MiFID

A report for

DEUTSCHE BÖRSE GROUP

mondovisione

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Contents

“Trading and transparency in EU capital markets will be transformed once MiFID II/MIFIR has been implemented.”

Herbie Skeete, managing director, Mondo Visione

Introduction

Since the financial crisis hit the headlines in 2007 and forced taxpayer bailouts of banks, a huge amount of work has been put into revamping the regulatory framework in order to improve the resilience of the financial system.

In the European Union one of the responses to the financial crisis has been a revision to the Markets in Financial Instruments Directive and new regulation (MiFID II/MIFIR).

The MiFID II legislation provides a European-wide legislative framework for regulating the operation of financial markets in the EU, introducing rules relating to investor protection and governance.

MiFID II is concerned with the framework of execution venues and the structures in which financial instruments are traded, fundamentally reshaping financial markets in Europe. MiFID II will impact the products and services that market participants provide and the relationship between market participants and their customers.

MiFIR is about the regulation of the operation of execution venues and structures, transaction execution as well as pre- and post-trade transparency, looking into processes, systems and governance measures adopted by market participants.

MiFID II is the biggest overhaul of EU securities rules and will significantly increase reporting requirements for market participants. Those of us who were around during the run up to the original MiFID (Classic MiFID) the decision to have a one-year delay to January 3, 2018 for introducing the landmark MiFID II reforms of EU financial markets, it’s like déjà vu all over again (as the late great Yogi Berra is alleged to have said), with both European Securities and Markets Authority and participants needing more time to prepare for the new obligations.

What is clear is that trading and transparency in EU capital markets will be transformed once MiFID II/MIFIR has been implemented.

In this series of four papers we will map out the key changes in the MiFID II regulatory directive.

This first paper sets the scene looking at what the initial MiFID Directive was about and how the recast directive (MiFID II/MiFIR) will likely turn out to be the most impactful financial regulation the EU has seen for over a decade.

The following papers will in turn look at:

- **Transaction reporting** – the full scope of application of Article 26 MiFIR
- **The concept of transparency** – pre-trade and post-trade publication requirements under MiFIR
- **The regulatory reporting hub** – how to cover multiple regulatory reporting requirements through one platform. MV

Changing MiFID

The Markets in Financial Instruments Directive (MiFID) brought together several elements to help European equity markets evolve in 2007. Firstly it reflected the competition that had developed between US market operators from the turn of the century. By allowing European stocks to be traded on platforms which had not issued them, MiFID broke the dominance of domestic markets over trading.

Secondly, it set out rules that applied equally to all European domestic markets, ostensibly creating a level playing field between them. The effect was to make market infrastructure operators and investment banks/brokers adhere to a regulatory framework.

Thirdly, it sought to help investors, largely as a consequence of the primary and secondary functions. In creating competition, and setting out clear rules for trading, MiFID was expected to make trading easier and cheaper, which would increase the use of Europe's capital markets as a source of funding – in a similar vein to the American model – and reduce the reliance on bank lending as a source of capital.

However the directive's impact was largely to loosen the existing market structure, rather than imposing a new framework to replace it. The shake-out of MiFID showed several gaps between the intentions and the effect of the rules:

1 / Regulators had not appreciated that equities were not obliged to trade on authorised venues and therefore a thriving over-the-counter (OTC) market already existed, for which authorities had no oversight, yet inadvertently encouraged by breaking the concentration rule via the directive.

2 / Market structure was largely determined by commercial drivers; consequently concepts like the consolidated price tape could be highly desirable to many market participants without being easily delivered, while venues such as 'dark pools' could be created without regulatory oversight.

3 / Principles-based rules limited the effect of standardisation between firms as they lacked any benchmarks for comparison. The use of a directive allowed interpretation by different national competent authorities which could prevent the rules from being applied evenly. For example, in Spain the requirement for securities transactions to be provided with a tag by the local central securities depositary allowed any transactions not conducted on the local exchange to face additional costs, limiting the new venues from competing on an even footing with the local exchange.

