



European Securities and  
Markets Authority

# Consultation Paper

MiFID II/MiFIR





Date: 22 May 2014  
ESMA/2014/549

## **Responding to this paper**

The European Securities and Markets Authority (ESMA) invites responses to the specific questions listed in this Consultation Paper.

In order to respond to this paper, please follow the instructions given in the document ‘Reply form for the MiFID II/MIFIR Consultation Paper’ also published on the ESMA website ([here](#)).

Please note that the responses must reach us by 1 August 2014.

## **Who should read this paper?**

This document will be of interest to all stakeholders involved in the securities markets. It is primarily of interest to competent authorities and firms that are subject to MiFID II and MiFIR – in particular, investment firms and credit institutions performing investment services and activities. This paper is also important for trade associations and industry bodies, institutional and retail investors and their advisers, and consumer groups, as well as any market participant because the MiFID II and MiFIR requirements seek to implement enhanced provisions to ensure investor protection and the transparency and orderly running of financial markets with potential impacts for anyone engaged in the dealing with or processing of financial instruments.



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## Acronyms and definitions used

ABCP	Asset-backed commercial paper
ABS	Asset-backed security
ADT	Average daily turnover
AIFMD	Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers (AIFMs)
A-IOI	Actionable indications of interest
AMP	Accepted market practice
AOR	Automated order routing
APA	Approved publication arrangement
AVT	Average value of transactions
BIC	Business Identifier Code. An 11-character alpha-numerical code that uniquely identifies a financial or non-financial institution. It is defined by ISO code 9362
BIS	Bank for International Settlements
CBO	Collateralised bond obligation
CDO	Collateralised debt obligation
CDS	Credit default swap
CEBS	Committee of European Banking Supervisors
CEIOPS	Committee of European Insurance and Occupational Pensions Supervisors
CESR	Committee of European Securities Regulators
CCP	Central counterparty
CFD	Contract for difference
CFI	Classification of Financial Instruments
CFTC	U.S. Commodities Futures Trading Commission
Class+	Class of OTC derivatives subject to the clearing obligation
CLO	Collateralised loan obligation
CMBS	Commercial mortgage backed security
COFIA	Classes of financial instrument approach
Coreper	The Permanent Representatives Committee or Coreper (Article 240 of the Treaty on the Functioning of the European Union – TFEU)
Commission	European Commission
CP	Consultation Paper



CRD IV	Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC
CRR	Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012
CSD	Central securities depository
CSF	Cash settled forward
CT	Consolidated tape
CTP	Consolidated tape provider
DA	Delegated act to be adopted by the European Commission
DEA	Direct electronic access
DP	Discussion Paper
EBA	European Banking Authority
EC	European Commission
ECB	European Central Bank
EEA	European Economic Area
EIOPA	European Insurance and Occupational Pension Authority
EMIR	European Market Infrastructures Regulation – Regulation (EU) 648/2012 of the European Parliament and Council on OTC derivatives, central counterparties and trade repositories – also referred to as “the Regulation”
EOD	End of the day
ESMA	European Securities and Markets Authority
ESMA Regulation	Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC
ETD	Exchange-traded derivative
ETF	Exchange-traded fund
EU	European Union
FC	Financial counterparty
FCD	Financial Collateral Directive – Directive 2002/47/EC of the European Parliament and the Council.
FESCO	Forum of European Securities Commissions
FINRA	Financial Industry Regulatory Authority
FRA	Forward rate agreement



FSB	Financial Stability Board
FX	Foreign exchange
HFT	High frequency trading
ISIN	International Securities Identification Number: a 12-character alpha-numerical code that uniquely identifies a security. It is defined by ISO code 6166
IBIA	Instrument by instrument approach
IOI	Indication of interest
IOSCO	International Organisation of Securities Commissions
IPO	Initial public offering
IRS	Interest rate swap
ISO	International Organization for Standardization
ITS	Implementing Technical Standards
KID	Key information document
KIID	Key investor information document
LEI	Legal entity identifier
LIS	Large in scale
LRIC	Long-run incremental cost
MAD	Directive no. [X] of the European Parliament and of the Council on criminal sanctions for market abuse
MAR	Regulation no. [X] of the European Parliament and of the Council on insider dealing and market manipulation (market abuse)
MiFID or MiFID I	Markets in Financial Instruments Directive – Directive 2004/39/EC of the European Parliament and the Council
MiFID II	Directive no. [X] of the European Parliament and of the Council on markets in financial instruments repealing Directive 2004/39/EC of the European Parliament and of the Council (compromise reached, number to be assigned)
MiFIR	Regulation no. [X] of the European Parliament and of the Council on markets in financial instruments and amending Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories [EMIR]
MO	Market operator
MMF	Money market fund
MS	Member State
MTF	Multilateral trading facility
MTN	Medium-term note



NCA	National Competent Authority
NDF	Non deliverable forward
NTW	Negotiated trade waiver
NFC	Non-financial counterparty
OIS	Overnight index swap
OJ	The Official Journal of the European Union
OTC	Over-the-counter
OTF	Organised trading facility
PRIIPs	Packaged retail and insurance based investment products
Q&A	Questions and Answers
RDS	Reference data system
RM	Regulated market
RMBS	Residential mortgage backed securities
RPW	Reference price waiver
RTS	Regulatory Technical Standards
RTS on OTC Derivatives	Commission Delegated Regulation (EU) No 149/2013
RTS on CCP	Commission Delegated Regulation (EU) No 153/2013
SA	Sponsored access
SFI	Structured finance instrument
SFP	Structured finance product
SI	Systematic internaliser
SME	Small and medium sized enterprise
SME-GM	Small and medium sized enterprise – growth market
SMMSG	Securities and Markets Stakeholder Group
SPV	Special purpose vehicle
TFEU	Treaty on the Functioning of the European Union
TR	Trade repository
UPI	Universal product identifier
TTCA	Title transfer collateral arrangement
TV	Trading venue
UCITS	Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009, on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS)
UTC	Coordinated universal time





WBS

Whole business securitisation



## 1. Overview

### Reasons for publication

1. On 20 October 2011, the Commission adopted two legislative proposals, a directive and a regulation, for the review of MiFID I. The review is an important and integral part of the reforms adopted at EU level in order to establish a safer, sounder, more transparent and more responsible financial system and to strengthen integration, efficiency and competitiveness of EU financial markets.
2. On 14 January 2014, the European Parliament and the Council reached political agreement on a compromise text.
3. The final legislative texts of the new Markets in Financial Instruments Directive (MiFID II) and the Markets in Financial Instruments Regulation (MiFIR) were approved by the European Parliament on 15 April 2014 and by the European Council on 13 May 2014. They will enter into force on the twentieth day following their publication in the Official Journal of the European Union (estimated in June 2014).
4. The European Securities and Markets Authority (ESMA) received a formal request (mandate) from the European Commission (Commission) on 23 April 2014 to provide technical advice to assist the Commission on the possible content of the delegated acts required by several provisions of MiFID II and MiFIR. ESMA is required to provide technical advice by no later than six months after the entry into force of MiFID II and MiFIR.
5. ESMA has prepared this Consultation Paper (CP) in order to consult interested parties for the purpose of producing its technical advice to the Commission. Respondents to this consultation are encouraged to provide the relevant information to support their arguments or proposals.

### Background

6. MiFID<sup>1</sup> is a cornerstone of the regulation of financial markets in the European Union (EU). It regulates, inter alia, the authorisation and the supervision of investment firms, the requirements for the provision of investment services and activities, the authorisation and supervision of trading venues and the requirements for trading activities of financial instruments across the EU.
7. The directive was implemented through a Commission Implementing Directive for organisational requirements and operating conditions for investment firms, and defined terms for the purpose of MiFID<sup>2</sup>; and a Commission Regulation for record-keeping obligations for investment firms, transaction reporting, market transparency, admission of financial instruments to trading, and defined terms for the purpose of MiFID.<sup>3</sup> The full MiFID package has been applicable in the EU since November 2007.
8. ESMA is publishing a package of documents aimed at starting the preparation of its technical standards and at presenting its proposed technical advice for the adoption of Commission delegated acts by

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<sup>1</sup> Directive 2004/39/EC of the European Parliament and the Council (also referred to in this document as MiFID I).

<sup>2</sup> Commission Directive 2006/73/EC (also referred to in this document as the MiFID Implementing Directive).

<sup>3</sup> Commission Regulation 1287/2006 (also referred to in this document as the MiFID Implementing Regulation).



the Commission. In particular, the package on which ESMA is consulting includes the following documents:

- i. a Discussion Paper (DP) on a selected number of more innovative or technically complex topics in order to receive first feedback from stakeholders for the preparation of ESMA technical standards. The DP will be followed by a consultation paper on all the areas for which MiFID II and MiFIR require ESMA to adopt technical standards; and
  - ii. a CP on all the topics on which the Commission has formally requested ESMA to provide technical advice for the adoption of delegated acts by the Commission.
9. In this CP ESMA is advising the Commission, inter alia, on MiFID II implementing measures with regard to organisational requirements and operating conditions for investment firms. Under MiFID I these implementing measures are included in the MiFID Implementing Directive. ESMA considers that several existing requirements of the MiFID Implementing Directive are in line with the MiFID II framework and are still adequate in the new regulatory context. For this reason, the CP focuses on areas in which new requirements or modifications to the MiFID Implementing Directive are proposed. In all cases where additions or amendments to the MiFID Implementing Directive are not proposed, ESMA considers that the existing requirements should be confirmed in the MiFID II implementing measures.

### **Cost-benefit analysis**

10. MiFID II and MiFIR require ESMA to prepare draft RTS and ITS on a large number of provisions. Articles 10 and 15 of the ESMA Regulation<sup>4</sup> require ESMA to conduct open public consultations on draft technical standards and to analyse the related potential costs and benefits, where appropriate. Such consultations and analyses shall be proportionate in relation to the scope, nature and impact of the draft technical standards.
11. The MiFID II and MiFIR texts also entail a number of provisions empowering the Commission to adopt delegated acts and implementing acts. ESMA has been requested by the Commission to provide technical advice in order to develop such acts. For ESMA to be able to deliver sound technical advice, ESMA is undertaking an independent data gathering exercise in certain areas. This exercise will be made available to the Commission in order to assist the Commission in conducting its impact assessments for any legal acts it may adopt based on MiFID II and MiFIR empowerments.
12. In the context of the preparation of MiFID II and MiFIR technical standards and technical advice to the Commission, ESMA launched a public tender<sup>5</sup>, in July 2013, and subsequently awarded a contract to an external contractor that will support ESMA in (i) preparing an in-depth impact assessment for the technical standards in order to meet the standards of the Impact Assessment Guidelines of the Commission<sup>6</sup>; and (ii) undertaking a data gathering exercise to support the technical advice to be delivered to the Commission for future legal acts.

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<sup>4</sup> Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC.

<sup>5</sup> Invitation to tender n° OJ/16/07/2013 – PROC/2013/005.

<sup>6</sup> SEC(2009) 92.



13. ESMA, in developing the preparatory work for the MiFID II and MiFIR technical standards and technical advice, is also taking into consideration the impact assessment accompanying the Commission's proposal of MiFID II and MiFIR.<sup>7</sup> ESMA has also included specific questions in the CP, aimed at gathering data from stakeholders on new or more sensitive aspects dealt with in the proposed technical advice to the Commission. Respondents are invited to provide ESMA with any available data about expected impacts of the proposed measures in any areas on which they would like to draw ESMA's attention.

### **Contents**

14. This CP covers the topics on which the Commission has requested ESMA to provide technical advice, namely: investor protection; transparency, data publication, micro-structural issues, requirements applying on and to trading venues, commodity derivatives, and portfolio compression.

### **Next steps**

15. ESMA will consider the responses it receives to this CP, and will finalise the draft technical advice for submission to the Commission by no later than six months after the entry into force of MiFID II and MiFIR.
16. ESMA will hold open hearings on the published DP and CP. The hearings will take place on 7 and 8 July 2014 in Paris and registration for the hearings will be available in the relevant section of the ESMA website in due course.

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<sup>7</sup> SEC(2011) 1226 final.



## 2. Investor protection

### 2.1. Exemption from the applicability of MiFID for persons providing an investment service in an incidental manner

#### Background/Mandate

##### Extract from the Commission's request for advice (mandate)

*ESMA is invited to provide technical advice on possible delegated measures clarifying when an activity is provided in an incidental manner. In particular, ESMA is invited to reflect on criteria which would ensure that the investment service has an intrinsic connection to the main area of the professional activity and is of minor and subordinated scope in comparison thereto.*

1. Article 2 of MiFID II provides for several exemptions regarding its applicability. Article 2(1)(c) provides that MiFID shall not apply to “persons providing an investment service where that service is provided in an incidental manner in the course of a professional activity and that activity is regulated by legal or regulatory provisions or a code of ethics governing the profession which do not exclude the provision of that service”. The wording of this provision is identical to MiFID I Article 2(1)(c) – i.e. MiFID remains unchanged in this regard.
2. According to Article 2(3) of MiFID II, the Commission shall adopt delegated acts “to clarify for the purposes of point (c) of paragraph 1 when an activity is provided in an incidental manner”.

#### Analysis

3. A number of Member States have developed their own definitions or interpretations concerning the circumstances under which an activity is provided “in an incidental manner”.
4. In ESMA's view, it is appropriate to develop common criteria for the application of the mentioned exemption. The proposed criteria should allow a strict interpretation of the exemption.
5. ESMA considers an investment service to be provided in an incidental manner if there is such a close and factual connection between the professional activity and the provision of the investment service that the investment service is regarded as accessory to one or more aspects of the main professional activity. Therefore, “incidental” shall not solely be defined through temporal criteria (i.e. frequency or duration of such services). Instead, the provision of the investment service shall have an inherent connection to the main area of the professional activity and be of minor and subordinated scope in comparison. For example, if the provision of investment service aims at the systematic creation of a source of income, this would not be considered to be of a minor and subordinated scope.
6. Further, an investment service is not considered as being provided in an incidental manner if the person who provides the service markets its ability to provide investment services. Any marketing of investment services by persons providing other professional activities and not authorised to provide such investment services in accordance with MiFID II would be inconsistent with the incidental nature of such services.
7. The above criteria should apply in relation to each client to whom such a service is rendered as well as to the overall business of the professional activity.



8. A possible example for the provision of an investment service in an incidental manner on the basis of the above mentioned criteria is the following:

A law firm that offers legal advice and guidance on transportation and logistics issues, including risk management, advises a client on negotiating and drafting a number of commercial agreements. In the course of negotiating and drafting these agreements, the client asks the law firm for advice regarding the hedging of certain risks arising as a result of the agreements negotiated and drafted by the law firm. Advice provided to hedge a risk is generally regarded as investment advice.<sup>8</sup> In this example, however, such investment advice would be provided in an incidental manner because it can be regarded as accessory to the main professional activity and has an inherent connection to the main area of the professional activity as well as to the service rendered to the individual client.

9. In contrast, in the following situation the provision of an investment service as part of the professional activity would not fall under the exemption:

A client mandates a lawyer for legal advice and court representation in a case of alleged incorrect investment advice. During the relationship, the client discovers that his lawyer is very skilled and experienced in matters of financial services and has a deep understanding of the financial markets. In consequence, he asks the lawyer to provide him with advice regarding his personal investments. The investment advice that the lawyer provides after accepting his client's inquiry cannot be deemed as to be provided in an incidental manner as there is no close and factual connection to his legal advice and court representation.

10. ESMA notes that, in addition to the above criteria concerning the incidental nature of the service provided, the professional activity should be regulated by legal or regulatory provisions or a code of ethics governing the profession. Such professional standards should not exclude the provision of the investment service rendered.

11. ESMA's proposals in this area will strengthen investor protection by establishing strict criteria in order to limit the provision of investment services by professionals that are not authorised and supervised as investment firms under MiFID, and therefore are not subject to the relevant MiFID organisational and conduct of business requirements aimed at ensuring an adequate level of protection to investors.

### **Draft technical advice**

1. An investment service is provided in an incidental manner if all the following conditions are fulfilled:
- i. a close and factual connection exists, including in temporal terms, between the professional activity and the provision of the investment service to the same client, such that the investment service is regarded as accessory to the main professional activity; and
  - ii. the provision of investment services to the clients of the main professional activity does not

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<sup>8</sup> 'Q&A Understanding the definition of advice under MiFID' CESR/10-293.



aim to provide a systematic source of income; and

- iii. the person providing the professional activity does not market or otherwise promote his/her availability to provide investment services.

**Q1. Do you agree with the proposed cumulative conditions to be fulfilled in order for an investment service to be deemed to be provided in an incidental manner?**



## 2.2. Investment advice and the use of distribution channels

### Background/Mandate

#### Extract from the Commission's request for advice (mandate)

*ESMA is invited to provide technical advice on necessary adjustments to the definition of investment advice, in particular on further clarifications with respect to the concept of “personal recommendation” set out in Article 52 of Directive 2006/73/EC, in order to achieve the broadest application of the MiFID II investor protection rules.*

1. MiFID I defines investment advice as the provision of personal recommendations to a client, either on request or at the initiative of the investment firm, in respect of one or more transactions relating to financial instruments (Article 4(1)(4)).
2. The MiFID Implementing Directive implements Article 4(1)(4) of MiFID I by specifying the definition of a personal recommendation. In this context, it sets out, inter alia, that “a recommendation is not a personal recommendation if it is issued exclusively through distribution channels or to the public” (the MiFID Implementing Directive Article 52, last subparagraph).
3. In its Questions & Answers on “*Understanding the definition of advice under MiFID*”<sup>9</sup>, CESR addressed the issue of the meaning of the last subparagraph of Article 52 of the MiFID Implementing Directive. Also in its 2010 technical advice to the Commission in the context of the review of MiFID I, CESR discussed the clarification of the last subparagraph of Article 52.<sup>10</sup> In the public consultation for the MiFID review, the Commission agreed with the CESR advice on this point (p. 57 of the Commission Consultation).
4. MiFID II confirms the definition of investment advice outlined above in Article 4(1)(4) of MiFID I.

### Analysis

5. As observed in the 2010 advice to the Commission in the context of the MiFID review, ESMA considers that the current wording of the last subparagraph of Article 52 of the MiFID Implementing Directive may lead to the incorrect interpretation that the provision of personal recommendations through distribution channels cannot amount to the provision of investment advice under MiFID.
6. ESMA considers that this interpretation would not be accurate, and would not be in line with Article 4(1)(4) of MiFID II. ESMA also notices that a growing number of intermediaries actually provide personal recommendations through the use of distribution channels, for example through the internet.
7. As already clarified in the CESR Questions & Answers on the definition of advice, the exemption covering distribution channels in accordance with Article 52 of the MiFID Implementing Directive only applies when the recommendation is actually addressed to the public in general and the use of a distribution channel cannot automatically exclude the provision of investment advice under MiFID. Therefore, situations in which, for instance, email correspondence is used to provide personal rec-

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<sup>9</sup> CESR/10-293.

<sup>10</sup> CESR/10-589.





ommendations to a specific person, rather than to address information to the public in general, may amount to investment advice.

8. For the reasons above, ESMA considers that the words “*through distribution channels*” should be removed from the definitions of investment advice in the MiFID Implementing Directive. This suggestion only aims at removing a possible ambiguity from the current legal text and it is not intended to represent a change in the substance of what currently constitutes investment advice.

#### **Draft technical advice**

- |   |
|---|
| <ol style="list-style-type: none"><li>1. The content of Article 52 of the MiFID Implementing Directive should be confirmed except for the reference to the words “<i>through distribution channels</i>”, which should be removed.</li></ol> |
|---|

- Q2. Do you agree that it is appropriate to clarify that the use of distribution channels does not exclude the possibility that investment advice is provided to investors?**



## 2.3. Compliance function

### Background/Mandate

#### Extract from the Commission's request for advice (mandate)

*ESMA is invited to consider and provide technical advice on any necessary updates or improvements to provisions set out in sections I and II of Chapter II of the MiFID I Commission Directive 2006/73/EC in light of the new framework and of the objective to set out an improved framework for effective organisational requirements. In particular, ESMA is invited to provide technical advice on further requirements with respect to the compliance function and to complaints handling aiming at better safeguarding clients' rights and more effective complaints management policies.*

1. The relevant provisions in MiFID II are:

Article 16(2):

*“An investment firm shall establish adequate policies and procedures sufficient to ensure compliance of the firm including its managers, employees and tied agents with its obligations under this Directive as well as appropriate rules governing personal transactions by such persons”.*

2. The existing compliance provisions of the MiFID Implementing Directive, included in Article 6, are primarily focused on the responsibilities of the compliance function to monitor the policies and procedures in place and to advise relevant persons in the firm. Furthermore, the MiFID Implementing Directive covers the means necessary for the compliance function to fulfil its responsibilities (including having the necessary authority, resources, expertise, access to information), the prohibition of the compliance function being involved in the services they monitor and the ability of the compliance function to act objectively. Article 6 also makes clear reference to the principle of proportionality, stating that in establishing a compliance function investment firms should take into account the nature, scale and complexity of the business of the firm, and the nature and range of investment services and activities undertaken in the course of that business.
3. In September 2012, ESMA published “Guidelines on certain aspects of the MiFID compliance function requirements”<sup>11</sup> (compliance guidelines). These guidelines focus on the responsibilities of the compliance function and increasing the effectiveness, and importance, of the compliance function. They specifically focus on:
  - i. the responsibilities of the compliance function for monitoring, reporting and advising;
  - ii. the organisational requirements of the compliance function for the standards of effectiveness, permanence and independence;
  - iii. the extent of interaction of the compliance function with other functions;
  - iv. outsourcing of the tasks of the compliance function; and
  - v. approaches for national competent authority (NCA) review of compliance function requirements.

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<sup>11</sup> ESMA/2012/388.



## Analysis

4. Considering that Article 16(2) of MiFID II consists of an identical recast of Article 13(2) of MiFID I, ESMA is of the view that the existing requirements set out in the MiFID Implementing Directive constitute a robust basis from which to build the provisions.
5. ESMA considers, however, that improvements to the MiFID Implementing Directive could be achieved by implementing some of the principles set out in the ESMA 2012 compliance guidelines, which could appropriately complement, and where relevant clarify, the text. These principles are summarised below.

### *Compliance risk assessment and risk-based approach*

6. General guideline 1 of the compliance guidelines requires that *“investment firms should ensure that the compliance function takes a risk based approach [...]”*. General guideline 1 also provides that *“a compliance risk assessment should be used to determine the focus of the monitoring and advisory activities of the compliance function”*.
7. ESMA considers that requiring the performance of a compliance risk assessment as a mandatory step, in order to comply with the responsibilities listed in Article 6(2) of the MiFID Implementing Directive under points (a) and (b), would be an appropriate addition.
8. ESMA also considers that requiring the compliance function to take a risk-based approach when establishing its monitoring programme would be a logical addition to the provision of Article 6(2)(a) of the MiFID Implementing Directive.

### *Monitoring programme*

9. General guideline 2 of the compliance guidelines requires that *“investment firms should ensure that the compliance function establishes a monitoring programme that takes into consideration all areas of the investment firm’s investment services, activities and any relevant ancillary services”*. General guideline 2 also provides that *“the monitoring programme should establish priorities determined by the compliance risk assessment ensuring that compliance risk is comprehensively monitored”*.
10. ESMA is of the view that requiring the permanent establishment of a risk-based monitoring programme that takes into consideration all areas of the investment firm’s investment services, activities and any relevant ancillary services would appropriately complement Article 6(2)(a) of the MiFID Implementing Directive.

### *Compliance function and management body*

11. General guideline 3 of the compliance guidelines provides that *“Investment firms should ensure that the regular written compliance reports are sent to senior management. The reports should contain a description of the implementation and effectiveness of the overall control environment for investment services and activities and a summary of the risks that have been identified as well as remedies undertaken or to be undertaken. Reports must be prepared at appropriate intervals and at least annually [...]”*.
12. General guideline 7 of the compliance guidelines provides that *“[...] the compliance officer should be appointed and replaced by senior management or by the supervisory function”*.



13. ESMA considers that requiring the compliance function to report to the management body<sup>12</sup>, at least annually, on the implementation and effectiveness of the overall control environment for investment services and activities, on the risks that have been identified as well as on the complaints-handling reporting would strengthen the independence of the compliance function.
14. ESMA considers that requiring the compliance officer be appointed and replaced by the management body or, when applicable, the supervisory function would be a sensible complement to Article 6(3) of the MiFID Implementing Directive.
15. ESMA also considers that it would be appropriate to clarify in the MiFID II implementing measures that the compliance function should be required to report directly to the management body whenever it detects a significant compliance risk.

#### *Permanence of the operation of the compliance function's tasks*

16. General guideline 6 of the compliance guidelines provides that investment firms shall ensure that the compliance function "*performs its tasks and responsibilities on a permanent basis*".
17. ESMA considers that clarifying in the MiFID II implementing measures, that the compliance function should perform its tasks on a permanent basis would be an appropriate addition to the existing requirement to have permanent compliance function in Article 6(2) of the MiFID Implementing Directive.

#### *Overseeing by the compliance function of the complaints process*

18. The compliance guidelines<sup>13</sup> require that "*the compliance function should have a role in overseeing the operation of the complaints process and it should consider complaints as a source of relevant information in the context of its general monitoring responsibilities*".
19. ESMA considers that the following would be sensible additions to the existing provisions of the MiFID Implementing Directive: (i) requiring the compliance function to oversee the operation of the complaints process; and (ii) requiring that complaints be considered by the compliance function as a source of information in the context of its monitoring responsibilities.

### **Draft technical advice**

1. ESMA considers that Article 6 of the MiFID Implementing Directive should be integrated and modified as set out below.
2. Investment firms should establish, implement and maintain adequate policies and procedures designed to detect any risk of failure by the firm to comply with its obligations under MiFID II, as well as the associated risks, and put in place adequate measures and procedures designed to minimise such risks and to enable NCAs to exercise their powers effectively under that Directive. For those purposes, investment firms should take into account the nature, scale and complexity of the business of the firm, and the nature and range of investment services and activities undertaken in the course of

<sup>12</sup> In keeping with the obligations under Directive 2014/\*\*/EC for increased reporting to the management body, ESMA proposes that such reports are sent to the management body rather than senior management.

<sup>13</sup> Supporting Guideline of General guidelines 2, Paragraph 26, page 26.

that business.

3. Investment firms should establish and maintain a permanent and effective compliance function that operates independently and that has the following responsibilities:
  - i. to monitor on a permanent basis and to assess, on a regular basis, the adequacy and effectiveness of the measures and procedures put in place in accordance with subparagraph 1 of Article 6(1) of the MiFID Implementing Directive, and the actions taken to address any deficiencies in the firm's compliance with its obligations;
  - ii. to advise and assist the relevant persons responsible for carrying out investment services and activities to comply with the firm's obligations under MiFID II;
  - iii. to report to the management body, at least annually, on the implementation and effectiveness of the overall control environment for investment services and activities, on the risks that have been identified and on the complaints-handling reporting as well as remedies undertaken or to be undertaken; and
  - iv. to oversee the operations of the complaints-handling process and consider complaints as a source of relevant information in the context of its general monitoring responsibilities.
4. In order to comply with points (i) and (ii) of the previous paragraph, the compliance function should conduct an assessment. On the basis of such an assessment, the compliance function must establish a risk-based monitoring programme that takes into consideration all areas of the investment firm's investment services, activities and any relevant ancillary services. The monitoring programme should establish priorities determined by the compliance risk assessment ensuring that compliance risk is comprehensively monitored.
5. In order to enable the compliance function to discharge its responsibilities properly and independently, investment firms should ensure that the following conditions are satisfied:
  - i. the compliance function must have the necessary authority, resources, expertise and access to all relevant information;
  - ii. the compliance officer must be appointed and replaced by the management body or, as applicable, by the supervisory function; and must be responsible for the compliance function and for any reporting required by MiFID II;
  - iii. the compliance function must be enabled to report on an ad-hoc basis directly to the management body whenever it has detected a significant risk of failure by the firm to comply with its obligations under MiFID II;
  - iv. the relevant persons involved in the compliance function must not be involved in the performance of services or activities they monitor; and
  - v. the method of determining the remuneration of the relevant persons involved in the compliance function must not compromise their objectivity and must not be likely to do so.
6. However, an investment firm shall not be required to comply with point (iv) or point (v) of the previ-



ous paragraph if it is able to demonstrate that in view of the nature, scale and complexity of its business, and the nature and range of investment services and activities, the requirement under that point is not proportionate and that its compliance function continues to be effective. In such case, the investment firm must assess whether the effectiveness of the compliance function is compromised by the proposed arrangements. This assessment must be reviewed on a regular basis.

- Q3. Do you agree that the existing compliance requirements included in Article 6 of the MiFID Implementing Directive should be expanded?**
- Q4. Are there any other areas of the Level 2 requirements concerning the compliance function that you consider should be updated, improved or revised?**



## 2.4. Complaints-handling

### Background/Mandate

#### Extract from the Commission's request for advice (mandate)

*ESMA is invited to consider and provide technical advice on any necessary updates or improvements to provisions set out in sections I and II of Chapter II of the MiFID I Commission Directive 2006/73/EC in light of the new framework and of the objective to set out an improved framework for effective organisational requirements. In particular, ESMA is invited to provide technical advice on further requirements with respect to the compliance function and to complaints handling aiming at better safeguarding clients' rights and more effective complaints management policies.*

1. The relevant provisions in MiFID II are:

Article 16:

*“(2) An investment firm shall establish adequate policies and procedures sufficient to ensure compliance of the firm including its managers, employees and tied agents with its obligations under this Directive as well as appropriate rules governing personal transactions by such persons.*

2. Following a review of existing organisational requirements already developed in the MiFID Implementing Directive, ESMA noted that requirements in respect of complaints-handling are of a high level nature.

3. Article 10 of the MiFID Implementing Directive text states:

*“Member States shall require investment firms to establish, implement and maintain effective and transparent procedures for the reasonable and prompt handling of complaints received from retail clients or potential retail clients, and to keep a record of each complaint and the measures taken for its resolution”.*

4. The G20 high-level principles on financial consumer protection, published in October 2011, specifically stated that:

*“Jurisdictions should ensure that consumers have access to adequate complaints handling and redress mechanisms that are accessible, affordable, independent, fair, accountable, timely and efficient. Such mechanisms should not impose unreasonable cost, delays or burdens on consumers. In accordance with the above, financial services providers and authorised agents should have in place mechanisms for complaint handling and redress”.*



## Analysis

5. On 6 November 2013, ESMA and EBA (in the context of the Joint Committee<sup>14</sup>) issued a consultation paper on draft guidelines for complaints-handling for the securities and banking sectors.<sup>15</sup> This consultation closed on 7 February 2014.
6. ESMA considers that these draft ESMA-EBA complaints-handling guidelines provide a sufficient basis from which principles for implementing measures in this area can be identified.
7. In developing these proposals, ESMA sought to ensure that any requirements should be relatively high level and should not contradict the draft proposed joint committee guidelines. This approach was sought to allow ESMA the flexibility in setting out more specific guidelines in the future. It should be noted that ESMA is of the view that these proposals will enable the existing (draft) ESMA/EBA guidelines for complaints-handling for the securities and banking sectors to be confirmed in their entirety.
8. ESMA considers that the development of proposals for implementing measures in this area will enhance investor protection by providing for strict complaints-handling provisions and harmonising the way that investment firms deal with complaints from investors. These proposals will also establish clear overarching principles from which any future guidelines in this area could be developed.

## Draft technical advice

1. Investment firms should establish and maintain a complaints management policy for clients or potential clients. The complaints management policy should provide clear, accurate and up-to-date information about the complaints-handling process. This policy should be endorsed by the firm's management body.
2. Investment firms should publish the details of the process to be followed when handling a complaint. This information should be provided to clients or potential clients, on request, or when acknowledging a complaint. Clients and potential clients should be able to submit complaints free of charge.
3. Investment firms should establish a complaints management function which enables complaints to be investigated. This function may be carried out by the compliance function.
4. Investment firms should communicate to clients in plain language that is clearly understood and provide a response to the complaint without any unnecessary delay.
5. Investment firms should explain to the client or potential client the firm's position on the complaint and set out the client's or potential client's options, where relevant, to refer the complaint to an Alternative Dispute Resolution (ADR) entity or for the client to take civil action.
6. Investment firms should provide information on complaints and complaints-handling to the relevant NCA, or ADR entity where applicable under national law.

<sup>14</sup> Article 54 of the ESMA Regulation and of the EBA Regulation respectively (ESMA - Regulation (EU) No 1095/2010; EBA - Regulation (EU) No 1093/2010).

<sup>15</sup> JC-CP-2013-03 published on both the ESMA and the EBA websites on 6 November 2013.





7. Investment firms' compliance functions should analyse complaints and complaints-handling data to ensure that they identify and address any issues.

**Q5. Do you already have in place arrangements that comply with the requirements set out in the draft technical advice set out above?**



## 2.5. Record-keeping (other than recording of telephone conversations or other electronic communications)

### Background/Mandate

#### Extract from the Commission's request for advice (mandate)

*ESMA is invited to provide technical advice on any possible improvements to the current record-keeping obligations, and in particular whether there is a need for any further details on possible arrangements to be established by firms in order to efficiently comply with record-keeping requirements or for a more harmonised approach with respect to the list of minimum records that investment firms are required to keep under the Directive.*

1. The relevant provision in MiFID II is Article 16(6):

*“An investment firm shall arrange for records to be kept of all services, activities and transactions undertaken by it which shall be sufficient to enable the competent authority to fulfil its supervisory tasks and to perform the enforcement actions under this Directive, Regulation (EU) No .../2014.\*, Directive 2014./.../EU\*\* and Regulation (EU) No .../2014\*\*\*, and in particular to ascertain that the investment firm has complied with all obligations including those with respect to clients or potential clients and to the integrity of the market”.*

### Analysis

2. MiFID II does not make any substantial changes to MiFID I in respect of general record-keeping obligations, other than emphasising that records should enable NCAs to fulfill supervisory tasks and perform enforcement actions under MiFID II and MiFIR as well as under the Market Abuse Directive (MAD)<sup>16</sup> and Regulation (MAR).<sup>17</sup> MiFID II also adds an explicit reference to market integrity in this record-keeping context.
3. ESMA notes that the MiFID Implementing Directive and the MiFID Implementing Regulation already provide for a significant number of record-keeping requirements, as listed below:
  - i. Article 7 of the MiFID Implementing Regulation sets out requirements in relation to record-keeping of client orders and decisions to deal and the details that an investment firm shall record, in relation to every order received from a client, and in relation to every decision to deal taken in providing the service of portfolio management;
  - ii. Article 8 of the MiFID Implementing Regulation sets out requirements in relation to record-keeping of transactions and the details that an investment firm shall record in relation to the execution of a client order or the transmission of the order to another person for execution;
  - iii. Article 51(1) of the MiFID Implementing Directive requires that investment firms retain all the records required by MiFID I and its implementing measures for a period of five years. Additionally, Article 51(1) also requires that records in relation to an agreement between an investment firm and its client be retained for at least for the duration of the relationship with the client. Arti-

<sup>16</sup> Directive No. [x] of the European Parliament and of the Council on criminal sanctions for market abuse.

<sup>17</sup> Regulation No. [x] of the European Parliament and of the Council on insider dealing and market manipulation (market abuse).



cle 51(2) provides for requirements concerning the medium, the form and the manner in which records should be retained are also provided for; and

- iv. Article 51(3) of the MiFID Implementing Directive requires that NCAs draw up and maintain a list of the minimum records investment firms are required to keep under MiFID and its implementing measures.
4. Further to these requirements, CESR issued Level 3 recommendations in 2007<sup>18</sup> (CESR Recommendations) that list the minimum records that NCAs need to draw up according to Article 51(3) of the MiFID Implementing Directive.
5. ESMA considers that the provisions of Article 51 of the MiFID Implementing Directive as well Articles 7 and 8 of the MiFID Implementing Regulation should be confirmed in the implementing measures of MiFID II.
6. However, ESMA sees benefits in transposing in the MiFID II implementing measures a list of minimum records, largely based on the one identified in the CESR Recommendations. The establishment of this list in the legislation may benefit stakeholders and may foster convergence across the EU.
7. Investment firms should also keep any policies that will be required under MiFID II and its implementing measures in writing (such as, execution policy, conflict of interest policy, order allocation policy and others).
8. At the same time, considering that record-keeping obligations are by nature linked to any activity carried out by a firm and need to reflect any future evolution in the regulatory framework, ESMA considers that the list should remain a non-exhaustive one and NCAs should continue to be able to add additional records to the list above. In addition, ESMA could be required to adopt and update guidelines in order to specify the exact content and the timing for each record and to add new records in the future.

### **Draft technical advice**

1. The provisions of Articles 7 and 8 of the MiFID Implementing Regulation and Article 51(1) and (2) of the MiFID Implementing Directive should be confirmed. Article 51(3) of the MiFID Implementing Directive should be replaced by the following provisions.
2. Investment firms should keep any policies they are required to maintain pursuant to MiFID II, MiFIR, MAD and MAR in writing.
3. Investment firms should keep at least the records identified in the table below. These records should be maintained in an electronic format that facilitates the search of information where the nature and volume of records warrants such a format.
4. The list of records identified in the table below shall not be exhaustive and should not be understood as a limitation of the scope of MiFID II, MiFIR, MAD and MAR and the respective implementing

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<sup>18</sup> “CESR Level 3 Recommendations on the List of minimum records in article 51(3) of the MiFID implementing Directive”, Ref. CESR/06-552c.

measures. The list should be without prejudice to any other record-keeping obligations arising from other legislations.

5. NCAs should be able to require investment firms to keep additional records to the list below. Additional records introduced in accordance with MiFID II, MiFIR, MAD or MAR should be notified to ESMA immediately after their introduction.
6. ESMA may publish and update guidelines specifying the detailed content and the timing of the records specified in the list below and providing for additional records.
7. Table demonstrating the types of records investment firms should be obliged to keep:

<b><u>Type of record</u></b>	<b><u>Summary of content</u></b>
Identity and categorisation of each client	The identity of each client and sufficient information to support categorisation as a retail client, professional client and/or eligible counterparty.
Client agreements	Records provided for under Article 25(5) of MiFID II.
Client details	The information about the client's or potential client's knowledge and experience, financial situation and investment objectives, relevant to the specific product or service, obtained by the investment firm in complying with its obligation under Article 25(2) of MiFID II.
Client details	The information about the client's or potential client's knowledge and experience, relevant to the specific product or service, obtained by the firm in complying with its obligation under Article 25(3) of MiFID II.
Transactions	The information required under Article 25(1) of MiFIR.
Client order-handling - Aggregated transaction that includes two or more client orders, or one or more client orders and an own account order	Identity of each client; whether transaction is in whole or in part for discretionary managed investment portfolio and any relevant proportions as well as the intended basis of allocation.
Client order-handling - Allocation of an aggregated transaction that includes the execution of a client order	The date and time of allocation; relevant financial instrument; identity of each client and the amount allocated to each client.
Client order-handling - Re-allocation	The basis and reason for any reallocation.

Order received or arising from any decision to deal taken in providing the service of portfolio management	The records provided for under Article 7 of the MiFID Implementing Regulation. Firms should record the date and hour that the order was sent by the investment firm for execution.
Orders executed on behalf of clients	The records provided for under Article 8(1) of the MiFID Implementing Regulation.
Orders and transactions effected for own account	The records concerning own account orders and transactions.
Cancellations and modifications of orders	The records concerning the cancellation and the modifications of orders on own account or executed on behalf of clients or in relation to decision to deal taken in providing the service of portfolio management.
Transmission of order received by the investment firm	The records provided for under Article 7 and Article 8(2) of the MiFID Implementing Regulation.
Periodic statements to clients	Information to evidence the content and the sending of the periodic statement to the client in respect of services provided, either as a copy, or in a manner that would enable reconstruction.
Client financial instruments held by an investment firm	The records required under Articles 16(8) of MiFID II and under Articles 16(1)(a) and (b) of the MiFID Implementing Directive.
Client financial instruments available for, and subject to, stock lending activities	The identity of client financial instruments that are available to be lent, and those which have been lent as well as information to evidence client consent (note also the requirements under Articles 16(8) of MiFID II and Article 19(2) subparagraph 2 of the MiFID Implementing Directive , where applicable).
Client funds	Sufficient records to show and explain the investment firm's transactions and commitments under Article 8 of the MiFID Implementing Regulation (note also the requirements under Articles 16(9) of MiFID II and under Articles 16(1)(a) and (b) of the MiFID Implementing Directive).
Marketing communications (except in oral forms)	Sample of each marketing communication addressed by the investment firm to clients or potential clients.
Investment research	Each item of investment research, in accordance with Article 24(1) of the MiFID Implementing Directive issued by the

	investment firm in writing.
The firm's business and internal organisation	Records provided for under Article 5(1)(f) of the MiFID Implementing Directive.
Compliance procedures	The investment firm's essential compliance procedures, under Article 6(1) of the MiFID Implementing Directive.
Services or activities giving rise to detrimental conflict of interest	The services or activities under Article 23 of the MiFID Implementing Directive.
Compliance reports	Each compliance report to senior management, under Articles 6(3)(b) and 9(2) of the MiFID Implementing Directive.
Risk management reports	Each Risk management report to senior management under Articles 7(2)(b) and 9(2) of the MiFID Implementing Directive.
Internal audit reports	Each internal audit report to senior management, under Articles 8(d) and 9(2) of the MiFID Implementing Directive.
Complaints records	Each complaint referred to in Article 10 of the MiFID Implementing Directive.
Complaints-handling	The measures taken for the resolution of each such complaint, according to Article 10 of the MiFID Implementing Directive.
Records of prices quoted by systematic internalisers	The quoted prices under Article 24(b) of the MiFID Implementing Regulation.
Records of personal transactions	The information required under Article 12(2)(c) of the MiFID Implementing Directive.
Record of the information disclosed to clients regarding inducements	The information disclosed to clients under Article 24(9) of MiFID II.
Investment advice to retail clients	(i) The fact that investment advice was rendered and (ii) the financial instrument that was recommended.

