory of markets known as “SME growth markets”
- the registration of these markets should raise their visibility and profile and help lead to common pan European regulatory standards for such markets, that are tailored to take into account the needs of issuers and investors in these markets while maintaining existing high levels of investor protection.

C1.2 The new elements

(c) Third country regime

- the proposal introduces a regime based on a preliminary equivalence assessment of third country jurisdictions by the Commission
- third country firms from third countries for which an equivalence decision has been adopted would be able to request to provide services in the Union
- furthermore, **the provision of services to retail clients would require the establishment of a branch**; the third country firm should be authorised in the Member State where the branch is established and the branch would be subject to EU requirements in some areas (organisational requirements, conduct of business rules, conflicts of interest, transparency and others)

C1.2 The new elements

(d) New investment services

- safekeeping and administration of financial instruments for the account of clients, including custodianship and related services such as cash/collateral management is upgraded (from ancillary) to investment service
- a new investment service is added: the operation of Organised Trading Facilities

C 2. The proposal for a Regulation (MiFIR)

Legal basis: article 114(1) of the TFEU

The proposal for a Regulation sets out requirements in relation to:

- the disclosure of trade transparency data to the public and transaction data to competent authorities,
- removing barriers to non-discriminatory access to clearing facilities,
- the mandatory trading of derivatives on organised venues,
- specific supervisory actions regarding financial instruments and positions in derivatives, and
- the provision of services by third-country firms without a branch

C 2. The proposal for a Regulation (MiFIR)

- According to the Commission, a Regulation is necessary to grant specific direct competences to ESMA in the areas of product intervention and position management powers
- For the fields of trade-transparency and transaction reporting the application of rules often depends on numeric thresholds and specific identification codes. Any deviation on the national level would lead to market distortions and regulatory arbitrage, preventing the development of a level-playing field. The imposition of a Regulation ensures that those requirements will be directly applicable to investment firms and promotes a level-playing field
- A Regulation would also enable the EU to implement any future changes more quickly, as amendments can apply almost immediately after adoption

C 2.1 The amendments to MiFID

(a) Extension of transparency rules to equity like instruments

- As already mentioned, MiFID has established transparency rules, both pre- and post- trade that apply to **shares** admitted to trading on regulated markets, including when those shares are traded on an MTF or over the counter (OTC)
- The proposed provisions extend the transparency rules applicable by these shares to **equity like instruments** such as depository receipts, exchange-traded funds, certificates and other similar financial instruments issues by companies
- obligation of the competent authorities to inform ESMA about the use of the waivers to the obligation to publish in real time current orders and quotes in their markets

C 2.1 The amendments to MiFID

(b) Extension of transparency rules to bonds, structured finance products and derivatives

- the proposal for a Regulation extends the principles of transparency rules **up to now only applicable to equity markets** to bonds, structured finance products, emission allowances and derivatives, taking into account that the existing level of transparency of these products which are, in most cases, traded OTC is not considered sufficient
- the provisions lay out also new requirements for both pre- and post- trade transparency on these four groups of instruments

C 2.1 The amendments to MiFID

(c) Transparency requirements for investment firms trading OTC including systematic internalisers

- The existing transparency rules for systematic internalisers apply to shares and equity-like instruments,
- The new provisions concern bonds, structured finance products admitted to trading on a regulated market or for which a prospectus has been published, emission allowances and derivatives which are clearing-eligible or are admitted to trading on a regulated market or are traded on an MTF or an OTF
- Post-trade transparency rules identical to those applicable to on-venue trades are proposed to apply to all shares including equity-like instruments, as well as to bonds and structured finance products for which a prospectus has been published, to emission allowances and to derivatives which are admitted to trading on a regulated market or traded on an MTF or OTF, as well as derivatives which are clearing-eligible or are reported to a trade repository

C 2.1 The amendments to MiFID

(d) Transaction reporting

- Transaction reporting under MiFID:
 - enables supervisors to monitor the activities of investment firms and ensure compliance with MiFID, and to monitor for abuses under the Market Abuse Directive
 - it is also useful for general market monitoring

C 2.1 The amendments to MiFID

(d) Transaction reporting

According to the proposal for a Regulation improvement of the quality of the reporting is aimed through:

- a new obligation for regulated markets, MTFs and OTFs to store order data in a manner accessible to supervisors for at least 5 years; the stored information will need to contain all information also required for the reported transactions, notably including identification of the client, and of the persons responsible for the execution of the transaction
- the scope of transaction reporting which was up to now limited to financial instruments admitted to trading on a regulated market, will be substantially extended and thus aligned with the scope of market abuse rules

C 2.1 The amendments to MiFID

(e) Provision of investment services by third countries without a branch

- As already mentioned, the proposal introduces a regime based on a preliminary equivalence assessment of third country jurisdictions by the Commission
- Services provided to **eligible counterparties** would not require the establishment of a branch; third country firms could provide them subject to ESMA registration. They would be supervised in their country. Appropriate cooperation agreement between the supervisors in third countries and national competent authorities and ESMA would be necessary

C 2.2 The new elements

(a) Trading of derivatives

- as part of the significant efforts underway to improve the stability, transparency and oversight of OTC derivatives markets, and in line with the G20 recommendations
- the proposal for a Regulation requires trading in suitably developed derivatives to occur **only on eligible platforms, that is regulated markets, MTFs or OTFs**
- this obligation will be imposed on both financial and non financial counterparties exceeding the clearing threshold in EMIR

C 2.2 The new elements

(b) Supervision of products and positions

According to the proposal for a Regulation:

- competent authorities may set permanent bans on financial products or activities or practices with coordination by ESMA
- ESMA may also temporarily ban products, practices and services,
- under certain conditions expressly provided, which create concerns on investor protection, or threats to the orderly functioning of financial markets or stability of the financial system
- *The ban could consist of a prohibition or restriction on the marketing or sale of financial instruments or on a certain practice or on persons engaged in the specific activity*

C 2.2 The new elements

(b) Supervision of products and positions

According to the proposal for a Regulation:

- in complement to the powers proposed in the revised Directive that give the possibility to competent authorities to manage positions including setting up position limits, the proposed provisions in the Regulation introduce a role for ESMA to coordinate the measures taken at national level
- it also gives ESMA specific powers to manage or limit positions for market participants under certain conditions expressly provided, notably in terms of a threat to the orderly functioning of markets or delivery arrangements for physical commodities, or to the stability of the financial system in the Union

D. Concluding remarks

- The reform of MiFID was influenced by the weaknesses exposed during the recent (2007-2009) international financial crisis; however, it was already scheduled
- The new proposals consist mainly of the revision of existing provisions of MiFID, either by extending their scope of application (e.g. transparency requirements) or by strengthening the existing requirements (e.g. in the fields of corporate governance, investor protection and organisational requirements), bringing however significant changes to the existing framework
- The purely new elements, such as the new category of “Organized Trading Facilities” or the requirement with respect to trading of derivatives only on eligible platforms change also the existing landscape in a significant way

D. Concluding remarks

- Any assessment of the new proposals would be premature taking into account that the proposals have not been finalized yet
- However, it is more than certain that the regulatory storm underway following the financial crisis, a part of which is MiFID II and MiFIR, requires very careful, costly and strategic preparation on the part of market participants in order to ensure compliance to the new requirements and efficiency in their implementation