A 2010 review of MiFID by the European Commission found that the key organising principles of MiFID needed updating, and incorporating with changes recognised as important at the G20 level. In 2009 two G20 meetings took place to develop a strategy that could handle the crisis triggered in late 2008 by the bankruptcy of Lehman Brothers. The G20 leaders stated in April 2009 "Strengthened regulation and supervision must promote propriety, integrity and transparency; guard against risk across the financial system; dampen rather than amplify the financial and economic cycle; reduce reliance on inappropriately risky sources of financing; and discourage excessive risk-taking." This ultimately led Europe to develop a much wider-ranging regulatory framework than had been envisaged before, incorporating third-country jurisdiction views in the reform process.

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MiFID II – A reform not a review

The 2010 review initially assessed MiFID in the context of markets post-crisis. It was conducted according to the 'Lamfalussy process' under which a directive is adopted containing framework principles and after which the European Commission (EC) adopts delegated acts, often with advice from the pan-European regulatory authority, the European Securities and Markets Association (ESMA).

It took account not only of the gaps in the original rules but also the regulatory agenda that the G20 had set after the crisis. The G20 had determined that the systemic risk posed by the collapse of a large trading firm required a series of safety measures in the OTC derivatives market. The leverage these contracts create can bankrupt a large firm. By standardising contracts, trading them on electronic venues and centrally reporting trades, then using a central counterparty (CCP) to hold the risk for each side of a trade, the damage created by a single default could be contained.

MiFID II therefore became a reform of the rules more than a review. It expanded the original 2007 rules around trading of equities to other assets classes including derivatives. That increased transparency by demanding detailed reports of the investment, trading and post-trade processes, while creating a catch-all framework for trading that prevented any activity falling outside of the rules. This enabled G20's aim of pushing derivatives trading onto electronics venues by creating the appropriate definition of those venues and giving them a set of responsibilities and requirements so they were aligned with the broader aims.

It also introduced a regulation – MiFIR – which carried certain elements of the reform in a structure that could not be interpreted differently by local competent authorities.

Originally slated to come into effect in January 2017, the timetable was postponed by a year when in early 2016 ESMA reported to the EC that neither it nor the market had the time to develop, acquire and test all of the necessary systems and processes to support compliance.

The additional time created some breathing space for market participants, however the timetable is still ambitious given the scope of change that they will be subject to.

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The elements of MiFID II

Market Structure

In addition to the existing rules around multilateral trading facilities, which are venues for trading equities off-exchange defined in MiFID I, a new category of trading venue has been created for trading bonds, structured finance products, emissions allowances and derivatives. Called an organised trading facility (OTF), this is specifically designed in broad terms so that trading cannot be conducted in such a way as to avoid the rules around access, execution and reporting that would otherwise apply.

Systematic internalisers (SIs), defined as "investment firms which, on an organised, frequent systematic and substantial basis, deal on own account by executing client orders outside a trading venue", had been a category that many dealers avoided due to the vagaries of the description. Those firms have had their status more closely defined by quantifiable metrics under MiFID II, for example a firm is considered an SI in equities if "executing client orders is equal to or larger than 0.4% of the total number of transactions in the relevant financial instrument" or over the past six months has executed own account client order OTC "equal to or larger than either: (i) 15% of the total turnover in that financial instrument executed by the investment firm on own account or on behalf of clients and executed on a trading venue or OTC; (ii) 0.4% of the total turnover in that financial instrument executed in the Union on a trading venue or OTC."

Access to trading venues and CCPs for securities, money market instruments and exchange-traded derivatives has been made open and non-discriminatory, so that venues can choose where to clear their trades and CCPs can clear instruments issued on any market, with access to any requisite data feed being provided on the same open terms. This is intended to increase competition between venues and market structure, further pushing down trading costs.

Transparency

Greater transparency was a key principle expounded by the G20 in 2009 and this led to a revision of the transparency requirements under MiFID II. Timely pre-trade and post-trade transparency requirements were applied to all types of trading including order-book, quote-driven, hybrid, periodic auction trading and voice trading systems, while the range of instruments to which they applied was broadened to include bonds, structured finance products, emission allowances and derivatives traded on a venue.