**Q6. Do you consider that additional records should be mentioned in the minimum list proposed in the table in the draft technical advice above? Please list any additional records that could be added to the minimum list for the purposes of MiFID II, MiFIR, MAD or MAR.**



**Q7. What, if any, additional costs and/or benefits do you envisage arising from the proposed approach? Please quantify and provide details.**



## 2.6. Recording of telephone conversations and electronic communications

### Background/Mandate

#### Extract from the Commission's request for advice (mandate)

*ESMA is invited to provide technical advice on the effective organisational requirements that firms need to establish, implement and maintain in order to ensure full compliance with the telephone recording and electronic communications requirements, having in mind the importance of such records which may constitute crucial, and sometimes the only, evidence to demonstrate the development of firm-client relationships and to verify compliance by firms with their obligations under MiFID II as well as to detect and prove the existence of market abuse. Such organisational requirements should address the possible involvement of the management body and the compliance function, the storage requirements, including providing legal clarity on the beginning of the period of time for the records retention.*

1. The relevant provisions in MiFID II are:

Article 16(7):

*“Records shall include the recording of telephone conversations or electronic communications relating to, at least, transactions concluded when dealing on own account and the provision of client order services that relate to the reception, transmission and execution of client orders.*

*Such telephone conversations and electronic communications shall also include those that are intended to result in transactions concluded when dealing on own account or in the provision of client order services that relate to the reception, transmission and execution of client orders, even if those conversations or communications do not result in the conclusion of such transactions or in the provision of client order services.*

*For those purposes, an investment firm shall take all reasonable steps to record relevant telephone conversations and electronic communications, made with, sent from or received by equipment provided by the investment firm to an employee or contractor or the use of which by an employee or contractor has been accepted or permitted by the investment firm.*

*An investment firm shall notify new and existing clients that telephone communications or conversations between the investment firm and its clients that result or may result in transactions will be recorded.*

*Such a notification may be made once, before the provision of investment services to new and existing clients.*

*An investment firm shall not provide, by telephone, investment services and activities to clients who have not been notified in advance about the recording of their telephone communications or conversations, where such investment services and activities relate to the reception, transmission and execution of client orders.*

*Orders may be placed by clients through other channels, however such communications must be made in a durable medium such as mails, faxes, emails or documentation of client orders made at meetings. In particular, the content of relevant face-to-face conversations with a client may be rec-*





*orded by using written minutes or notes. Such orders shall be considered equivalent to orders received by telephone.*

*An investment firm shall take all reasonable steps to prevent an employee or contractor from making, sending or receiving relevant telephone conversations and electronic communications on privately-owned equipment which the investment firm is unable to record or copy.*

*The records kept in accordance with this paragraph shall be provided to the client involved upon request and shall be kept for a period of five years and, where requested by the competent authority, for a period of up to seven years”.*

2. On 29 July 2010, CESR delivered technical advice to the Commission on investor protection and intermediaries issues as part of MiFID Review process.<sup>19</sup> The advice of most CESR members was that the existing discretion in Article 51(4) of the MiFID Implementing Directive should be replaced by a minimum harmonisation recording obligation in relation to records of telephone conversations and electronic communications. Those CESR members considered that such a regime would be an important step forward in terms of certainty, investor protection and deterrence of market abuse. The rationale for introducing the requirements was as follows:
  - i. to help deter and detect market abuse and to facilitate enforcement in this area. Records can provide additional material about the facts of a case that may not be available through other sources (such as documents and oral testimony). In particular, recordings often help to show the intention behind trading and the knowledge of the person at the point at which they trade, which are matters that are often not easily established, but may be crucial in a successful enforcement case;
  - ii. to assist the NCA in assessing an investment firms’ on-going compliance with conduct of business obligations and, in particular, with the requirements in MiFID on information to clients and potential clients, on best execution and on client order-handling; and
  - iii. to ensure that there is evidence to resolve disputes between an investment firm and its clients over the terms of transactions, being in some cases the sole evidence to be relied on in the event of a dispute.

## **Analysis**

3. MiFID II has introduced organisational requirements for firms under Article 16(7), which requires them to record telephone conversations or electronic communications relating to the investment services listed in point 4 below.

### *Types of telephone conversations and electronic communications*

4. MiFID II sets out that the investment services to be captured by telephone/electronic recording requirements are the following services:
  - i. reception and transmission of orders;

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<sup>19</sup> CESR/10-975.



- ii. execution of orders on behalf of clients; and
  - iii. dealing on own account.
5. The specific conversations and communications that should be recorded in relation to the investment services outlined above are:
- i. the receipt of an order from a client;
  - ii. the transmission of an order (both where the investment firm will transmit the order, and where it will execute it);
  - iii. the conclusion of a transaction when executing orders on behalf of clients; and
  - iv. the conclusion of a transaction when dealing on own account regardless of whether a client is involved in the transaction.
6. This includes all telephone conversations and electronic communications relating to these activities that are intended to result in the conclusion of an agreement, even if those conversations or communications do not result in the conclusion of such an agreement. The recordings shall not only include any placed orders, but also modifications and cancellations of orders, as executed orders and indications of interest. The term ‘electronic communication’ has a wide application. It captures any electronic communication involving the provision of the services listed in Article 16(7) of MiFID II. Due to the continuing innovation and advancement in technology, an exhaustive list would frequently become outdated. ESMA would expect senior management to exercise their judgement in this area.
7. The CESR advice of 29 July 2010 suggested that it was not intended that such recording requirements would capture internal conversations and communications within investment firms (although it would capture conversations and communications between two investment firms in the same group). However, ESMA considers that some internal calls are subject to the MiFID II recording requirement where the internal call in question “*relates to or is intended to result in transactions*” in the provision of investment services subject to the telephone recording obligation. This view aligns with Recital 57 of MiFID II which sets out that: “*such records should ensure that there is evidence to prove the terms of any orders given by clients and its correspondence with transactions executed by the investment firms, as well as to detect any behaviour that may have relevance in terms of market abuse, including when firms deal on own account*”.
8. Market abuse is one of the most difficult offences to investigate and prosecute. Good quality recordings of voice conversations and of electronic communications can assist NCAs in detecting and deterring inappropriate behaviour. Capturing relevant conversations and communications will enable NCAs to capture and deter more inappropriate behaviour which would not be in the clients’ best interests.
9. ESMA considers that the recording requirements should be imposed on investment firms and on branches of third country firms authorised in accordance with Article 41 of MiFID II.

#### *Face-to-face conversations*

10. Article 16(7) subparagraph 7 of MiFID II provides for the provision of orders through other channels. Communications made by “*other channels*” must be in a durable medium, and include the documen-



tation of client orders made at meetings. The content of relevant face-to-face conversations with a client may be recorded by using written minutes or notes. ESMA proposes that where relevant face-to-face conversations taking place with clients result or may result in transactions in respect of the client order services listed in Article 16(7) subparagraph 1 of MiFID II, firms are required to document the content of these conversations. ESMA proposes to set out the minimum required information.

11. These recording rules do not apply generally to the service of investment advice, however conversations will need to be recorded when they result or may result in the provision of the following services: reception and transmission of orders, execution of orders on behalf of clients and dealing on own account.

#### *Instruments subject to the telephone conversations and electronic communications*

12. In relation to the financial instruments included in the recording requirement, MiFID conduct of business protections extend to transactions in all instruments covered by the definition of a financial instrument in Annex 1 of MiFID II.

#### *Equipment provided by an investment firm and privately owned equipment*

13. Article 16(7) subparagraph 3 of MiFID II provides for the firm to take all reasonable steps to record conversations and communications under the scope of the recording requirement, including equipment provided by an investment firm to its employees and contractors and privately owned equipment that has been accepted or permitted for use by the investment firm. ESMA proposes that the firm should have in place organisational requirements to ensure that this requirement is effectively implemented.
14. Article 16(7) subparagraph 8 of MiFID II includes an explicit reference to the treatment of privately owned equipment, which the firm cannot record. Firms should take all “*reasonable steps to prevent*” the use of privately owned equipment, which the firm is unable to record or copy (i.e. equipment that has not been accepted/permitted by the firm). Again, in this context, ESMA proposes that the firm should be required to have robust organisational requirements in place to ensure that it has satisfied that it is in the position to demonstrate to the NCA compliance with its telephone recording requirements.

#### *Privacy matters*

15. Regarding privacy matters, European legislation provides a framework to protect the privacy of the communications and of data held about individuals. Of most relevance here are the E-Privacy Directive<sup>20</sup> and the Data Protection Directive<sup>21</sup>. This legislation does not prevent the recording of telephone conversations and electronic communications, but it does limit the circumstances in which recordings can be made and places safeguards around the handling of the recordings. The MiFID II recording requirement does not impact the ability of firms to comply with the recording requirement whilst also complying with their obligations under the above legislation.
16. ESMA’s proposals in this area, which are also based on the work carried out by CESR since 2010, seek to build on the strong investor protection focus of MiFID II. To achieve this, ESMA proposes that in-

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<sup>20</sup> 2002/58/EC.

<sup>21</sup> 95/46/EC.



vestment firms should have effective policies and control and oversight in place to ensure that the recording obligations are met and that compliance in this area is monitored. ESMA also aims to ensure consistency among investment firms in terms of the storage and retention of records.

### **Draft technical advice**

#### *Control and oversight*

1. Investment firms should establish, implement and maintain effective organisational arrangements to ensure compliance with the rules on recording telephone conversations and electronic communications.
2. Investment firms should ensure that the management body has effective oversight and control over the policies and procedures relating to the firm's recording of telephone conversations and electronic communications.
3. Investment firms should establish, implement and maintain an effective recording of telephone conversations and electronic communications policy, set out in writing, and appropriate to the size and organisation of the firm, and the nature, scale and complexity of its business. The policy shall include the following content:
  - i. the identification of the conversations and communications that are subject to the recording requirements; and
  - ii. the specification of the procedures to be followed and measures to be adopted to ensure the firm's compliance with Article 16(7) subparagraph 3 and Article 16(7) subparagraph 8 where exceptional circumstances arise and the firm is unable to record the conversation/communication on devices issued, accepted or permitted by the firm. Evidence of these circumstances must be retained in a medium that is accessible by the NCA.
4. Investment firms should ensure that the arrangements to comply with recording requirements are technology neutral. Firms must periodically re-evaluate the effectiveness of the firm's measures and procedures and adopt any such alternative or additional measures and procedures as are necessary and appropriate. At a minimum, this should occur when a new medium of communication is accepted or permitted for use by the firm.
5. Investment firms should keep and regularly update a record of those individuals who have firm devices or privately owned devices that have been approved for use by the firm.
6. Investment firms should educate and train employees in procedures governing the Article 16(7) requirements.
7. Investment firms should have in place requirements to ensure compliance with the recording and record-keeping requirements in accordance with Article 16(7) and Recital 57 of MiFID II and their wider regulatory requirements. The firm shall periodically monitor the records of all transactions and orders subject to these requirements including relevant conversations, to monitor compliance with the regulatory requirements.
8. Investment firms should be able to demonstrate to the relevant NCA the policies, procedures and



management oversight of these recording rules.

**Q8. What additional measure(s) could firms implement to reduce the risk of non-compliance with the rules in relation to telephone recording and electronic communications?**

**Q9. Do you agree that firms should periodically monitor records to ensure compliance with the recording requirement and wider regulatory requirements?**

*Face-to-face conversations*

9. Investment firms shall record in written minutes or notes all relevant information related to relevant face-to-face conversations with clients. The information recorded is at the discretion of the firm but must include at least the following:
- i. date of meeting;
  - ii. location of meeting;
  - iii. identity of the attendees;
  - iv. initiator of the meeting; and
  - v. other relevant information about the transaction.

**Q10. Should any additional items of information be included as a minimum in meeting minutes or notes where relevant face-to-face conversations take place with clients?**

**Q11. Should clients be required to sign these minutes or notes?**

*Storage*

10. Records should be stored in a durable medium, which allows them to be replayed or copied and must be retained in a format that does not allow the original record to be altered or deleted. This supports the general record-keeping requirements under Article 51 of the MiFID Implementing Directive.
11. In addition, records should be stored in a medium so that they are accessible and readily available to NCA's on request.
12. Firms should ensure the quality, accuracy and completeness of the records of all telephone recordings and electronic communications.

*Retention*

13. The period of time for the retention of a record begins to run from the date that the record is created.



- Q12.** Do you agree with the proposals for storage and retention set out in the above draft technical advice?
- Q13.** More generally, what additional costs, impacts and/or benefits do you envisage as a result of the requirements set out in the entire draft technical advice above?



## 2.7. Product governance

### Background/Mandate

#### Extract from the Commission's request for advice (mandate)

*ESMA is invited to provide technical advice on detailed product governance arrangements for investment firms manufacturing and distributing financial instruments (and structured deposits) in order to avoid and reduce, from an early stage, potential risks of failure to comply with investor protection rules. Strengthening the role of the management bodies or of the compliance function, should be duly considered. The technical advice should also specify the obligation for manufactures and distributors to regularly review their product governance policies as well as the products they manufacture, offer or recommend, and refer to any appropriate actions to be taken by manufacturers or distributors.*

*As these requirements are also relevant for investment firms offering or recommending investment products manufactured by firms which are not captured under MiFID II (non-MiFID entities/third-country firms), ESMA should consider what reasonable steps the distributor should take in order to ensure that investors' interests are similarly protected.*

*In developing its technical advice, ESMA should ensure there is sufficient clarity regarding the respective obligations of investment firms when acting as manufacturers, distributors or both.*

1. The relevant provisions in MiFID II are:

Recital 71:

*“Member States should ensure that investment firms act in accordance with the best interests of their clients and are able to comply with their obligations under this Directive. Investment firms should accordingly understand the features of the financial instruments offered or recommended and establish and review effective policies and arrangements to identify the category of clients to whom products and services are to be provided. Member States should ensure that the investment firms which manufacture financial instruments ensure that those products are manufactured to meet the needs of an identified target market of end clients within the relevant category of clients, take reasonable steps to ensure that the financial instruments are distributed to the identified target market and periodically review the identification of the target market of and the performance of the products they offer. Investment firms that offer or recommend to clients financial instruments not manufactured by them should also have appropriate arrangements in place to obtain and understand the relevant information concerning the product approval process, including the identified target market and the characteristics of the product they offer or recommend. That obligation should apply without prejudice to any assessment of appropriateness or suitability to be subsequently carried out by the investment firm in the provision of investment services to each client, on the basis of their personal needs, characteristics and objectives.*

*In order to ensure that financial instruments will be offered or recommended only when in the interests of the client, investment firms offering or recommending the product manufactured by firms which are not subject to the product governance requirements set out in this Directive or manufactured by third-country firms should also have appropriate arrangements to obtain sufficient information about the financial instruments”.*

Article 16:

*“(3) An investment firm shall maintain and operate effective organisational and administrative arrangements with a view to taking all reasonable steps designed to prevent conflicts of interest as defined in Article 23 from adversely affecting the interests of its clients.*

*An investment firm which manufactures financial instruments for sale to clients shall maintain, operate and review a process for the approval of each financial instrument and significant adaptations of existing financial instruments before it is marketed or distributed to clients.*

*The product approval process shall specify an identified target market of end clients within the relevant category of clients for each financial instrument and shall ensure that all relevant risks to such identified target market are assessed and that the intended distribution strategy is consistent with the identified target market.*

*An investment firm shall also regularly review financial instruments it offers or markets, taking into account any event that could materially affect the potential risk to the identified target market, to assess at least whether the financial instrument remains consistent with the needs of the identified target market and whether the intended distribution strategy remains appropriate.*

*An investment firm which manufactures financial instruments shall make available to any distributor all appropriate information on the financial instrument and the product approval process, including the identified target market of the financial instrument.*

*Where an investment firm offers or recommends financial instruments which it does not manufacture, it shall have in place adequate arrangements to obtain the information referred to in the fifth subparagraph and to understand the characteristics and identified target market of each financial instrument.*

*The policies, processes and arrangements referred to in this paragraph shall be without prejudice to all other requirements under this Directive and Regulation (EU) No .../2014\*, including those relating to disclosure, suitability or appropriateness, identification and management of conflicts of interests, and inducements”.*

Article 24:

*“(1) Member States shall require that, when providing investment services or, where appropriate, ancillary services to clients, an investment firm act honestly, fairly and professionally in accordance with the best interests of its clients and comply, in particular, with the principles set out in this Article and in Article 25.*

*(2) Investment firms which manufacture financial instruments for sale to clients shall ensure that those financial instruments are designed to meet the needs of an identified target market of end clients within the relevant category of clients, the strategy for distribution of the financial instruments is compatible with the identified target market, and the investment firm takes reasonable steps to ensure that the financial instrument is distributed to the identified target market.*

*An investment firm shall understand the financial instruments they offer or recommend, assess the compatibility of the financial instruments with the needs of the clients to whom it provides investment services, also taking account of the identified target market of end clients as referred to in Article 16(3), and ensure that financial instruments are offered or recommended only when this is in the interest of the client”.*



2. The European Commission's Consultation Paper on the review of MiFID<sup>22</sup> (Commission Consultation) expressed the Commission's view that the organisational requirements in the MiFID Implementing Directive could be better specified by highlighting their relevance also at the stage when investment firms decide on their high-level business strategies and the products, operations and services that will be offered to both retail and professional clients (section 7.3.3 entitled "*Organisational requirements for the launch of products, operations and services*").
3. Specifically, the Commission suggested that the MiFID Implementing Directive could be amended by including the following:
  - i. requiring investment firms to run an assessment of the compatibility of the product, service or operation with the characteristics and needs of the clients to whom these products would be offered;
  - ii. strengthening the duty of the compliance function in ensuring that procedures and measures are in place to ensure the product, service or operation complies with all applicable rules including those relating to disclosure, suitability/appropriateness, inducements and proper management of conflicts of interest (including remuneration);
  - iii. ensuring as part of the organisational requirements for risk management that the risks to the firm of new products, operations and services are adequately managed;
  - iv. stress-testing the products and services as appropriate;
  - v. periodically reviewing the distribution and performance of products and services;
  - vi. ensuring that staff possess the necessary expertise to understand the characteristics and risk of products and services provided and that they receive the appropriate training when new products are offered; and
  - vii. ensuring that the board of directors or a corresponding governing body has effective control over the aspects mentioned above. In this regard, information about products and services could be systematically included in compliance reports to senior management and made available to regulators on request.
4. This content of the Commission Consultation is consistent with the final legislative text of MiFID II. Other relevant work has also been taken into consideration in the development of these proposals, as set out below:
  - i. In November 2013, the European Supervisory Authorities issued an Article 56<sup>23</sup> Joint Position on "*Manufacturers' Product Oversight and Governance Processes*<sup>24</sup>" setting out high-level principles applicable to the oversight and governance processes of financial instruments. These principles cover in particular the responsibilities of manufacturers and producers in setting up processes, functions and strategies for designing and marketing financial instruments, as well as at reviewing the life cycle of products.

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<sup>22</sup> European Commission Public Consultation: Review of the Markets in Financial Instruments Directive (MiFID), December 2010, available at [http://ec.europa.eu/internal\\_market/consultations/docs/2010/mifid/consultation\\_paper\\_en.pdf](http://ec.europa.eu/internal_market/consultations/docs/2010/mifid/consultation_paper_en.pdf)

<sup>23</sup> Regulation (EU) No 1095/2010, available at: [http://www.esma.europa.eu/sl/system/files/Reg\\_716\\_2010\\_ESMA.pdf](http://www.esma.europa.eu/sl/system/files/Reg_716_2010_ESMA.pdf)

<sup>24</sup> JC-2013-77, available at: [http://www.esma.europa.eu/system/files/jc-2013-77\\_pog\\_-\\_joint\\_position\\_o.pdf](http://www.esma.europa.eu/system/files/jc-2013-77_pog_-_joint_position_o.pdf)

- ii. In December 2013, the International Organisation of Securities Commissions (IOSCO) published a report entitled “*Regulation of retail structured products*”<sup>25</sup>. This report includes a toolkit setting out regulatory options for IOSCO members to use in their regulation of retail structured products, with the goal of enhancing investor protection. The toolkit has five sections that are organised ‘along the value chain’ of the retail structured product market, from issuance to distribution to investment. The tools cover the following areas:
  - a. a potential overall regulatory approach to retail structured products;
  - b. potential regulation of the design and issuance of the products;
  - c. potential regulation of the disclosure and marketing of the products;
  - d. potential regulation of the distribution of the products; and
  - e. potential regulation of post-sales practices.
- iii. Lastly, in March 2014, ESMA published an Article 29(1)<sup>26</sup> opinion on “Structured Retail Products - Good practices for product governance arrangements<sup>27</sup>”. The opinion sets out non-exhaustive examples of good practices aimed at facilitating a more consistent framework for SRPs across Europe, with the intention of improving investor protection by illustrating arrangements that investment firms could put in place to improve their ability to deliver on investor protection (taking into account the nature, scale and complexity of their business). In particular the opinion sets good practice examples relating to:
  - a. the complexity of the Structured Retail Products (SRPs) investment firms manufacture or distribute;
  - b. the nature and range of the investment services and activities undertaken in the course of that business, and
  - c. the type of investors investment firms target.<sup>28</sup>

## Analysis

5. ESMA considers that:
  - i. the MiFID Implementing Directive should be amended by adding new provisions aimed at specifying how investment firms manufacturing and/or distributing investment products should organise themselves in order to reduce, from an early stage, potential risks of mis-selling;
  - ii. product governance arrangements should be considered broadly, meaning that they should also apply, where relevant, to the provision of investment services; and

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<sup>25</sup> FR14/13, available at: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD434.pdf>

<sup>26</sup> Regulation (EU) No 1095/2010, available at: [http://www.esma.europa.eu/sl/system/files/Reg\\_716\\_2010\\_ESMA.pdf](http://www.esma.europa.eu/sl/system/files/Reg_716_2010_ESMA.pdf)

<sup>27</sup> ESMA/2014/332, available at: [http://www.esma.europa.eu/system/files/2014-332\\_esma\\_opinion\\_structured\\_retail\\_products\\_-\\_good\\_practices\\_for\\_product\\_governance\\_arrangements.pdf](http://www.esma.europa.eu/system/files/2014-332_esma_opinion_structured_retail_products_-_good_practices_for_product_governance_arrangements.pdf)

<sup>28</sup> It also highlights that, when an investment firm distributes a SRP manufactured by a firm which is not a MiFID firm, it is a good practice for that firm to take all reasonable measures to verify that the manufacturer of that SRP ensures investors’ interests in a similar way to the good practices contained in the opinion.



- iii. the measures are to be applied in an appropriate and proportionate manner, in line with the MiFID proportionality principle, to different national legal and economic models.
6. In this context, ESMA proposes the introduction of two sets of policy proposals for product governance arrangements for:
    - i. investment firms to adopt when manufacturing products ('product governance obligations for manufacturers'), and/or
    - ii. investment firms to adopt when deciding the range of products and services they intend to offer to clients ('product governance obligations for distributors').<sup>29</sup>
  7. The proposals in this chapter are relevant for investment firms that that create, develop and design products and offer the products directly to clients (manufacturer and distributor), investment firms that develop products and offer these products to clients through other investment firms (manufacturers), and firms that offer clients products manufactured by third parties or other investment firms, without being involved in the manufacturing of these products (distributors).
  8. When an investment firm acts both as a manufacturer and a distributor of investment products, it should be required to fulfil all relevant obligations set out for both manufacturers and distributors.
  9. Where one legal entity is responsible for product manufacture and distribution, it need only have a single product governance process (i.e. it need not duplicate its actions), so long as all relevant product governance obligations are met.
  10. In the context of a group, where the product is developed by one legal entity and distributed by a separate legal entity, the product governance requirements set out for manufacturers and distributors below apply to each entity depending on the activities undertaken.
  11. The proposals aim to enhance investor protection by introducing specific oversight, control and governance obligations on investment firms that manufacture financial instruments and on investment firms that distribute such products. ESMA expects that these proposals, in addition to existing point of sale requirements, will help to ensure that new products and services are marketed or provided to the right investors.

#### *Product governance obligations for manufacturers*

12. ESMA considers that the obligations for manufacturers should include requirements for the following:
  - i. procedures and arrangements to ensure that conflicts of interest (including those related to remuneration) are properly managed as part of the product design, creation and development process;
  - ii. governance processes to ensure effective oversight and control over the product design and manufacture process;

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<sup>29</sup> 'Distributor' refers to an investment firm that offers and/or recommends the product to clients. In this context, 'offers' has a wide application and is to be read in a broad sense.



- iii. the assessment of the potential target market for products designed and developed, to limit the risk of products being sold to investors that are not compatible with their characteristics, needs and objectives;
  - iv. the assessment of the risks of poor investor outcomes posed by products and the circumstances that may cause these outcomes to occur;
  - v. due consideration of the charging structure proposed for products, and the extent to which this can impact the outcomes for the target market;
  - vi. the provision of adequate information to distributors, to enable distributors to understand and sell the product properly; and
  - vii. the regular review of the investment products offered or marketed, taking into account any event that could materially affect the potential risk to the identified target market, to assess at least whether the product remains consistent with the needs of the identified target market and whether the intended distribution strategy remains appropriate.
13. ESMA proposes imposing a positive duty on firms to check that products function as intended, rather than only requiring them to react when detriment becomes apparent or at issuance or re-launch of the same product. ESMA has considered different options for the frequency of product reviews. These are as follows:
- Option 1: investment firms shall review investment products prior to any re-launch or further issue of the same product;
- Option 2: investment firms shall review investment products where they become aware, for example from information supplied by distributors, of any event that could materially affect the potential risk to investors;
- Option 3: investment firms shall review investment products at regular intervals determined by the firm, based on the product complexity, market conditions, the wider legal and regulatory environment and the needs, characteristics and objectives of the target market; and
- Option 4: investment firms shall review investment products on an annual basis.
14. These options are not mutually exclusive and ESMA proposes that options 1, 2 and 3 should apply. Rather than prescribe the frequency of these reviews, however, ESMA proposes that firms should consider how regularly to review their products based on relevant factors. More innovative investment strategies that rely on complicated investment structures, for example, should probably be reviewed more often than simpler and longer-established strategies.

#### *Product governance obligations for distributors*

15. ESMA considers that the obligations for distributors should include requirements for the following:
- i. product governance processes to ensure that the products and services that investment firms intend to offer are compatible with the characteristics, objectives and needs of an identified target market. ESMA considers that these processes should also take into account how the products and services relate to other applicable MiFID conduct of business and organisational require-

- ments. For example, investment firms should consider if a product has features that are difficult to explain to the target market or if there is no sufficient information available on a specific product and how it may need to adapt its sales processes as a result;
- ii. the periodic review of product governance arrangements to ensure that they remain robust and fit for purpose;
  - iii. the provision of sales information to manufacturers, to assist manufacturers in meeting their post-sale product governance responsibilities. This requirement would be particularly helpful where manufacturers work with third-party distributors. Such information could include, for example, copies of promotional material and other information to support product reviews carried out by manufacturers;
  - iv. the involvement of the compliance function in the development and periodic review of product governance arrangements, in order to detect any risk of failure by distributors to comply with their obligations in this chapter;
  - v. the endorsement of the management body or other corresponding governing body of the range of investment products and services that will be offered and their respective target markets, and the provision of information to senior management in the compliance function's periodic reports to the management body; and
  - vi. when investment products are manufactured or issued by third-country firms or non-MiFID firms, distributors should take all reasonable steps to ensure that the level of product information obtained from the manufacturer/issuer is of a reliable and adequate standard to ensure that products will be distributed in accordance with the characteristics, objectives and needs of the target market.
16. ESMA considers that distributor product governance arrangements may apply to more than one firm where different firms work together in the distribution of a product (for example, if a product is recommended by one firm but the transaction takes place using the platform of another firm). In such cases, the final distributor in the chain (i.e. the firm with the direct client relationship) has ultimate responsibility to meet the product governance obligations but the intermediate distributor firm(s) must:
- i. ensure that relevant product information is passed from the manufacturer to the final distributor in the chain;
  - ii. similarly, if the product manufacturer requires information on product sales in order to comply with their own product governance obligations, the intermediate firm must enable them to obtain it; and
  - iii. apply the product governance obligations for manufacturers, as relevant, in relation to the service they provide.



17. The proposals in this chapter do not override responsibilities in other directives, such as the Prospectus Directive<sup>30</sup> and UCITS.<sup>31</sup>

### **Draft technical advice**

#### *Product governance obligations for manufacturers*

1. The proposals set out below should apply to investment firms manufacturing investment products – i.e. those firms that create, develop and design investment products.<sup>32</sup>
2. The investment firm shall maintain procedures and measures to ensure the design of the product complies with the requirements relating to the proper management of conflicts of interest (including remuneration). In particular, when an investment firm develops a new product, it should be reviewed to ensure that the product design, including the product features, does not adversely affect clients or lead to problems with market integrity by enabling the firm to mitigate and/or dispose of its own risks or exposure to the underlying assets of the product, where the investment firm already holds the underlying assets on own account.<sup>33</sup>
3. An analysis of potential conflicts of interests should be conducted each time a product is generated. In particular, the analysis should look at whether the product creates a situation where the client may be adversely affected if they take:
  - i. an exposure opposite to the one previously held by the firm itself; or
  - ii. an exposure opposite to the one that the firm wants to hold after the sale of the product.
4. A firm shall ensure that relevant staff possess the necessary expertise or receive the appropriate training to understand the characteristics and risk of the products they want to manufacture before new products are manufactured.
5. A firm shall ensure that the management body or a corresponding governing body has effective control over the firm's product governance process. In this regard, information about the products a firm manufactures should be systematically included in compliance reports to the management body and made available to NCAs on request.
6. Where investment firms collaborate with a third party based in a non-EEA Member State to create or manage a product, they shall outline their mutual responsibilities in a written agreement.
7. When designing products, the firm shall identify the potential target market for each product and be able to specify the type(s) of client for whose needs, characteristics and objectives the product is com-

<sup>30</sup> Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC (as amended).

<sup>31</sup> Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009, on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (as amended).

<sup>32</sup> Product governance obligations shall also apply to manufacturers when providing investment services which are distributed through other parties.

<sup>33</sup> In these circumstances, the first risk to consider is regarding the conflict of interests with clients. Nevertheless, the firm should also consider whether the product may represent a significant threat to the orderly functioning and integrity of financial markets or to the stability of the whole or part of the financial system before deciding to proceed with the launch of the product.

patible. As part of this process, the firm should identify any groups of investors for whose needs, characteristics and objectives the product is not compatible. Where an existing product is changed, and this change is significant for the operation of the product, the firm shall re-determine the target market for that product. Where the firm makes significant adaptations to existing products the firm shall re-determine the target market of these products.

8. The target market must be specified at a sufficiently granular level to avoid the inclusion of any groups of investors for whose needs, characteristics and objectives the product is not compatible.
9. Investment firms shall undertake a scenario analysis of their products. These tests should assess the risks of poor investor outcomes posed by the product and what circumstances might cause these outcomes to occur. They could, for example, assess the product under negative conditions covering what would happen if (the following list is non-exhaustive and other tests may be appropriate):
  - i. the market environment deteriorated;
  - ii. the manufacturer or a third party involved in manufacturing and or functioning of the product experiences financial difficulty;
  - iii. the product fails to become commercially viable;
  - iv. demand for the product is much higher than anticipated, putting strain on the firm's resources or on the dynamics of the underlying product; and
  - v. counterparty risk materialises.
10. Investment firms shall consider the charging structure proposed for the product, checking for example that (the following list is not exhaustive):
  - i. product costs and other charges are compatible with the needs, objectives and characteristics of the target market;
  - ii. charges do not undermine the return expectations of the product. For example, it is unlikely to be appropriate for a tax advantaged financial product to have costs or charges that equal, or exceed, the expected tax benefit for investors. It is important, during the product design process, that the firm ensures that the fees do not remove almost all the tax advantages. The product's final risk/reward profile has to be considered to identify which needs it potentially meets, and to which kind of investor it may be sold;
  - iii. product design is driven by features that benefit the client and not by a business model that is dependent on poor client outcomes; and
  - iv. the charging structure of the product is appropriately transparent for the target market (e.g. it should not be too complex to understand or disguise charges).
11. Investment firms shall ensure that the provision of information and details about an investment product to distributors is of an adequate standard to enable distributors to understand and sell the product properly. This should include information about the appropriate sales channel for the product, the product approval process and the target market assessment. Firms remain subject to the

overarching disclosure requirements in Article 24 of MiFID II.

12. Investment firms shall review the investment products they offer or market on a regular basis, taking into account any event that could materially affect the potential risk to the identified target market.
13. Firms should determine how regularly to review their products based on relevant factors (for example, innovative investment strategies that rely on complicated investment structures should be reviewed more frequently than simpler and longer-established strategies). Investment firms should review investment products: prior to any further issue or re-launch; if they become aware of any event that could materially affect the potential risk to investors; and at regular intervals to investigate whether the products function as intended.
14. When reviewing existing products, the firm should consider if the product remains consistent with the objectives, characteristics and needs of the target market and consider if the product is being distributed to the target market, or is reaching clients for whose needs, characteristics and objectives the product is not compatible. As part of this review, the firm shall make its best effort to identify crucial events that would affect the potential risk or return expectations of the product. For example (the following list is not exhaustive):
  - i. the crossing of a threshold that will affect the return profile of the product (for instance if a reference index has decreased by 5%, the return rate of the product will fall from 10% to 1%);
  - ii. the solvency of certain issuers whose securities or guarantees may impact the performance of the product; and
  - iii. other changes in the financial environment that will affect the assumptions used for the design of the product.
15. The firm shall make its best effort to identify events that would affect the potential risk or return expectations of the product and, when such an event occurs, firms should consider the impact and take appropriate action. This action could include (the following list is not exhaustive):
  - i. the provision of any relevant information on the event and its consequences on the product to the clients, or the distributors of the product if the firm does not offer directly the product to the clients;
  - ii. changing the product approval process;
  - iii. stopping further issuance of the product; and
  - iv. changing the product to avoid unfair contract terms; or if they become aware the product is not being sold as envisaged (for example, if a product was designed for a niche market of sophisticated investors but is being sold to a much larger group of clients), investment firms may need to consider whether the sales channels through which the products are sold are appropriate.

*Product governance obligations for distributors*

16. The obligations for distributors should apply to investment firms when deciding the range of products (issued by itself or other investment firms) and services they intend to offer to clients. These proposals also apply to distributors selling investment products issued by entities that do not fall under



MiFID scope (e.g. if they distribute bonds issued by a car company).

17. When deciding the range of investment products and services that will be offered, investment firms shall have in place adequate product governance arrangements to ensure that products and services they intend to offer are compatible with the characteristics, objectives and needs of an identified target market.<sup>34</sup> In this regard, investment firms should identify and assess appropriately the circumstances and needs of the clients that they intend to focus on, so as to ensure that clients' interests are not compromised as a result of commercial or funding pressures. As part of this process, the firm should identify any groups of investors for whose needs, characteristics and objectives the product or service is not compatible. This obligation should apply without prejudice to any assessment of appropriateness or suitability to be subsequently carried out by the investment firm in the provision of investment services to each client.<sup>35</sup>
18. When deciding the range of investment products and services that will be offered and the respective target markets, investment firms shall maintain procedures and measures to ensure compliance with all applicable MiFID requirements including those relating to disclosure, suitability/appropriateness, inducements and proper management of conflicts of interest. In this context, particular care should be given when distributors intend to offer new products or there are variations to the services they provide.
19. Investment firms shall periodically review and update product governance arrangements already put in place in order to ensure that they remain robust and fit for their purpose, taking appropriate actions where necessary.
20. Firms shall review the investment products they offer or market on a regular basis, taking into account any event that could materially affect the potential risk to the identified target market, to assess at least whether the product remains consistent with the needs of the identified target market and whether the intended distribution strategy remains appropriate. If distributors become aware that they have mis-judged the target market for a specific product or that a given product no longer meets the circumstances of the identified target market (e.g. if the product becomes illiquid due to market trend changes), they should reconsider the target market and/or update the product governance arrangements already put in place as appropriate.
21. Distributors should provide the manufacturer with sales information to support product reviews carried out by manufacturers.
22. Investment firms' compliance function shall be involved in the development and periodic review of product governance arrangements in order to detect any risk of failure by distributors to comply with their obligations in this chapter.
23. Investment firms shall ensure that the relevant staff involved in the development of product govern-

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<sup>34</sup> As explained above, manufacturers designing products that are distributed through other investment firms have to ascertain the needs and characteristics of clients for whom the product is compatible on a theoretical basis (potential target market, see paragraph 7 since they do not have a direct relationship with clients. Conversely, distributors – based on the information on their own clients and taking into account the information obtained by manufacturers - ought to identify the needs and characteristics of the group of clients to whom they are effectively going to offer the product, as well as define how they are going to distribute it. When an investment firm acts both as a manufacturer and a distributor, one target market assessment only shall be required.

<sup>35</sup> It must be clear that the analysis of the target market for the purposes of product governance arrangements is distinct from and does not replace the suitability/appropriateness assessments which are conduct of business rules that take place for each specific transaction concluded by a given investor in relation to a given product.

ance arrangements fully understand the characteristics and risks of products and services that will be offered as well as the characteristics, objectives and needs of the identified target market.

24. Investment firms shall ensure that the management body, if applicable, or a corresponding governing body endorses the range of investment products and services that will be offered and the respective target markets. In this regard, information about the investment products and services offered should be systematically included in the compliance function's periodic reports to the management body.
25. When investment products are manufactured/issued by investment firms that fall under the MiFID scope, distributors shall obtain information to gain the necessary understanding and knowledge of the products they intend to offer in order to ensure that these products will be distributed in accordance with the characteristics, objectives and needs of the target market.<sup>36</sup>
26. When investment products are manufactured/issued by third-country firms or non-MiFID firms, distributors shall take all reasonable steps to ensure that the level of product information obtained from the manufacturer/issuer is of a reliable and adequate standard to ensure that products will be distributed in accordance with the characteristics, objectives and needs of the target market. Where all relevant and material information is not publicly or otherwise available, the reasonable steps required of the distributor include an agreement with the manufacturer or its agent that the manufacturer or its agent will provide all relevant information. Publicly available information may only be accepted if it is clear, reliable and produced to meet directive requirements, such as the requirements in the Prospectus Directive or in the Transparency Directive.<sup>37</sup> This obligation is relevant for products sold on primary and secondary markets and should apply in a proportionate manner, depending on the degree to which publicly available information is obtainable and the complexity of the product.
27. Where different firms work together in the distribution of a product, the final distributor in the chain (i.e. the firm with the direct client relationship) has ultimate responsibility to meet the product governance obligations but the intermediate distributor firm(s) must:
  - i. ensure that relevant product information is passed from the manufacturer to the final distributor in the chain;
  - ii. similarly, if the product manufacturer requires information on product sales in order to comply with their own product governance obligations, the intermediate firm must enable them to obtain it; and
  - iii. apply the product governance obligations for manufacturers, as relevant, in relation to the service they provide.

**Q14. Should the proposed distributor requirements apply in the case of distribution of products (e.g. shares and bonds as well as over-the-counter (OTC) products) available on the primary market or should they also apply to distribution of products on the**

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<sup>36</sup> When the issuer is an investment firm under MiFID, this obligation should be considered as complementary to the duty of manufacturers of making information on products available to distributors.

<sup>37</sup> Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC (as amended).

**secondary market (e.g. freely tradable shares and bonds)? Please state the reason for your answer.**

- Q15. When products are manufactured by non-MiFID firms or third country firms and public information is not available, should there be a requirement for a written agreement under which the manufacturer must provide all relevant product information to the distributor?**
- Q16. Do you think it would be useful to require distributors to periodically inform the manufacturer about their experience with the product? If yes, in what circumstances and what specific information could be provided by the distributor?**
- Q17. What appropriate action do you think manufacturers can take if they become aware that products are not sold as envisaged (e.g. if the product is being widely sold to clients outside of the product's target market)?**
- Q18. What appropriate action do you think distributors can take, if they become aware of any event that could materially affect the potential risk to the identified target market (e.g. if the distributor has mis-judged the target market for a specific product)?**
- Q19. Do you consider that there is sufficient clarity regarding the requirements of investment firms when acting as manufacturers, distributors or both? If not, please provide details of how such requirements should interact with each other.**
- Q20. Are there any other product governance requirements not mentioned in this paper that you consider important and should be considered? If yes, please set out these additional requirements.**
- Q21. For investment firms responding to this consultation, what costs would you incur in order to meet these requirements, either as distributors or manufacturers?**

## 2.8. Safeguarding of client assets

### Background/Mandate

#### Extract from the Commission's request for advice (mandate)

*ESMA is invited to provide, taking into account the above considerations, technical advice on governance and organisational arrangements concerning the safeguarding of client assets and the prevention of unintended use of client financial instruments, on measures to ensure an appropriate use of TTCA when dealing with non-retail clients, on arrangements to be adopted with respect to securities financing transactions, on how to further strengthen the due diligence requirements, including diversification, for firms depositing client funds, on recording and disclosure requirements with respect to inappropriate custody liens or similar rights, to the extent this is allowed or required by certain regulatory regimes, over client assets as well as on measures aiming to increase the effectiveness of segregation requirements.*

1. The following MiFID II provisions are relevant:

#### Article 16:

*“(8) An investment firm shall, when holding financial instruments belonging to clients, make adequate arrangements so as to safeguard the ownership rights of clients, especially in the event of the investment firm's insolvency, and to prevent the use of a client's financial instruments on own account except with the client's express consent.*

*(9) An investment firm shall, when holding funds belonging to clients, make adequate arrangements to safeguard the rights of clients and, except in the case of credit institutions, prevent the use of client funds for its own account.*

*(10) An investment firm shall not conclude title transfer financial collateral arrangements with retail clients for the purpose of securing or covering present or future, actual or contingent or prospective obligations of clients.*

*[...]*

*(12) The Commission shall be empowered to adopt delegated acts in accordance with Article 89 to specify the concrete organisational requirements laid down in paragraphs 2 to 10 of this Article to be imposed on investment firms and on branches of third-country firms authorised in accordance with Article 41 performing different investment services and/or activities and ancillary services or combinations thereof”.*

2. In developing its proposals, ESMA has considered the Commission Consultation, the recently published Recommendations Regarding the Protection of Client Assets<sup>38</sup> by IOSCO, and the consultation

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<sup>38</sup> Recommendations Regarding the Protection of Client Assets, IOSCO, January 2014, available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD436.pdf>



document of the Financial Stability Board (FSB) on the Application of the Key Attributes of Effective Resolution Regimes to Non-Bank Financial Institutions.<sup>39</sup>

3. The IOSCO recommendations establish 8 principles applicable to firms and their regulators, which relate to:
  - i. appropriate record-keeping;
  - ii. regular statements to clients;
  - iii. arrangements to protect clients' rights;
  - iv. consideration of risks of placing client assets in foreign jurisdictions;
  - v. risk disclosure to clients;
  - vi. controls in the event of waiver or modifications of clients assets protections;
  - vii. regulators overseeing compliance; and
  - viii. regulators consideration when assets are placed in foreign jurisdictions.
4. ESMA considers that it would be useful to incorporate these recommendations, to the extent they are relevant, to the arrangements of safeguarding client assets.
5. The provisions relating to the safeguarding of client assets contained in the MiFID Implementing Directive (Articles 16 to 20) are as follows:
  - i. Article 16 relates to both client financial instruments and funds, covering organisational requirements. These include maintaining accurate records and accounts that distinguish client assets from the firm's own and those of one client from those of another, conducting reconciliations between internal and third-party records, separate identification of client and firm assets held at third parties, and measures to adequately protect any assets held;
  - ii. Articles 17 and 18 relate to the depositing client financial instruments and funds at third parties, ensuring appropriate due diligence in their selection, and that such third parties and their jurisdictions are subject to appropriate oversight;
  - iii. Article 19 places restrictions on the use of client financial instruments by investment firms, including requirements for client consent and organisational arrangements; and
  - iv. Article 20 requires external audits for investment firms.
6. Based on this, ESMA proposes advising the Commission on the following:

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<sup>39</sup> See Key Attributes of Effective Resolution Regimes for Financial Institutions, FSB, October 2011, available at [http://www.financialstabilityboard.org/publications/r\\_111104cc.pdf](http://www.financialstabilityboard.org/publications/r_111104cc.pdf) and Application of the Key Attributes of Effective Resolution Regimes to Non-Bank Financial Institutions: Consultative Document, FSB, August 2013, available at [http://www.financialstabilityboard.org/publications/r\\_130812a.pdf](http://www.financialstabilityboard.org/publications/r_130812a.pdf)



- i. governance arrangements in investment firms concerning the safeguarding of client assets;
  - ii. indiscriminate use of Title Transfer Collateral Arrangements (TTCA);
  - iii. securities financing, TTCA and collateralisation;
  - iv. diversification of an investment firm's holding of client funds as part of due diligence requirements;
  - v. inappropriate custody liens on client financial instruments and funds;
  - vi. segregation of client financial instruments in third country jurisdictions;
  - vii. preventing unintended use of client financial instruments; and
  - viii. making information easily available to insolvency practitioners.
7. In order to strengthen investor protection in this area, ESMA proposes introducing additional requirements in respect of both client instruments and client funds. ESMA is proposing that firms should have proper and specific governance in place to ensure the safeguarding of client assets. More specifically, ESMA proposes addressing concerns around inappropriate lending of, and liens over client assets; and restricting any inappropriate activity in this area; increasing disclosure to clients; and addressing, through diversification, the contagion risk to client funds that occurs when held exclusively in group banks.

## **Analysis**

### *Governance arrangements in investment firms concerning the safeguarding of client assets*

8. The responsibility for meeting requirements of the MiFID Implementing Directive on the safeguarding of client assets may in practice be spread across diverse areas and departments, especially in very large and complex institutions. After the first wave of the crisis in 2008, it emerged from supervisory experience that some insolvencies were complicated by the absence of a single person taking overall responsibility for the firm fulfilling its obligations under these requirements.
9. Notwithstanding the existing requirements relating to the compliance function under Article 6 of the MiFID Implementing Directive, there is currently no requirement under MiFID I to appoint a single officer with responsibility for operational oversight over the safeguarding of client assets. If there is insufficient seniority and oversight within a firm to raise issues relating to client assets, this could reduce the effectiveness of controls over what are often complex operations in this area, and increase the risk that senior management may receive limited or incomplete reporting these matters.
10. The safeguarding of client assets is an important part of the MiFID investor protection requirements. A situation where firms do not have overarching sight of their means of meeting their obligations in this area is not satisfactory. The appointment of a single officer with responsibility for matters relating to the safeguarding of client instruments and funds would reduce these risks of fragmented responsibility, in an analogous way to the requirements for the compliance function in Article 6 of the MiFID Implementing Directive (albeit in this case limited to the specific topic of client assets).

11. In a small firm it may be proportionate for the compliance officer to fulfil this role. Where a firm has responsibility for safeguarding a significant amount of client assets or has complex associated operations, it may be more appropriate for a separate officer to have operational oversight.

*Indiscriminate use of title transfer collateral arrangements (TTCA)*

12. The definition of TTCA is included in the Financial Collateral Directive (FCD)<sup>40</sup> as referred to in MiFID I, Recital 27(b): “*title transfer financial collateral arrangement*’ means an arrangement, including repurchase agreements, under which a collateral provider transfers full ownership of financial collateral to a collateral taker for the purpose of securing or otherwise covering the performance of relevant financial obligations; (FCD Article 2(1)(b))”.
13. TTCA is a legal mechanism under which a firm takes full ownership of a client’s instruments or funds so that they no longer belong to the client, who will not benefit from the MiFID protections that would otherwise apply. Instead, under a TTCA, the client accepts the investment firm’s promise to repay the funds or (equivalent) financial instruments. The nature of the risks involved for the client is therefore significantly altered.
14. TTCA can be used in the course of some types of transactions such as repos or re-hypothecation in prime brokerage. There are numerous risks with TTCA.
15. Article 16(10) of MiFID II prohibits TTCA arrangements for retail clients when it is “*for the purpose of securing or covering clients present or future, actual or contingent or prospective obligations*”. Due to the broad possibilities of using TTCA for non-retail clients (i.e. professional clients and eligible counterparties) under this provision, there is a risk that without further guidance on what is appropriate, investment firms could make use of such provisions indiscriminately.
16. The Commission Consultation highlighted that the indiscriminate use of TTCAs by investment firms “*would jeopardise the effectiveness of segregation of client assets requirements*”. MiFID II clearly sets out an obligation to safeguard client financial instruments and funds, and if TTCA is used without proper consideration, it undermines the regime put in place to protect client assets.
17. ESMA considers that applying TTCA would be inappropriate:
  - i. where a firm applies TTCA when there is only a very weak connection between the client’s liability or consideration to the firm and the use of TTCA, including where the likelihood of a liability arising is low or negligible;
  - ii. where the amount of client funds or financial instruments subject to TTCA far exceeds the client’s liability, or is even unlimited if the client has any liability at all to the firm; or
  - iii. where firms insist that all clients’ assets must be subject to TTCA, without considering what obligation each client has to the firm.
18. In order to mitigate the risk of blanket use of TTCA that amounts to bypassing the safeguarding requirements required by MiFID II, one measure could be to require investment firms to consider and to be able to demonstrate the appropriateness of any TTCA used with its clients by means of the

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<sup>40</sup> Directive 2002/47/EC.



relationship between the client's obligation to the firm and the client assets subjected to TTCA by the firm; they should not be able to rely on TTCA as a means of bypassing MiFID safeguarding requirements. Under such a measure, firms may still make use of TTCA, provided that they have considered and are able to demonstrate the appropriateness of TTCA.

19. In order to ensure that clients are properly informed of the risks involved in entering into a TTCA, firms should highlight to clients the risks involved, and the effect of the TTCA on the client's assets.
20. Many firms may already consider the extent of their client's obligations in their use of TTCA. For those that do not, there may be some costs involved in introducing measures to assess the appropriateness of TTCA arrangements for their clients.

#### *Securities financing transactions and TTCA*

21. ESMA considers that Article 16(10) of MiFID II prevents all use of TTCA by any party for retail clients. Similarly, ESMA considers that Article 19 of the MiFID Implementing Directive requires retail client consent for the use of their assets by any party. ESMA believes that Article 16(10) of MiFID II does not affect this use of client instruments under Article 19 of MiFID Implementing Directive - for example, securities lending (which falls under the definition of 'securities financing transaction') - when all the requirements of Article 19 are met.
22. By allowing some types of transactions under Article 19 of MiFID II that may in certain jurisdictions require transfer of title, this could be understood as allowing collateral arrangements with retail clients for the purpose of securing or otherwise covering present or future, actual or contingent or prospective obligations that are prohibited by Article 16(10) of MiFID II. ESMA is of the view that firms should not be able to make use of Article 19 to effect arrangements that are prohibited under Article 16(10) of MiFID II.
23. ESMA does not envisage that this would mean that it is no longer possible to undertake arrangements discussed in Article 19 of the MiFID Implementing Directive for retail clients. However, this does mean that securities lending arrangements must be undertaken using an alternative legal mechanism. ESMA does not consider that Article 16(10) of MiFID II will prevent any arrangements contemplated under Article 19 of the MiFID Implementing Directive.

#### *Securities financing transactions and collateralisation*

24. The Commission Consultation identified that there was scope to include additional protections for clients in relation to securities financing transactions. It specifically stated: "*The Commission services consider that the implementing directive could require firms, at least for retail client assets, to adopt specific arrangements to ensure that the borrower of client assets (for instance in the case of stock lending activities) provides the appropriate collateral and that the firm monitors the continued appropriateness of such collateral and takes the necessary steps to maintain the balance with the value of client assets*".
25. ESMA considers that these are appropriate measures to protect retail clients and could also be suitable for non-retail clients. While it seems that firms should already consider and have in place such measures, since they would take such measures in respect of their own house financial instruments, if a firm does not already have them in place, it could incur some one-off costs in developing systems and on-going monitoring and maintenance.



26. In line with IOSCO recommendations, to ensure oversight of activities contemplated under Article 19, ESMA considers that the express prior consent of non-retail clients, while already required, should be clear and recorded in writing or in a legally equivalent alternative means, and affirmatively executed by the client.<sup>41</sup>

*Considering diversification of investment firm's holding of client funds as part of due diligence requirements*

27. The Commission Consultation proposed that investment firms consider diversification of client funds as part of their due diligence requirements:

*“Investment firms are required to place client funds into accounts opened with a central bank or a credit institution or certain money market funds and, except for central banks, to exercise all due skill, care and diligence in the selection and review of the institutions they choose. As a result of the financial crisis, it has emerged that the concentration of client money in group entities may face the risk of contagion when intra-group insolvency occurs. The Commission services consider that diversification in the placement of client funds could be one of the criteria of conducting the due diligence and that implementing acts could be proposed in this area”.*<sup>42</sup>

28. Under Article 18 of the MiFID Implementing Directive investment firms must, on receiving any client funds, promptly place those funds into one or more accounts opened with any of the following: a central bank; a credit institution authorised in accordance with the Banking Consolidation Directive<sup>43</sup>; a bank authorised in a third country; or a qualifying money market fund. For example, stockbrokers could receive and hold their clients' funds, in connection with the investment services they are providing, which they then deposit with a third party (for instance, in a deposit account at a credit institution). Though the MiFID Implementing Directive includes due diligence requirements for the selection of a third party in which to place client funds<sup>44</sup>, there are no requirements to consider diversification.
29. These proposals regarding diversification and those below do not apply to: credit institutions in relation to deposits as per Article 18(1) of the MiFID Implementing Directive; or where the investment firm does not hold the money (for example, where the client has their own bank account and the investment firm has a mandate to instruct the bank).
30. If an investment firm places all the client funds that it is holding in a single institution, this could cause significant risk to client funds. This is because in the event of the failure of the institution where the funds are held, there is significant risk of diminution and loss, or that all clients' funds will be subject to insolvency proceedings.
31. Investment firms take into account factors such as diversification when considering where to place their own funds, so it seems reasonable to expect them to make the same kinds of considerations when dealing with client funds. There may be many factors to take into account as part of the requirement under Article 18(3) of the MiFID Implementing Directive to “*exercise all due skill, care and diligence*”, which could vary significantly between different investment firms. It is therefore appropriate for firms to make their own judgement about the factors for consideration.

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<sup>41</sup> See Recommendations Regarding the Protection of Client Assets, IOSCO, January 2014, Principle 6, page 6.

<sup>42</sup> Public Consultation: Review of the Markets in Financial Instruments Directive (MiFID), December 2010, p 71.

<sup>43</sup> Directive 2000/12/EC.

<sup>44</sup> MiFID Implementing Directive, Article 18(3).

32. Requiring firms to make such a judgement should be proportionate because a firm's considerations would be in proportion to the scale, nature and complexity of their business. A very large and complex firm with a highly differentiated client base may have to consider many more factors than a smaller firm with a simpler business model and a more homogenous client base. However, considering diversification should always be in proportion to particular circumstances of each firm. In the light of the firm's existing due diligence obligations, it does not seem that this extra consideration would impose a significant additional cost burden.
33. It is important to note that, after consideration, some firms may conclude, bearing in mind all their particular circumstances and having undertaken the required due diligence, that it is appropriate for them to select one institution for holding client funds. For example, a firm may conclude that given the small balance of client funds it holds, the credit worthiness of the bank it intends to use and for operational risk reasons, that one bank is sensible. Another firm in a different scenario may conclude that more than one banking relationship is suitable. However, while it may sometimes be proportionate and appropriate for a firm to hold all client funds in one bank, firms should not assume that this is the case, and in line with the existing due diligence requirements, should review such arrangements periodically.
34. The proposals in this chapter are intended to apply specifically to client funds deposited in accordance with Article 18 of the MiFID Implementing Directive, and not to interfere with the operational necessities of undertaking transactions for clients. To this end, where a firm has transferred client funds to a transaction account in order to make a specific transaction, such funds should not be subject to a requirement to diversify, for example where a firm has transferred funds to a clearing house or exchange in order to pay a margin call.

#### *Intra-group deposits of client funds*

35. When, after considering the existing due diligence requirements in Article 18(3) of the MiFID Implementing Directive, an investment firm places a large proportion (or even all) of the client funds for which they are responsible with a credit institution in their own group, they subject these funds to significant contagion risk, in addition to the general risk of concentration arising when all funds are placed at a single institution. This is because the failure of one firm in a group is frequently followed by the failure of the other firms in the same group. If the investment firm itself fails, the other firms in the group, including the credit institution, are likely to follow suit shortly thereafter - subjecting the funds to significant risk. For example, on the failure of the investment firm Lehman Brothers International (Europe) in 2008, this was the case for various firms in the Lehman group.
36. All of the investment firm's client funds are simultaneously subject to loss or insolvency proceedings if the investment firm fails and all the client funds are held within the same group. The risk of this occurring is different to the general concentration risk addressed by the separate proposal to consider the need for diversification generally, even where investment firms deposit client money outside of their own group. If an investment firm places client money with a single institution, there is still concentration risk, but the risk of failure of that institution is separate from the risk of failure of the investment firm itself.
37. In addition to the general requirement to consider the need for diversification of holdings of client funds, a specific limit on the percentage of client funds that can be deposited at an intra-group credit institution may significantly reduce the risk of loss or diminution of client funds in the event of a firm's insolvency, addressing the contagion risk inherent in placing all client funds with a credit insti-

tution in the same group. This may also reduce any potential conflicts with the existing due diligence requirements in Article 18(3) of the MiFID Implementing Directive.

38. The portion of client funds that is deposited outside the group in accordance with the intra-group proposed approach should of course be subject to due diligence requirements as presented in the previous section.
39. When considering the need for diversification generally, concentration risk (the risk arising when placing all client funds in a single institution) is dependent on varying factors in the particular situation a firm is subject to, such as the total balance of client funds held, the operational risks of using more than one institution and the credit worthiness of the institution in question.
40. When considering contagion risk (the risk that when one firm in a group fails, the other firms will also fail) the most appropriate way to deal with this risk would be, as proposed above, to diversify funds outside of the group by limiting the percentage of client funds that can be deposited at an intra-group credit institution. However, ESMA considers that the assessment of proportionality described in relation to the concentration risk can also be relevant in the case of intra-group deposits of client funds and investment firms might still consider retaining the funds within the group. In particular, smaller investment firms with small balances of client money, having considered both concentration and contagion risks might still, for operational reasons, consider retaining the funds within the group. Due to the different nature of the risk addressed, ESMA considers that, in the case of intra-group deposit of client funds, investment firms should notify NCAs in advance about the reasons for not diversifying funds outside of their group. ESMA expects NCAs to ensure a strict application of the proportionality assessment in this area in order to avoid creating loopholes in the way in which the general intra-group limit for depositing client funds outside the group is applied.
41. An intra-group limit would only be relevant where client funds are received and held as contemplated by Article 18(1) of the MiFID Implementing Directive. It would not be relevant where an investment firm does not receive client funds, for example, where it merely has control of a client bank account. The proposal would also not apply to credit institutions in accordance with Article 18(1), in which case the credit institution would be subject to the appropriate prudential regime and oversight addressing the risks specific to banking. Consequently, some markets could be less affected by such a proposal than others, depending on the prevalent model of holding client funds.
42. ESMA notes that some credit institutions could be relying on funds deposited by their intra-group investment firms. Requirements that could see these funds withdrawn may impact on the liquidity and capital of these credit institutions, thus having cost implications. The precise extent of this issue is unknown, and could potentially result in significant unintended consequences.

*Inappropriate custody liens over client financial instruments and funds and recording liens and other encumbrances*

43. Currently, an investment firm is permitted to use a client's assets under Article 13(7) and Article 13(8) of MiFID I and Article 19 of the MiFID Implementing Directive where a client's express consent is obtained. The investment firm is obliged to inform the client about the existence of such security interest or lien. Article 32(6) of the MiFID Implementing Directive states: "*An investment firm shall inform the client about the existence and the terms of any security interest or lien which the firm has or may have over the client's financial instruments or funds, or any right of set-off it holds in relation to those instruments or funds. Where applicable, it shall also inform the client of the fact that a*

*depository may have a security interest or lien over, or right of set-off in relation to those instruments or funds”.*

44. In the case of a firm’s retail clients, their consent should be based, in part, on the firm having provided clear, full and accurate information on that use. Article 32(7) of the MiFID Implementing Directive provides: *“An investment firm, before entering into securities financing transactions in relation to financial instruments held by it on behalf of a retail client, or before otherwise using such financial instruments for its own account or the account of another client, shall in good time before the use of those instruments provide the retail client, in a durable medium, with clear, full and accurate information on the obligations and responsibilities of the investment firm with respect to the use of those financial instruments, including the terms for their restitution, and on the risks involved”.*
45. It emerged from supervisory action in 2008 that in some cases when an investment firm is responsible for clients’ financial instruments and these are placed at a third party, the investment firm may have agreed to liens over these instruments, which are of a general and wide-ranging nature. Examples of liens that were identified after the Lehman insolvency in 2008 included liens granting a third party the right to dispose of financial instruments in the event of the default of the firm itself or its affiliate group entities (and not the client whose financial instruments are in question) to satisfy the firm’s obligation to that third party. These types of arrangements do not meet the MiFID II obligations to protect clients’ rights and ensure the safekeeping of their financial instruments. Furthermore, such liens are not likely to be clear and transparent to clients until insolvency, as the client will not be party to the agreement, so that the client is not aware of the risks they face.
46. One measure to mitigate the risk of investment firms agreeing to unsuitable liens and rights of set off over the client assets they hold in accordance with MiFID could be the introduction of an explicit prohibition on allowing liens over client assets that would allow a third party to dispose of these in order to recover debts that do not relate to the clients or provision of services to the clients.
47. ESMA is aware that there may be some third country jurisdictions in which the holding of client assets may require general and wide-ranging liens to be granted. This could mean that these assets are used to pay off unrelated debts or charges, such as the investment firm’s own debts or its affiliate group entities. In order to prevent the risk of clients going uninformed of the risks associated with such liens where a firm is obliged to grant one, one measure could be to provide for specific risk disclosure requirements.
48. This area has also been addressed by international work streams. Principle 3(5) of the IOSCO recommendations states: *“An intermediary should be aware of the effect of liens and other encumbrances on client assets and take appropriate steps to ensure that any such lien or encumbrance is only granted to the extent, if any, permitted by the regulatory regime, including with respect to any requirement for client consent. Each intermediary should consider the best interest to the clients to the extent it has a choice in agreeing to liens or encumbrances”.*
49. For firms with large client bases carrying out business in multiple jurisdictions, there could be notable cost implications of reviewing and potentially renegotiating existing agreements. Such costs should be proportionate in the sense that they should be in relation to the scale and complexity of the firm’s business. There may be some on-going costs in respect of risk warnings to clients.
50. As noted above, the existence of some liens or similar rights over client funds or financial instruments may be valid. In accordance with IOSCO Principles 1 and 3, such security interests or other encum-

branches, where granted by the firm or where the firm has been informed that they are granted, should be recorded in the firm's own records. This should make the ownership status of client assets clearer, especially in the event of insolvency.

#### *Segregation of client financial instruments in third country jurisdictions*

51. Articles 16(1)(d) and (e) of the MiFID Implementing Directive require investment firms to ensure that any client assets deposited with a third party are “*identifiable separately from the financial instruments belonging to the investment firm and of that third party, by means of differently titled accounts*” or “*held in an account or accounts identified separately from any account used to hold funds belonging to the investment firm*”.
52. Normally, an investment firm will be able to open the requisite number of accounts or sub-accounts with a third party in order to achieve this segregation. Article 16(2) of the MiFID Implementing Directive recognises that there can be situations where applicable national law may prevent compliance with the need to segregate. In this case, “*Member States must prescribe the measures that investment firms must take*”.
53. In order to counter the risk of investment firms inappropriately relying on the possibility of ‘other equivalent measures’ outlined in Article 16(1)(d) of the MiFID Implementing Directive, firms should only be able to rely on this provision when they are unable to comply with the segregation requirements in third country jurisdictions due to reasons of applicable law or market practice. In these instances, a specific disclosure should be made to make clients aware that they do not benefit from the protections as envisaged under MiFID when firms must rely on ‘other equivalent measures’.

#### *Preventing unintended use of client financial instruments*

54. Article 16(8) of MiFID II contains a general prohibition on using client financial instruments without client consent (which remains unchanged from Article 13(7) of MiFID I). This is currently expanded in Article 19 of the MiFID Implementing Directive, which sets out the conditions, including client consent, for using client financial instruments. The measures proposed in this section aim to strengthen organisational requirements in order to prevent unintended use of client financial instruments and are intended to supplement MiFID I measures, including those of Article 19 of the MiFID Implementing Directive.
55. One situation that poses a risk of unintended use of client financial instruments relates to the use of automated settlement systems and omnibus accounts opened at a central securities depository (CSD) containing securities of a fungible nature, for example, where an investment firm holds a number of shares in a company for several of its clients. A risk can arise in sales transactions where the instruments are not available on the client's account on the transaction date, and where the delivery and settlement will occur at some future date on an automated basis.
56. In such instances, it could be possible for fungible securities held in an omnibus account to be delivered on the settlement date without them being available on the client's account, and therefore the assets of an unrelated client used to settle the transaction. It is therefore particularly important for the investment firm to make sure that the client has the corresponding instruments available on their account on the settlement date to avoid delivering securities belonging to other clients, especially where this process could be carried out on an automated basis.
57. The measures the investment firm could take to avoid this risk include:

- i. the conclusion of agreements with clients on measures to be taken by the investment firm in case the client does not have the provision on its account on the settlement date (e.g. borrowing of the corresponding securities on behalf of the client or unwinding the position);
- ii. the close monitoring, by the investment firm, of its projected ability to deliver on the settlement date and the putting in place remedial measures if this cannot be done; and
- iii. the close monitoring and prompt requesting of undelivered securities outstanding on the settlement day and beyond.

*Making information easily available to insolvency practitioners and relevant authorities and strengthening record-keeping requirements*

58. Another risk of fragmented oversight of the obligations under safeguarding of client assets is the risk of severe delays in accessing information relating to client financial instruments and funds in order to return these to clients. Insolvency practitioners responsible for returning client money and assets sometimes have significant difficulty in gathering basic information. This is particularly relevant in a situation where there is weak oversight of compliance with the various obligations relating to the safeguarding of client assets.
59. Such information needs are often required promptly in order for an insolvency practitioner to take action following their appointment to safeguard the client assets, for example, to request freezing orders or the immediate return of funds. Competent authorities such as regulators and those responsible for the resolution of failed institutions may also need prompt access to such information not necessarily only in the event of insolvency.
60. One way to mitigate this risk would be to require firms to hold basic information and information under existing record-keeping requirements relating to the safeguarding of client assets in a way that can be easily accessed by an insolvency practitioner at short notice. This would help clients' rights to their financial instruments and funds, and potentially increase the speed of their return after insolvency. Investment firms could be obliged under such a requirement to include the following information:
  - i. related internal accounts and records (such as reconciliations, client ledgers, cash books etc.) that readily identify the balances of funds and instruments held for each client;
  - ii. (where client funds are held by the investment firm in accordance with Article 18 of the MiFID Implementing Directive) details of the accounts where client funds are held (bank or qualifying money market fund) and the relevant agreements with those entities;
  - iii. (where financial instruments held by the investment firm in accordance with Article 17 of the MiFID Implementing Directive), details of accounts opened with third parties and the relevant agreements with those entities;
  - iv. details of third parties carrying out any related (outsourced) tasks;
  - v. key individuals of the firm involved in related processes, including those responsible for oversight of the firm's requirements in relation to the safeguarding of client assets; and
  - vi. relevant client agreements.

61. ESMA believes that firms should already maintain such information, although not all firms may maintain it in a way that could be accessed at very short notice. The cost implications of making the necessary systems changes to enable firms to retrieve the data will vary significantly between firms depending on their existing arrangements, and depending on the scale and complexity of the business. Some firms may also face costs in terms of allowing systems to operate post-failure in order to make information available to NCAs and insolvency practitioners.
62. In line with IOSCO Principle 1, the record-keeping requirements in existing Article 16 of the MiFID Implementing Directive should be strengthened to add that the records should be maintained in such a way ‘that they may be used as an audit trail’. This addition would permit an independent party to verify the financial instruments and funds held for clients.

### **Draft technical advice**

#### *Governance arrangements concerning the safeguarding of client assets*

1. Investment firms should appoint a single officer with specific responsibility for matters relating to the firm’s compliance with its obligations regarding the safeguarding of client instruments and funds.
2. In accordance with MiFID proportionality principle, investment firms shall decide where it is appropriate to attribute responsibilities for obligations under this proposal to a separate dedicated officer, or where it may be appropriate for the compliance officer to have operational oversight for these obligations.

**Q22. Do you agree with the proposal for investment firms to establish and maintain a client assets oversight function?**

**Q23. What would be the cost implications of establishing and maintaining a function with specific responsibility for matters relating to the firm’s compliance with its obligations regarding the safeguarding of client instruments and funds?**

#### *Indiscriminate use of Title Transfer Collateral Arrangements (TTCA)*

3. Article 16(10) of MiFID II prohibits TTCA arrangements for retail clients. For non-retail clients, investment firms should not apply TTCA without proper consideration. TTCA is not appropriate:
  - i. when there is only a very weak connection between the client’s liability or consideration to the firm and the use of TTCA, including where the likelihood of a liability arising is low or negligible;
  - ii. where the amount of client funds or financial instruments subject to TTCA far exceeds the client’s liability, or is even unlimited if the client has any liability at all to the firm; or
  - iii. where firms insist that all clients’ assets must be subject to TTCA, without considering what obligation each client has to the firm.
4. Investment firms should consider and to be able to demonstrate the appropriateness of any TTCA used with its clients by means of the relationship between the client’s obligation to the firm and the



client assets subjected to TTCA by the firm.

5. Where using TTCA, investment firms should highlight to clients the risks involved and the effect of the TTCA on the client's assets.

**Q24. Do you think that the examples in this chapter constitute an inappropriate use of TTCA? If not, why not? Are there any other examples of inappropriate use of or features of inappropriate use of TTCA?**

**Q25. Do you agree with the proposal to clarify that the use of TTCA is not a freely available option for avoiding the protections required under MiFID? Do you agree with the proposal to place high-level requirements on firms to consider the appropriateness of TTCA? Should risk disclosures be required in this area? Please explain your answer. If not, why not?**

**Q26. Do you agree with the proposal to require a reasonable link between the client's obligation and the financial instruments or funds subject to TTCA?**

**Q27. Do you already make any assessment of the suitability of TTCAs? If not, would you need to change any processes to meet such a requirement, and if so, what would be the cost implications of doing so?**

*Securities financing transactions and TTCA*

6. While some transactions permitted under Article 19 of the MiFID Implementing Directive may require the transfer of title, it should not be possible to make use of Article 19 to effect arrangements that are prohibited under Article 16(10) of MiFID II.

**Q28. Are any further measures needed to ensure that the transactions envisaged under Article 19 of the MiFID Implementing Directive remain possible in light of the ban on concluding TTCAs with retail clients in Article 16(10) of MiFID II?**

*Securities financing transactions and collateralisation*

7. Investment firms should adopt specific arrangements for retail and non-retail clients to ensure that the borrower of client assets provides the appropriate collateral and that the firm monitors the continued appropriateness of such collateral and takes the necessary steps to maintain the balance with the value of client assets.
8. Where an investment firm enters into arrangements for securities financing transactions under Article 19(1)(a) of the MiFID Implementing Directive, the express prior consent of a retail client should be evidenced by signature or equivalent. The express prior consent of non-retail clients should



be clear and recorded in writing or in a legally equivalent alternative means, and affirmatively executed by the client.<sup>45</sup>

- Q29.** Do you agree with the proposal to require firms to adopt specific arrangements to take appropriate collateral, monitor and maintain its appropriateness in respect of securities financing transactions?
- Q30.** Is it suitable to place collateral, monitoring and maintaining measures on firms in respect of retail clients only, or should these be extended to all classes of client?
- Q31.** Do you already take collateral against securities financing transactions and monitor its appropriateness on an on-going basis? If not, what would be the cost of developing and maintaining such arrangements?
- Q32.** Do you agree that investment firms should evidence the express prior consent of non-retail clients to the use of their financial instruments as they are currently required to do so for retail clients clearly, in writing or in a legally equivalent alternative means, and affirmatively executed by the client? Are there any cost implications?
- Q33.** Do you anticipate any additional costs in order to comply with the requirements proposed in relation to securities financing transactions and collateralisation? If yes, please provide details.

*Considering diversification of investment firm's holding of client funds as part of due diligence requirements*

9. An investment firm that deposits client funds at a third party in accordance with Article 18(1) of the MiFID Implementing Directive should consider the diversification of these funds as part of their due diligence in the selection, appointment and periodic review of that third party (as set out in Article 18(3) of the MiFID Implementing Directive).
10. Where a firm has transferred client funds to a transaction account in order to make a specific transaction, such funds should not be subject to a requirement to diversify.

- Q34.** Do you think that it is proportionate to require investment firms to consider diversification of client funds as part of the due diligence requirements when depositing client funds? If not, why? What other measures could achieve a similar objective?
- Q35.** Are there any cost implications to investment firms when considering diversification as part of due diligence requirements?

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<sup>45</sup> See Recommendations Regarding the Protection of Client Assets, IOSCO, January 2014, Principle 6, page 6.

*Intra-group deposits of client funds*

11. Where an investment firm deposits client funds at a third party (as per Article 18(1) of the MiFID Implementing Directive) and that third party is within its own group, an intra-group deposit limit of 20% of such funds should be imposed.
12. However, an investment firm shall be allowed not to comply with the previous paragraph if it is able to demonstrate that, in view of the nature, scale and complexity of its business, and also the safety offered by the third parties considered in the previous paragraph, and including in any case the small balance of client funds it holds, the requirement under the previous paragraph is not proportionate. Investment firms should periodically review the assessment made in accordance with this paragraph and should notify their initial and reviewed assessment(s) to NCAs.

**Q36. Where an investment firm deposits client funds at a third party that is within its own group, should an intra-group deposit limit be imposed? If yes, would imposing an intra-group deposit limit of 20% in respect of client funds be proportionate? If not, what other percentage could be proportionate? What other measures could achieve similar objectives? What is the rationale for this percentage?**

**Q37. Are there any situations that would justify exempting an investment firm from such a rule restricting intra-group deposits in respect of client funds, for example, when other safeguards are in place?**

**Q38. Do you place any client funds in a credit institution within your group? If so, what proportion of the total?**

**Q39. What would be the cost implications for investment firms of diversifying holdings away from a group credit institution?**

**Q40. What would be the impact of restricting investment firms in respect of the proportion of funds they could deposit at affiliated credit institutions? Could there be any unintended consequences?**

**Q41. What would be the cost implications to credit institutions if investment firms were limited in respect of depositing client funds at credit institutions in the same group?**

*Inappropriate custody liens over client financial instruments and funds and recording liens and other encumbrances*

13. Liens over client assets that would enable a third party to dispose of these assets in order to recover debts, that do not relate to the clients or provision of services to the clients, should not be permitted except in cases where this is required in a jurisdiction when holding assets there.
14. Where a firm is obliged to enter into these types of liens, the firm should disclose this information to clients so that they are informed of the risks associated with these arrangements.
15. Where liens, security interests or other encumbrances are granted by the firm, or where the firm has



been informed that they are granted, these should be recorded in the firm's own records to make the ownership status of client assets clear, e.g. in the event of an insolvency.

- Q42. Do you agree with the proposal to prevent firms from agreeing to liens that allow a third party to recover costs from client assets that do not relate to those clients, except where this is required in a particular jurisdiction?**
- Q43. Do you agree with the proposal to specify specific risk warnings where firms are obliged to agree to wide-ranging liens exposing their clients to the risk?**
- Q44. What would be the one off costs of reviewing third party agreements in the light of an explicit prohibition of such liens, and the on-going costs in respect of risk warnings to clients?**
- Q45. Should firms be obliged to record the presence of security interests or other encumbrances over client assets in their own books and records? Are there any reasons why firms might not be able to meet such a requirement? Are there any cost implications of recording these?**

*Segregation of client financial instruments in third country jurisdictions*

16. Investment firms should only be permitted to rely on 'other equivalent measures' as outlined in Article 16(1)(d) of the MiFID Implementing Directive when they are unable to comply with the segregation requirements in third country jurisdictions, due to reasons of applicable law or market practice. In these cases, Member States should be responsible for specifying the necessary 'other equivalent measures' to be taken.
17. A specific disclosure should be made to clients when relying on 'other equivalent measures' under Article 16(1)(d) of the MiFID Implementing Directive to make clients aware they do not benefit from the provisions envisaged under MiFID in these instances.

- Q46. Should the option of 'other equivalent measures' for segregation of client financial instruments only be available in third country jurisdictions where market practice or legal requirements make this necessary?**
- Q47. Should firms be required to develop additional systems to mitigate the risks of 'other equivalent measures' and require specific risk disclosures to clients where a firm must rely on such 'other equivalent measures', where not already covered by the Article 32(4) of the MiFID Implementing Directive?**
- Q48. What would be the on-going costs of making disclosures to clients when relying on 'other equivalent measures'?**

*Preventing unintended use of client financial instruments*

18. Investment firms should take appropriate measures to prevent the unintended use of client financial

instruments. These measures may include (but are not limited to):

- i. the conclusion of agreements with clients on measures to be taken by the investment firm in case the client does not have the provision on its account on the settlement date (e.g. borrowing of the corresponding securities on behalf of the client or unwinding the position);
- ii. the close monitoring, by the investment firm, of its projected ability to deliver on the settlement date and the putting in place remedial measures if this cannot be done; and
- iii. the close monitoring and prompt requesting of undelivered securities outstanding on the settlement day and beyond.

**Q49. Should investment firms be required to maintain systems and controls to prevent shortfalls in client accounts and to prevent the use of one client's financial instruments to settle the transactions of another client, including:**

- i. advancing monitoring systems to ensure the ability to deliver on the settlement date and putting in place remedial measures to be taken if this cannot be done;**
- ii. agreeing arrangements with clients regarding how to manage client shortfalls that may arise; and**
- iii. proactively resolving unsettled transaction, including requesting undelivered securities, outstanding beyond the settlement date?**

**Q50. Do you already have measures in place that address the proposals in this chapter? What would be the one-off and on-going cost implications of developing systems and controls to address these proposals?**

*Making information easily available to insolvency practitioners and relevant authorities and strengthening record-keeping requirements*

19. Investment firms should make information easily available to NCAs, insolvency practitioners and those responsible for the resolution of failed institutions, including the following information:
  - i. related internal accounts and records (reconciliations, client ledgers, cash books etc.) that readily identify the balances of funds and instruments held for each client;
  - ii. where client funds are held by the investment firm in accordance with Article 18 of the MiFID Implementing Directive, details of the accounts where client funds are held (bank or qualifying money market fund) and the relevant agreements with those entities;
  - iii. where financial instruments held by the investment firm in accordance with Article 17 of the MiFID Implementing Directive, details of accounts opened with third parties and the relevant agreements with those entities;
  - iv. details of third parties carrying out any related (outsourced) tasks;

- v. key individuals of the firm involved in related processes, including those responsible for oversight of the firm's requirements in relation to the safeguarding of client assets; and
  - vi. relevant client agreements.
20. The record-keeping requirements in existing Article 16 of the MiFID Implementing Directive should also state that records should be maintained in such a way 'that they may be used as an audit trail', in line with IOSCO Principle 1.