As the regulation now makes demands of over-the-counter (OTC) traded products such as bonds it creates previously unforeseen challenges and potentially advantages. Illiquid markets are harder to price effectively due to gaps in trading activity. Greater price transparency could provide more pricing data. Conversely firms are less likely to trade due to information leakage, negatively impacting liquidity.

"Access to trading venues and CCPs for securities, money market instruments and exchange-traded derivatives has been made open."

Competent authorities are able to provide pre-trade transparency waivers, however specific volume caps and metrics are applied to limit trading in the dark, for example if one venue trades 4% of total volume for an financial instrument on all trading venues over the previous 12 months or if total dark trading hits trading 8% of total volume for the financial instrument for the previous 12 months.

SIs are subject to pre-trade reporting requirements like exchanges, MTFs, and OTFs. Waivers that apply to other venues such as large in size also apply to SIs. Post-trade transparency requirements and waivers are also in line with investment firms.

The concern about off-market trading is addressed by the 'trading obligation', requiring investment firms to execute orders on a regulated market, an MTF, a systematic internaliser or an equivalent third-country trading venue, with a limited set of exclusions.

That trading obligation extends to derivatives, and requires that venues are not able to claim exclusive rights in relation to any derivatives, thereby preventing other trading venues from offering trading in those financial instruments, and with no control over which CCPs are used to clear trades, including via fees.

Reporting

The scope of transaction reporting under MiFID II is considerably greater than under the 2007 version of MiFID. Investment firms have to report information about the instruments traded, when and how the transaction took place, clients for whom the trade was conducted, and even the people or algorithms responsible for making investment and trading decisions, retaining records for five years.

In total the number of fields in a report has risen from 23 to 65, and the type of data – which includes national ID numbers for the traders/portfolio managers recorded as making decisions – is challenging for firms to hold and move, due to data protection rules.

Transaction data can be reported by the investment firm or has to be reported via an approved reporting mechanism or trading venue, and the investment firm retains responsibility for any reporting errors that are not introduced by the intermediary.

Investor Protection

The increased transparency introduced by the directive and regulation are intended to support a restoration of trust in the markets, however more explicit measures are also taken under the recast MiFID II. The responsibilities of investment firms are highlighted, with any investment advice or decision sitting with the advisor even where an automated system is used. Investment firms have to check that advice they provide:

(a) meets the investment objectives of the client including their level of risk tolerance;

(b) lets the client carry risks consistent with their investment objectives;

(c) is appropriate for the experience and understanding of risks that the client has.

Investment firms have to gather a considerable depth of information around a client or potential client including information on the source and extent of their regular income, assets, liquid assets, investments and real property, as well as regular financial commitments.

To ensure the investment process works in the best interests of the end investors, the best execution obligation, first introduced for equities under MiFID I, is applied across assets with spot FX being a notable exclusion. The payment for execution has to be separated from that of research in order to deliver more effective remuneration for specific sell-side services. The ban on inducements takes a hard line on commission payments and will require firms to revisit existing models for commission unbundling.

With five years of telephone and electronic communications stored for any contact which is 'intended' to support processing of execution, there will be a wealth of data for regulators to mine in the event that execution obligations need to be checked.

Ultimately any product can also be suspended from trading by ESMA, the European Banking Authority or a national competent authority where it poses a threat to market integrity or the wider system.

Governance

Enhanced governance of investment firms sees the compliance function become involved in remuneration, product development, involvement in the safeguarding of client assets and oversight of the complaints procedures.

The level of record keeping required, alongside the stringent limits on compensation, requirements on product information and disclosure, and strict rules on the security and movement of client assets create a far more stringent regime than existed under MiFID I.

Conclusion

The most immediate point about MiFID II is its demand upon information gathering. Whether this is under post-trade reporting or client protection, the rules make enormous demands of a firm's ability to capture, process and act upon data and information. Only once a business has grasped what it needs to capture and how, can it start to understand the investment it will need to make in technology and process.

Despite the additional 12 months granted by the EC, complying with MiFID II is likely to stretch many market participants to breaking point, if they are not adequately prepared for the level of work involved.

With much expertise absorbed by the large sell-side firms early in the process, many smaller or buy-side operators are finding it hard to develop internal talent. Finding a trusted partner with the right level of expertise to match the firm's demand will become an increasingly popular model.