- Q51. Do you agree that requiring firms to hold necessary information in an easily accessible way would reduce uncertainty regarding ownership and delays in returning client financial instruments and funds in the event of an insolvency?**
- Q52. Do you think the information detailed in the draft technical advice section of this chapter is suitable for including in such a requirement?**
- Q53. Do you already maintain the information listed in a way that would be easily accessible on request by a competent person, either before or after insolvency? What would be the cost of maintaining such information in a way that is easily accessible to an insolvency practitioner in the event of firm failure?**



## 2.9. Conflicts of interest

### Background/Mandate

#### Extract from the Commission's request for advice (mandate)

*ESMA is invited to provide technical advice to consider further improvements of the existing conflicts of interest framework, including the establishment of a requirement for periodical review of conflicts of interest policies or clarifications with respect to the last resort nature of disclosure which should not be over-relied on by firms nor used as a measure to manage conflicts of interests. However, for those situations where the organisational and administrative arrangements established by firms proved insufficient to prevent and manage conflicts of interests so as to ensure with reasonable confidence that risks of damage to client interests will be prevented, ESMA should also consider how to further strengthen the content and quality of the information provided to clients to enable them to make an informed investment decision with respect to the service in the context of which the conflict of interest had arisen. With a view to establishing appropriate criteria for determining the types of conflict of interest whose existence may damage the interests of the clients or potential clients of the investment firm, ESMA should assess the need to update or expand the minimum criteria set out in Article 21 of Commission Directive 2006/73/EC.*

*ESMA should also provide technical advice on whether the current requirements concerning the management of conflicts of interests that might arise from the production and dissemination of investment research continue to appropriately protect the objectivity and independence of financial analysts and of the investment research they produce.*

1. The following MiFID II provisions are relevant to this topic:

Article 16(3), subparagraph 1:

*“An investment firm shall maintain and operate effective organisational and administrative arrangements with a view to taking all reasonable steps designed to prevent conflicts of interest as defined in Article 23 from adversely affecting the interests of its clients”.*

Article 23:

*“(1) Member States shall require investment firms to take all appropriate steps to identify and to prevent or manage conflicts of interest between themselves, including their managers, employees and tied agents, or any person directly or indirectly linked to them by control and their clients or between one client and another that arise in the course of providing any investment and ancillary services, or combinations thereof, including those caused by the receipt of inducements from third parties or by the investment firm's own remuneration and other incentive structures”.*

*(2) Where organisational or administrative arrangements made by the investment firm in accordance with Article 16(3) to prevent conflicts of interest from adversely affecting the interest of its client are not sufficient to ensure, with reasonable confidence, that risks of damage to client interests will be prevented, the investment firm shall clearly disclose to the client the general nature and/or sources of conflicts of interest and the steps taken to mitigate those risks before undertaking business on its behalf”.*

*The disclosure referred to in paragraph 2 shall:*



(a) be made in a durable medium; and

(b) include sufficient detail, taking into account the nature of the client, to enable that client to take an informed decision with respect to the service in the context of which the conflict of interest arises.”

2. The Commission Consultation expressed the view that the current MiFID rules on conflicts of interest constitute an effective and proportionate framework for the identification and management of such conflicts. The Commission Consultation stated that “*implementing measures in the area of conflicts of interest would be useful*” in order to ensure a more consistent application of the conflicts of interest requirements across Europe. In this regard, the Commission made specific reference to the disclosure requirements, clarifying that disclosure should only be “*a measure of last resort and not a means for managing conflicts*”.<sup>46</sup>

### Analysis

3. ESMA is of the view that the MiFID Implementing Directive should be amended by adding new provisions to:
  - i. specify that placing an over-reliance on disclosure without adequate consideration as to how the conflicts can be appropriately managed is not permitted;
  - ii. ensure that the disclosure provided to the client is sufficiently detailed and meaningful to enable the client to make an informed decision whether or not, in light of the conflict, to proceed with the service; and
  - iii. introduce a requirement on firms to assess and periodically review their conflicts of interest policy and take all reasonable steps to address any deficiencies.
4. ESMA proposes building on existing MiFID investor protection requirements by requiring that investment firms must ensure specific disclosure of any potential conflicts to clients.

### Over-reliance on disclosure

5. In circumstances where procedures and measures adopted by firms are not sufficient to ensure that the risk of detriment to clients’ interests can be prevented, firms should consider whether any other reasonable measures could be taken that would effectively reduce the potential damage to clients’ interests, before relying on disclosure. It is implicit in the MiFID Implementing Directive requirements that firms should not over-rely on disclosure or use it as a self-standing measure to manage conflicts.

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<sup>46</sup> More specifically, the Commission Consultation specified that “*conflicts of interest requirements [...] include the remuneration of sales forces and the structure of incentives for the distribution of financial products. The Commission services consider that the framework for addressing conflicts of interest within MiFID is still appropriate to prevent failures in the sales process provided that it is consistently applied across Europe. The key element of this framework is the management and the avoidance of conflicts – not just disclosure. While the framework also addresses circumstances in which the disclosure of conflicts of interest might be necessary, this is a measure of last resort and not a means for managing conflicts of interest. For instance, it would be very difficult for a firm which creates strong incentives for its sales staff to sell certain products, e.g. through internal bonus structures, to be able to manage the conflicts of interest thereby created. It is unlikely that such a firm could, in this situation, demonstrate compliance with MiFID*”.



In order to address any uncertainty in the interpretation of this requirement, ESMA proposes to make this principle explicit.

6. ESMA considers that before relying on disclosure, firms should first consider whether other reasonable measures effectively mitigate the conflict of interest and prevent potential detriment. In this regard, it would be reasonable for NCAs to request evidence from firms to demonstrate compliance with this requirement.

#### *Content of the disclosure obligations*

7. The purpose of the required disclosure is to provide the client with the opportunity to make an informed investment decision. The rules apply irrespective of the categorisation of the client.
8. ESMA considers that, for some clients, in particular those who are less sophisticated, the current requirements are too high-level and therefore may be ineffective. This is particularly relevant for retail clients, who may not understand the risks associated with the conflicts of interest. In particular, NCAs, in their supervisory activities, have seen examples where the disclosures are very generic. NCAs have also found that they do not include the specific details on the nature of the conflict. They have also found that the disclosures are drafted in such language that the client is unclear as to the risks that arise from the conflict or the detriment that may be incurred. To address these behaviours, ESMA proposes that the disclosure requirements are strengthened as outlined in the draft technical advice section of this chapter.
9. With regard to more sophisticated clients, ESMA's proposal is to require more detailed disclosure that aligns with the MiFID II changes to strengthen the protections for non-retail clients by applying the overarching high-level principle to act honestly, fairly and professionally and the obligation to be fair, clear and not misleading. To this effect, ESMA considers that, while MiFID II allows an investment firm to take into account the nature of clients when disclosing conflicts of interest, the use of generic conflicts of interest warnings would not to comply with the disclosure requirements irrespective of the category of clients to whom the disclosure is directed.

#### *Review of the conflicts of interest policy*

10. Under the current regime, although there is no explicit obligation requiring firms to periodically review conflicts of interest policies established in accordance with Article 22 of the MiFID Implementing Directive, in ESMA's understanding it is a normal business practice for investment firms to do so. Therefore, ESMA proposes formalising a specific requirement to this effect.

#### *Identification of conflicts of interest and additional organisational requirements for investment research*

11. Provisions on conflicts of interest in the MiFID Implementing Directive also include:
  - i. a general provision identifying a list of situations that, at a minimum, investment firms have to take into account when identifying the types of conflict of interest that arise in the course of providing investment or ancillary services (Article 21 of the MiFID Implementing Directive); and
  - ii. specific measures addressing the provision of investment research and the additional organisational requirements that investment firms are required to comply with when producing and disseminating investment research (Articles 24 and 25 of the MiFID Implementing Directive). In particular, these measures regulate the distinction between investment research and marketing





communications (Article 24 of the MiFID Implementing Directive) and the treatment of financial analysts within investment firms by addressing, inter alia, their personal transactions and their relationship with issuers and other interested parties.

12. ESMA would like to receive feedback from stakeholders on the continued appropriateness of these requirements, and the need for any improvements that may have emerged from their application.

### **Draft technical advice**

1. ESMA considers that Article 22 of the MiFID Implementing Directive on conflicts of interest policies should be amended by inserting new provisions in relation to the disclosure of conflicts of interest. The following proposals are not intended to replace the existing provisions on conflicts of interest, but rather to clarify or supplement the existing regime.
2. Investment firms should ensure that disclosure to clients, pursuant to Article 23(2) of MiFID II, is a measure of last resort that can be used only where the effective organisational and administrative arrangements established by the investment firm to prevent or manage its conflicts of interest in accordance with Article 23 of MiFID II are not sufficient to ensure, with reasonable confidence, that the risks of damage to the interests of the client will be prevented.
3. When disclosure of specific conflicts of interest is required, the disclosure shall clearly state that the organisational and administrative arrangements established by the investment firm to prevent or manage that conflict are not sufficient to ensure, with reasonable confidence, that the risks of damage to the interests of the client will be prevented. The disclosure to clients must be made in a durable medium and it must also include a specific description of the conflict of interest that arises in the provision of investment and/or ancillary services, taking into account the nature of the clients to whom the disclosure is being made. That description must explain the general nature and/or sources of conflicts of interest, as well as the risks to the client that arise as a result of the conflict and the steps undertaken to mitigate these risks, in sufficient detail to enable that client to make an informed investment decision.
4. Member States shall require investment firms to assess and periodically review - at least annually - the conflicts of interest policy established in accordance with this article and to take all appropriate measures to address any deficiencies. Over reliance on disclosure of conflicts of interest must be considered a deficiency in an investment firm's conflicts of interest policy.

- Q54. Should investment firms be required to assess and periodically review - at least annually - the conflicts of interest policy established, taking all appropriate measures to address any deficiencies? Please also state the reason for your answer.**
- Q55. Do you consider that additional situations to those identified in Article 21 of the MiFID Implementing Directive should be mentioned in the measures implementing MiFID II? Please explain your rationale for any additional suggestions.**
- Q56. Do you consider that the distinction between investment research and marketing communications drawn in Article 24 of the MiFID Implementing Directive is sufficient and sufficiently clear? If not, please suggest any improvements to the existing framework and the rationale for your proposals.**



- Q57. Do you consider that the additional organisational requirements listed in Article 25 of the MiFID Implementing Directive and addressed to firms producing and disseminating investment research are sufficient to properly regulate the specificities of these activities and to protect the objectivity and independence of financial analysts and of the investment research they produce? If not, please suggest any improvements to the existing framework and the rationale for your proposals.**



## 2.10. Underwriting and placing – conflicts of interest and provision of information to clients

### Background/Mandate

#### Extract from the Commission's request for advice (mandate)

*ESMA is invited to provide technical advice on possible organisational, conflicts of interest and conduct of business requirements that could better address the specificities of underwriting and placing process and activities.*

1. The MiFID II provisions relevant to the topic of underwriting and placing are as follows:

Article 16(3):

*“An investment firm shall maintain and operate effective organisational and administrative arrangements with a view to taking all reasonable steps designed to prevent conflicts of interest as defined in Article 23 from adversely affecting the interests of its clients.”*

Article 23:

*“(1) Member States shall require investment firms to take all appropriate steps to identify and to prevent or manage conflicts of interest between themselves, including their managers, employees and tied agents, or any person directly or indirectly linked to them by control and their clients or between one client and another that arise in the course of providing any investment and ancillary services, or combinations thereof, including those caused by the receipt of inducements from third parties or by the investment firm's own remuneration and other incentive structures.*

*(2) Where organisational or administrative arrangements made by the investment firm in accordance with Article 16(3) to prevent conflicts of interest from adversely affecting the interest of its client are not sufficient to ensure, with reasonable confidence, that risks of damage to client interests will be prevented, the investment firm shall clearly disclose to the client the general nature and/or sources of conflicts of interest and the steps taken to mitigate those risks before undertaking business on its behalf.*

*(3) The disclosure referred to in paragraph 2 shall:*

*(a) be made in a durable medium; and*

*(b) include sufficient detail, taking into account the nature of the client, to enable that client to take an informed decision with respect to the service in the context of which the conflict of interest arises.*

*(4) The Commission shall be empowered to adopt delegated acts in accordance with Article 89 to:*

*(a) define the steps that investment firms might reasonably be expected to take to identify, prevent, manage and disclose conflicts of interest when providing various investment and ancillary services and combinations thereof;*

*(b) establish appropriate criteria for determining the types of conflict of interest whose existence may damage the interests of the clients or potential clients of the investment firm”.*

2. The Commission Consultation expressed the Commission’s view that the MiFID I framework for addressing conflicts of interest is appropriate to prevent failures in the sales process as long as it is applied consistently by Member States. Section 7.3.7. of the Commission Consultation states:

*“Corporate finance business is covered under different investment and ancillary services in MiFID: underwriting and placing, advice to undertakings, including services related to mergers, services related to underwriting. Firms providing the investment service of underwriting and placing need to be authorised and are subject to MiFID requirements. The most relevant aspects emerging from the provision of these services include managing in an appropriate way the process preceding the issue of the new instruments, governing the internal flow of information concerning the offering, ensuring a proper pricing of the securities, ensuring the availability of the necessary information about the new instruments, allocating the securities in a way that respects the interest of the different actors involved, and keeping complete internal records of the entire process.*

*Given the specificities surrounding these services more detailed and tailored requirements in the implementing directive might be appropriate. The following options could be considered:*

- a) *Requiring firms to establish specific organisational arrangements and procedures concerning all the different steps of the underwriting process (preliminary contacts with the issuer, formation of the syndication, pricing of the securities, actual issue of the securities, methods used to mitigate risk) and to keep the relevant records;*
  - b) *Introducing specific rules in the implementing directive in order to deal with the allotment process, including conduct of business rules (for instance, information requirements towards issuers and investors concerning procedures and criteria adopted by the firm in distributing the financial instruments; specific recordkeeping obligations which also include the overall allotment of financial instruments in the case of syndications involving different investment firms);*
  - c) *Addressing relevant practices through specific conflicts of interest requirements in order to better capture the peculiarities of underwriting and placing activities. This model has already been followed for conflicts of interests arising in the context of investment research”.*
3. ESMA has identified previous work which is also relevant for this topic, notably, IOSCO’s “Market Intermediary Management of Conflicts that arise Securities Offerings - November 2007”, and CESR’s Responses to Questions 15-18 and 20-25 of the European Commission Request for Additional Information in Relation to the Review of MiFID.

## **Analysis**

4. For the purpose of this chapter, references to the service of “*underwriting and placing*” should be considered as including the following investment services (IS) and ancillary services (AS) under Annex 1 of MiFID II:
  - i. underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis (IS);
  - ii. placing of financial instruments without a firm commitment basis (IS);



- iii. advice to undertakings on capital structure, industrial strategy, and related matters and advice and services relating to mergers and the purchase of undertakings (hereinafter referred to as “*corporate finance advice*”)<sup>47</sup> (AS); and
    - iv. services related to underwriting (AS).
5. The term “*underwriting and placing*” includes the above services where they are provided in relation to financial instruments as defined in MiFID II whether through a public or private placement, or on the primary or secondary markets or otherwise.
6. It is important to set out the person to whom the firm owes a duty in the provision of underwriting and placing services. When carrying out a mandate to manage an offering, the investment firm’s duty is to its corporate finance client (from now on called “the issuer client”). In this relationship, ESMA has identified the main elements of the underwriting and placing process where the potential for conflicts of interest to arise is significant and therefore there is a need for firms to have in place systems and controls, namely:
  - i. when the firm advises the issuer client to undertake an offering;
  - ii. in the pricing and underwriting of an issue;
  - iii. the placing/allocation of the issue; and
  - iv. circumstances where any previous lending/provision of credit to the issuer by the investment firm (or a group entity) may be repaid with the proceeds of the issue.
7. Where the investment firm provides an investment service (e.g. investment advice, execution of orders or portfolio management) to a client buying the securities issued as part of an offering (thereafter referred to as “*investment client*”), the investment firm has regulatory responsibilities to these clients. These duties remain, irrespective of whether the investment firm is also acting for the issuer client. The investment firm’s arrangements should ensure that the interests of the issuer client do not improperly impact the servicing of the investment clients. The investment firm must still comply with the applicable conduct of business requirements, for example, the rules on suitability and provision of information to clients.
8. ESMA has identified, in particular, the following persons between whom conflicts of interest may arise in the provision of underwriting and placing:
  - i. the issuer client and the investment firm’s investment clients who are possible purchasers of the securities;
  - ii. the issuer client and the investment firm (including when the investment firm is engaged in proprietary trading activity);
  - iii. the investment firm and its investment clients;
  - iv. one issuer client and another issuer client; and

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<sup>47</sup> See paragraph 77 of CESR’s Q&A entitled “Understanding the definition of advice under MiFID”.

- v. one investment client and another investment client.
9. These conflicts of interest are considered in the provisions of Article 18(1) of MiFID I and Articles 21(a), (b), (c), (d) and (e) of the MiFID Implementing Directive. References to the investment firm in this context include any managers, employees and tied agents, or any person directly or indirectly linked to them by control in accordance with existing MiFID provisions. If the investment firm is part of a group, Article 22(1) of the MiFID Implementing Directive provides that the conflicts of interest policy of an investment firm that is part of a group “*must take into account any circumstances [...] which may give rise to a conflict of interest arising as a result of the structure and business activities of other members of the group*”.
  10. Conflicts of interest can also arise in the process of forming a syndicate for the purpose of underwriting and placing. An example of such a conflict is that existing between the firm’s interests in the selection of syndicate members, and the issuer client’s interests in attaining the best possible group. A firm may, for instance, have an interest in keeping a key competitor out of the syndicate group for a lucrative offering, at the expense of the issuer client. As these are conflicts of interest between the firm and its issuer client, they are similarly covered by the existing provisions of Article 18(1) of MiFID I and Article 21(b) of the MiFID Implementing Directive.
  11. It is important to note that MiFID II subjects investment firms to the general organisational requirements set out in Article 16, the general conflicts of interest obligations set out in Articles 16(3) and 23(1) and the conduct of business obligations set out in Articles 24 and 25. In addition, it is expected that many of the provisions of the MiFID Implementing Directive will be retained under the MiFID II regime including the current general provisions dealing with conflict of interest matters.
  12. Accordingly, ESMA does not propose to redefine the MiFID I and MiFID Implementing Directive provisions in relation to the persons between whom conflicts of interest may arise in the provision of investment and ancillary services, or in relation to the need to adapt conflict of interest policies to cater for group activities. Considerable work was already done in this area prior to the introduction of MiFID II, and MiFID II does not appear to mandate a fundamental review of the existing conflict of interest rules in that regard.
  13. However, in line with the Commission’s mandate, ESMA is of the view that proposals could be inserted in order to introduce organisational arrangements and procedures that address the different steps of the underwriting and placing process, as well as measures requiring investment firms to identify and manage conflicts of interest that arise in the provision of the service of underwriting and placing. New provision of information requirements may also be appropriate. The proposed measures should apply irrespective of the nature of the financial instruments to be offered. ESMA proposes that these measures should follow the same style as those inserted in relation to conflicts of interest associated with investment research under MiFID I (i.e. that the MiFID Implementing Directive measures in relation to conflicts of interest would remain largely as currently drafted. New articles would be inserted in relation to underwriting and placing in the same way that specific articles were inserted concerning the conflicts of interest in investment research under MiFID I).
  14. ESMA proposes to introduce supplemental requirements relating to organisational arrangements and the provision of information to address the specific topics identified as areas of concern by ESMA.<sup>48</sup> These include: advising to undertake an offering; pricing; placing; retail advice; and provision of cred-

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<sup>48</sup> These topics reflect the areas of concern identified by IOSCO.



it. ESMA considers that any organisational measures introduced need to be capable of being applied in a differentiated and proportionate manner and the MiFID proportionality principle should apply: “measures should be appropriate to the size and organisation of the firm and the nature, scale and complexity of its business”.

#### *Advising to undertake an offering*

15. Investment firms have to act in the best interests of the issuer client and communicate with them in a way that is fair, clear and not misleading (Articles 24 and 30 of MiFID II). Conflicts of interest may arise where the interests of the investment firm diverge from those of its issuer client or other clients. The potential for conflicts of interest to arise is much more likely in an integrated investment bank where the investment firm offers a large number of different products and services to the issuer.
16. Set out below are some examples where conflicts of interest may arise due to the many different roles that can be performed by the same investment firm:
  - i. while acting as adviser to the issuer client, the investment firm has an interest in recommending a financing action (e.g. a public equity offering) that will maximise the fees payable to the investment firm and result in less risk to the investment firm. In this instance, other financing alternatives may be available that are more beneficial to the issuer, such as the provision of lending;
  - ii. an investment firm may recommend an equity fundraising so that the issuer client repays a loan previously extended by the investment firm (or a group entity);
  - iii. an investment firm may recommend an equity fundraising to improve certain league table statistics that could potentially help the investment firm win future financing mandates from other potential issuer clients;
  - iv. the conflicts arising from an investment firm’s dual role as adviser and underwriter can be exacerbated by the fact that the investment firm may have a longstanding relationship as corporate banker to the issuer client. In these cases, the issuer client may not be in a strong position to search more widely for underwriting and placing services. Furthermore, an issuer client may be dis-incentivised to change underwriters, as this could be viewed negatively by the market and interpreted as a sign that the issuer client is having difficulties with prospective financing; and
  - v. there is likely to be an asymmetry of information between the investment firm and the issuer client, resulting from the fact that the investment firm acts in a professional capacity whereas an issuer client may not frequently be involved in raising capital and may not have expertise. The complexity of transactions and bundling of services can also make it difficult to assess the full costs of a transaction.
17. Because of the high potential for conflicts of interest to occur when an investment firm is advising to undertake an offering, it is important that the investment firm has established effective organisational arrangements that ensure that its own interests or interests of its other clients do not improperly influence the servicing of the issuer client. These arrangements should be explained to the issuer client, along with other relevant information about the offering process, before the investment firm accepts a mandate to manage the offering.

#### *Pricing*

18. There are a number of potential conflicts that occur as part of the pricing process when an investment firm is engaged in underwriting or placing activity. These conflicts can create incentives for the underpricing or overpricing of an offering, depending on the circumstances.
19. The issuer client may have an interest in maximising the price it gets in the offering. The investment firm may however have any number of competing interests, for example:
  - i. securing a low purchase price for its investment clients participating in the offering;
  - ii. securing a low purchase price for its own proprietary trading desk that may participate; or
  - iii. to inflate demand for an issue, to reward favoured investment clients who are early participants in the placing and may benefit from a subsequent increase in the price.
20. When the investment firm is acting as an underwriter it assumes the underwriting risk, i.e. the risk of not selling the issued stock at the offer price and having to take it up itself. This may create a conflict between obtaining the best price for the issuer client and the investment firm's desire to reduce the underwriting risk by underpricing the offer.
21. An investment firm may often short-sell the issuer client's securities to mitigate its own market risk from underwriting the offering. In the case of an over-allotment option (a 'greenshoe option') the investment firm may short-sell an amount greater than the total issue to make additional purchases after the issue to stabilise the price. This short-selling may have an adverse impact on the value of the securities, to the detriment of the interests of the issuer client. Supervisory experience has shown that some recent offerings have included language in the underwriting agreement that explicitly restricts or limits the ability of the firm to engage in these types of hedging activity.
22. Conversely, it may also be in the interests of the investment firm to overprice the offering, for example:
  - i. where the investment firm (or other group entities) are existing owners and possible sellers of the securities, to protect the value of those investments;
  - ii. where the investment firm (or a group entity) has lent money to the issuer client and the investment firm is seeking to retire the maximum amount of debt with the proceeds of the offer; or
  - iii. where the pricing of a debt issue would enable the firm to revalue other holdings of the issuer's debt securities and possibly liquidate the holdings at an inflated price.
23. It is therefore important for investment firms to establish effective organisational arrangements that ensure that its own interests or interests of its other clients do not improperly influence the pricing process, to the detriment of the issuer client.
24. It is also important that the issuer client understands the process the investment firm takes when determining the price and the timings involved. In addition to the general measures proposed in this chapter, ESMA proposes additional measures to inform the issuer client how the investment firm will determine the price of the offer.

### *Placing*



25. Placing is the result of discussion between the issuer client and the investment firm and the approach taken to the placing process involves the exercise of judgement by the investment firm, based on the particular facts and circumstances of the arrangement. Where the investment firm exercises discretion in relation to the placing of securities, there is an increased risk of conflicts of interest arising.
26. During the placing process, conflicts of interest may arise between the investment firm's own interests and the interests of the issuer client or the investment firm's investment clients. For example:
  - i. in cases where there is more demand for shares than supply in an offering, it may be in the interests of an investment firm to allocate securities to its own proprietary trading group or its own asset management arm (or those of group companies), before allocating securities to its investment clients;
  - ii. the investment firm may pursue its own interests in how it facilitates the distribution of the offering. For example, the investment firm may favour investment clients that are likely to conduct future trading business with the investment firm over other investment clients, or by allotting securities to existing investment clients to increase the chance of securing future investment banking mandates;
  - iii. the investment firm may favour its own interests over those of its investment clients by being selective or unclear in the information it provides about the issue, for example to control the demand for a placing to the benefit of the investment firm; or
  - iv. the investment firm might allocate financial instruments to investment clients that are known to be active traders and might be expected to generate substantial future trading commissions for the investment firm, to the detriment of the issuer client's interest in having a stable base of long-term shareholders.
27. Many of these conflicts of interest are made effective when there is a material under-pricing of an offering; therefore they are particularly relevant in the context of a 'hot' initial public offering (IPO) where the value of a security is expected to rise significantly in its opening trading sessions.
28. It is therefore important that firms have in place organisational arrangements to ensure that allocations made as part of the placing process do not result in the investment firm's interests being placed ahead of the interests of the issuer client. Firms should clearly set out the process for developing allocation recommendations in an allocation policy.
29. It is also important that the issuer client understands the process the investment firm takes when determining the placing and the timings involved. The investment firm should invite the issuer client to participate in the placing process so that its interests can be taken into account. One way to do this could be for the investment firm to obtain the issuer client's agreement to its proposed allocation policy for the transaction.
30. An investment firm must not accept third party payments that are in conflict with the conditions of the inducements regulations in Article 26(b) of the MiFID Implementing Directive from those with a material interest in the allocation of the issue. For the avoidance of doubt, it may be useful to explicitly set out abusive practices in the context of underwriting and placing. For example:
  - i. an allocation made to incentivise the payment of a large amount of fees for unrelated services provided by the investment firm ('laddering'). For example, very high rates of commissions paid

to the investment firm by an investment client, or an investment client providing very high volumes of business at normal levels of commission as compensation for receiving an allocation of the issue;

- ii. an allocation made to a senior executive or a corporate officer of an existing or potential issuer client, in consideration for the future or past award of corporate finance business (spinning); and
- iii. an allocation that is expressly or implicitly conditional on the receipt of future orders or the purchase of any other service from the investment firm by an investment client, or any entity of which the investor is a corporate officer.

#### *Retail advice/Distribution*

31. A conflict of interest may arise where the distribution side of an investment firm also provides other investment services<sup>49</sup> to their investment clients. In this instance, the investment clients acquire the financial instruments that are the subject of an offering where the investment firm (or a group entity) is also paid an underwriting fee arising out of the underwriting and placing of the financial instruments being offered. This conflict may influence an investment firm to act otherwise than in the best interests of its investment clients, because of the investment firm's (or a group entity's) interest in a having a successful offering.
32. In this context, CESR previously<sup>50</sup> noted that underwriting fees paid in such circumstances should generally be considered as inducements according to the inducements rules in Article 26 of the MiFID Implementing Directive: "*Underwriting fees where the investment firm participating in the underwriting also sells the financial instruments issued to investors would generally fall within Article 26(b) of the Level 2 Directive, while if the firm is not selling/placing the financial instruments issued and is only performing all or part of the underwriting to the issuer, the underwriting fee will generally fall within Article 26(a) of the Level 2 Directive*". CESR expressed that underwriting fees received in such circumstances must comply with Article 26(b) of the MiFID Implementing Directive.
33. Similarly, there may be conflicts of interest where a firm creates remuneration arrangements that incentivise members of its sales staff to sell the underwritten financial instruments above other products, in circumstances where other products that are more suitable to a particular investment client may be available. Proposals in relation to remuneration arrangements are set out separately in this CP.
34. Conflicts of interest also arise when investment firms and credit institutions sell proprietary financial instruments – such as common equity shares, preference shares, hybrid securities and debt – to their existing clients ('self-placement'). This practice is a common way for firms, most notably banks, to raise capital from the retail sector that they may be unable to raise from institutional investors, or unable to raise at reasonable costs. Therefore, it is necessary that firms establish effective arrangements to ensure that clients' interests are not compromised as a result of commercial or funding pressures.
35. An example of such a conflict is that arising when banks place financial instruments issued by themselves or other group entities with their existing depositor clients. In these cases, it is important that

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<sup>49</sup> Including for example 'portfolio management' or 'investment advice'.

<sup>50</sup> "Inducements: Report on good and poor practices", 19 April 2010 at paragraph 47.

clients are fully aware of all the risks involved in such investments compared to deposits<sup>51</sup> (including the risk of losing the capital invested in case of a bank's default), as well as of the possible higher concentration risk they may incur if their exposure towards the bank is increased. Another example of such conflicts is when a firm's clients sell or are advised to sell financial instruments issued by third parties that they already hold in their portfolios (such as government bonds) to invest in financial instruments issued by the firm itself or other group entities.

#### *Lending/ Provision of Credit*

36. Where an investment firm (or a group entity) has provided credit to an issuer client and is also arranging a securities offering for that issuer client, there may be an incentive for the investment firm to:
- i. fail to provide complete information on the financial situation of the issuer to persons subscribing to the offer (investment clients);
  - ii. make less robust inquiries of the issuer client concerning its financial situation than might otherwise be made, against the interests of investment clients subscribing to the offer and against the interests of the issuer client; or
  - iii. maximise immediate financing proceeds in order to repay the loan, without adequate consideration of the long-term interests of the issuer client in securing the appropriate amount and type of financing.
37. Where an arranging firm (or a group entity) is owed money by the issuer client, the arranging firm's interest may be to maximise the size of the subsequent capital raising without giving full regard to the circumstances or financial situation of the issuer. To ensure that the arranging firm is aware of such circumstances, it may be necessary to have an obligation, where more than one entity is involved (i.e. the lender/credit provider and arranger are separate but related entities), for full sharing of information between the different entities in relation to the issuer's financial situation. Such a provision could be made in the group conflicts of interest policy already required under MiFID.

#### *Record-keeping*

38. In order for firms to be able to demonstrate that they are acting in the best interest of their clients, firms should keep records of the instructions received from clients, especially their content and their timing. In addition, a record of the allocation decisions taken for each operation should be kept in order to provide for a complete audit trail between the movements registered in clients' accounts and the instruction received. In particular, the final allocation made for each client should be clearly justified and recorded. The complete audit trail of all steps in the underwriting and placing process should be accessible on request for the NCA.

#### *Oversight*

39. In order to correctly identify all the possible conflicts of interest, the investment firm should have in place a centralised process to identify all potential underwriting and placing operations of the firm and keep a record of this information, including the date on which the investment firm has been in-

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<sup>51</sup> In fact, deposits are guaranteed by Compensation Schemes in case of default.



formed about underwriting and placing operations. This process should also identify all the potential conflicts of interests arising from other activities of the firm (or its group) and implement appropriate management procedures including:

- i. surveillance or restriction for some activities that might conflict with the operation (e.g. proprietary trading or production of general recommendations); and
- ii. surveillance of personal transactions. In some cases, the conflict of interest may not be able to be managed by any procedures or arrangements.

In these cases, the only way to manage the conflict would be for the investment firm to not engage in the operation (for instance, when the proposed operation involves an issuer that is a major competitor of an important client of the firm).

### **Draft technical advice**

*Proposed new Organisational requirements to be issued under Article 16(3) of MiFID II and/or Provision of Information requirements to be issued under Article 24 of MiFID II*

1. Article 16(3) of MiFID II requires a firm to maintain and operate effective organisational or administrative arrangements, with a view to taking all reasonable steps designed to prevent conflicts of interest (as defined in Article 23 of MiFID II) from adversely affecting the interests of its clients. The potential for conflicts of interest to arise in the underwriting and placing process is significant, therefore, the establishment of organisational arrangements specific to underwriting and placing is important.
2. ESMA therefore proposes that the following organisational arrangements and/or provision of information requirements should be placed on firms.

*Advising to undertake an offering*

3. The investment firm, before it accepts a mandate to manage the offering, should have arrangements in place to ensure that it explains to the issuer client:
  - i. the various financing alternatives available, and an indication of the level of transaction fees associated with each;
  - ii. the timing and the process the investment firm will take in respect to how it will reach its corporate finance advice in respect to pricing the offer;
  - iii. the timing and the process the investment firm will take in respect to how it will reach its corporate finance advice in respect to placing of the offering;
  - iv. details of the targeted investors, to whom it is planned to offer the securities;
  - v. the relevant individuals involved in the production of corporate finance advice on the price and allotment; and
  - vi. how it intends to manage conflicts of interest that may arise in circumstances where it places the

relevant securities with investment clients of the firm or with its own proprietary book.

#### *Pricing*

4. Investment firms should have in place systems, controls and procedures to identify and manage the conflicts that arise in relation to possible under-pricing and over-pricing of issues and involvement of relevant parties in this process including 'book building'. Specifically:
  - i. investment firms should have in place internal arrangements that ensure that the pricing of the offer does not promote the interests of other clients or the investment firm's interests, which are distinct from the issuer client's interests; and
  - ii. investment firms should have in place internal arrangements that manage or prevent a situation where individuals ordinarily responsible for providing services to the firm's investment clients are involved directly in decisions about corporate finance advice to the issuer client on pricing.
5. In addition, investment firms should provide clients with information about how the investment firm determines the price of the offering and the timings involved. Specifically:
  - i. investment firms should discuss with the issuer client any hedging or stabilisation strategies it plans to undertake with respect to the offering, including how these strategies may impact the issuer clients' interests; and
  - ii. investment firms should take reasonable steps to keep the issuer client informed on developments relevant to the pricing during the offering process.

#### *Placing*

6. Investment firms should have in place internal arrangements that prevent placing recommendations from being inappropriately influenced by any existing or future relationships.
7. Investment firms should have in place internal arrangements that manage or prevent a situation where individuals ordinarily responsible for providing services to the firm's investment clients are involved directly in decisions about recommendations to the issuer client on allocation.
8. An investment firm must not accept third party payments that are in conflict with the conditions of the inducements regulations in Article 26(b) of the MiFID Implementing Directive. In the context of underwriting and placing, the following practices would be considered abusive (this list is not exhaustive):
  - i. an allocation made to incentivise the payment of a large amount of fees for unrelated services provided by the investment firm ('laddering'). For example, very high rates of commissions paid to the investment firm by an investment client, or an investment client providing very high volumes of business at normal levels of commission as compensation for receiving an allocation of the issue;
  - ii. an allocation made to a senior executive or a corporate officer of an existing or potential issuer client, in consideration for the future or past award of corporate finance business (spinning); and
  - iii. an allocation that is expressly or implicitly conditional on the receipt of future orders or the pur-

chase of any other service from the investment firm by an investment client, or any entity of which the investor is a corporate officer.

9. Investment firms should have in place an allocation policy that sets out the process for developing allocation recommendations. This allocation policy should be provided to the issuer client before agreeing to undertake a placing. The policy should set out relevant information (to the extent it is known at that stage) about the proposed allocation methodology for the issue.
10. The investment firm should invite the issuer client to participate in discussions about the placing process so that the investment firm can take the interests of the issuer client into account, for example by obtaining the issuer client's agreement to its proposed allocation policy for the transaction.

#### *Retail advice/Distribution*

11. Investment firms should have in place systems, controls and procedures to identify and manage the conflicts that arise where investment firm provides investment services to an investment client to participate in a new issue, where the investment firm is in receipt of commissions/fees in relation to arranging the issuance. Underwriting fees received in such circumstances must comply with Article 26(b) of the MiFID Implementing Directive. This should be documented in the investment firm's conflicts of interest policies, and reflected in the firm's inducement arrangements.
12. Investment firms (and credit institutions) that engage in the placement of financial instruments issued by themselves (or other group entities) to their own clients, including their existing depositor clients or investment funds managed by entities of their group, must have in place clear procedures for the identification and management of the potential conflicts of interest that arise in relation to this type of activity. Such procedures may include consideration of refraining from engaging in the activity, where conflicts of interest cannot be appropriately managed so as to prevent any adverse effects on clients.
13. When disclosure of conflicts of interest is required, investment firms should explain the nature and source of the conflicts of interest inherent to this type of activity, providing details about the specific risks related to such practices so as to enable clients to make an informed investment decision.

#### *Lending/Provision of credit*

14. In circumstances where any previous lending or credit to the issuer client by the investment firm (or a group entity) may be repaid with the proceeds of the issue, investment firms should consider whether in such circumstances it would be appropriate to refrain from acting as arranger for the securities offering.
15. If the investment firm acted as arranger and the steps it took to manage the conflicts of interest were not sufficient to ensure that the risk of damage to the client would be prevented, the investment firm should disclose to the client the specific conflicts of interest that have arisen in relation to the activities of the investment firm (or group entity) acting in their capacity as a credit provider, and the activity of the investment firm in acting as arranger for the securities offering.
16. Where one entity within a group is acting as a credit provider, and another is acting as arranger for a securities offering, the investment firm's conflict of interest policy should require that full information should be shared between the different entities, in relation to the issuer's financial situation.

*Record-keeping*

17. Investment firms should keep records of the content and timing of instructions received from clients. A record of the allocation decisions taken for each operation should be kept to provide for a complete audit trail between the movements registered in clients' accounts and the instructions received by the investment firm. In particular, the final allocation made for each client should be clearly justified and recorded. The complete audit trail of all steps in the underwriting and placing process should be made available on request to NCAs.

*Oversight*

18. Investment firms should have in place a centralised process to identify all potential underwriting and placing operations of the firm and keep a record of this information, specifying the date on which the firm was informed of potential underwriting and placing operations.
19. The firm should identify all potential conflicts of interests arising from other activities of the investment firm (or its group), and implement appropriate management procedures. In some cases, if the conflict of interest cannot be managed by procedures or arrangements, the only way to manage the conflict would be for the investment firm not to engage in the operation.

- Q58. Are there additional details or requirements you believe should be included?**
- Q59. Do you consider that investment firms should be required to discuss with the issuer client any hedging strategies they plan to undertake with respect to the offering, including how these strategies may impact the issuer client's interest? If not, please provide your views on possible alternative arrangements. In addition to stabilisation, what other trading strategies might the firm take in connection with the offering that would impact the issuer?**
- Q60. Have you already put in place organisational arrangements that comply with these requirements?**
- Q61. How would you need to change your processes to meet the requirements?**
- Q62. What costs would you incur in order to meet these requirements?**



## 2.11. Remuneration

### Background/Mandate

#### Extract from the Commission's request for advice (mandate)

*ESMA is invited to provide technical advice on appropriate requirements aiming at ensuring that the design, the implementation and the oversee of remuneration policies and practices do not influence or interfere with firms' duties to act in the best interest of clients and in particular with the requirements set out in Articles 16(3), 23 and 24. ESMA should for instance consider criteria for the design of remuneration policies and remuneration structures, the need to establish or reinforce certain internal procedures to ensure the involvement of the compliance function and of the management bodies in the definition, approval or oversee of remuneration policies. Such arrangements should encourage responsible business conduct, fair treatment of clients as well as the avoidance of conflict of interests in the relationships with clients.*

1. The remuneration of staff involved in the provision of investment services to clients is a crucial investor protection issue. ESMA has recently published Guidelines in this area on the basis of MiFID I.<sup>52</sup>
2. Although remuneration issues are not specifically mentioned in MiFID I and its implementing measures, the importance of these issues is highlighted in MiFID II.
3. Article 9(3)(c) of MiFID II introduces a new, explicit requirement on the management bodies of investment firms to “*define, approve and oversee [...] a remuneration policy of persons involved in the provision of services to clients aimed at encouraging responsible business conduct, fair treatment of clients as well as avoiding conflicts of interest in the relationships with clients*”.
4. Whereas the current requirement on investment firms to “*maintain and operate effective organisational and administrative arrangements with a view to taking all reasonable steps designed to prevent conflicts of interest [...] from adversely affecting the interests of its clients*” will be maintained under Article 16(3) of MiFID II. Article 23(1) of MiFID II highlights the issues related to remuneration by requiring firms to “*take all appropriate steps to identify and to prevent or manage conflicts of interest [...] including those caused by [...] the firm's own remuneration and other incentive structures*”.
5. In addition to these broadly framed organisational requirements, Article 24(10) of MiFID II will provide that an investment firm “*which provides investment services to clients shall ensure that it does not remunerate or assess the performance of its staff in a way that conflicts with its duty to act in the best interests of its clients. In particular, it should not make any arrangement by way of remuneration, sales targets or otherwise that could provide an incentive to its staff to recommend a particular financial instrument to a retail client when the investment firm could offer a different financial instrument which would better meet that client's needs*”.

### Analysis

6. ESMA believes that the principles included in the recent ESMA Guidelines on remuneration under MiFID I should form the basis for ESMA advice on the implementing measures for MiFID II. In particular, the definition of remuneration provided in these Guidelines should be used as the basis of ESMA advice.

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<sup>52</sup> ESMA/2013/606.





7. ESMA believes that MiFID II should specify requirements in the following areas:
  - i. Governance – before approving remuneration policies, management bodies should seek advice from the compliance function;
  - ii. General criteria for the design of remuneration policies – these criteria should avoid creating incentives for relevant persons to favour their own interest or the firm’s interest over the interest of clients. For example, these criteria should be able to adequately tackle risks arising the sale of financial instruments that are more lucrative for the firm or for relevant persons (for example those arising from self-placement); and
  - iii. Variable remuneration – an appropriate balance between fixed and variable remuneration should be maintained at all time and variable remuneration should be based on qualitative criteria.
8. The principles above should apply broadly to all relevant persons who can have a material impact on the ability of the firm to comply with its overarching obligations to act fairly, honestly and professionally in accordance with the best interest of the clients, both retail and professional.
9. The principles above should be without prejudice to the provisions on remuneration under CRD IV and AIFMD. This is consistent with the distinct objectives of remuneration provisions under MiFID and under CRD IV and AIFMD. For example, any quantitative cap or quantitative criterion related to fixed and variable remuneration should always apply to persons within the scope of remuneration provisions under the prudential regulatory framework. Furthermore, the provisions on remuneration should be without prejudice to the rights, where applicable, of the social partners to conclude and enforce collective agreements, in accordance with national law and customs. This limitation is intended to apply to the extent that investment firms are legally bound by the provisions on remuneration in collective agreements. The proposals in this chapter will enhance investor protection by specifically requiring investment firms to put in place remuneration policies and internal procedures that are aimed at encouraging responsible conduct which is in the best interest of clients, and that avoid conflicts of interest between the investment firm and its clients.

### **Draft technical advice**

1. ESMA considers that the future delegated act should contain the main points set out below:

#### *Scope*

2. The provisions below should apply to all relevant persons who can have a material impact, directly or indirectly, on investment and ancillary services provided by the firm, regardless of whether the clients are retail or professional, to the extent that the remuneration of such persons and related incentives – including non-financial remuneration such as in-kind benefits and career progression – may create a conflict of interest that encourages them to act against the interests of the clients.

#### *Design criteria*

3. Investment firms should define their remuneration policies under appropriate internal procedures taking into account the interests of clients, with a view to ensuring that clients are treated fairly and their interests are not impaired by the remuneration practices adopted by the firm in the short, medium or long term. In particular, remuneration policies and practices should be designed in such a way so as not to create incentives that may lead relevant persons to favour their own interests or the firm’s



interests to the potential detriment of clients.

*Governance*

4. The design of the firm's remuneration policy should be approved by the management body of the firm after taking advice from the compliance function.
5. The day-to-day implementation of the remuneration policy and the monitoring of compliance risks related to the policy should be the responsibility of the senior management of the firm.

*Variable remuneration*

6. Remuneration and similar incentives may be partly based on commercial criteria, but should be principally based on criteria reflecting compliance with the applicable regulations, the fair treatment of clients and the quality of services provided to clients, so that an appropriate balance between fixed and variable components of remuneration is maintained at all times, and provided that in any event the remuneration structure does not favour the interests of the firm or its staff against the interests of any clients.

**Q63. Do you agree with the definition of the scope of the requirements as proposed? If not, why not?**

**Q64. Do you agree with the proposal with respect to variable remuneration and similar incentives? If not, why not?**



## 2.12. Fair, clear and not misleading information

### Background/Mandate

#### Extract from the Commission's request for advice (mandate)

*ESMA is invited to provide technical advice to specify the conditions for information to clients to be fair, clear and not misleading while taking into account the objectives of the Directive.*

1. Article 24(3) of MiFID II states “All information, including marketing communications, addressed by the investment firm to clients or potential clients shall be fair, clear and not misleading. Marketing communications shall be clearly identifiable as such”.
2. No changes have been introduced in this area since the MiFID I. Article 24(13) of MiFID II specifies that “The Commission shall be empowered to adopt delegated acts [...] to ensure that investment firms comply with the principles set out in this Article when providing investment or ancillary services to their clients, including (a) the conditions with which the information must comply in order to be fair, clear and not misleading”.
3. In providing advice to the Commission, it should also be considered that one of the objectives of the MiFID review was to improve, where appropriate, the treatment of non-retail clients (i.e. professional clients and eligible counterparties). In this respect, the general principles applying to the provision of investment services – obligations to act honestly, fairly and professionally and to provide fair, clear and not misleading information – as well as some specific conduct of business rules in the area of information and reporting have been extended to eligible counterparties. ESMA has taken this evolution into account in order to propose targeted improvements to the regime applicable to non-retail clients, where appropriate.
4. The existing Article 27 of the MiFID Implementing Directive, “Conditions with which information must comply in order to be fair clear and not misleading”, applies only to retail or potential retail clients.

### Analysis

5. ESMA considers that Article 27 of the MiFID Implementing Directive requires targeted adjustments to better serve the objectives to provide retail clients with fair, clear and not misleading information. In particular, ESMA notes that:
  - i. the language of different documents sent to retail clients is not always consistent;
  - ii. information provided by investment firms is not always updated, even when provided online;
  - iii. the presentation of risks/warnings to clients does not always reflect the particular relevance of these pieces of information; and
  - iv. information about the future performance doesn't illustrate sufficiently the potential functioning of the financial instruments or services.
6. ESMA considers that some of the detailed principles relating to the treatment of retail clients should also apply to communications addressed to professional clients. For example, professional clients



should also be entitled to receive accurate, sufficient and up-to-date information to ensure the fairness of the information communicated.

7. For the reasons above, ESMA considers that the conditions with which information must comply in order to be fair, clear and not misleading (Article 27 of the MiFID Implementing Directive) should be strengthened.
8. To improve the consistency of the information received by investors, ESMA proposes to strengthen the MiFID Implementing Directive by including a requirement that the information provided to each retail client should be consistently presented in the same language throughout all forms of information and marketing material that is provided to that client.
9. ESMA considers that investment firms should always be required to give a fair and prominent indication of any relevant risks, including where potential benefits are referenced (rather than emphasised as stated by the MiFID Implementing Directive), in order to provide a fair and balanced presentation of the trade-off between risks and benefits.
10. ESMA considers it necessary to include a requirement that information is up-to-date and relevant to the method of communication used (e.g. information provided online should always be kept up-to-date but there may be some time lag in relation to printed media etc.).
11. ESMA suggests adding a requirement that in order for indications and explanations of risks or warnings to be considered prominent<sup>53</sup> when in a durable medium, they must be in a font size that is at least equal to the predominant font size used throughout the document.
12. Finally, when providing information to clients based on simulated future performance (Article 27(6) of the MiFID Implementing Directive), this information should be based on performance scenarios in different market conditions and should reflect the nature and risks of the specific types of instruments included in the analysis.
13. In addition to the strengthening of these conditions for retail clients, the revision of Article 27 should include the extension of some of the relevant principles to clients categorised as professional. The information and marketing documentation likely to be received by professional clients should meet the following conditions (which are already applicable to retail clients):
  - i. it should be accurate and not reference any potential benefit without giving a fair and prominent indication of any relevant risks;
  - ii. it shall not disguise, diminish or obscure important items, statements or warnings; and
  - iii. it should be up-to-date, relevant to the method of communication used.
14. ESMA's proposals on this topic will strengthen investor protection by improving the detailed requirements to comply with the obligation to provide clients with fair, clear and not misleading information. Benefits will also arise from the extension of some requirements to the relationship with professional clients.

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<sup>53</sup> Article 27(2) of the MiFID Implementing Directive.



## Draft technical advice

1. The content of Article 27 of the MiFID Implementing Directive should be modified in the areas below.
2. Information addressed to or likely to be received by retail clients or potential retail clients:
  - i. shall always give a fair and prominent indication of any relevant risks and shall not reference any potential benefits of an investment service or financial instrument without also giving a fair and prominent indication of any relevant risks;
  - ii. shall use a font size in the indication of relevant risks that is at least equal to the predominant font size used throughout the information provided, as well as a layout ensuring such indication is prominent;
  - iii. shall be consistently presented in the same language throughout all forms of information and marketing materials that are provided to each client; and
  - iv. shall be up-to-date, relevant to the method of communication used.
3. Where the information contains information on future performance, in addition to those already required by Article 27(6) of the MiFID Implementing Directive the following condition should be satisfied: the information provided should be based on performance scenarios in different market conditions (both negative and positive scenarios), and should reflect the nature and risks of the specific types of instruments included in the analysis.
4. Information addressed to or likely to be received by professional clients or potential professional clients:
  - i. shall not reference any potential benefits of an investment service or financial instrument without also giving a fair and prominent indication of any relevant risks;
  - ii. shall not disguise, diminish or obscure important items, statements or warnings; and
  - iii. shall be accurate and up-to-date, relevant to the method of communication used.

- Q65. Do you agree that the information to retail clients should be up-to-date, consistently presented in the same language, and in the same font size in order to be fair, clear and not misleading?**
- Q66. Do you agree that the information about future performance should be provided under different performance scenarios in order to illustrate the potential functioning of financial instruments?**
- Q67. Do you agree that the information to professional clients should comply with the proposed conditions in order to be fair, clear and not misleading? Do you consider that the information to professional clients should meet any of the other conditions proposed for retail clients?**



## 2.13. Information to clients about investment advice and financial instruments

### Background/Mandate

#### Extract from the Commission's request for advice (mandate)

*ESMA is invited to provide technical advice on future requirements concerning the provision and content of information to clients, including, where applicable, in relation to the type of investment advice and the range of financial instruments, the provision of a periodic suitability assessment or of information on financial instruments and in particular their complexity. ESMA should also consider possible improvements to the general information requirements set out in the Commission Directive 2006/73/EC. MiFID II introduces a number of additional requirements relating to the information to be provided to investors and potential investors, in particular when investment advice is provided and in relation to the characteristics of financial instruments (whether they are intended for retail or professional clients).*

1. The following provisions in MiFID II are relevant to this topic:

Article 24(4):

*“Appropriate information shall be provided in good time to clients or potential clients with regard to the investment firm and its services, the financial instruments and proposed investment strategies, execution venues and all costs and related charges. That information shall include the following:*

*(a) when investment advice is provided, the investment firm must, in good time before it provides investment advice, inform the client:*

*(i) whether or not the advice is provided on an independent basis;*

*(ii) whether the advice is based on a broad or on a more restricted analysis of different types of financial instruments and, in particular, whether the range is limited to financial instruments issued or provided by entities having close links with the investment firm or any other legal or economic relationships, such as contractual relationships, so close as to pose a risk of impairing the independent basis of the advice provided;*

*(iii) whether the investment firm will provide the client with a periodic assessment of the suitability of the financial instruments recommended to that client;*

*(b) the information on financial instruments and proposed investment strategies must include appropriate guidance on and warnings of the risks associated with investments in those instruments or in respect of particular investment strategies and whether the financial instrument is intended for retail or professional clients, taking account of the identified target market in accordance with paragraph 2”.*

2. The MiFID Implementing Directive includes several provisions on information to clients, including general requirements and requirements on specific aspects (Articles 28 to 34 of the MiFID Implementing Directive). Different sections of this CP deal with suggested measures arising from modifications in the MiFID II text (compared to MiFID I) or from the identified need to improve the existing implementing measures. In particular, specific sections of this paper address information about in-



vestment advice, financial instruments, costs and associated charges and safeguarding of client assets. Where appropriate, ESMA is proposing the extension of detailed information requirements to non-retail clients (eligible counterparties and professional clients). Improved disclosure to clients is also suggested in other specific areas, such as conflicts of interest and best execution.

3. While these proposals cover the most sensitive and relevant information requirements for investors, ESMA invites stakeholders to express any view they may have on the continuing appropriateness of any other information requirements that are not specifically addressed in this CP.

## **Analysis**

### *Information about advice (independent or not, range of financial instruments and periodic assessment of suitability)*

4. MiFID II introduces the provision of investment advice on an independent basis and envisages the possibility of periodic suitability assessments. Investment firms may establish different approaches to the scope of investment advice they provide according to their business model and the type of client they intend to approach, as well as factors such as the complexity, risks, and sector of financial instruments they advise on. ESMA therefore considers it important to properly explain the scope and the features of the advice provided to clients given the diverse types of advice offered by investment firms and the value added by providing this service in addition to the more straightforward marketing of financial instruments.
5. MiFID II requires that when investment advice is provided the investment firm must indicate to the client:
  - i. whether the advice is provided on an independent basis or not. In this respect ESMA considers that investment firms should explain in a clear and concise way whether and why investment advice could qualify as independent or not and the type and nature of the restrictions that apply in each case;
  - ii. whether the advice is based on a broad or restricted analysis of different types of instruments, and in particular whether the range is limited to financial instruments issued or provided by entities having close links or any other legal or economic relationship, so close to pose a risk of impairing the independence of the advice provided. In this respect, ESMA considers that investment firms should disclose the proportion of the total number of financial instruments analysed that is issued by the investment firm itself, or issued or provided by entities having close links or any other close legal or economic relationship with the investment firm. This detailed information should help clients to assess the quality of the advice provided and gain insight into the scope of the service provided. Investment firms providing advice on an independent basis should also inform clients about the selection process they adopt, the relevant aspects taken into consideration (such as risk, costs and complexity of the financial instruments); and
  - iii. if it will provide the client with the periodic assessment of the suitability of the financial instruments recommended to clients.
6. Given the recognition of independent advice as a specific type of investment advice, the option to provide a periodic assessment of suitability and the different business models in the market for the provision of investment advice, potential clients will need to review information provided to them to understand the type of service or services that they will receive. Firms should therefore provide in-



formation about the scope and nature of the investment advice service, including whether a periodic assessment of suitability will be performed, before the service is agreed. In accordance with existing requirements, such information should be provided in a durable medium.

#### *Information about financial instruments*

7. The features and structures of different financial instruments have in recent years become a key topic in the context of investor protection. The complexity of financial instruments often makes it difficult for investors to understand the risk to which they are exposed. In its recent work, ESMA has already focused on these issues by emphasising investment firms' obligations towards clients, including the information that should be provided to clients, when dealing in more complex products.<sup>54</sup>
8. ESMA considers that the results of this work can be used as a basis to implement MiFID II. In particular, while the content of Article 31 of the MiFID Implementing Directive can be confirmed, new requirements should require investment firms to provide clients with:
  - i. information about the functioning and performance of financial instruments in different market conditions;
  - ii. specific description when the disinvestment of specific financial instruments is subject to impediments or restrictions;
  - iii. the legal nature and status of financial instruments composed of two or more different financial instruments and how their interaction affects their risks (not only in situations in which risk has increased, as currently required); and
  - iv. information about financial instruments incorporating a guarantee or capital protection, not only in situations where a guarantee is provided by a third party (as currently required).
9. Furthermore, Article 24(4)(b) of MiFID II requires investment firms to inform the clients about whether the financial instrument is intended for retail or professional clients, taking into account the identified target market. ESMA considers that information provided to clients about the intended target market should not create any ambiguity or confusion about their own responsibilities in ensuring that the financial instrument is distributed to the identified target market.
10. The proposals in this area will increase investor protection by specifying the information that should be provided to investors and potential investors, so that clients are able to understand the scope and nature of investment advice provided to them and how the suitability of investment advice they have received will be ensured on an on-going basis. Further proposals concern the information that should be provided to clients on the nature and performance of financial instruments in different market conditions, aimed at ensuring that investors better understand the risks to which they are exposed.

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<sup>54</sup> ESMA/2014/146.





## **Draft technical advice**

### *Information about advice*

#### *Information provided about whether investment advice is independent or not*

1. Investment firms should inform clients if the advice is provided to them on an independent basis (based on the conditions defined in Article 24(7) of MiFID II) or not. Investment firms should explain in a clear and concise way whether and why investment advice could qualify as independent or not and the type and nature of the restrictions that apply.
2. Where both types of advice are intended to be proposed or provided to the same client, investment firms should (i) explain the scope of both services to allow investors to understand the differences between them; and (ii) avoid presenting itself as independent in a broad sense.

#### *Information about the broad or restricted analysis of different types of financial instruments*

3. When an investment firm intends to provide investment advice on an independent or non-independent basis it must explain to the client the range of financial instruments that may be recommended, including its relationship with the issuers or providers of the instruments.
4. Investment firms should provide a description of the types of financial instruments considered, the total number of financial instruments and providers analysed per each type of instrument according to the scope of the service, and, when applicable, how the service provided satisfies the conditions for the provision of independent advice. The basis of the selection process used by the investment firm to recommend financial instrument(s) should also be provided.
5. When the range of financial instruments assessed by the investment firm includes the investment firm's own financial instruments or those issued or provided by entities having close links or any other close legal or economic relationship with the investment firm and other issuers or providers, the investment firm should distinguish, for each type of financial instrument, the proportion of the financial instruments issued or provided by entities not having any links with the investment firm.

#### *Information about the periodic assessment of suitability*

6. Where the investment advice service includes a periodic assessment of the suitability of the recommendations provided, investment firms should disclose:
  - i. the frequency and extent of the periodic suitability assessment and where relevant, the conditions that trigger that assessment;
  - ii. the extent to which the information previously collected will be subjected to re-assessment; and
  - iii. the way in which an updated recommendation will be communicated to the client.
7. Investment firms that provide a periodic suitability assessment should consider reviewing the

suitability of the recommendations given in order to enhance the service at least annually. The frequency of this assessment should be increased depending on the risk profile of the client and the type of financial instruments recommended.

**Q68. Do you agree with the objective of the above proposals to clarify the distinction between independent and non-independent advice for investors?**

*Information about financial instruments*

The content of Article 31 of the MiFID Implementing Directive should be modified in the areas below.

8. Article 31(1) should provide for an additional requirement for investment firms to inform clients about the functioning and performance of financial instruments in different market conditions (including both positive and negative conditions).
9. Article 31(2), relating to the description of risks, should specifically address the risk of financial instruments involving impediments or restrictions for the disinvestment (for example as may be the case for illiquid financial instruments or financial instruments with a fixed investment term). Information on impediments or restrictions should include an illustration of the possible exit methods and consequences of any exit, possible constraints and the estimated time frame for the sale of the financial instrument.
10. Where a financial instrument is composed of two or more different financial instruments or services, the investment firm shall provide an adequate description of the legal nature and status of the financial instrument, the components of the instrument and the way in which the interaction between components affects the risks of the investment.
11. In the case of financial instruments that incorporate a guarantee or capital protection, the information shall specify the scope and nature of such guarantee or capital protection. When the guarantee is provided by a third party, the information about the guarantee shall include sufficient detail about the guarantor and the guarantee to enable the retail client or potential retail client to make a fair assessment of the guarantee.
12. Information on financial instruments may be provided in a standardised format such as a product fact sheet.

**Q69. Do you agree with the proposal to further specify information provided to clients about financial instruments and their risks?**

**Q70. Do you consider that, in addition to the information requirements suggested in this CP (including information on investment advice, financial instruments, costs and charges and safeguarding of client assets), further improvements to the information requirements in other areas should be proposed? If yes, please specify, by making reference to existing requirements in the MiFID Implementing directive.**



## 2.14. Information to clients on costs and charges

### Background/Mandate

#### Extract from the Commission's request for advice (mandate)

*ESMA is invited to provide technical advice on measures specifying the requirement to provide information on all costs and associated charges set out in Article 24(4)(c). In particular, ESMA should provide technical advice on:*

- the costs and charges to be disclosed to clients as well as their aggregation, which could be expressed both as a cash amount and as a percentage;*
- the format and timing of disclosure (ex-ante and ex-post) of information on costs and charges, including methodologies to calculate ex-ante costs;*
- appropriate modalities to provide such information to professional clients and eligible counterparties;*
- the scope of investment firms subject to this obligation bearing in mind the objective to ensure such important information is provided on the broadest possible basis and bearing in mind situations where more than one investment firm provides investment or ancillary services to a client;*
- the requirements to be met by firms when providing their clients with information on the cumulative effect of costs on return in order to increase the client's understanding and awareness of the cumulative effect of costs and charges on their investment.*

*In developing its advice, ESMA should consider how these requirements could apply to communications to eligible counterparties, taking into consideration that MiFID II extends some of the investor protection requirements to the relationship with eligible counterparties (Article 30). Recital 104 of MiFID II reminds that the "financial crisis has shown limits in the ability of non-retail clients to appreciate the risk of their investments. (...) To that extent, it is appropriate to extend some information and reporting requirements to the relationship with eligible counterparties". Reference is also made to requirements in the area of safeguarding of client financial instruments and funds. Article 24(4) of MiFID II has clarified the MiFID I provision relating to information to clients on costs and charges. Article 33 of the MiFID Implementing Directive already requires investment firms to provide information on costs and charges to be paid by clients.*

1. Article 24(4) of MiFID II has clarified the MiFID I provisions relating to information to clients on costs and charges. Article 33 of the MiFID Implementing Directive already requires investment firms to provide information on costs and charges to be paid by clients. Article 24(4) of MiFID II sets additional requirements with regard to information about costs and also clarifies some existing requirements. This article now reads as follows:

*"Appropriate information shall be provided in good time to clients or potential clients with regard to the investment firm and its services, the financial instruments and proposed investment strategies, execution venues and all costs and related charges. That information shall include the following:*

[...]

c) the information on all costs and associated charges must include information relating to both investment and ancillary services, including the cost of advice, where relevant, the cost of the financial instrument recommended or marketed to the client and how the client may pay for it, also encompassing any third-party payments.

*The information about all costs and charges, including costs and charges in connection with the investment service and the financial instrument, which are not caused by the occurrence of underlying market risk, shall be aggregated to allow the client to understand the overall cost as well as the cumulative effect on return of the investment, and where the client so requests, an itemised breakdown. Where applicable, such information shall be provided to the client on a regular basis, at least annually, during the life of the investment”.*

2. Article 24(5) of MiFID II continues with a description of the format of the disclosure (“*shall be provided in a comprehensible form*”) and determines that “Member States may allow that information to be provided “*in a standardised format*”.
3. Article 33 of the MiFID Implementing Directive already requires information on costs and charges to be provided to clients, including information on the total price to be paid by clients including related fees: “*the total price to be paid by the client in connection with the financial instrument or the investment service or ancillary service, including all related fees, commissions, charges and expenses, and all taxes payable via the investment firm...*”. Notwithstanding the detail of Article 33 of the MiFID Implementing Directive, the text could still result in different applications by investment firms because of certain ambiguities in the drafting. For instance, Article 33:
  - i. refers to all related fees, commissions, charges or expenses, but it does not provide any further specification that could help the common understanding and application of these items; and
  - ii. emphasises the possibility that other costs related to transactions may arise for the clients that are not imposed by the firm (i.e. this could imply that costs arising from third parties may be excluded from disclosure).
4. The MiFID Implementing Directive provides that, except in specific cases, information to clients on costs has to be provided in good time *before* the provision of the investment or ancillary service.
5. The new regime on information about costs and charges includes requirements on any kinds of third party payments paid or received by the firm in connection with the service provided to the client. Article 24(9) of MiFID II refers to the conditions that third party payments must comply with and the requirement to disclose such payments. It states: “*the existence, nature and amount of the payment or benefit [...] or, where the amount cannot be ascertained, the method of calculating that amount, must be clearly disclosed to the client, in a manner that is comprehensive, accurate and understandable, prior to the provision of the relevant investment or ancillary service*”.

## **Analysis**

6. Cost disclosure, together with the disclosure about risk, is an important element to improve the ability of investors to assess the products that are offered to them. The development of the regulatory



framework in the EU, especially in the areas of MiFID and PRIIPs<sup>55</sup>, underlines the importance and relevance of costs for investors, and the difficulties experienced by investors in understanding the overall costs of their investments and/or the actual impact on returns. With this in mind, MiFID II has been drafted to improve information on costs and charges.

7. MiFID II includes the following key aspects:
  - i. all costs and associated charges related to investment/ancillary services and financial instruments should be disclosed to clients;
  - ii. the client should be informed about the method of payment, including when payments are provided by third parties;
  - iii. clients should be provided with an aggregated overview of all costs and charges of the investment, including the possibility to request an itemised breakdown;
  - iv. the information provided to the client should allow him to understand the cumulative effect of costs and charges on the return of the investment; and
  - v. clients should be provided with the above information at point of sale (ex-ante) as well as, where applicable, on an ex-post basis.
8. In order for investment firms to fulfil their MiFID obligations in relation to the disclosure of costs, investment firms should be provided with reliable information about the costs and charges related to financial instruments by the product manufacturer. Recital 78 states that:

*“Where sufficient information in relation to the costs and associated charges or to the risks in respect to the financial instrument itself is provided in conformity with other Union law that information should be regarded as appropriate for the purposes of providing information to clients under this Directive. However, investment firms or credit institutions distributing that financial instrument should additionally inform their clients about all the other costs and associated charges related to their provision of investment services in relation to that financial instrument”.*
9. This recital clarifies that for costs relating to the financial instrument, investment firms may rely on the information that the product manufacturer or issuer of the financial instrument is obliged to publish under existing Union law. According to ESMA this means that investment firms may rely on information on costs of the relevant financial instrument as disclosed in the prospectus and the UCITS key investor information document (KIID) or PRIIPs key information document (KID). However, the recital also makes clear that reliance on such disclosure documents is subject to the assumption that all costs relating to the financial instrument are disclosed in that document.
10. Article 24(4) of MiFID II only excludes those costs caused by the occurrence of underlying market risk.
11. This CP addresses the following topics:

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<sup>55</sup> Regulation (EU) of the European Parliament and of the Council on key information documents for packaged retail and insurance based investment products (PRIIPs) Packaged Retail and Insurance based Investment Products (PRIIPs).



#### *Scope – professional clients and eligible counterparties*

12. Article 33 of the MiFID Implementing Directive (“Information about costs and associated charges”) applies to retail clients only.
13. ESMA notices that, as also emphasised by the Commission in its request for technical advice, the extension of certain safeguards to the relationship between investment firms and non-retail clients (including eligible counterparties) has been one of the innovative elements of the review of MiFID.
14. ESMA considers that increased transparency on costs is relevant for all categories of clients, including non-retail clients. Therefore, ESMA proposed that the implementing measures proposed in this chapter should apply, in line with the MiFID II text, to all categories of clients.
15. ESMA considers, however, that, considering the different status of professional clients and eligible counterparties, clients in these categories should have the possibility, in certain cases, to opt-out from the application of the detailed requirements described in the following sections of this chapter (for instance they could choose not to receive post-sale periodic disclosure).
16. This possibility should however be excluded in situations in which, the nature of the services provided or the financial instruments concerned justifies the full application of the requirements, including in the relationship with non-retail clients. In particular, the possibility to opt-out from the application of these requirements should not be possible in the following cases:
  - i. when the services of investment advice or portfolio management are provided; or
  - ii. when, irrespective of the investment service provided, the financial instruments concerned embed a derivative.

#### *Scope - point of sale disclosure (ex-ante)*

17. According to Article 24(4) of MiFID II, there is a general duty to inform the clients about “*all costs and associated charges*” related to the services provided and the financial instruments. More specifically:
  - i. Article 24(4)(c) subparagraph 1 of MiFID II requires that information on costs and charges should “*include [...] the cost of the financial instruments recommended or marketed*”; and
  - ii. Article 24(4)(c) subparagraph 2 of MiFID II requires that “*all costs and charges*” shall be aggregated.
18. ESMA considers that the implementation of these requirements should take into account the overarching obligation to act in accordance with the best interest of clients, which applies to the provision of investment services to clients and the importance of making the client aware, on an ex-ante basis, of costs and charges. For the purpose of this rule, ESMA considers that the above reference to the financial instruments “*recommended or marketed*” should be understood in a broad manner. In particular, it should include firms providing the investment services of portfolio management or investment advice to their clients. It should also include firms providing general recommendation concerning financial instruments or promoting certain financial instruments in the provision of investment and ancillary services to clients. For this purpose it can be assumed that an investment firm that has



entered into distribution and/or placement agreements with a product manufacturer or issuer will recommend or market financial instruments from that product manufacturer or issuer.

19. In accordance with the overarching obligation mentioned above and taking into account the obligations resulting from specific legislation regulating certain financial instruments (in particular, UCITS and PRIIPs), ESMA considers that investment firms should disclose and aggregate all costs and charges, including the costs of the financial instrument, in all cases where investment firms are obliged to provide the client with information about the costs of a financial instrument in accordance with Union legislation – even when the investment firm has not recommended or marketed the financial instrument concerned. This is typically the case, for instance, with investment firms obliged to provide clients with the KIID or the KID in accordance with UCITS or PRIIPs legislation.
20. Based on the above and the MiFID II legal text, if an investment firm does not recommend or market certain financial instruments to the client (i.e. passively provides execution of orders services) and is not subject to the obligation to provide the client with a KID/KIID in relation to the financial instrument concerned, the firm is only required to inform the client, on an ex-ante basis, about all costs and charges relating to the service. The limitation above is intended to reflect the fact that, if an investment firm has not actually marketed or recommended a financial instrument and the relevant financial instrument is not associated with a KID/KIID, the investment firm may not be in the position to take into account all the costs associated with that instrument.
21. Even in these residual instances, ESMA would like to emphasise that “costs of the instrument” are distinct from “price of the instrument” and that the proposals above should not relieve the firm from disclosing the price of acquiring the relevant financial instruments. Furthermore, the investment firm is still required to comply with any other MiFID II obligations to provide appropriate information about the risk of the relevant financial instrument in accordance with Article 24(4)(b) of MiFID II and to provide clients, on an ex-post basis, with adequate reports on the service provided in accordance with Article 25(6) of MiFID II (which also includes cost elements).
22. In some cases more than one firm is involved in the processing of a client’s investment. The question then arises as to whether an investment firm having recommended or marketed the financial instrument to the client should take into account the costs charged by other firms. For example, an investment firm is in charge of the provision of the portfolio management service to a client, but does not provide custody services. ESMA considers that this investment firm should only take into account the costs related to the custody services if it directs the client to a particular custodian (or chooses a custodian on behalf of the client). In other cases (i.e. where a client itself chooses a custodian), the investment firm providing portfolio management services is not in a position to take into account the cost charged by that custodian. An investment firm should only take into account the costs associated to the provision by other firms of other investment or ancillary services (on top of the costs associated to the services provided by itself) if it has directed the client to these firms. The costs charged by the firm or such other parties associated to services should be disclosed separately (see Example 3).
23. Given the need to ensure the implementation of this provision is proportionate to the service provided and to the circumstances of the relationship with clients, ESMA does not feel it is appropriate to mandate whether the disclosure should be provided at a ‘service’ level or at an ‘individual financial instrument’ level. It is for firms to decide what is appropriate. In the case of multiple financial instruments, if the disclosure is provided at a service level it should not make it difficult for the client to understand and assess the impact of costs and charges for each financial instrument.

### *Third party payments (inducements)*

24. Due to the different business models, investment firms may not always directly and/or fully charge the client with a commission or charge for their services. Instead they may receive payments from third parties. In such cases, the client indirectly pays the investment firm for the services rendered through higher commissions included in the charges and/or in the price of the financial instruments, which are subsequently (partially) passed on to the investment firm.
25. MiFID II sets the conditions for the acceptance of third party payments by investment firms (inducements) under Article 24(9). In accordance with this article, an investment firm should provide its clients with information on the existence, nature and amount of third party payments received, or, where the amount cannot be ascertained, the method of calculating that amount. In addition, Article 24(4)(c) of MiFID II requires that information about third-party payments is provided to clients in the context of information on costs and associated charges.
26. The information provided to clients about third party payments should allow the client to ascertain the total costs of the service provided and to compare between different services, financial instruments and investment firms, prior to the provision of the service. In these situations, the client should be informed about how he indirectly pays for the service, as this will have an effect on the total costs paid. For example, an investment firm may receive rebates paid out of the management fees from the management company for investment advice provided by the investment firm in relation to a collective investment scheme. In that case, the rebates are considered to be the income of the investment firm for the service provided to the client. The client has paid for this service through the charges in the financial instrument. ESMA advises the Commission that third party payments received by investment firms shall be regarded as part of the cost of the service, in order to reflect the fact that the client will pay them through the charges or the price of the financial product.
27. Example 4 below illustrates how the disclosure of third party payments should interact with the disclosure of the aggregated costs and charges.

### *Scope – aggregation of costs and charges*

28. Article 24(4)(c), subparagraph 2 of MiFID II, requires that “*all costs and charges*” shall be aggregated in order to allow the client to understand the overall cost as well as the cumulative effect on return of the investment. This section of this chapter considers the scope of application of this requirement, while subsequent sections discuss the details of the costs and charges that have to be aggregated.
29. ESMA considers that, in accordance with the obligation to disclose costs and charges, investment firms should aggregate information about the costs related to the financial instrument and costs related to investment or ancillary services when they recommend or market financial instruments to clients or when they are required to provide specific disclosure about the costs of the financial instrument in accordance with relevant Union legislation (e.g. where the relevant instrument is subject to the UCITS KIID or the PRIIPs KID). The details of the costs and charges that have to be aggregated are in the ‘Costs and charges to be aggregated’ section of this chapter.

### *Scope – periodic post sale disclosure*

30. Article 24(4)(c) subparagraph 2 of MiFID II also requires that “*where applicable*” information on costs and charges should be provided to the client on a regular basis, at least annually, during the life of the investment.



31. ESMA would like to identify the situations in which investment firms are subject to the periodic post sale disclosure requirement to provide aggregated information on all costs and charges (i.e. define what “*where applicable*” means in practice). In particular, ESMA considers that investment firms that offer a ‘one-off’ investment service should not be required to provide their clients with periodic information about costs related to the financial instruments. If the investment firm only provides ‘one-off’ investment services (such as execution of orders on one occasion or advice on a particular transaction), the investment firm should not be obliged to annually disclose aggregated information about the incurred costs and charges related to the ‘one-off’ investment service(s) provided, as the investment firm would not generally have any such on-going costs or charges to report.
32. However, ESMA advises the Commission that an investment firm should be required to provide annual post-sale aggregated information about costs and charges related to both the financial instrument(s) and investment and ancillary service(s) if it has recommended or marketed financial instruments (or has provided the client with the KID/KIID) and it has a continuing relationship with the client (such as portfolio management or a continuing advisory relationship). The MiFID Implementing Directive already establishes certain post-sale reporting obligations for firms providing execution of orders other than portfolio management (Article 40), portfolio management (Article 41) or holding client financial instruments or funds (Article 43). The current reporting obligations can be used as a basis to comply with the additional post-sale periodic disclosure requirements provided under Article 24(4) of MiFID II.
33. ESMA therefore advises the Commission to include additional reporting obligations in order to reflect Article 24(4) of MiFID II. These additional reporting obligations are set out below for different types of investment service (please note that the list provided is for indicative purposes only, and is not intended to be an exhaustive list of the relevant investment or ancillary services). As discussed in paragraph 22, the disclosures listed should include the costs and charges related to the provision of any other investment or ancillary service provided by the investment firm or any other party to which the investment firm has directed the client:
  - i. **Reporting obligations in respect of execution of orders other than for portfolio management:** In addition to the current reporting obligations in Article 40 of the MiFID Implementing Directive and where there is a continuing relationship with the client (for example, where a trading account has been established and is in active use), ESMA advises the Commission that the investment firm should annually aggregate costs and charges related to the provision of the execution or reception and transmission of orders services carried out during the year. No further disclosure requirements are recommended in regard to one-off execution services (other than the existing reporting requirements already required in accordance with Article 40 of the MiFID Implementing Directive).
  - ii. **Portfolio management:** In addition to the current reporting obligations in Article 41 of the MiFID Implementing Directive, ESMA proposes that the investment firm should annually aggregate all costs and charges (meaning costs related to both the portfolio management services and the financial instrument(s)) incurred during the year and where the client so requests, an itemised breakdown should be provided.
  - iii. **Investment advice:** There are currently no reporting obligations in the MiFID Implementing Directive. ESMA proposes that with regard to one-off advice there should be no specific periodic post-sale obligation for the investment firm to provide information about the overall costs and charges. However, with regard to ‘on-going’ investment advice (i.e. in the case that a client re-

quests a periodic suitability assessment or a continuing advisory relationship is otherwise established), ESMA advises the Commission that an investment firm should be required to annually aggregate all costs and charges (meaning costs related to both the investment service and the financial instrument(s)) incurred during the year and where there the client so requests, an itemised breakdown should be provided.

34. In addition to the obligations above, as proposed in the chapter on inducements, in all cases where an investment firm receives on-going payments by a third party in connection with the provision of an investment or ancillary service to a client, the investment firm should inform its clients on an individual basis, at least once a year, about the actual amount of the inducement received (ESMA notes that, as expressed in the section on the legitimacy of third party payments, on-going inducements should be justified by the provision of on-going services to clients). The same obligation applies when an investment firm was unable to ascertain on an ex-ante basis the amount of any payment or benefit it was to receive, and instead disclosed to the client the method of calculating that amount (in accordance with Article 24(9) of MiFID II); in that case, the investment firm should also provide the client with post-sale information on the exact amount of the inducement received.

#### *Costs and charges to be aggregated*

35. ESMA has identified various cost items that are related to investment and ancillary services and the different types of financial instruments that are not caused by the underlying market risk. ESMA considers that these identified costs should form part of the costs to be disclosed to the clients. These cost items are listed in the Annex to this chapter.
36. Moreover, ESMA notes that currently the UCITS KIID does not include an obligation to provide information about transaction costs.<sup>56</sup> Taking into account Recital 78 of MiFID II this could mean that the information currently provided in conformity with the UCITS KIID would be different in scope compared to MiFID II requirements, in which case the investment firms or credit institutions recommending or marketing UCITS should additionally provide their clients with information about the transaction costs. These transaction costs have therefore been included in the Annex to this chapter, as Article 24(4) refers to all costs related to the financial instruments, and only excludes costs that are caused by the occurrence of the underlying market risk.
37. ESMA notes however that the PRIIPs Regulation introduces a KID to be produced for all packaged retail investment products, including potentially UCITS. The KID will have to disclose costs associated with the investment comprising both direct and indirect costs, one-off and recurring costs. In this light ESMA therefore advises the Commission to further consider this issue in the UCITS/PRIIPs context. This is essential because the investment firm providing disclosure in the context of MiFID should be able to rely, as per Recital 78 of MiFID II, on the costs and charges disclosed in the PRIIPs KID when aggregating the costs and charges according to MiFID II.

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<sup>56</sup> However, where the impact of portfolio transaction costs on returns is likely to be material due to the strategy adopted by the UCITS, a statement to this effect must be included in the KIID, making it also clear that portfolio transaction costs are paid from the assets of the fund (c.f. Article 7(2)(e) of the Level 2 KIID Regulation. The reasons behind CESR's decision not to recommend explicit disclosure of portfolio transaction costs in the UCITS KIID are set out in the Consultation paper on technical issues relating to Key Investor Information Document (KIID) disclosures for UCITS (CESR/09-047). See paragraphs 30-32 of Chapter 3. However the PRIIPs proposal, which might eventually lead to the PRIIPs KID replacing the UCITS KIID, does not exclude these costs.



38. In order for the client to understand the overall costs of the services provided and the financial instruments, an investment firm should aggregate:
- i. all costs and associated charges charged by the investment firm or other parties where the client has been directed to such other parties for the investment services(s) and/or ancillary services provided to the client; and
  - ii. all costs and associated charges associated with the manufacturing and managing of the financial instruments.
39. The amount that should be disclosed to the client (both ex-ante and ex-post) should be an aggregation of the abovementioned two elements (which consist of the costs and charges that are listed in the Annex to this chapter). ESMA also advises the Commission that the aggregated amount should generally be one single figure that is expressed in a cash amount and a percentage. If a client requests an itemised breakdown of the overall costs, such a breakdown should be provided by the investment firm. The breakdown should make it possible for the client to have insight in the underlying cost items as listed in the Annex to this chapter.
40. To illustrate how the aggregated costs and charges could be disclosed, a number of examples are provided below. These examples are for illustrative purposes only and do not represent a prescribed format.

Example 1

41. A client has €100,000 to invest and subscribes to a portfolio management service. The portfolio manager charges 2% to create and implement the agreed investment portfolio, with the client's monies invested in a range of ordinary shares. This 2% initial charge also covers the costs of managing the portfolio in the first year, with a 0.75% charge levied for all subsequent years. The aggregated costs and charges associated with the investment service and financial instrument could be disclosed to the client in the form of the following table:

Costs and charges	Initial costs <sup>57</sup>		On-going annual fees for subsequent years <sup>58</sup>	
all costs and associated charges charged by the portfolio manager or other parties for the investment service(s) and/or ancillary services	2%	€2,000	0.75%	€750
all costs and associated charges associated with the financial instruments <sup>59</sup>	-	-	-	-
<b>Aggregated overall costs</b>	<b>2%</b>	<b>€2,000</b>	<b>0.75%</b>	<b>€750</b>

### Example 2

42. A client invests €50,000 in a structured investment product after receiving advice from an independent adviser.
43. The client paid the adviser €1,000 for the advice and to implement the recommendations. The client also agrees to pay the adviser 0.5% per annum to assess the on-going suitability of the investment.
44. The structured product has a 2% upfront fee, a total on-going annual charge of 0.4% and would impose a 4% exit penalty if the investment was cancelled within the first 5 years.
45. The aggregated costs and charges associated with the investment service and financial instrument could be disclosed to the client in the form of the following table:

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<sup>57</sup> The *initial costs* include any fees or other costs due when the share portfolio is established and the first year's costs associated with the investment service or financial instrument. So in this example, it reflects the cost of establishing and implementing the portfolio management service.

<sup>58</sup> The *ongoing annual fees for subsequent years* include all ongoing charges associated with investment service and financial instrument. In this example, there are no costs associated with the shares held by the client, with a 0.5% ongoing charge payable for the portfolio management service.

<sup>59</sup> There are no costs or charges associated with purchasing or holding the ordinary shares (for the purpose of this example, ESMA has assumed there are no transactional taxes associated with the trade). Any broker or transaction costs associated with purchasing the shares are reflected in the cost of the portfolio management service.

<b>All costs and charges</b>	<b>Upfront costs<sup>60</sup></b>		<b>On-going costs<sup>61</sup></b>		<b>Exit costs<sup>62</sup></b>	
all costs and associated charges charged by the adviser or other parties for the investment service(s) and/or ancillary services	2%	€1,000	0.5%	€250	€0	0%
all costs and associated charges associated with the financial instruments	2%	€1,000	0.4%	€200	4%*	€2,000*
<b>Aggregated overall costs</b>	<b>4%</b>	<b>€2,000</b>	<b>0.9%</b>	<b>€450</b>	<b>4%*</b>	<b>€2,000*</b>

\*The exit cost associated with the financial instrument is only payable in the event that the instrument is cashed in within 5 years of its inception.

### Example 3

46. A client invests €80,000 in a structured investment product after receiving advice from an independent adviser. The client paid the adviser €800 for the advice provided. The adviser then referred the client to an execution broker who arranged and implemented the recommended financial instrument. The client paid €400 to the execution broker for their services. The client did not enter into an on-going service agreement with either the adviser or execution broker. The structured product had a 2.5% upfront fee, a total on-going annual charge of 0.5%.
47. The aggregated costs and charges associated with the investment services and financial instrument could be disclosed to the client in the form of the following table:

<sup>60</sup> The *upfront costs* include any fees or other costs associated with the initial advice provided and to set up the financial instrument. So in this example, it reflects the cost of the advice received and implementing of the recommendations, plus the upfront fee associated with the structured product.

<sup>61</sup> The *ongoing costs* include all ongoing charges associated with investment service and financial instrument. In this example, this includes the fee payable to the adviser for conducting an ongoing assessment of suitability and the total ongoing costs associated with the structured product.

<sup>62</sup> The *exit costs* include any exit charges due if the client cancels the investment advice service or cancels the financial instrument. So in this example, there are no costs to cancel the ongoing advice service but the client would incur a 4% charge if the structured investment product was cancelled within five years of its inception.

<b>Costs and charges</b>	<b>Initial costs<sup>63</sup></b>		<b>On-going costs<sup>64</sup></b>	
all costs and associated charges charged by the independent adviser	1.00%	€800	0.00%	€0
all costs and charges charged by the execution broker associated with the reception, transmission and execution of the order	0.50%	€400	0.00%	€0
all costs and associated charges associated with the financial instruments	2.50%	€2,000	0.50%	€400
<b>Aggregated overall costs</b>	<b>4%</b>	<b>€3,200</b>	<b>0.50%</b>	<b>€400</b>

48. For on-going costs in Examples 1, 2 and 3, any potential growth in the investment has not taken into account. Work to develop the PRIIPs implementing measures is likely to consider how projected future growth of the investment should be accounted for when disclosing aggregated costs in the PRIIPs KID. Any position reached on this is likely to have relevance to the MiFID II costs disclosure document.
49. Examples 1, 2 and 3 assume the client pays a separate charge for the financial instruments and investment services. Where a client receives non-independent advice or invests in a financial instrument without seeking financial advice, the investment firm may receive a commission payment from the financial instrument manufacturer for arranging the sale of the instrument. As such the client would not pay any monies directly to the investment firm. Where a manufacturer pays a fee, commission or monetary inducement to an investment firm, this shall be disclosed separately from the cost of the financial instrument as cost of the service. This enables the client to compare costs and charges across different instruments and services. This is illustrated in Example 4.

#### Example 4

50. A client invests €25,000 in a mutual fund through a broker without receiving financial advice. The mutual fund includes a 5% upfront charge and a total on-going annual charge of 0.5%. There are no exit penalties or other charges associated with the mutual fund, although the mutual fund manufacturer makes a 3% commission payment to the execution-only broker for arranging the sale of the mutual fund. The aggregated costs and charges associated with the investment service and financial instrument could be disclosed to the client in the form of the following table, which should make the client aware that part of the fees he paid for the financial instruments are rebated to the broker providing the investment service:

<sup>63</sup> The *initial costs* include any fees or other costs associated with the initial advice provided and to set up the financial instrument. So in this example, it reflects: (i) the fee paid to the independent adviser for the advice provided; (ii) the fee paid to the execution broker for arranging and implementing the recommended investment and (iii) the upfront fee associated with the structured product.

<sup>64</sup> The *ongoing costs* include all ongoing charges associated with investment service and financial instrument. In this example, there is no ongoing investment service provided to the client by either the adviser or execution broker. The only ongoing cost is the 0.5% ongoing annual charge associated with the structured investment product.

<b>Costs and charges</b>	<b>Upfront fees<sup>65</sup></b>		<b>On-going fees<sup>66</sup></b>	
all costs and associated charges associated with the financial instruments	5%	€1,250	0.5%	€125
<i>- of which: costs and associated charges for investment service(s) and/or ancillary services paid by third parties to the broker (arrangement fee)</i>	(3%)	(€750)	(0%)	(€0)
<b>Aggregated overall costs</b>	<b>5%</b>	<b>€1,250</b>	<b>0.5%</b>	<b>€125</b>

51. The 3% (€750) commission payment in Example 4 is now allocated to the costs related to the investment services. However in disclosing this amount through such an illustration the investment firm should also provide an explanation about the nature of this amount in a comprehensive, accurate and understandable manner. In other words it should be clear to the client that this amount is a third party payment.
52. It is not necessary to separately disclose any non-monetary inducements provided by an investment manufacturer to an investment firm unless these are of significant value. Any inducement that meets the definition of a minor non-monetary benefit is unlikely to be significant.

#### *Timing and format of disclosure*

##### Point of sale disclosure of information (ex-ante disclosure)

53. ESMA considers that the aggregated information about all costs and charges should be provided to (potential) clients in good time before the provision of the investment and/or ancillary service (point of sale disclosure). The (potential) clients should be allowed enough time to consider material information when they make their investment decisions.
54. This means that the information on costs and charges should be provided early in the investment process, so that the investor should have enough time to evaluate the information and compare different financial instruments and investment services with each other.
55. Article 24(5) of MiFID II requires that the information about costs and charges shall be provided in a comprehensible form and that Member States may allow that information to be provided in a standardised format. ESMA considers that the word “standardised” refers to the formal appearance, con-

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<sup>65</sup> The *upfront fees* include any fees or other costs associated with the investment service or financial instrument. In this example, there is an initial 5% charge associated with the mutual fund. However, 3% of this is paid to the execution-only broker for arranging the sale of the mutual fund. 3% of the total upfront charge is therefore attributable to the cost of the investment service and 2% to the financial instrument.

<sup>66</sup> The *ongoing fees* include all ongoing charges associated with investment service and financial instrument. In this example, there is a 0.5% ongoing charge associated with the mutual fund.



tent and layout only. “Standardised” does not therefore determine whether the disclosure has to be individualised or generic.

56. ESMA is of the view that for the purpose of point of sale disclosure the information provided about the costs related to the financial instrument can be provided on a generic basis as long as the investment firm ensures that the costs and charges provided in the generic disclosure are representative of the costs that the client would actually incur. This would ensure consistency between information provided by UCITS KIID and an eventual PRIIPs KID, which is not personalised. Recital 78 of MiFID II clarifies that for costs relating to the financial instrument, investment firms may rely on the information that the product manufacturer or issuer of the financial instrument is obliged to publish under existing Union law. However, with regard to information provided about the costs related to the investment and/or ancillary services, the investment firm should provide personalised/tailored information of the costs that the client will incur. For example, if an investment firm offers two levels of services; a basic service and premium service, and if a client was likely to subscribe to the premium service, it would not be appropriate to disclose the costs of the basic service to that client as this could mislead the client.

#### Methodology of calculation of ex-ante figures

57. The methodology for calculating ex-ante cost figures should be based on the principle that the investment firm should use costs actually incurred as a proxy for the expected costs and charges. If actual costs are not available, the investment firm should make reasonable estimations of these costs. Moreover the investment firm shall have an obligation to review its ex-ante assumptions based on the ex-post experience and should make adjustments to these assumptions, if necessary.

#### Post-sale periodic disclosure of information (ex-post disclosure)

58. The current ex-post information, as prescribed by Article 40 and Article 41 of the MiFID Implementing Directive is provided on a personalised basis, and is based on actual costs incurred. In line with this ESMA proposes that the additional periodic reporting requirements as proposed in this CP should also be provided on a personalised basis, using costs actually incurred.

#### Cumulative effect of costs on return

59. ESMA considers that an investment firm should be obliged to provide its clients both ex-ante and ex-post with an illustration showing the cumulative effect of costs on return when providing investment services, such as portfolio management and investment advice. The illustration should help the client to understand the overall costs and should increase the client’s understanding of the cumulative effect of costs and charges on the investment. The illustration can be a graph, a table or a narrative and should be provided at the point of sale. When providing the illustration the investment firm should ensure that the illustration meets the following high level requirements:
- i. the illustration shows the effect of the overall costs and charges on the return of the investment;
  - ii. the illustration shows any anticipated spikes or fluctuations in the costs, such as high costs in the first year of the investment (upfront fees), lower costs in the subsequent years (on-going fees) and higher costs at the end of the investment (exit fees); and
  - iii. the illustration is accompanied by an explanation of what the illustration shows.





## **Draft technical advice**

### *Scope – professional clients/eligible counterparties*

1. Detailed information on costs and associated charges should be made available to professional clients and eligible counterparties.
2. When providing investment services to professional clients and eligible counterparties, investment firms shall be able to agree a limited application of these requirements, except in the following situations:
  - i. when the services of investment advice or portfolio management are provided, or
  - ii. when, irrespective of the investment service provided, the financial instruments concerned embed a derivative.

### *Scope – point of sale disclosure (ex-ante)*

3. The obligation to provide a full point of sale disclosure, where aggregated information about the costs related to the financial instrument and the costs related to the investment or ancillary service is provided, should apply to investment firms in the following situations:
  - i. when the investment firm recommends or markets financial instruments to clients; or
  - ii. when the investment firm providing any investment services is required to provide clients with a KID/KIID in relation to the relevant financial instruments, in accordance with relevant Union legislation.
4. If the investment firm does not recommend or market a financial instrument to the client and is not obliged to provide the client with a KID/KIID in accordance with relevant Union legislation, the investment firm has to inform the client about all costs and charges relating to the investment and/or ancillary service provided.
5. When more than one investment firm provides investment or ancillary services to the client, each investment firm should provide information about the costs of the investment or ancillary services it provides. An investment firm that recommends or markets to its clients the services provided by another firm, should aggregate the cost of its services together with the cost of the services provided by the other firm.
6. Third party payments received by investment firms in connection with the investment service provided to a client shall be regarded as part of the cost of the service provided to the client.

### *Scope of post-sale periodic disclosure*

7. Investment firms should be obliged to provide annual post-sale information about all costs and charges related to both the financial instrument(s) and investment and ancillary service(s) if they have recommended or marketed the financial instrument(s) or they have provided the client with the KID/KIID in relation to the financial instrument(s) and it has a continuing relationship with the cli-

ent.

8. Investment firms should be allowed to provide aggregated information on costs and charges of the investment services and the financial instruments together with any existing periodic reporting provided to clients.

*Costs and charges to be aggregated*

9. Costs and charges listed in the Annex to this chapter should be disclosed to clients.
10. In relation to UCITS, the Commission should consider the possibility to require, in the MiFID II implementing measures or in the UCITS regulatory framework, the disclosure of product costs and charges that are not included in the UCITS KIID.
11. Investment firms should aggregate:
  - i. all costs and associated charges charged by the investment firm or other parties where the client has been directed to such other parties, for the investment services(s) and/or ancillary services provided to the client; and
  - ii. all costs and associated charges associated with the manufacturing and managing of the financial instruments.
12. The aggregated costs and charges should be expressed in one single figure, both as a cash amount and as a percentage.

*Timing and format of disclosure*

*Point of sale disclosure of information (ex-ante disclosure)*

13. The aggregated information about all costs and charges should be provided to clients or potential clients in good time before the provision of the investment and/or ancillary service. The (potential) clients should be allowed enough time to consider material information when they make their investment decisions. The information on the financial instrument provided at the point of sale can be provided on a generic basis as long as the investment firm ensures that the costs and charges provided in the disclosure are representative of the costs that the client would actually incur.

*Methodology for the calculation of ex-ante figures*

14. The methodology for calculating ex-ante cost figures should be based on the principle that the investment firm should use actually incurred costs as a proxy for the expected costs and charges. If actual costs are not available, the investment firm should make reasonable estimations of these costs.
15. Investment firms shall review ex-ante assumptions based on the ex-post experience and should make adjustment to these assumptions, if necessary.

*Post-sale periodic disclosure of information (ex-post disclosure)*

16. Information about costs provided on a regular basis during the life of the investment should be based

on actual costs incurred and should be provided on a personalised basis.

*Cumulative effect of costs on the return*

17. An investment firm should be obliged to provide its clients with an illustration showing the cumulative effect of costs on return when providing investment services. Such an illustration should be provided at the point of sale. When providing the illustration the investment firm should ensure that the illustration meets the following high level requirements:
- i. the illustration shows the effect of the overall costs and charges on the return of the investment;
  - ii. the illustration shows any anticipated spikes or fluctuations in the costs; and
  - iii. the illustration is accompanied by an explanation of what the illustration shows.

- Q71. Do you agree with the proposal to fully apply requirements on information to clients on costs and charges to professional clients and eligible counterparties and to allow these clients to opt-out from the application of these requirements in certain circumstances?**
- Q72. Do you agree with the scope of the point of sale information requirements?**
- Q73. Do you agree that post-sale information should be provided where the investment firm has established a continuing relationship with the client?**
- Q74. Do you agree with the proposed costs and charges to be disclosed to clients, as listed in the Annex to this chapter? If not please state your reasons, including describing any other cost or charges that should be included.**
- Q75. Do you agree that the point of sale information on costs and charges could be provided on a generic basis? If not, please explain your response.**
- Q76. Do you have any other comments on the methodology for calculating the point of sale figures?**
- Q77. Do you have any comments on the requirements around illustrating the cumulative effect of costs and charges?**
- Q78. What costs would you incur in order to meet these requirements?**



**Annex 2.14.1: Identified costs that should form part of the costs to be disclosed to the clients**

*All costs and associated charges charged for the investment service(s) and/or ancillary services provided to the client that should form part of the amount to be disclosed*

Cost items to be disclosed		Examples:
<b>One-off charges related to the provision of an investment service</b>	All fees paid to the investment firm at the beginning or at the end of the provided investment service(s).	Deposit fee, termination fee and switching costs.
<b>On-going related to the provision of an investment service charges</b>	All on-going charges paid to investment firms for their services provided to the client.	Management fee, advisory fee, custodian fee.
<b>All costs related to transactions initiated in the course of the provision of an investment service</b>	Costs and charges that are related to transactions performed by the investment firm or other parties.	Broker commissions, entry- and exit charges paid to the fund manager, platform fees, marks up embedded in the transaction price, stamp duty, transactions tax and foreign exchange costs.
<b>Any charges that are related to ancillary services</b>	Any charges that are related to ancillary services that are not included in the costs mentioned above.	Research costs. Custody costs.

*All costs and associated charges related to the financial instrument that should form part of the amount to be disclosed*

Cost items to be disclosed		Examples:
<b>One-off charges</b>	All fees (included in the price or in addition to the price of the financial instrument) paid to product suppliers at the beginning or at the end of the investment in the financial instrument.	Front-loaded management fee, structuring fee, distribution fee.

<p><b>On-going charges</b></p>	<p>All on-going charges related to the management of the financial product that are deducted from the value of the financial instrument during the investment in the financial instrument.</p>	<p>Management fee, performance fee, service costs, swap fee, securities lending costs and taxes, financing costs.</p>
<p><b>All costs related to the transactions</b></p>	<p>Costs and charges that are related to transactions that are performed by the manager of the financial instrument.</p>	<p>Broker commissions, entry- and exit charges paid by the fund, marks up embedded in the transaction price, stamp duty, transactions tax and foreign exchange costs.</p>

## 2.15. The legitimacy of inducements to be paid to/by a third person

### Background/Mandate

#### Extract from the Commission's request for advice (mandate)

*ESMA is invited to provide technical advice on:*

*- the conditions under which investment firms providing investment advice on an independent basis and portfolio management fulfil the requirement to not accept and retain any monetary or non-monetary third party fees commissions or benefits as well as on the definition and conditions for acceptable minor non-monetary benefits;*

*- the conditions under which payments and non-monetary benefits, paid to or provided by investment firms providing all other investment or ancillary services, are not deemed to meet the requirement of enhancing the quality of the relevant service to the client;*

*- disclosure and organisational arrangements to be complied with by investment firms in order to meet the requirements set out in Article 24(7), (8) and (9).*

1. MiFID I contains requirements for third party payments in the context of Article 26(b) of the MiFID Implementing Directive, regulating inducements. The essential requirements for the legitimacy of inducements to be paid by/to a third person (other than payments by or on behalf of the client) are:
  - i. disclosure of the existence, the nature and amount of the fee, commission or benefit, or, where the amount cannot be ascertained the method of calculating that amount prior to providing investment or ancillary services;
  - ii. the third party payment must be designed to enhance the quality of the relevant service to the client; and
  - iii. the third party payment must not impair compliance with the firm's duty to act in the best interest of the client.
2. CESR published recommendations on the topic of inducements in 2007<sup>67</sup> and 2010.<sup>68</sup>
3. MiFID II aims to strengthen the current MiFID requirements for third party payments and benefits. To this end MiFID II distinguishes between the rules that apply to: (i) the investment services of portfolio management and investment advice on an independent basis; and (ii) all other investment services.
4. Recitals 74 and 75 of MiFID II state that:

*“(74) In order to strengthen the protection of investors and increase clarity to clients as to the service they receive, it is also appropriate to further restrict the possibility for firms providing the service of investment advice on an independent basis and the service of portfolio management to ac-*

<sup>67</sup> CESR/07-228b 'Recommendations on Inducements under MiFID' May 2007.

<sup>68</sup> CESR/10-295: 'Inducements: Report on good and poor practices' April 2010.

*cept and retain fees, commissions or any monetary and non-monetary benefits from third parties, and particularly from issuers or product providers. This implies that all fees, commissions and any monetary benefits paid or provided by a third party must be returned in full to the client as soon as possible after receipt of those payments by the firm and the firm should not be allowed to offset any third-party payments from the fees due by the client to the firm. The client should be accurately and, where relevant, periodically, informed about all fees, commissions and benefits the firm has received in connection with the investment service provided to the client and transferred to him. Firms providing independent advice or portfolio management should also set up a policy, as part of their organisational requirements, to ensure that third party payments received are allocated and transferred to the clients. Only minor non-monetary benefits should be allowed provided that they are clearly disclosed to the client, that they are capable of enhancing the quality of the service provided and that they do not, or could not be judged to, impair the ability of investment firms to act in the best interest of their clients.*

*(75) When providing the service of investment advice on an independent basis and the service of portfolio management, fees, commissions or non-monetary benefits paid or provided by a person on behalf of the client are allowed only as far as the person is aware that such payments have been made on that person's behalf and that the amount and frequency of any payment is agreed between the client and the investment firm and not determined by a third party. Cases which would satisfy this requirement include where a client pays a firm's invoice directly or it is paid by an independent third party who has no connection with the investment firm regarding the investment service provided to the client and is acting only on the instructions of the client and cases where the client negotiates a fee for a service provided by an investment firm and pays that fee. This would generally be the case for accountants or lawyers acting under a clear payment instruction from the client or where the person is acting as a mere conduit for the payment”.*

#### *Portfolio management and investment advice on an independent basis*

5. Article 24(7)(b) and 24(8) of MiFID II state that when an investment firm provides investment advice on an independent basis or portfolio management, it shall not accept and retain fees, commissions or any monetary or non-monetary benefits paid or provided by any third party or a person acting on behalf of a third party in relation to the provision of the service to clients. Minor non-monetary benefits that are capable of enhancing the quality of service provided to a client and are of a scale and nature such that they could not be judged to impair compliance with the investment firm's duty to act in the best interest of the client should be clearly disclosed and are excluded from this provision.

#### *All other investment services*

6. Article 24(9) of MiFID II states that investment firms are not regarded as fulfilling their obligations under Article 23 or Article 24(1) where they pay or are paid any fee or commission, or provide or are provided with any non-monetary benefit in connection with the provision of an investment service or ancillary service, to or by any party except the client or a person on behalf of the client, other than where the payment or benefit:
  - i. is designed to enhance the quality of the relevant service to the client; and
  - ii. does not impair compliance with the firm's duty to act honestly, fairly and professionally in accordance with the best interest of its clients.
7. Article 24(9) of MiFID II also states that:

*“The existence, nature and amount of the payment or benefit referred to in the first subparagraph, or, where the amount cannot be ascertained, the method of calculating that amount, must be clearly disclosed to the client, in a manner that is comprehensive, accurate and understandable, prior to the provision of the relevant investment or ancillary service. Where applicable, the investment firm shall also inform the client on mechanisms for transferring to the client the fee, commission, monetary or non-monetary benefit received in relation to the provision of the investment or ancillary service.*

*The payment or benefit which enables or is necessary for the provision of investment services, such as custody costs, settlement and exchange fees, regulatory levies or legal fees, and which by its nature cannot give rise to conflicts with the firm’s duties to act honestly, fairly and professionally in accordance with the best interests of its clients is not subject to the requirements”.*

## **Analysis**

8. According to the Commission mandate the following four areas require further specification in the MiFID II implementing measures:
  - i. the conditions under which investment firms providing investment advice on an independent basis and portfolio management fulfil the requirement to not accept and retain any monetary or non-monetary third party payments;
  - ii. the definition and conditions for ‘minor non-monetary benefits’ that can be received when providing independent advice or portfolio management;
  - iii. the use of payments and non-monetary benefits that meet the requirement of enhancing the quality of the relevant service to the client; and
  - iv. requirements for the disclosure to the client in relation to the existence, nature and amount of the third party payment or benefit.
9. In relation to each of these aspects, ESMA considers the following:

### *Accept and not retain third party payments*

10. If independent investment advice or portfolio management is provided, investment firms are not allowed to accept and retain fees, commissions or any monetary and non-monetary benefits paid or provided by a third party. Recital 74 of MiFID II makes clear that an investment firm providing independent investment advice and/or portfolio management may still consider financial instruments with the traditional remuneration model. Under such a model, the issuer pays a commission, fee or monetary benefit to the investment firm distributing the product. However, the recital also clarifies that in such cases the investment firm should return to the client any monies received from third parties in full as soon as possible after receipt.

### *Minor non-monetary benefits*

11. Investment firms providing independent investment advice or portfolio management are allowed to receive minor non-monetary benefits that are capable of enhancing the quality of service, provided that they are of such scale and nature that they cannot be judged to impair compliance with the firm's duty to act in the best interests of its clients. In order to prevent investment firms from circumventing





the general prohibition to receive third party payments, ESMA believes that this exemption should be interpreted strictly, such that non-monetary benefits likely to influence the behaviour of the recipient should not be allowed. ESMA is also of the opinion that the receipt of minor non-monetary benefits should be permitted in respect of all MiFID investment and ancillary services, not only for independent advice or portfolio management, in accordance with the same conditions.

12. ESMA has considered the potential for research to be permissible as a minor non-monetary benefit for portfolio managers and independent investment advisers.<sup>69</sup> ESMA views that ‘financial research’ referred to in paragraph 23 may include forms of investment research provided it is of a scale and nature such that it could not be judged to impair a firm’s duty to act in the best interests of their clients. In practice, research is often received by a portfolio manager from a broker with whom they execute orders on behalf of their clients.
13. ESMA proposes that for financial analysis to be acceptable it would need to be intended for distribution so that it is, or is likely to become, accessible by a large number of persons, or for the public at the same time. For example, simultaneously widely distributed research or information on a single financial instrument or issuer of financial instruments, or generic economic commentary, may meet this provision.
14. In contrast, based on the intention of the ‘minor non-monetary benefits’ exemption, ESMA considers that any research that involves a third party allocating valuable resources to a specific portfolio manager would not constitute a minor non-monetary benefit and could be judged to impair compliance with the portfolio manager’s duty to act in their client’s best interest. For example, it is often common practice for a portfolio manager to agree higher execution rates to allow them to also obtain higher-value research from a broker (i.e. the additional services from the broker are explicitly cross-subsidised by the transaction charges taken from the portfolio manager’s client’s funds). A firm may also be influenced to direct order flow or ‘churn’ client portfolios to gain access to more valuable research services for ‘free’. As such, any research that is tailored or bespoke in its content or rationed in how it is distributed or accessed would be of a scale and nature such that its provision is likely to influence the recipient’s behaviour and cannot be a minor non-monetary benefit. This would include privileged access to research analysts (e.g. face-to-face meetings or conference calls), bespoke reports or analytical models, investor field trips, or services linked to research such as corporate access and market data services, which by their nature are limited in access and/or can have a material value.
15. ESMA acknowledges that this restriction on research that can be accepted as a minor non-monetary benefit may mean a portfolio manager or firm offering independent advice will wish to separately acquire additional third party research to fulfil their needs. ESMA is therefore clear that the restriction on research as an inducement does not prevent a portfolio manager or independent adviser, who requires bespoke or valuable external investment research services as part of fulfilling their duties to their clients, from contracting and paying for such research on a distinct and separate basis with a broker or other third party (subject to meeting their other MiFID requirements, such as managing conflicts of interest). The portfolio manager or independent adviser would need to ensure that the terms of such arrangements with a third party are not influenced by other services they acquire directly on behalf of their clients in their provision of independent investment advice or portfolio management services where they acquire these from the same third party. For example, a portfolio manager may regularly use a broker for executing orders on behalf of their clients, but may also wish to

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<sup>69</sup> In this context, the terms ‘portfolio manager’ and ‘investment adviser’ should be read to indicate the investment firm performing these activities (rather than individuals employed by or acting on behalf of the investment firm).



acquire one or more bespoke research services from that same broker. The portfolio manager would need to have a clear, separate contractual agreement between themselves and the broker for the provision of such research that included a reasonable level of payment for that service.

16. ESMA is conscious of the fact that restricting the scale and nature of investment research received in the context of discretionary portfolio management, which is an investment service under MiFID II, would create an un-level playing field in comparison to the activity of collective portfolio management, which is not an investment service under MiFID II and is often provided by the same firms. ESMA therefore advises the Commission to consider the possibility of aligning the relevant provisions that fall under UCITS and AIFMD with the MiFID II implementing provisions on this topic.

*Other investment services: quality enhancement and disclosure requirements*

17. For investment services other than independent investment advice and portfolio management, the MiFID Implementing Directive rules for third party payments have been kept as the basis for MiFID II. ESMA believes that the current rules should be improved in order to enhance investor protection. ESMA considers it important that the clients are accurately informed about all fees, commissions and benefits the investment firm has received from third parties in connection with providing investment services to the client. ESMA also proposes to clarify the requirement of quality enhancement of Article 26(b)(ii) of the MiFID Implementing Directive.
18. The proposals in this chapter will enhance investor protection by specifying in detail the requirements that must be met by investment firms if they have a business model that involves the receipt of money or benefits from a third party, including the requirement to disclose the existence, nature and amount of third party payments, and the criteria that must be met in order for a third party payment to be permissible under the MiFID rules. This is aimed at addressing the situations where potential conflicts can arise between the interests of the investment firm and the best interests of its clients, where an investment firm receives payments or benefits from third parties.

**Draft technical advice**

*Accept and not retain third party payments*

1. Independent investment advisers and portfolio managers must return to clients any monetary third party payments received in relation to the services provided to that client as soon as possible after receipt by transferring the monies received to the client money account. The obligation to pass on the monetary benefits should comprise all sums the investment firm receives from third parties in relation to the provision of independent investment advice and portfolio management. The requirement to pass on such monies should not contain a specific timeframe, since third party payments can be received by the investment firm at various points in time and for several clients at once. It is the responsibility of the investment firm to ensure that any such payments received are passed on to the client as soon as reasonably possible. In this context, investment firms should be required to set up a policy to ensure that third party payments received are allocated and transferred to the each individual client as part of the organisational requirements under Article 16 of MiFID II.
2. Clients should be informed about the monetary amounts transferred to them through regular bank account statements for their money account. Additional reporting requirements by investment firms can be kept to a minimum. By requiring independent investment advisers and portfolio managers to

inform a client about the total amount of third party payments received and passed on to the client as part of the regular periodic reporting statements provided to the client, the client will have a comprehensive overview of the relevant information in respect of the services provided to him.

3. Investment firms providing the service of independent investment advice and portfolio management are not allowed to receive non-monetary benefits that do not qualify as minor.

*Minor non-monetary benefits*

4. ESMA advises the Commission to introduce an exhaustive list of non-monetary benefits that can be considered to be minor and are therefore acceptable. All such benefits should only qualify as minor when they are reasonable and proportionate and of such a scale that they are unlikely to influence the recipient's behaviour in any way that is detrimental to the interests of the relevant client.
5. This list should include the following benefits:
  - i. information or documentation relating to a financial instrument (including financial research) or an investment service. This information could be generic in nature or personalised to reflect the circumstances of an individual client;
  - ii. participation in conferences, seminars and other training events on the benefits and features of a specific financial instrument or an investment service; and
  - iii. hospitality of a reasonable *de minimis* value, this could for example include food and drink during a business meeting or a conference, seminar or other training events mentioned under ii.
6. Minor non-monetary benefits as defined above should be clearly disclosed by investment firms before providing investment or ancillary services to clients.

*Other investment services: disclosure requirements*

7. In relation to monetary payments and non-monetary benefits received from or paid to third parties, investment firms should disclose to the client the following information:
  - i. prior to the provision of the relevant investment or ancillary service, the investment firm shall disclose to the client in a clear, comprehensive, accurate and understandable manner, the existence, nature and amount of the payment or non-monetary benefit concerned. Where the amount cannot be ascertained, the method of calculating that amount must be clearly disclosed to the client;
  - ii. where an investment firm was unable to ascertain on an ex-ante basis the amount of any payment or benefit it was to receive, and instead disclosed to the client the method of calculating that amount (in accordance with Article 24(9) of MiFID II), it should also provide its clients with information of the exact amount of the inducement received on an ex-post basis;
  - iii. at least once a year, as long as (on-going) inducements are received by the investment firm in relation to the investment services provided to the relevant clients, the investment firm should inform its clients on an individual basis about the actual amount of payments or non-monetary

benefits received.

8. In implementing these requirements, the investment firm should take into account the rules with regard to disclosure on costs and charges, as outlined in the 'Information to clients on costs and charges' chapter of this CP.
9. When a number of entities are involved in the distribution channel, each investment firm that is providing an investment or ancillary service must comply with its obligations to make disclosures to its clients.

*Other investment services: quality enhancement*

10. ESMA advises the Commission to introduce a non-exhaustive list of circumstances and situations that NCAs should consider in determining when the quality enhancement test is not met. A fee, commission or non-monetary benefit may not generally be regarded as designed to enhance the quality of the relevant service to the client if:
  - i. it is used to pay or provide goods or services that are essential for the recipient firm in its ordinary course of business;
  - ii. it does not provide for an additional or higher quality service above the regulatory requirements provided to the end user client;
  - iii. it directly benefits the recipient firm, its shareholders or employees without tangible benefit or value to its end user client; or
  - iv. in relation to an on-going inducement, it is not related to the provision of an on-going service to an end user client.
11. In understanding whether or not the enhancement test can be met in accordance with these criteria, it should be understood that a fee, commission or non-monetary benefit could be considered acceptable if it enables the client to receive access to a wider range of suitable financial instruments or the provision of non-independent advice on an on-going basis, so long as any such service is provided without bias or distortion as a result of the fee, commission or non-monetary benefit being received.
12. In order to specify the circumstances listed in the above criteria, it could also be considered appropriate to develop further ESMA Guidelines and Recommendations at a later point of time.
13. Investment firms should be obliged, as part of the organisational requirements for investment firms, to demonstrate that they pay or receive payments and non-monetary benefits to enhance the quality of the service to the investor in the following ways:
  - i. by keeping an internal list of any and all commissions, fees and non-monetary benefits accepted by the investment firm from a third party in relation to the provision of investment or ancillary services; and
  - ii. by recording how the investment firm uses or intends to use the commissions and fees in order to enhance the quality of the services provided to its clients.



- Q79.** Do you agree with the proposed exhaustive list of minor non-monetary benefits that are acceptable? Should any other benefits be included on the list? If so, please explain.
- Q80.** Do you agree with the proposed approach for the disclosure of monetary and non-monetary benefits, in relation to investment services other than portfolio management and advice on an independent basis?
- Q81.** Do you agree with the non-exhaustive list of circumstances and situations that NCAs should consider in determining when the quality enhancement test is not met? If not, please explain and provide examples of circumstances and situations where you believe the enhancement test is met. Should any other circumstances and/or situations be included in the list? If so, please explain.
- Q82.** Do you anticipate any additional costs in order to comply with the requirements proposed in this chapter? If yes, please provide details.

## 2.16. Investment advice on independent basis

### Background/Mandate

#### Extract from the Commission's request for advice (mandate)

*ESMA is invited to provide technical advice on requirements to be complied with by investment firms providing investment advice on an independent basis. In particular, ESMA should advise on appropriate measures concerning the selection process to assess a sufficient range of financial instruments as well as the conditions under which investment firms may offer advice on an independent basis and on a non-independent basis.*

1. Recital 73 of MiFID II states that:

*“In order to further establish the regulatory framework for the provision of investment advice, while at the same time leaving choice to investment firms and clients, it is appropriate to establish the conditions for the provisions of this service when firms inform clients that the service is provided on an independent basis. When advice is provided on an independent basis a sufficient range of different product providers' products should be assessed prior to making a personal recommendation. It is not necessary for the advisor to assess investment products available on the market by all product providers or issuers, but the range of financial instruments should not be limited to financial instruments issued or provided by entities with close links with the investment firm or with other legal or economic relationships, such as a contractual relationship, that are so close as to put at risk the independent basis of the advice provided”.*

2. Article 24(4) of MiFID II states that information to clients shall specify whether the advice is provided 1) on an independent basis or not and 2) *“whether the advice is based on a broad or more restricted analysis of different types of financial instruments and, in particular, whether the range is limited to financial instruments issued or provided by entities having close links with the investment firm or any other legal or economic relationships, such as contractual relationships, so close as to pose a risk of impairing the independent basis of the advice provided”.*

3. Article 24(7) of MiFID II states that when the investment firm informs the client that investment advice is provided on an independent basis, the firm shall:

*“(a) assess a sufficient range of financial instruments available on the market, which should be sufficiently diverse with regard to their type and issuers or product providers to ensure that the client's investment objectives can be suitably met and should not be limited to financial instruments issued or provided by:*

*(i) the investment firm itself or by entities having close links with the investment firm; or*

*(ii) other entities with which the investment firm has such close legal or economic relationships, such as contractual relationships, as to pose a risk of impairing the independent basis of the advice provided*

*(b) not accept and retain fees, commissions or any monetary or non-monetary benefits paid or provided by any third party or a person acting on behalf of a third party in relation to the provision of the service to clients. Minor non-monetary benefits that are capable of enhancing the quality of service provided to a client and are of a scale and nature such that they could not be judged to*

*impair compliance with the investment firm's duty to act in the best interest of the client must be clearly disclosed and are excluded from this point".*

4. Article 4(1)(35) of MiFID II states that: *"Close links' means a situation in which two or more natural or legal persons are linked by: (a) 'participation in the form of ownership, direct or by way of control, of 20% or more of the voting rights or capital of an undertaking; (b) 'control' which means the relationship between a parent undertaking and a subsidiary, in all the cases referred to in Article 22(1) and (2) of 2013/34/EU, or a similar relationship between any natural or legal person and an undertaking, any subsidiary undertaking of a subsidiary undertaking also being considered to be a subsidiary of the parent undertaking which is at the head of those undertakings; (c) a situation in which they are permanently linked to one and the same person by a control relationship"*.
5. Article 24(13) of MiFID II empowers the Commission to adopt delegated acts concerning measures to ensure that investment firms comply with these principles, including the criteria for the assessment of a range of financial instruments available on the market.

### **Analysis**

6. The reference to the provision of investment advice *"on an independent basis"* has been introduced in MiFID II for the first time.
7. A crucial requirement for the identification of investment advice provided on independent basis and its differentiation from the non-independent advice is the investment firm's ability to assess a sufficiently diversified range of financial instruments available on the market, in accordance with the new regulatory framework.
8. If an investment firm providing investment advice claims the relevant services as 'independent', it is essential from ESMA's point of view that the recommendations provided to investors are based on a selection process that is not influenced by any interest the investment firm or its adviser could have in a specific financial instrument (as could be the case if products are issued by the investment firm itself or entities with close links to the investment firm). This view is reflected in the final MiFID II text which requires intermediaries providing independent advice not to limit their offer to their own products or products coming from entities having close links with the investment firm, while the retention of any inducements coming from third parties is forbidden.
9. It is therefore crucial that investment firms providing the service on an independent basis implement a selection process that fosters a fair and appropriate comparison of different financial instruments, not limiting the analysis to products for which the recommendation could be biased. The reference to *"a sufficient range of financial instruments available on the market"* should therefore be understood as inherent to the comparison process and thus requiring implementing measures under Article 24(13) of MiFID II. Once the investment firm has selected different financial instruments to be challenged one against the other, the final selection must not be flawed because of close links to the investment firm or adviser, taking into account the conflict of interest rules.
10. In this context, ESMA believes that it is not appropriate to set a specific or minimum number of financial instruments or product providers to be considered when selecting the products that may be recommended to the client: the number, types and product providers to be compared will depend on the scope of the advice to be given, client preferences and needs and the circumstance that the service provider is including or excluding products. It is crucial that the variety and number of financial in-



struments to be considered allows an appropriate consideration of what the market offers as alternatives to the products issued by the investment firm itself or provided or issued by entities with close links with the investment firm providing the advice.

11. ESMA considers that the scope of investment advice can range from broad and general to specialist and specific. The scope of advice offered by investment firms providing advice on an independent basis, depends on its business model. ESMA is of the opinion that a firm could specialise in particular financial instruments and still hold itself out as being independent. If the investment firm limits itself to advising on certain classes or range of financial instruments (for example of ethical and socially responsible investments), the firm could still be considered to be independent only if the scope of its service still allows a fair comparison between different financial instruments coming from different providers, in particular in cases where products coming from entities with close links with the adviser also are considered.
12. If such a comparison would not be possible because of the business model or the scope of the service provided, the investment firm providing investment advice will not be allowed to claim or present itself as independent.
13. For example, if an investment firm specialises in (or is asked by a client to provide a recommendation on) bespoke OTC derivatives for hedging purposes and it would be difficult to find alternatives on the market to the financial instrument engineered by an entity with close links with the adviser, then it would not be possible to present the advice service as ‘independent’. Additional work could be performed by ESMA at a later stage to provide further clarification of the concept of independence.
14. Additionally, ESMA believes it is important to consider whether and under which conditions an investment firm could offer both independent and non-independent advice. Any advice understood by the client to be ‘independent’ must possess the features required by Article 24(7) of MiFID II. If the investment firm’s business model implies the provision of both ‘independent’ and ‘non-independent’ advice, then it should take all necessary steps to keep the client informed at all stages about what kind of service is being provided. In these types of situations, disclosure and adequate organisational requirements play a crucial role.
15. The proposals in this area will increase investor protection by specifying the requirements for advice to be considered ‘independent’ and by proposing requirements tackling the provision of independent and non-independent investment advice within the same investment firm. These proposals aim at better distinguishing, from an investor’s perspective, different types of advice provided to make it easier for clients to understand the nature and basis of investment advice provided to them.

### **Draft technical advice**

#### *Sufficient range of sufficiently diverse financial instruments available on the market*

1. An investment firm informing a client that investment advice is provided on an independent basis shall define and implement a selection process to assess and compare a sufficient range of financial instruments available on the market. The selection process should include all of the following elements:
  - i. a diversified selection of financial instruments by type, issuer, or product provider, which is not limited to financial instruments issued or provided by the investment firm itself or by entities



having close links with the investment firm should be considered;

- ii. the number and variety of financial instruments considered should be proportionate to the scope of advice services offered by the independent investment adviser;
  - iii. the number and variety of financial instruments considered comprises a substantial part of financial instruments and available on the market;
  - iv. the quantity of financial instruments issued by the investment firm itself or by entities closely linked to the investment firm itself is proportionate to the total amount of financial instruments considered; and
  - v. the criteria for comparing the various financial instruments should include all relevant aspects such as risks, costs and complexity as well as the characteristics of the investment firm's clients, and should ensure that neither the selection of the instruments that may be recommended nor the recommendations that are made to client are biased.
2. If such a comparison would not be possible because of the business model or the specific scope of the service provided, the investment firm providing advice should not be allowed to claim itself as "independent".
3. An investment firm that provides investment advice on an independent basis and that focuses on certain classes or a specified range of financial instruments should comply with the following requirements:
- i. the firm is able to market itself in a way that only attracts clients with a preference for certain classes or a range of financial instruments;
  - ii. (potential) clients should be able to easily identify a preference for the specified classes or range of financial instruments and be able to self-select with a high degree of accuracy;
  - iii. clients indicate that they are only interested in investing in the specified classes or range of financial instruments; and
  - iv. the firm is able to easily confirm whether its service is appropriate for each new client, i.e. that it's business model matches the client's needs and objectives, and the range of financial instruments are suitable for the client. If this is not the case the firm must not provide such a service to the client and should refer the client to another firm.

*Investment firms providing both independent and non-independent advice*

4. An investment firm offering investment advice on both an independent basis and on a non-independent basis should comply with the following obligations:
- i. in good time before the provision of its services, the investment firm should inform retail clients, in a durable medium, whether the advice will be independent or non-independent in accordance with Article 24(4)(a) of MiFID II and the relevant implementing measures (see the 'Information to clients about investment advice and financial instruments' chapter of this CP);
  - ii. the investment firm should not hold itself out as "independent" for its business as a whole.

However a firm may hold itself out as acting independently in respect of the services for which it provides independent advice; and

- iii. it should have adequate organisational requirements and controls in place to ensure that both types of advice services and advisers are clearly separated from each other. To this end the firm should not allow a relevant person to provide both independent and non-independent advice. These requirements and controls should also ensure that clients are not confused about the type of advice that they are receiving and are given the type of advice that is appropriate for them.

- Q83. Do you agree with the approach proposed in the technical advice above in order to ensure investment firm's compliance with the obligation to assess a sufficient range of financial instruments available on the market? If not, please explain your reasons and provide for alternative or additional criteria.**
- Q84. What type of organisational requirements should firms have in place (e.g. degree of separation, procedures, controls) when they provide both independent and non-independent advice?**
- Q85. Do you anticipate any additional costs in order to comply with the requirements proposed in this chapter? If yes, please provide details.**



## 2.17. Suitability

### Background/Mandate

#### Extract from the Commission's request for advice (mandate)

*ESMA is invited to provide technical advice on the information to obtain when assessing the suitability or appropriateness of the services and financial instruments for their clients, criteria to assess non-complex financial instruments, the content and the format of records and agreements for the provision of services to clients and of periodic reports to clients on the services provided. In particular, the technical advice should consider any updates or improvements to the suitability assessment requirements as well as proposals for the content of suitability reports aiming to ensure a real added value for the client. Moreover, technical advice should further clarify and update the criteria to assess non-complex products set out in Article 38 of the Commission Directive 2006/73/EC.*

*The advice should take into account: (i) the nature of the services offered or provided to the client, taking into account the type, object, size and frequency of the transaction, (ii) the nature of the products being offered, including types of fin instrument and structured products and (iii) the retail and professional nature of the client, eligible counterparty.*

1. The assessment of suitability is one of the most relevant obligations for investor protection. It applies to the provision of any type of investment advice (whether independent or not) and portfolio management. In accordance with this obligation, investment firms providing investment advice or portfolio management have to provide suitable personal recommendations to their clients or have to make suitable investment decisions on behalf of their clients. Suitability has to be assessed against clients' knowledge and experience, financial situation and investment objectives. To achieve this, investment firms have to obtain the necessary information from clients.
2. ESMA is required to advise the Commission on the general suitability provision in Article 25(2) and the contents of the suitability report in Article 25(6) of MiFID II.
3. Article 25(2) of MiFID II states:

*“When providing investment advice or portfolio management the investment firm shall obtain the necessary information regarding the client's or potential client's knowledge and experience in the investment field relevant to the specific type of product or service, that person's financial situation including his ability to bear losses, and his investment objectives including his risk tolerance so as to enable the investment firm to recommend to the client or potential client the investment services and financial instruments that are suitable for him and, in particular, are in accordance with his risk tolerance and ability to bear losses.*

*Member States shall ensure that where an investment firm provides investment advice recommending a package of services or products pursuant to Article 24(11), the overall bundled package is suitable”.*

4. Article 25(6), subparagraph 2 states:

*“When providing investment advice, the investment firm shall, before the transaction is made, provide the client with a statement on suitability in a durable medium specifying the advice given and how that advice meets the preferences, objectives and other characteristics of the retail client”.*



5. In July 2012, ESMA published guidelines on certain aspects of the MiFID I suitability requirements.<sup>70</sup> This provided guidelines in relation to the suitability assessment provisions included in MiFID I and the MiFID Implementing Directive.

## **Analysis**

### *Suitability assessment*

6. The suitability provisions in Article 35 of the MiFID Implementing Directive focus primarily on the information which investment firms should obtain from clients as part of undertaking the suitability assessment. ESMA considers that these are a good basis for the development of the MiFID II implementing measures. ESMA therefore proposes that these provisions are retained as currently drafted, except Article 35(1), which should be updated to reflect that MiFID II now explicitly requires investment firms, when undertaking a suitability assessment, to assess both a client's ability to bear losses and a client's risk tolerance.
7. Based on supervisory experience of the provisions included in Article 35 of the MiFID Implementing Directive, ESMA considers it appropriate to expand these provisions in a number of key areas. The text would also then better reflect expectations on firms previously communicated in ESMA's guidelines.

### *Suitability reports*

8. When providing investment advice to a retail client, MiFID II requires investment firms to provide the client with a suitability report specifying how the advice given meets the retail client's circumstances and needs.
9. Providing a suitability report to a retail client is not currently an explicit requirement in MiFID I. However, some Member States require a written suitability statement where a personal recommendation is made in some or all cases based on the MiFID I requirement for firms to "provide adequate reports".
10. ESMA's proposals relating to the assessment of suitability will strengthen investor protection by detailing the suitability requirements, including requiring firms to adopt policies and procedures to assess whether alternative financial instruments, less complex or with lower costs, could meet their client's profile and by regulating the content of the suitability reports in a way enabling clients to understand why advice provided has been assessed as suitable for them.

## **Draft technical advice**

### *Suitability assessment*

1. ESMA recommends that Article 35 of the MiFID Implementing Directive is expanded to clarify that:
  - i. the responsibility to undertake the suitability assessment lies with the investment firm. When undertaking this, a firm should inform clients, clearly and simply, that the reason for assessing

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<sup>70</sup> <http://www.esma.europa.eu/system/files/2012-387.pdf>

suitability is to enable the firm to act in the client's best interest. At no stage should investment firms create any ambiguity or confusion about their own responsibilities in the process;

- ii. the suitability assessment is not limited to recommendations to buy a financial instrument. Every personal recommendation given to the client, or decision whether to trade, should be suitable, which includes, for example, whether or not to buy, hold or sell an investment;
- iii. investment firms should have, and be able to demonstrate, adequate policies and procedures to ensure that they understand the nature, features, including costs and risks of instruments selected for their clients and that they assess whether alternative financial instruments, less complex or with lower costs, could meet their client's profile;
- iv. where an investment firm offers or has access to a limited range of instruments, or investment choices associated with instruments, they must not make a recommendation or decision to trade if none of the investments they offer are suitable for the client;
- v. when providing advice and, where appropriate, portfolio management services that involve switching investments (either by selling an instrument and buying another, or by exercising a right to make a change in regard to an existing instrument), a firm should collect the necessary information on the client's existing investments and the recommended new investments to undertake an analysis of the costs and benefits of the switch, such that they are reasonably able to demonstrate that the benefits of switching are greater than the costs;
- vi. where the investment firm has an on-going relationship with the client, e.g. by providing an on-going advice or portfolio management service, the firm should have, and be able to demonstrate, appropriate procedures to maintain adequate and up-to-date information about the client to the extent necessary to fulfil the requirements at Article 35(1) of the MiFID Implementing Directive;
- vii. investment firms should determine the extent of the information to be collected from clients in light of all the features of the investment advice or portfolio management services to be provided to those clients;
- viii. investment firms should take reasonable steps to ensure that the information collected about their clients is reliable. This includes, but is not limited to:
  - a. ensuring clients are aware of the importance of providing accurate and up-to-date information;
  - b. having robust processes for assessing the risk a client is willing and able to take, including their ability to bear the investment risk;
  - c. ensuring all tools employed in the suitability assessment process are appropriately designed for use with their clients and are fit-for-purpose, with any limitations identified and actively mitigated through the suitability assessment process. This includes, for example, any risk assessment profiling tools that may be used;
  - d. ensuring questions used in the process are likely to be understood by clients, capture an accurate reflection of the client's views and needs, and the information necessary to undertake

the suitability assessment; and

- e. taking steps, as appropriate, to ensure the consistency of client information. This includes, for example, considering whether there are obvious inaccuracies in the information provided by clients.
- ix. when recommending a financial instrument to a client, investment firms should assess whether an alternative instrument, less complex and with lower costs, would better meet the client's profile;
- x. where a client is a legal person or a group of two or more natural persons or where one or more natural persons are represented by another natural person, to identify who should be subject to the suitability assessment, the investment firm should first rely on the applicable legal framework;
- xi. if the legal framework does not provide sufficient indications in this regard, and in particular where no sole representative has been appointed (as may be the case for a married couple), the investment firm, based on a policy it has defined beforehand and that provides that the best interests of all the persons concerned and their need for protection are taken into consideration, should agree with the relevant persons (the representatives of the legal entity, the persons belonging to the group or the natural persons represented) as to who should be subject to the suitability assessment and how this assessment will be done in practice, including from whom information about knowledge and experience, financial situation and investment objectives, should be collected (in any case the agreement shall ensure that the person carrying out transactions on behalf of the entity has the necessary level of knowledge and experience). The investment firm should make a record of the agreement; and
- xii. where a natural person is represented by another natural person and where a small entity is to be considered for the suitability assessment, the financial situation and investment objectives should be those of the underlying client (natural person who is represented or small entity). The knowledge and experience should be that of the representative of the natural person or the person authorised to carry out transactions on behalf of the entity.

#### *Suitability reports*

- 2. In relation to suitability reports, investment firm should be required, when providing investment advice, to provide a report to the retail client that must include:
  - i. an outline of the advice given;
  - ii. how the recommendation provided is suitable for the retail client, including how it meets the client's objectives and personal circumstances with reference to the investment term required, client's knowledge and experience and client's attitude to risk and capacity for loss; and
  - iii. an explanation of the disadvantages of the recommended course of action.
- 3. Where the recommended instruments are likely to require the retail client to seek a periodic review of their arrangements, this should be brought to the client's attention and included in the report. This includes, for example, where a client is likely to need to seek advice to bring a portfolio of investments

back in line with the original recommended allocation where there is a probability that the portfolio could deviate from the target asset allocation. Where an investment firm provides a service that involves periodic suitability assessments and reports, the subsequent reports after the initial service is established would only need to cover any changes in the instrument(s) and/or the circumstances of the client. It would not be necessary for these reports to repeat all the detail of the first report. A periodic report could simply refer back the original report to a varying degree depending on any changes, and could be shorter in cases where the on-going assessment affirms the continued suitability of a previous recommendation or portfolio.

- Q86. Do you agree that the existing suitability requirements included in Article 35 of the MiFID Implementing Directive should be expanded to cover points discussed in the draft technical advice of this chapter?**
- Q87. Are there any other areas where MiFID Implementing Directive requirements covering the suitability assessment should be updated, improved or revised based on your experiences under MiFID since it was originally implemented?**
- Q88. What is your view on the proposals for the content of suitability reports? Are there additional details or requirements you believe should be included, especially to ensure suitability reports are sufficiently 'personalised' to have added value for the client, drawing on any initiatives in national markets?**
- Q89. Do you agree that periodic suitability reports would only need to cover any changes in the instruments and/or circumstances of the client rather than repeating information which is unchanged from the first suitability report?**



## 2.18. Appropriateness

### Background/Mandate

#### Extract from the Commission's request for advice (mandate)

*ESMA is invited to provide technical advice on the information to obtain when assessing the suitability or appropriateness of the services and financial instruments for their clients, criteria to assess non-complex financial instruments, the content and the format of records and agreements for the provision of services to clients and of periodic reports to clients on the services provided. In particular, the technical advice should consider any updates or improvements to the suitability assessment requirements as well as proposals for the content of suitability reports aiming to ensure a real added value for the client. Moreover, technical advice should further clarify and update the criteria to assess non-complex products set out in Article 38 of the Commission Directive 2006/73/EC.*

*The advice should take into account: (i) the nature of the services offered or provided to the client, taking into account the type, object, size and frequency of the transaction, (ii) the nature of the products being offered, including types of fin instrument and structured products and (iii) the retail and professional nature of the client, eligible counterparty.*

1. When providing investment services other than investment advice and portfolio management, firms have to ask clients to provide information about their knowledge and experience in order to be able to assess the appropriateness of the service or product offered or demanded. Under specific identified circumstances this assessment is not required (so called execution-only services).
2. ESMA is required to advise the Commission on the appropriateness provision in Article 25(3) and (4) of MiFID II, which includes the definition of a non-complex instrument. This specifically includes providing advice in relation to the criteria to assess non-complex financial instruments for the purpose of paragraph 4(a)(vi) of Article 25 of MiFID II.
3. The main provisions in the MiFID Implementing Directive relating to appropriateness are set out in Articles 36, 37 and 38. To clarify the application of this, in 2009 CESR published a Q&A statement on MiFID complex and non-complex instruments.<sup>71</sup> In due course, ESMA intends to review this statement in light of the updated criteria included in MiFID II and market developments since 2009, to provide greater clarity around the distinction between the two types of investments.
4. MiFID II introduces the concept of a “*structure making it difficult for the client to understand the risk*” involved. Where a bond, other form of securitised debt or money market instrument incorporates such a structure, it should be considered complex. ESMA is required under Article 25(10) of MiFID II to develop and periodically update guidelines for the assessment of financial instruments that incorporate a structure that makes it difficult for the client to understand the risks involved. ESMA will take forward this work and publish the guidelines as required by MiFID II.

### Analysis

5. Article 38 of the MiFID Implementing Directive sets out four criteria by which an instrument should be considered non-complex, even where it is not specifically identified as such in MiFID I.

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<sup>71</sup> CESR/09-559.





6. ESMA considers these criteria to be a good basis to determine what constitutes “*other non-complex financial instruments*” as included in Article 25(4)(a)(vi) of MiFID II. However, in light of market developments since both the MiFID Implementing Directive and the CESR Q&A statement on complex and non-complex instruments were issued, ESMA considers it appropriate to add some additional criteria.
7. In effect, MiFID II also signals, at Article 25(4)(a), that some types of financial instruments should not be considered non-complex. These are shares that embed a derivative or are in non-UCITS collective investments undertakings; bonds or other forms of securitised debt or money market instruments that embed a derivative or incorporate a structure that makes it difficult for the client to understand the risk involved; shares or units in structured UCITS; and structured deposits that incorporate a structure that makes it difficult for the client to understand the risk of return or the cost of exiting the product before term. For the avoidance of doubt, ESMA believes that the Implementing Directive should clarify that such financial instruments are complex – i.e. it should not be possible for instruments identified in this way in MiFID II to pass the tests in Article 38 of the current MiFID Implementing Directive and be labelled as non-complex.
8. ESMA’s proposals in this area will enhance the level of protection for investors receiving execution services by adding further criteria limiting the possibility to classify a financial instrument as non-complex. Consequently, this will extend the scope of financial instruments that are subject to the MiFID II obligation to assess the client’s knowledge and experience in order to determine their appropriateness for investors.

#### **Draft technical advice**

1. ESMA recommends adding two additional criteria to Article 38 of the MiFID Implementing Directive, which an instrument not included explicitly in Article 25(4)(a) of MiFID II would need to meet to be considered non-complex:
  - i. it does not incorporate a clause, condition or trigger that could fundamentally alter the nature or risk of the investment or pay out profile. This would include, for example, investments that incorporate a right to convert the instrument into a different investment; and
  - ii. it does not include any explicit or implicit exit charges that have the effect of making the investment illiquid even though technically frequent opportunities to dispose or redeem it would be possible.
2. ESMA also recommends the clarification that financial instruments that are described in Article 25(4)(a) of MiFID II, which do not meet the specific requirements of any of the tests i) to v) of that Article should be considered complex.

**Q90. Do you agree the existing criteria included in Article 38 of the Implementing Directive should be expanded to incorporate the above points, and that an instrument not included explicitly in Article 25(4)(a) of MiFID II would need to meet to be considered non-complex?**



- Q91.** Are there any other areas where the MiFID Implementing Directive requirements covering the appropriateness assessment and conditions for an instrument to be considered non-complex should be updated, improved or revised based on your experiences under MiFID I?



## 2.19. Client agreement

### Background/Mandate

#### Extract from the Commission's request for advice (mandate)

*ESMA is invited to provide technical advice on the information to obtain when assessing the suitability or appropriateness of the services and financial instruments for their clients, criteria to assess non-complex financial instruments, the content and the format of records and agreements for the provision of services to clients and of periodic reports to clients on the services provided. In particular, the technical advice should consider any updates or improvements to the suitability assessment requirements as well as proposals for the content of suitability reports aiming to ensure a real added value for the client. Moreover, technical advice should further clarify and update the criteria to assess non-complex products set out in Article 38 of the Commission Directive 2006/73/EC.*

*The advice should take into account: (i) the nature of the services offered or provided to the client, taking into account the type, object, size and frequency of the transaction, (ii) the nature of the products being offered, including types of fin instrument and structured products and (iii) the retail and professional nature of the client, eligible counterparty.*

1. Article 25(5) of MiFID II is identical to Article 19(7) of MiFID I:

*“The investment firm shall establish a record that includes the document or documents agreed between the firm and the client that set out the rights and obligations of the parties, and the other terms on which the firm will provide services to the client. The rights and duties of the parties to the contract may be incorporated by reference to other documents or legal texts”.<sup>72</sup>*

2. Article 25(8) of MiFID II empowers the Commission to adopt delegated acts to ensure that investment firms comply with the principles set out in Article 25, including:

*“the content and format of records and agreements for the provision of services to clients”.*

3. The MiFID Implementing Directive contains the following provisions:

*“Member States shall require an investment firm that provides an investment service other than investment advice to a new retail client for the first time after the date of application of this Directive to enter into a written basic agreement, in paper or another durable medium, with the client setting out the essential rights and obligations of the firm and the client.*

*The rights and duties of the parties to the agreement may be incorporated by reference to other documents or legal texts” (Article 39 of the MiFID Implementing Directive, implementing Articles 19(1) and 19(7) of MiFID I, on Retail client agreement).*

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<sup>72</sup> For the sake of completeness, it should be mentioned that MiFID II also requires a “binding written agreement” with the client where an investment firm provides direct electronic access to a trading venue (Article 17(5) of MiFID II), and where an investment firm acts as a general clearing member (Article 17(6) of MiFID II).



## Analysis

4. ESMA considers it appropriate to reflect on whether, and to what extent, the scope of the requirement to conclude a client agreement, in written or equivalent<sup>73</sup> form, should be expanded, in terms of clients, services provided, and the content of the agreement.

### *Scope in relation to clients*

5. The requirement to enter into a written agreement currently only applies for retail clients to whom the investment firm began providing services after the date of application of the MiFID Implementing Directive, i.e. 'new retail clients'.
6. ESMA has considered whether the requirement for a written (or equivalent) client agreement should be extended to relationships with professional clients.
7. It is sometimes considered that it would be burdensome and unnecessary in terms of investor protection to require the investment firm to conclude a written agreement with its professional clients.
8. On the other hand, in practice such relationships very often result in written agreements, in particular to provide legal certainty. Written agreements also enable clients, including professional clients, to better understand the nature of the services to be provided, and in some cases to seek judicial recourse if the firm has not abided by the terms of the agreement.
9. For these reasons, ESMA considers that there would be benefit in requiring investment firms to enter into a written (or equivalent) agreement with their professional clients. ESMA sees advantages in terms of legal certainty, as well as investor protection because of the possibility for the client to petition the courts to enforce the terms and conditions of the agreement.
10. At the same time, in line with the approach adopted by the MiFID Implementing Directive, ESMA considers that such a requirement should only apply to 'new' professional clients, and should only apply where the firm and the professional client intend to establish an on-going business relationship.

### *Scope in relation to the services provided*

11. The requirement to enter into a written agreement currently applies to the provision of all investment services to retail clients except the provision of investment advice (it applies, for instance, to the reception and transmission of orders, the execution of orders and individual portfolio management).
12. Therefore, the requirement does not cover presently investment advice and ancillary services.
13. ESMA has considered whether the scope of the requirement to enter into a written agreement should be extended to cover investment advice and at least one of the most important ancillary services, that of safekeeping (custody) of financial instruments.
14. ESMA considers that it remains proportionate to exclude the requirement for a written agreement in the case of one-off investment advice to clients. However, MiFID II increases the emphasis on the

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<sup>73</sup> In paper or another durable medium.



provision of investment advice on an on-going basis and also further stresses the importance of safeguarding client assets.

15. In ESMA's view, the new regulatory framework justifies the introduction of a requirement to enter into a written agreement for the provision of investment advice when there is a continuing relationship with the client as well as for custody services.

#### *Scope in relation to the content of the agreement*

16. The current obligation refers only to the "essential rights and obligations" of the investment firm and the client.
17. ESMA has considered whether any more specific obligation in relation to the content for certain services and/or certain clients should be imposed.
18. ESMA believes that, due to the importance of client agreement in setting the respective position of the parties, more details should be included, especially when the services of investment advice, portfolio management and safekeeping and administration of client financial instruments are provided.
19. The proposals on the aspects above will increase investor protection by extending the services for which written agreement between investment firms and clients is required and by detailing its content. This aims at enabling clients, including professional clients, to better understand the nature of the services provided and, where appropriate, to enable clients to seek judicial recourse if the firm has not abided by the terms of the agreement.

#### **Draft technical advice**

1. The content of Article 39 of the MiFID Implementing Directive should be modified in the areas below.
2. Investment firms providing investment services and the ancillary service specified in Annex I, Section B(1) of MiFID II<sup>74</sup> to a new professional client after the date of application of MiFID II should enter into a written agreement, in paper or another durable medium, with the client setting out the essential right and obligations of the firm and the client. This obligation should only apply where the firm and the professional client intend to establish a continuing business relationship.
3. In addition to requirements established by Article 39 of the MiFID Implementing Directive, investment firms should enter into a written agreement with retail clients when providing the services of investment advice, except when the investment firm does not have a continuing relationship with the client, and the ancillary service mentioned in Annex I, Section B(1) of MiFID II.
4. The written basic agreement should set out the "essential rights and obligations" of the parties including the following:
  - i. the client agreement should describe the nature and extent of any investment advice services to

<sup>74</sup> MiFID II Annex I Section B(2): "(1) *Safekeeping and administration of financial instruments for the account of clients, including custodianship and related services such as cash/collateral management and excluding maintaining securities accounts at the top tier level*".

be provided;

- ii. the client agreement should state the types of financial instruments that may be purchased and sold and the types of transactions that may be undertaken on behalf of the client, as well as any instruments or transactions prohibited, in the context of any portfolio management services to be provided; and
  - iii. the client agreement should describe the main features of any custody services to be provided, including where applicable the role of the firm with respect to corporate actions relating to client securities and the terms on which securities financing transactions involving client securities will generate a return for the client.
5. The proposals above are intended to achieve a common minimum regime in the European Union. ESMA considers that client agreements should remain a minimum harmonisation area under MiFID II.

- Q92. Do you agree that investment firms should be required to enter into a written (or equivalent) agreement with their professional clients, at least for certain services? If yes, in which circumstances? If no, please state your reason.**
- Q93. Do you agree that investment firms should be required to enter into a written (or equivalent) agreement for the provision of investment advice to any client, at least where the investment firm and the client have a continuing business relationship? If not, why not?**
- Q94. Do you agree that investment firms should be required to enter into a written (or equivalent) agreement for the provision of custody services (safekeeping of financial instruments) to any client? If not, why not?**
- Q95. Do you agree that investment firms should be required to describe in the client agreement any advice services, portfolio management services and custody services to be provided? If not, why not?**

## 2.20. Reporting to clients

### Background/Mandate

#### Extract from the Commission's request for advice (mandate)

*ESMA is invited to provide technical advice on the information to obtain when assessing the suitability or appropriateness of the services and financial instruments for their clients, criteria to assess non-complex financial instruments, the content and the format of records and agreements for the provision of services to clients and of periodic reports to clients on the services provided. In particular, the technical advice should consider any updates or improvements to the suitability assessment requirements as well as proposals for the content of suitability reports aiming to ensure a real added value for the client. Moreover, technical advice should further clarify and update the criteria to assess non-complex products set out in Article 38 of the Commission Directive 2006/73/EC.*

*The advice should take into account: (i) the nature of the services offered or provided to the client, taking into account the type, object, size and frequency of the transaction, (ii) the nature of the products being offered, including types of fin instrument and structured products and (iii) the retail and professional nature of the client, eligible counterparty.*

1. The first subparagraph of Article 25(6) of MiFID II states: *“The investment firm shall provide the client with adequate reports on the service provided in a durable medium. These reports shall include periodic communications to clients, taking into account the type and the complexity of financial instruments involved and the nature of the service provided to the client and shall include, where applicable, the costs associated with the transactions and services undertaken on behalf of the client”.*
2. There has not been any major change in MIFID II compared to MIFID I in relation to the provision of reports on services provided, apart from Article 30(1), which states that transactions with eligible counterparties are no longer exempt from applying Article 25(5). There is also one other amendment to clarify the requirement that reports should include *“periodic communications to clients, taking into account the type and the complexity of financial instruments involved and the nature of the service provided to the client”.*
3. The MiFID Implementing Directive contains the following relevant provisions:
  - i. reporting obligations in respect of execution of orders other than for portfolio management (Article 40);
  - ii. reporting obligations in respect of portfolio management (Article 41);
  - iii. additional reporting obligations for portfolio management or contingent liability transactions (Article 42); and
  - iv. statements of client financial instruments or client funds (Article 43).



## **Analysis**

### *General*

4. Given that MiFID II has only been slightly amended compared to MIFID I, ESMA does not envisage major changes to the existing MiFID Implementing Directive. However, the minor amendments in MiFID II should be considered in the context of some of the objectives of the review of MiFID I, which are to provide:
  - i. a more defined regime applicable to non-retail clients; and
  - ii. improved protection of retail clients at each stage in their relationship with investment firms providing services to them.
5. The following proposals aim at strengthening the MiFID Implementing Directive, in line with the objectives of the review of MiFID I.
6. ESMA has also made recommendations on additional reporting requirements in relation to costs and charges, arising from Article 24(4)(c) of MiFID II. These are discussed in the ‘Disclosure of costs and charges’ chapter of this CP.

### *Reporting obligations to eligible counterparties*

7. Under MIFID I, investment firms were not subject to any reporting obligations in relation to eligible counterparties. Under Article 30(1) of MiFID II, transactions with eligible counterparties are no longer exempt from the application of Article 25(6).
8. Taking into account the nature of interactions between investment firms and eligible counterparties, it seems reasonable to require the parties to determine contractually between themselves who owes information to whom and what information is due.

### *Reporting obligations to professional clients*

9. In relation to the reporting obligations applicable to professional clients, there is no other obligation than a very general one to provide such a report in a durable medium, both for portfolio management and execution of orders.
10. With regards to the execution of orders other than for portfolio management, ESMA is of the view that Article 40(1)(b) of the MiFID Implementing Directive, which states that the report should be sent on “the first business day following execution” should also apply to professional clients.
11. ESMA also considers that it is appropriate to align the content of reports for professional clients (both for portfolio management and execution of orders) with those applicable to non-professional clients.

### *Reporting obligations in respect of portfolio management*

#### Content of reports

12. Article 41 of the MiFID Implementing Directive mainly concerns information obligations relating to the content and value of the portfolio.





13. ESMA notes that Article 105 of the December 2012 Commission Delegated Regulation of AIFMD<sup>75</sup> (the AIFMD Implementing Regulation of 19 December 2012) requires firms to report, inter alia, on the fund performance during the relevant period (please also refer to the Annex to this chapter).
14. ESMA considers that there should be a certain level of harmonisation in relation to the quality of the information given to investors should they invest their money in the form of a collective investment scheme or in a discretionary managed portfolio.
15. Therefore, ESMA proposes to include an additional obligation in Article 41 of the MiFID Implementing Directive in line with Article 105(b) of the AIFMD Implementing Regulation of 19 December 2012.

#### Timing of reports

16. Article 41(3) of the MiFID Implementing Directive provides that “*in the case of retail clients, the periodic statement [...] shall be provided once every six months*” except in specific cases.
17. ESMA considers that, in line with proposals on the reporting on client assets held by investment firms, a quarterly report would be more appropriate.
18. ESMA considers that this frequency should also benefit professional clients.

#### *Reporting obligations in respect of portfolio management or contingent liability transactions*

19. Article 42 of the MiFID Implementing Directive currently requires additional reporting where “*investment firms provide portfolio management transactions for retail clients or operate retail client accounts that include an uncovered open position in a contingent liability transaction*”. The application of these requirements has raised some uncertainties over the scope and the effects of this obligation.
20. ESMA considers that this requirement should be modified in order to:
  - i. clarify that the service of portfolio management is covered under this obligation irrespective of the type of transactions or financial instruments included in the portfolio;
  - ii. cover situations in which the investment firm operates an account that includes or is likely to include leveraged financial instruments or other contingent liability transactions; and
  - iii. clarify that the agreement of loss thresholds triggering the reporting obligation is an obligation and not an option for firms. Specific predetermined thresholds could also be identified (e.g. 10 % (and multiples of 10%) of the initial investment or the value of the investment at the beginning of each year.

#### *Reporting obligations in respect of holding clients' financial instruments and funds*

21. According to Article 43 of the MiFID Implementing Directive, Member States must require investment firms to send statements of client financial instruments or funds to clients at least annually.

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<sup>75</sup> Commission Delegated regulation (EU) No 231/2013 of 19 December 2012, supplementing Directive 2011/61/EU.

22. Providing statements annually may be an insufficient frequency in some situations. Clients may need more frequent information on the holding of their funds or financial instruments in order to understand their position or exposure to the investment firm they are doing business with.
23. In specific cases, some clients may even require very frequent reporting. For example, in the wake of Lehman Brothers collapse, it became apparent that some prime brokerage clients did not have access to up-to-date information about the funds and financial instruments that they held with the firm. There was also uncertainty about whether clients' assets had been subject to re-hypothecation; which clients' instructions had been executed prior to insolvency; and which clients' assets had been segregated. This contributed to the uncertainty in the period following the firm's insolvency.
24. Clients in these types of cases need to be able to understand on a daily basis the nature and extent of their exposure, and the use that their broker has made of their assets in order to meet reasonable risk measurement and mitigation standards. While such frequent statements could be necessary in an extremely limited number of cases, reporting on such a frequent basis to clients would clearly be disproportionate in a majority of cases.
25. However, even for clients who do not undertake complex and continuous business with their firm, statements could still provide a useful opportunity to challenge a firm if they feel that the statement is incorrect. Appropriately frequent statements could go some way to preventing discovery of errors at a late stage, for example just before or after insolvency, and should help to ensure quicker remedying of any errors and eventually more accurate records. This could also reduce the likelihood of clients forgetting about or not being aware of firms holding client funds and client instruments.
26. Bearing this in mind, ESMA considers that the provision of statements is a measure that can increase protection of client funds and instruments. It seems appropriate that the minimum requirement should be to provide a quarterly report rather than an annual one and that clients should be able to request more frequent or ad hoc statements if they wish to review their holdings.
27. Furthermore, the content of such statements should be presented so that clients can use them appropriately. In particular, given the importance of the requirements on safeguarding of client assets, it seems appropriate that clients should easily be able to identify which (if any) of their assets are not subject to MiFID protections, which are those financial instruments subject to TTCA, and which assets no longer belong to the client, to the extent permitted. It is also appropriate for clients to be able to identify clearly which of their assets are affected by some peculiarities in their ownership status, for instance due to a security interest. It could also be argued that it would be beneficial to clients to not only provide details of those financial instruments that are subject to TTCA at the point the statement is issued, but also details of those financial instruments that have been subject to TTCA during the reporting period.
28. In general, the value of the assets is also an important consideration for the client. Therefore, investment firms should be required to provide information on the valuation of the financial instruments in the statement on financial instruments and funds. Investment firms should be required to provide clients with the market value of financial instruments, where available, or with an estimated value based on reasonable underlying assumptions.
29. In cases where the valuation is based on an estimated value, the method used should be in line with the usual professional practices and the methods used by the investment firm to evaluate its own assets.



30. For completeness, the client should be informed that the absence of a market price is likely to be indicative of a lack of liquidity.
31. ESMA's proposals on reporting to clients aim at improving investor protection by improving the content, quality and timing of reporting to clients, including non-retail clients, receiving investment services.

### **Draft technical advice**

1. The content of Articles 40 to 43 of the MiFID Implementing Directive should be modified in the following areas.

#### *Reporting obligations to eligible counterparties and professional clients*

2. Investment firms should be required to enter into agreements with eligible counterparties to determine the nature and timing of reporting.
3. Investment firms should send execution reports to professional clients no later than the first business day following execution. The content of the reports for professional clients should be aligned with the requirements applicable to reports for retail clients, both for portfolio management and execution of orders.

#### *Reporting obligations in respect of portfolio management*

4. Reporting obligations for portfolio management should include information about the activities undertaken and the performance of the portfolio during the relevant period.
5. The basic frequency for reports for portfolio management services should be quarterly instead of every six months.

#### *Reporting obligations in respect of portfolio management or contingent liability transactions*

6. Investment firms that operate a retail client account that includes or is likely to include leveraged financial instruments or other contingent liability transactions or provide the service of portfolio management should agree with their retail clients on loss thresholds that should trigger a specific reporting obligation.

#### *Reporting obligations in respect of statements to clients on their holdings of instruments and funds*

7. Investment firms should provide statements to clients on their financial instruments and funds on a quarterly basis and should provide such statements more frequently on request at reasonable commercial cost.
8. Statements concerning reporting obligations concerning client assets should include:
  - i. a clear indication of the assets or funds which are subject to MiFID protections and those that are not, for example, those that are subject to TTCA;
  - ii. a clear indication of which assets are affected by some peculiarities in their ownership status,

for instance due to some security interest; and

iii. the market or estimated value of the financial instruments included in the statement with a clear indication of the fact that the absence of a market price is likely to be indicative of a lack of liquidity.

9. Regarding reporting obligations in respect of cost and charges, ESMA refers to its recommendations in relation to Article 24(4) of MiFID II (considered in the 'Disclosure of costs and charges' section of this CP).

- Q96. Do you agree that the content of reports for professional clients, both for portfolio management and execution of orders, should be aligned to the content applicable for retail clients?**
- Q97. Should investment firms providing portfolio management or operating a retail client account that includes leveraged financial instruments or other contingent liability transactions be required to agree on a threshold with retail clients that should at least be equal to 10% (and relevant multiples) of the initial investments (or the value of the investment at the beginning of each year)?**
- Q98. Do you agree that Article 43 of the MiFID Implementing Directive should be updated to specify that the content of statements is to include the market or estimated value of the financial instruments included in the statement with a clear indication of the fact that the absence of a market price is likely to be indicative of a lack of liquidity?**
- Q99. Do you consider that it would be beneficial to clients to not only provide details of those financial instruments that are subject to TTCA at the point in time of the statement, but also details of those financial instruments that have been subject to TTCA during the reporting period?**
- Q100. What other changes to the MiFID Implementing Directive in relation to reporting to clients should ESMA consider advising the Commission on?**



**Annex 2.20.1: Commission Delegated regulation (EU) No 231/2013 of 19 December 2012 supplementing AIFMD (Directive 2011/61/EU)**

*Article 105*

**Activities of the financial year**

1. *The report on activities of the financial year shall include at least:
  - (a) *an overview of investment activities during the year or period, and an overview of the AIF's portfolio at year-end or period end;*
  - (b) *an overview of AIF performance over the year or period;*
  - (c) *material changes as defined below in the information listed in Article 23 of Directive 2011/61/EU not already present in the financial statements.**
2. *The report shall include a fair and balanced review of the activities and performance of the AIF, containing also a description of the principal risks and investment or economic uncertainties that the AIF might face.*
3. *To the extent necessary for an understanding of the AIF's investment activities or its performance, the analysis shall include both financial and non-financial key performance indicators relevant to that AIF. The information provided in the report shall be consistent with national rules where the AIF is established.*
4. *The information in the report on the activities of the financial year shall form part of the directors or investment managers report in so far as this is usually presented alongside the financial statements of the AIF.*



## 2.21. Best execution

### Background/Mandate

#### Extract from the Commission's request for advice (mandate)

*ESMA is invited to provide technical advice on criteria for determining the relative importance of the different factors the investment firm takes into account for determining the best possible result for their clients and factors that may be taken into account by an investment firm when reviewing its execution arrangements and the circumstances under which changes to such arrangements may be appropriate. With a view to increasing clients' understanding and scrutiny over the quality of the execution, technical advice should also be provided with respect to the nature and extend of the information to be provided to clients, including information on selection of different venues or entities retained, any third-party payments or other fees being paid to the firm where a firm charges for instance both participants in a transaction. The technical advice should take account of requirements set out in Articles 44 - 46 of the Commission Directive 2006/73/EC.*

1. The following MiFID II provisions are relevant to the topic of best execution:

Recital 97:

*"Information provided by investment firms to clients in relation to their execution policy often are generic and standard and do not allow clients to understand how an order will be executed and to verify firms' compliance with their obligation to execute orders on term most favourable to their clients. In order to enhance investor protection it is appropriate to specify the principles concerning the information given by investment firms to their clients on the execution policy and to require firms to make public, on an annual basis, for each class of financial instruments, the top five execution venues where they executed client orders in the preceding year and to take account of that information and information published by execution venues on execution quality in their policies on best execution".*

Article 27:

*"(1) Member States shall require that investment firms take all sufficient steps to obtain, when executing orders, the best possible result for their clients taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order. Nevertheless, where there is a specific instruction from the client the investment firm shall execute the order following the specific instruction.*

*Where an investment firm executes an order on behalf of a retail client, the best possible result shall be determined in terms of the total consideration, representing the price of the financial instrument and the costs relating to execution, which shall include all expenses incurred by the client which are directly relating to the execution of the order, including execution venue fees, clearing and settlement fees and any other fees paid to third parties involved in the execution of the order.*

*For the purposes of delivering best possible result in accordance with the first subparagraph where there is more than one competing venue to execute an order for a financial instrument, in order to assess and compare the results for the client that would be achieved by executing the order on each of the execution venues listed in the investment firm's order execution policy that is capable of exe-*

*cuting that order, the investment firm's own commissions and the costs for executing the order on each of the eligible execution venues shall be taken into account in that assessment.*

*(2) An investment firm shall not receive any remuneration, discount or non-monetary benefit for routing client orders to a particular trading venue or execution venue which would infringe the requirements on conflicts of interest or inducements set out in paragraph 1 of this Article and Article 16(3) and Articles 23 and 24.*

*(3) Member States shall require that for financial instruments subject to the trading obligation in Articles 23 and 28 Regulation (EU) No .../2014\* each trading venue and systematic internaliser and for other financial instruments each execution venue makes available to the public, without any charges, data relating to the quality of execution of transactions on that venue on at least an annual basis and that following execution of a transaction on behalf of a client the investment firm shall inform the client where the order was executed. Periodic reports shall include details about price, costs, speed and likelihood of execution for individual financial instruments.*

*(4) Member States shall require investment firms to establish and implement effective arrangements for complying with paragraph 1. In particular, Member States shall require investment firms to establish and implement an order execution policy to allow them to obtain, for their client orders, the best possible result in accordance with paragraph 1.*

*(5) The order execution policy shall include, in respect of each class of financial instruments, information on the different venues where the investment firm executes its client orders and the factors affecting the choice of execution venue. It shall at least include those venues that enable the investment firm to obtain on a consistent basis the best possible result for the execution of client orders.*

*Member States shall require that investment firms provide appropriate information to their clients on their order execution policy. That information shall explain clearly, in sufficient detail and in a way that can be easily understood by clients, how orders will be executed by the investment firm for the client. Member States shall require that investment firms obtain the prior consent of their clients to the order execution policy.*

*Member States shall require that, where the order execution policy provides for the possibility that client orders may be executed outside a trading venue, the investment firm shall, in particular, inform its clients about that possibility. Member States shall require that investment firms obtain the prior express consent of their clients before proceeding to execute their orders outside a trading venue. Investment firms may obtain such consent either in the form of a general agreement or in respect of individual transactions.*

*(6) Member States shall require investment firms who execute client orders to summarise and make public on an annual basis, for each class of financial instruments, the top five execution venues in terms of trading volumes where they executed client orders in the preceding year and information on the quality of execution obtained.*

*(7) Member States shall require investment firms who execute client orders to monitor the effectiveness of their order execution arrangements and execution policy in order to identify and, where appropriate, correct any deficiencies. In particular, they shall assess, on a regular basis, whether the execution venues included in the order execution policy provide for the best possible result for the client or whether they need to make changes to their execution arrangements, taking account of, in-*

*ter alia, the information published under paragraphs 3 and 6. Member States shall require investment firms to notify clients with whom they have an on-going client relationship of any material changes to their order execution arrangements or execution policy.*

[...]

*(9) The Commission shall be empowered to adopt delegated acts in accordance with Article 89 concerning:*

*(a) the criteria for determining the relative importance of the different factors that, pursuant to paragraph 1, may be taken into account for determining the best possible result taking into account the size and type of order and the retail or professional nature of the client;*

*(b) factors that may be taken into account by an investment firm when reviewing its execution arrangements and the circumstances under which changes to such arrangements may be appropriate. In particular, the factors for determining which venues enable investment firms to obtain on a consistent basis the best possible result for executing the client orders”.*

2. MiFID II requires an execution policy to be clear, precise and sufficiently detailed so that it is easily understood by clients. NCA experience of sub-standard quality of execution policies provided by investment firms clearly points to the need to develop new requirements in this field.
3. The Commission Consultation also raised the issue of content of best execution policies, asking (see Question 110) *“What is your opinion of the requirements concerning the content of execution policies and usability of information given to clients should be strengthened? Please explain the reasons for your views.”*
4. Furthermore, CESR in its *“Technical Advice to the European Commission in the context of the MiFID Review – Investor Protection and Intermediaries”<sup>76</sup>* also indicated that: *“There is a need to clarify through Level 3 guidance the obligations on investment firms executing orders in shares to collect information to enable them to assess which execution venues should be included in their execution policies, in particular in regard to investment firms executing client orders on behalf of retail clients. This should be backed up by a general obligation in the Level 1 text for executing venues to produce data on execution quality. The Directive could give to ESMA the discretion to introduce binding technical standards and requirements for execution venues to produce regular reports on execution quality in shares. If these reports are prescribed the metrics should at least cover price, speed of execution and likelihood of execution for individual shares.”*
5. In the summary of the answers received to its 2009 best execution questionnaire, CESR noted that:
  - i. many responses *“provided limited information about what is included in execution policies regarding ‘strategies’ and ‘key steps’ for obtaining best execution”*;
  - ii. when firms provide the service of receiving and transmitting orders (RTO) or are portfolio managers, they generally *“deferred to the policies of the executing firms, reasoning that if these entities had a policy which set out their strategy for obtaining best execution, then that was sufficient”*; and

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<sup>76</sup> CESR/10-859, 29 July 2010.



- iii. executing firms “*stated that they provided information on their execution policies in simple, clear terms*” to their clients, and RTO/portfolio managers “*said that the information they are given by firms who execute orders on their behalf is generally sufficient and they did not usually request additional information*”. Nevertheless, some of the firms were very critical about the quality of the information provided, and listed additional questions they had submitted to the executing firms.
6. Further, some NCAs have identified issues with the implementation of the best execution rules by investment firms. For example:
  - i. firms that are in direct contact with retail clients are often receiving and transmitting orders for execution, rather than executing orders directly. There is no obligation for an RTO firm or portfolio manager to obtain the agreement of the end client to the execution policy of the entity that ultimately executes the client’s order. Instead, it is the RTO firm or portfolio manager that is required to consent to the execution policy of the firm to which it transmits orders for execution. The RTO firm or portfolio manager must have a policy (RTO/placing policy) which governs how it intends to select firms to which it intends to transmit or place orders for execution, but does not need client consent to this policy. Also, the MiFID I requirement to obtain prior express consent from clients before proceeding to execute an order outside a regulated market or an MTF is not applicable to clients of RTO firms or portfolio managers;
  - ii. the information that firms supply to clients is sometimes unclear, incomplete or even biased and can have the effect of inducing clients to give specific instructions that may not be in their best interests. For example, some firms indicate to their clients that their execution fees will be lower according to which venue they choose to use. The risk associated with this approach is that if a client issues a specific instruction to use a particular execution venue, this removes the protection of the best execution rule; and
  - iii. firms may satisfy the requirement to disclose the identity of their execution venues by stating that they execute on a regulated market, even though they might actually direct orders to a limited subset of market makers that are active on that market, or give priority to a subset of available market makers. If these are not clearly explained to clients, these types of approach can limit the ability of clients to make meaningful comparisons between the services that are actually provided.
7. Studies conducted by some NCAs have highlighted the following issues with best execution and RTO/placing policies used by investment firms:
  - i. policies were very generic and similar to one another despite differences between the services actually provided or instruments traded;
  - ii. policies did not set out the relative importance of the execution factors;
  - iii. the venues/entities used for execution were not always listed;
  - iv. where information is provided to clients, the appropriateness of the information is often insufficient - in particular, some firms that transmitted orders to a single or small number of entities for execution did not disclose this fact to their clients;

- v. the monitoring of the effectiveness of the policies and their regular review are often insufficient and/or not documented;
  - vi. it is difficult for the NCA to obtain information about the implementation of the best execution obligation;
  - vii. some firms consider that as portfolio managers they neither execute nor receive and transmit orders and therefore do not have to apply the best execution rules; and
  - viii. a number of firms deal with only one entity for execution purposes without being able to demonstrate that it enables them to satisfy the best execution requirement - more generally, there is a lack of understanding of the evidential requirements to demonstrate that orders are executed in accordance with the firm's best execution policy.
8. In view of the number of problems identified above, ESMA considers it appropriate to develop more detailed and precise requirements to give NCAs clearer standards and a better focus for supervisory intervention if similar issues are identified in future.
  9. ESMA remains mindful of the need to ensure that any new obligations on investment firms are proportionate. The policy proposals in this chapter may have cost implications for firms, both at the implementation stage and on a recurring basis. However, ESMA considers that as the proposals are for incremental improvements to the current disclosure of requirements, the marginal costs to firms will be justified by the benefits to clients of increased transparency.

### **Analysis**

10. MiFID II does not set out major changes to the best execution requirements. Nevertheless, there are a few additional requirements and clarifications that should contribute to improving investor protection and the efficiency of best execution assessment by increasing the transparency of firms' policies and procedures.

#### *Detail of execution and RTO/placing policies*

11. In practice, execution and RTO/placing policies provided to clients can be very generic and many do not specify the execution venues or entities to which firms transmit orders for execution. In addition, many lack detail on:
  - i. how firms execute orders for the different classes of instruments (even though the criteria for selecting an executing venue/entity may be different, e.g. for liquid shares and contracts for difference);
  - ii. how the types of service provided modify the type of policy required (e.g. a firm should select an executing firm when it transmits orders for execution and an executing venue when the firm itself executes the order); and
  - iii. the way in which firms prioritise and apply the execution factors.
12. NCAs also need to be able to supervise whether firms are adequately reviewing their execution and RTO/placing policies and arrangements. For this reason, it is necessary that firms document their review processes and keep this documentation available for analysis by NCAs. When assessing execu-

tion and RTO/placing policies, NCAs have often noted examples where reviews were poorly documented and/or only contained very generic information.

13. In particular, there is commonly a lack of systematic links between the best execution factors listed in firms' policies and those used in their reviews of whether these policies continue to deliver best execution on a consistent basis. When specific execution factors are listed in policies, their evaluation and ranking in both the policy and in the review process are rarely specified.
14. ESMA believes that there is a crucial link between the factors that firms take into account when deciding where to execute orders and their subsequent monitoring of compliance with the best execution obligation. In particular, the specificity of bespoke products should not be used as a pretext by the firm to circumvent its best execution obligations.

#### *Disclosure and consent*

15. Adequate disclosure of appropriate information, both prior to the provision of services and on request by a client, is a key element of the best execution obligation. Clients need to know how investment firms are handling their orders if they are to feel empowered to scrutinise the execution quality that they receive. This principle applies equally to firms that execute orders directly and to those that receive and transmit or place orders for execution by another entity.
16. The MiFID Implementing Directive clarifies that the best execution provisions are not intended to require a firm that transmits or places orders with other entities for execution to duplicate the efforts of its execution entities. Rather, a firm should determine that the entities it uses will enable it to comply with the overarching best execution requirement when placing an order with, or transmitting an order to another entity for execution. This can result from the executing entity being subject to MiFID I, or because the executing entity undertakes to meet the obligation on a contractual basis. RTO firms and portfolio managers are, however, still required to implement an appropriate policy and to monitor and review its effectiveness including the execution quality actually delivered by the entities they choose.
17. MiFID I therefore takes a different approach to the respective services. Firms that execute orders or decisions to deal should establish execution arrangements and an execution policy for complying with the overarching best execution requirement. Similarly, firms that transmit or place orders with other entities for execution should establish a policy. This RTO/placing policy is the means that investment firms employ to obtain the best possible result for their clients when transmitting or placing orders with other entities for execution.
18. Both the execution policy and the RTO/placing policy used by firms transmitting or placing orders with other entities for execution should set out the investment firm's strategy for obtaining the best possible result for the execution of its client orders, including: (i) the key steps the firm is taking to comply with the overarching best execution requirement; and (ii) how those steps enable the firm to obtain the best possible result. The execution policy should also include an account of the relative importance the firm places on the best execution factors when executing client orders or decisions to deal (or the process for determining the relative importance), as well as information on how those factors affect the firm's choice of execution venues for inclusion in the execution policy.
19. ESMA considers that where a retail client requests additional information about a firm's execution policy, and such a request is reasonable and proportionate, the firm, by virtue of its duty to act fairly and professionally, should honour such a request. This is especially the case where such information



is needed to enable the client to make a properly informed decision about whether to use, or to continue to use, the services of the firm.

20. When a firm executes a client order, prior express consent from the client is required if the order is executed outside a regulated market (RM), a multilateral trading facility (MTF) or an organised trading facility (OTF). But, when the firm only transmits the order to another entity for the execution, the client does not receive any information about the potential for execution outside a RM, MTF or OTF. ESMA considers that requiring systematic prior express consent from the client in such a situation would be disproportionate. Nevertheless, the client should at least be informed that his order may be executed outside a RM, MTF or OTF. This is in order to allow the client to take this information into consideration when transmitting an order, and to request any additional information about the consequences of this means of execution.

#### *Content of disclosure*

21. When a firm executes orders or transmits or places orders with an entity that may execute these orders outside a RM, MTF or OTF, this should be clearly indicated in the firm's execution policy or RTO/placing policy. The consequences stem from the fact that such a transaction is executed on an OTC basis, between two counterparties. In such a situation, as the OTC transaction does not benefit from any clearing mechanism, the client is exposed to a counterparty risk and this risk should be duly explained.
22. ESMA considers that on a purposive reading of the "prior express consent" requirement, an investment firm does not have to obtain express consent from its clients where the relevant instruments are not admitted to trading on a RM, MTF or OTF. This prevents a disproportionate burden on firms trading in instruments where the market expectation is that transactions will take place OTC. However, in this situation the counterparty risk should still be disclosed to the client.
23. The adequacy of execution and RTO/placing policies is a key point of the MiFID investor protection rules. This is why ESMA considers that the proposals in this chapter are necessary. Nevertheless, it has to be taken into consideration that not all retail investors are either interested, or able to understand, the detailed specifications of the best execution policy. For this reason, it seems appropriate that firms dealing with retail clients provide them with a summarised best execution policy, simply and clearly explained, as well as focussed on the points that are essential for this category of investors.

#### *Third party payments*

24. The MiFID I inducements obligations permit payments by a client for the provision of execution services or for proper fees that are necessary for the provision of the service. Other payments by a firm to a third party are governed by whether the payment meets three tests. These are:
  - i. it must not impair compliance with the MiFID I clients' best interests rule;
  - ii. it must be disclosed prior to the provision of the service; and
  - iii. it must be designed to enhance the quality of the service provided.
25. Payments to/from third parties under MiFID II are also discussed in more detail in the 'legitimacy of inducements to be paid to/by a third person' chapter of this CP. As such payments may generate some



conflicts of interest, it is crucial to check that these are correctly managed by the firm and that they do not impair its ability to provide best execution.

26. In some cases, firms have argued that when they execute a client order in certain markets, they charge both the client and also market makers at the same time because they take the view that they are also executing on behalf of the market maker (and therefore the charge is not a third party payment but a legitimate payment from a client).
27. Where firms receive payments from one venue or broker this may incentivise them to select this means of execution. Alternatively, it may incentivise clients to give specific instructions to direct their orders because the inducement has the effect of reducing the client's explicit costs. These inducements, or other potential conflicts of interests (such as those created by the existence of close links<sup>77</sup>) may lead the firm to limit the list of entities to which client orders are routed, or of the venues on which the orders are executed, without taking sufficiently into account the liquidity, prices or costs of these firms compared to others.
28. ESMA considers that, since any permissible third party payment must be disclosed prior to the provision of a service, it is reasonable to require firms to discharge this obligation in their execution or RTO/placing policies. This will enable clients to see all information that may be relevant to execution costs and quality within a single policy.

#### *Transparency of venue selection*

29. ESMA believes that clients should not be induced to select their own execution venues or entities and that this choice should, in the overwhelming majority of cases, be made by the investment firm executing or transmitting or placing the order for execution. Protections already exist in the MiFID Implementing Directive's provisions on best execution. Article 44(4) of the MiFID Implementing Directive prevents firms from structuring their fees or charges to discriminate unfairly between execution venues.
30. In addition, according to Recital 68 of the MiFID Implementing Directive firms should not induce their clients to give specific instructions to execute an order in a particular way, by expressly indicating or implicitly suggesting the content of the instruction to the client, when they ought reasonably to know that an instruction to that effect is likely to prevent it from obtaining the best possible result.
31. However, ESMA considers that, in the limited circumstances where a client may be invited to choose between two or more specified trading venues covered by a firm's execution policy, the client must have access to adequate and transparent information to support that choice.
32. ESMA has considered the risk that presenting information on fees and charges may incentivise clients to choose the lowest figure. This may occur even where their total cost is higher because of the price paid when executing an order. However, if differences in pricing are not placed in the context of relevant differences in the service provided (such as the level of available liquidity, or the existence of conflicts of interest) then they can be misleading. Therefore, information on known fees and charges should be presented in the context of the actual level of service provided by a venue or entity to which orders are transmitted for execution. One method of compliance could be to for the relevant policy to

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<sup>77</sup> For instance, when the firm is a shareholder of a venue, or when the firm and the venue belong to the same group.



display the respective known fees and charges of each alternative venue, provided that these costs are presented in the context of the respective services offered by different venues.

*Factors that may constitute a “material change”*

33. Investment firms are required to review their execution policy or RTO/placing policy and arrangements at least annually and whenever there is a material change that affects its ability to obtain the best possible results for the execution of its client orders. As a result of current ESMA work on supervisory convergence in the area of best execution, ESMA considers that there is scope for clarification of some of the factors that may constitute a ‘material change’ which should trigger a review of execution policies and arrangements.
34. What is material will depend on the nature and scope of any change and the nature and size of a firm’s business. Nevertheless, a material change could be understood as a significant event of internal or external change that could impact parameters of best execution (cost, price, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order).
35. In certain cases, new offers from existing or newly created venues can also be considered as material changes, when they relate to the financial instruments for which the investment firm is providing investment services.
36. Please also consider the content of paragraphs 30-32 of Chapter 2.3 in the DP on MiFID II/MiFIR areas requiring regulatory technical standards, for further discussion of the factors that may constitute a material change.

*Use of a single venue or entity for execution*

37. ESMA also considers as a result of its recent work on best execution that there is scope to clarify how investment firms should satisfy the overarching best execution requirement when using a single venue or entity for execution.

**Draft technical advice**

*Detail of execution policies*

1. Both execution policies and the policies of firms transmitting or placing orders with other entities for execution should be customised depending on the class of instrument and on the type of service provided. Investment firms should set out in their execution or RTO/placing policy the list of factors used to select an entity or venue for execution (including qualitative factors such as clearing scheme, circuit breakers), and the relative importance of each factor.
2. The list of venues or entities used by an investment firm for execution must be listed in its execution or RTO/placing policy. The list should specify, when appropriate, which venues are used for each category of financial instruments.
3. The information about the factors used to select an entity or venue for execution and the venues used by the firm should be consistent with the controls used by the firm to demonstrate to clients that best execution has been achieved on a consistent basis and when reviewing the adequacy of its policy and

arrangements.

4. In the case of bespoke OTC products, the investment firm should be able to check the fairness of the price proposed to the client.

#### *Disclosure and consent*

5. Investment firms shall answer clearly and within a reasonable time when their clients make reasonable and proportionate requests for information about its policies or arrangements and how they are reviewed.
6. Investment firms performing the services of reception and transmission of orders or of portfolio management must provide appropriate information on their RTO/placing policy for achieving the best possible result for their clients. While prior express consent is not required for firms transmitting or placing orders that may be executed outside a RM, MTF or OTF, investment firms should provide their clients with appropriate information before proceeding to transmit or place their orders. This should include relevant information on the execution policies of the entities that they have selected to execute transactions, in each category of financial instruments.

#### *Content of disclosure*

7. When a firm executes orders or transmits or places orders with an entity that may execute these orders outside a RM, MTF or OTF, this must be clearly indicated in the firm's execution policy or RTO/placing policy to allow the client to take this information into consideration and to request any additional information about the consequences of this means of execution. The relevant policy should also indicate the consequences of counterparty risk to the client from this means of execution.
8. When the execution policy or RTO/placing policy concerns retail clients, these clients shall be provided with a summary of the relevant policy, focused on the total known costs they face when the firm executes or transmits their orders, including venue fees, clearing and settlement fees, regulatory levies, taxes or any other charges. Although the policy cannot include price data (which is not known in advance), it should provide a link to the most recent execution quality data published by each venue.

#### *Third party payments*

9. To the extent that firms are able to receive third party payments without a breach of the MiFID inducements rule, the execution or RTO/placing policy has to include clear information about the inducements that may be received by the firm from the venues, market makers, or entities to which the orders are transmitted. This requirement shall remain consistent with the expectations articulated with the inducements rules.
10. Where a firm is able, within the scope of the inducements requirements, to charge more than one participant in a transaction, both parties should be aware of the fees being paid to the firm. This is particularly important if the firm is charging different fees to different participants in the same transaction.
11. When a firm charges both participants in a transaction (for example, the client and the market maker), the execution policy has to indicate that such a scheme may be used, and to specify the fees charged by the firm on each leg of the transaction. If the fees are different depending on the client, the

policy must indicate the maximum fees or the range of the fees paid by each.

*Transparency of venue selection*

12. When the fees applied to a client by the firm are different depending of the execution venue or entity retained, the execution or RTO/placing policy should provide sufficient information to the client in order to allow him to understand both the advantages and the disadvantages of choosing a venue or entity rather than an alternative. The information should be fair, clear, not misleading, and sufficient to prevent the client from choosing one execution venue or entity rather than another on the sole basis of the price policy applied by the firm.

*Factors that may constitute a 'material change'*

13. Investment firms are required to review their execution or RTO/placing policy and arrangements at least annually and whenever there is a material change that affects its ability to obtain the best possible results for the execution of its client orders.
14. A material change should be understood as a significant event of internal or external change that could impact parameters of best execution (cost, price, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order). An investment firm should consider the materiality of any changes it makes to the relative importance of the best execution factors or to the venues or entities on which it places significant reliance in meeting the overarching best execution requirement.

*Use of a single venue or entity for execution*

15. An investment firm that executes orders or transmits or places orders with other entities for execution can include a single venue or entity in its policy if it is able to show that this allows it to satisfy the overarching best execution requirement.
16. The investment firm should reasonably expect that the venue or entity it selects will enable it to obtain results for its clients that are at least as good as the results that it reasonably could expect from using alternative entities. This reasonable expectation must be supported by relevant data or information published under Article 27 of MiFID II or by other internal analysis conducted by the firm.

**Q101. Do you have any additional suggestions to provide clarity of the best execution obligations in MiFID II captured in this section or to further ESMA's objective of facilitating clear disclosures to clients?**

**Q102. Do your policies and your review procedures already the details proposed in this chapter? If they do not, what would be the implementation and recurring cost of modifying them and distributing the revised policies to your existing clients? Where possible please provide examples of the costs involved.**





## 2.22. Client order-handling

### Background/Mandate

#### Extract from the Commission's request for advice (mandate)

*ESMA is invited to provide technical advice on adaptations and further improvements to the procedures and arrangements which result in the prompt, fair and expeditious execution of client orders and the situations in which or types of transaction for which investment firms may reasonably deviate from prompt execution so as to obtain more favorable terms for clients as well as to the different methods through which an investment firm can be deemed to have met its obligation to disclose not immediately executable client limit orders to the market.*

1. The following MiFID II provisions on client order-handling are relevant with respect to the mandate above:

Article 28:

*“(1) Member States shall require that investment firms authorised to execute orders on behalf of clients implement procedures and arrangements which provide for the prompt, fair and expeditious execution of client orders, relative to other client orders or the trading interests of the investment firm.*

*Those procedures or arrangements shall allow for the execution of otherwise comparable client orders in accordance with the time of their reception by the investment firm.*

*(2) Member States shall require that, in the case of a client limit order in respect of shares admitted to trading on a regulated market or traded on a trading venue which are not immediately executed under prevailing market conditions, investment firms are, unless the client expressly instructs otherwise, to take measures to facilitate the earliest possible execution of that order by making public immediately that client limit order in a manner which is easily accessible to other market participants. Member States may decide that investment firms comply with that obligation by transmitting the client limit order to a trading venue. Member States shall provide that the competent authorities may waive the obligation to make public a limit order that is large in scale compared with normal market size as determined under Article 4 of Regulation (EU) No .../2014\*.”*

### Analysis

2. This section does not deal with the last part of the mandate, which refers to the proposed implementing measures concerning Article 28(2) of MiFID II on the different methods through which an investment firm can meet its obligation to disclose not immediately executable client limit orders to the market. This part of the mandate is dealt with in the section of the consultation paper on data publication.
3. Article 28(1) of MiFID II does not make any changes to Article 22(1) of MiFID I in respect of client order-handling rules.
4. Article 22(1) of MiFID I has been implemented with the following measures of the MiFID Implementing Directive:
  - i. Article 47 setting general principles that investment firms have to satisfy when carrying out client orders;
  - ii. Article 48 on aggregation and allocation of orders; and



iii. Article 49 on the aggregation and allocation of transactions for own account.

5. ESMA is not aware of specific issues emerged in the application of these requirements and seeks stakeholders views on their continuing appropriateness.

**Draft technical advice**

1. The existing provisions the MiFID Implementing Directive on client order-handling should be confirmed.

**Q103. Are you aware of any issues that have emerged with regard to the application of Articles 47, 48 and 49 of the MiFID Implementing Directive? If yes, please specify.**



## 2.23. Transactions executed with eligible counterparties

### Background/Mandate

#### Extract from the Commission's request for advice (mandate)

*ESMA is invited to provide technical advice on the procedures for eligible counterparties, referred to under Article 30(2) first subparagraph, to request, either on a general form or on a trade-by-trade basis, treatment as clients whose business with investment firms is subject to Articles 24, 25, 27 and 28 and the pre-determined proportionate requirements, including quantitative thresholds that would allow an undertaking to be an eligible counterparty under Article 30(3), as well as the procedures for obtaining the express confirmation from the prospective counterparty that it agrees to be treated as an eligible counterparty. Any further improvements to the current implementing framework should be considered.*

1. The following main provisions of MiFID II are relevant with respect to transactions executed with eligible counterparties:

#### Article 30(2):

*“Member States shall recognise as eligible counterparties for the purposes of this Article investment firms, credit institutions, insurance companies, UCITS and their management companies, pension funds and their management companies, other financial institutions authorised or regulated under Union law or under the national law of a Member State, national governments and their corresponding offices including public bodies that deal with public debt at national level, central banks and supranational organisations.*

*Classification as an eligible counterparty under the first subparagraph shall be without prejudice to the right of such entities to request, either on a general form or on a trade-by-trade basis, treatment as clients whose business with the investment firm is subject to Articles 24, 25, 27 and 28.”*

#### Article 30(3):

*“Member States may also recognise as eligible counterparties other undertakings meeting pre-determined proportionate requirements, including quantitative thresholds. In the event of a transaction where the prospective counterparties are located in different jurisdictions, the investment firm shall defer to the status of the other undertaking as determined by the law or measures of the Member State in which that undertaking is established.*

*Member States shall ensure that the investment firm, when it enters into transactions in accordance with paragraph 1 with such undertakings, obtains the express confirmation from the prospective counterparty that it agrees to be treated as an eligible counterparty. Member States shall allow the investment firm to obtain that confirmation either in the form of a general agreement or in respect of each individual transaction.”*

2. Article 30(2) subparagraph 1 of MiFID II lists the entities that should be recognised as eligible counterparties when certain services, mentioned in paragraph 1 of the same Article, are provided to them; the list mainly includes entities active in the financial sector. Investment firms providing services to eligible counterparties are not obliged to comply with a number of rules aimed at protecting investors (a number of conduct of business rules, best execution and client order-handling requirements).



3. Article 30(2) subparagraph 2 gives eligible counterparties the right to request, either on a general form or on a trade-by-trade basis, treatment as professional or retail clients, whose business with the investment firm benefits from the application of investor protection requirements.
4. Article 30(3) of MiFID II enables Member States to recognise as eligible counterparties undertakings, other than the entities mentioned in Article 30(2) subparagraph 1 of MiFID II, provided that they meet pre-determined proportionate requirements, including quantitative thresholds. Investment firms should obtain the express confirmation from the prospective counterparty that it agrees to be treated as an eligible counterparty.
5. According to Article 30(5) of MiFID II, the Commission shall be empowered to adopt delegated acts to specify:
  - i. the procedures for requesting treatment as clients under Article 30 (2) of MiFID II;
  - ii. the procedures for obtaining the express confirmation from prospective counterparties under Article 30(3) of MiFID II; and
  - iii. the pre-determined proportionate requirements, including quantitative thresholds that would allow an undertaking to be considered to be an eligible counterparty under Article 30(3) of MiFID II.
6. The Commission empowerment is unchanged in comparison with Article 24(5) of MiFID I. Article 24 (5) of MiFID I has been implemented with Article 50 of the MiFID Implementing Directive.
7. In its request for advice, the Commission recognises that Article 50 of the MiFID Implementing Directive might still constitute an adequate and satisfactory framework but requires ESMA to consider the need for specific improvements of that provision.

### **Analysis**

8. ESMA has not recorded any significant issue with respect to the procedural aspects mentioned in the empowerment in accordance with Article 30(5)(a) and (b) of MiFID II. Therefore, ESMA considers that Article 50 of the MiFID Implementing Directive does not need any modification in relation to these empowerments.
9. ESMA considers, however, that the empowerment under Article 30(5)(c) of MiFID II deserves a specific attention since it concerns the possibility to recognise as eligible counterparties undertakings other than the entities already recognised as such by Article 30(2) subparagraph 1 of MiFID II (which, typically, are entities active in the financial sector).
10. Therefore, the empowerment relates to the possibility to extend the perimeter of entities that, being classified as eligible counterparties, do not benefit from a number of important protections under MiFID II.
11. In this respect, Article 50 of the MiFID Implementing Directive implements this empowerment by allowing Member States to recognise as eligible counterparties two categories of undertakings:

- i. other undertakings that are to be considered as professional clients pursuant to Section I of Annex II to MiFID I (Article 50(1) subparagraph 1 of the MiFID Implementing Directive). This list includes large undertakings, that is undertakings meeting certain size requirements; and
  - ii. undertakings who have requested to be treated as professional clients (professional clients on request in accordance with Annex II, section 2 of MiFID I (Article 50(1), subparagraph 2 of the MiFID Implementing Directive).
12. ESMA notes that one of the objectives of the MiFID review has been to increase the protection of investors and reduce the areas of exemption, including strengthening the treatment of eligible counterparties. Recital 104 of MiFID II states that “*the financial crisis has shown limits in the ability of non-retail clients to appreciate the risk of their investments*”. Furthermore, the review of MiFID has broadened the scope of investor protection requirements in different areas.
13. The possibility provided by Article 50(1), subparagraph 2, of the MiFID Implementing Directive to recognise undertakings that are not large undertakings as eligible counterparties does not seem in line with the objectives of the MiFID review described above.

#### **Draft technical advice**

1. The provisions of Article 50 of the MiFID Implementing Directive shall be confirmed with the exception of Article 50(1) subparagraph 2, which should not be maintained.

- Q104. Do you agree with the proposal not to allow undertakings classified as professional clients on request to be recognised as eligible counterparties?**
- Q105. For investment firms responding to this consultation, how many clients have you already classified as eligible counterparties using the following approaches under Article 50 of the MiFID Implementing Directive:**
- i. other undertakings that are to be considered as professional clients pursuant to Section I of Annex II to MiFID I (Article 50(1) subparagraph 1); and
  - ii. clients who have requested to be treated as professional clients (professional clients on request in accordance with Annex II, section 2 of MiFID) (Article 50(1) subparagraph 2)?
- Q106. For investment firms responding to this consultation, what costs would you incur in order to meet these requirements?**



## 2.24. Product intervention

### Background/Mandate

#### Extract from the Commission's request for advice (mandate)

*ESMA is invited to provide technical advice on measures specifying the criteria and factors to be taken into account by competent authorities in determining when there is a significant investor protection concern or a threat to the orderly functioning and integrity of financial markets or commodity markets or to the stability of the whole or part of the financial system of the Union or of the financial system within at least one Member State. As the Regulation establishes an identical framework for EBA intervention powers in respect of structured deposits and as factors and criteria to be taken into account for the exercise of product intervention powers for structured deposits should be similar to (if not identical to) those set for ESMA with respect to financial instruments, ESMA is invited to closely liaise with and consult EBA when providing its technical advice to the Commission and proposing factors and criteria for intervention powers in accordance with Articles 40, 41 and 42 of the Regulation.*

1. Under Articles 40(8), 41(8) and 42(7) of MiFIR, the Commission is required to adopt delegated acts specifying criteria and factors to be taken into account by ESMA, EBA and NCAs in determining when there is a significant investor protection concern, or a threat to the orderly functioning and integrity of financial markets or commodity markets and to the stability (of the whole or part) of the financial system (of the Union or within at least one Member State, respectively) arise. These criteria and factors shall include:
  - i. the degree of complexity of a financial instrument or structured deposit and the relation to the type of client to whom it is marketed and sold;
  - ii. the size or the notional value of an issuance of financial instruments or structured deposits;
  - iii. the degree of innovation of a financial instrument or structured deposit, an activity or a practice;
  - iv. the leverage a financial instrument or structured deposit or practice provides; and
  - v. (and regarding the intervention by NCAs) in relation to the orderly functioning and integrity of financial markets or commodity markets, the size or the notional value of an issuance of financial instruments or structured deposits.
2. In light of the EBA's intervention powers in respect of structured deposits, ESMA has been in contact with, and will formally consult, EBA in order to receive any feedback and contribution before submitting ESMA's advice to the Commission on Articles 40, 41 and 42 of MiFIR. Note that the EBA is likely to conduct a separate consultation on its product intervention powers on structured deposits in accordance with Article 41 of MiFIR.

### Analysis/issues

3. Articles 40 to 43 of MiFIR introduce a framework for product intervention in order to enable NCAs and ESMA (in accordance with, and within the scope of, Article 40) or EBA (in accordance with, and within the scope of, Article 41) to prohibit or restrict the marketing, distribution or sale of certain financial instruments or structured deposits or financial instruments or structured deposits with certain specified features or a type of financial activity or practice.

4. Recital 29 of MiFIR clarifies that the product intervention powers do not require either NCAs, ESMA or EBA to introduce or apply a product approval or licensing regime. Nor do these powers relieve investment firms of their responsibility to comply with all the relevant requirements set out in MiFID and MiFIR.
5. The product intervention powers complement the existing empowerments for sanctions and other measures in reaction to service-related violations of MiFID and thus allow NCAs and ESMA or EBA inter alia to take action on products and practices that are not sufficiently addressed by MiFID. ESMA is aware, on the other hand, that the specification of criteria and factors to be taken into account in determining when the prerequisites for such an intervention are met are intended limit the wide discretion granted and help develop a common understanding of the purpose of these powers.
6. It is essential that intervention powers are dynamic enough to enable NCAs and ESMA or EBA to deal with a range of different exceptional situations and to allow steps to be taken to address issues before they become widespread. ESMA is therefore of the view that flexibility is required, both to be able to intervene in relation to new instruments that may not meet given criteria, or conversely not necessarily intervene if given criteria are met but overall consumer detriment or disorderly functioning of markets is not foreseen or detected. Therefore, criteria and factors should be non-exhaustive and general and it appears impracticable to suggest specific quantitative thresholds for intervention. This is further supported by the possibility to exercise these powers on a precautionary basis, a possibility that would not seem compatible with a quantitative definition of amount of losses or thresholds to intervene or other very specific circumstances.
7. Given the product intervention powers are new, ESMA intends to undertake further work in this area in the future, including by promoting the exchange of information between national authorities, EBA and ESMA, and a common understanding about how the powers are used, according to the coordination role to be played according to Article 43 of MiFIR.
8. ESMA is of the opinion that, considering the overall legal conditions regulating these powers, the application of this empowerment should in general be limited. This view is supported by the principle of proportionality, which is explicitly emphasised in Articles 40(3)(a), 41(3)(a) and Article 42(2)(c) of MiFIR.
9. The assessment of proportionality will in most cases be a major focus within the decision making process about whether to implement the intervention powers. This assessment of proportionality will cover many aspects that could also be addressed as criteria for the assessment of whether there is a significant investor protection concern or a threat to the orderly functioning and integrity of financial markets or commodity markets and to the stability of the financial system of the Union. This is why, while ESMA believes that factors such as the potential scale of the problem in terms of ‘numbers affected’, ‘amount of loss and persistence’, ‘nature of the problem and social context’ are by nature relevant in judging proportionality, most of these factors are also listed as “criteria” for deciding on whether or not to intervene. Such criteria are therefore taken into account both for the purpose of determining whether there is a significant concern or threat, and as part of the proportionality assessment.
10. In addition to the proportionality assessment, other requirements in Article 42(2) for NCAs (and in Article 40(2)(b), 40(2)(c) and 40(3) and Article 41(2)(b), 41(2)(c) and 41(3), respectively, for ESMA and EBA) also contribute to set the framework for intervention and to limit discretion. These requirements include inter alia:



- i. existing regulatory requirements under applicable Union law do not sufficiently address the risks;
  - ii. the issue would not be better addressed by improved supervision or enforcement of existing requirements;
  - iii. proper consultation with other NCAs or bodies affected; and
  - iv. no discriminatory effect on services or activities from other Member States.
11. ESMA is of the view that the product intervention powers should also be seen in the context of the new product governance principles that are introduced by Articles 16(3) and 24(2) of MiFID II. These requirements implement essential product related requirements and processes that establish a benchmark for financial instruments and distribution (e.g. product approval process, definition of target market, product design to meet the needs of customers, regular review of financial instruments). ESMA considers that appropriate product governance processes should, inter alia, help to ensure that investment firms adequately take into account investors' interests, therefore limiting the use of product intervention powers.
  12. ESMA therefore believes that criteria and factors for intervention to be specified in future delegated acts will supplement an intervention regime that is already well developed, and notes that Article 40(8), 41(8) and Article 42(7) of MiFIR already contain a number of appropriate factors and criteria. ESMA's advice will have therefore to be considered in the context of the broader and detailed framework described above.
  13. When considering factors in relation to a potential threat to the orderly functioning and integrity of financial markets or commodity markets and to the stability of the whole or part of the financial system, ESMA carefully reviewed the criteria of Article 24 of the Short Selling Regulation (No 918/2012). ESMA considers that these criteria were drawn up specifically in the context of short-selling and uncovered sovereign credit default swaps and therefore do not fully reflect the wider factors that could lead to a threat to the orderly functioning and integrity of financial markets or to the commodity markets in the broader MiFIR intervention regime. ESMA has therefore used these criteria as a starting point but developed and adjusted this approach to fit the more general intervention regime of MiFIR.
  14. These proposals will strengthen the level of protection to investors by providing criteria that will enable NCAs, ESMA and EBA to intervene, in accordance with all the other conditions provided under MiFIR, by restricting the marketing, distribution or sale of certain financial instruments or structured deposits or the exercise of certain practices or activities if there is a significant investor protection concern or a threat to the integrity or the orderly functioning of financial markets or the stability of the financial system.

#### **Draft technical advice**

- |   |
|---|
| <ol style="list-style-type: none"><li>1. As all three empowerments in Articles 40, 41 and 42 broadly share the same wording, the criteria and factors to be specified should generally be the same for all three provisions. Consistently with this ap-</li></ol> |
|---|



proach, reference to financial instruments should generally be construed as also including structured deposits.<sup>78</sup>

2. The below listed range of factors could be taken into consideration when assessing whether there is a *significant investor protection concern or a threat to the orderly functioning and integrity of financial markets or commodity markets and to the stability of the whole or part of the financial system of the Union*.<sup>79</sup>
3. ESMA notes that the existence of a “threat” is the intervention pre-requisite in the perspective of the orderly functioning and integrity of financial/commodity markets or stability of the financial system. In comparison to the consumer protection prerequisite, where there would need to be a “significant concern”, this requires the existence of a more intense detriment before the intervention power was used. This does not prevent the power being used where only a single factor, as set out below, is present.
4. The factors and criteria listed in this advice are elements that should be taken into account by ESMA or a NCA when considering the possibility to exercise their product intervention powers. These factors and criteria are not intended to represent an exhaustive list. ESMA notes that in the more detailed examples below, each of the supporting elements for consideration can sometimes apply to more than one criterion. For example: “costs and charges” may lead to a higher degree of complexity of an instrument (lit. a) as well as to its non-transparency (lit. d) or should generally be considered regarding pricing matters (lit. h) as well. Possible repetitions are therefore intentional to help to explain how different elements can impact each criterion. ESMA considers that the following criteria are relevant:
  - i. The degree of complexity of the financial instrument or type of financial activity or practice. Under this factor, more detailed elements to be considered could include, for example:
    - a. the type and transparency of the underlying;
    - b. multiple layers of costs and charges;
    - c. the performance calculation complexity;
    - d. the nature and scale of any risks;
    - e. whether the instrument or service is bundled with other products or services; and
    - f. the complexity of any terms and conditions.

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<sup>78</sup> MiFID II defines structured deposits (Article 4(1)(3) of MiFID II) and extends several MiFID requirements to the sale or advice of structured deposits by credit institutions and investment firms. These MiFID requirements that are already applicable to the sale or advice of financial instruments are mainly in the areas of conduct of business rules, conflicts of interest and record-keeping (Article 1(4) of MiFID II).

<sup>79</sup> It should be noted that, in accordance with Article 42(2)(a)(ii) of MiFIR, NCAs should consider whether “a derivative has a detrimental effect on the price formation mechanism in the underlying market”. No delegated act is however required in this area. On the other hand, as specified in paragraph 17, ESMA considers that the possibility that a financial instrument leads to a significant and artificial disparity between prices of a derivative and those in the underlying market is a criterion that can be relevant in considering the threat to the orderly functioning and integrity of the financial market or commodity market and to the stability of the financial system or the significant concerns in the perspective of investor protection.

- ii. The size of the potential problem or detriment. Under this factor, more detailed elements to be considered could include, for example:
  - a. the notional value of the financial instrument;
  - b. number of clients, investors or market participants involved;
  - c. relative share the product has in investors' portfolios;
  - d. probability, scale and nature of any detriment, including the amount of loss potentially suffered;
  - e. anticipated persistency of the problem or detriment;
  - f. volume of the issuance;
  - g. number of intermediaries involved; and
  - h. growth of the market or sales.
- iii. The type of clients involved in an activity or practice or to whom a financial instrument is marketed or sold. Under this factor, more detailed elements to be considered could include, for example:
  - a. whether the client is a retail client, professional client or eligible counterparty under MiFID;
  - b. features characterising clients' skills and abilities, e.g. level of education, experience with similar financial instruments or selling practices;
  - c. features characterising clients' economic situation, e.g. income, wealth;
  - d. clients' core financial objectives, e.g. pension saving, home ownership financing; and
  - e. whether the instrument or service is being sold to clients outside the intended target market.
- iv. The degree of transparency of the financial instrument or type of financial activity or practice. Under this factor, more detailed elements to be considered could include, for example:
  - a. the type and transparency of the underlying;
  - b. any hidden costs and charges;
  - c. the use of features that draw clients' attention but that do not necessarily reflect the suitability or overall quality of the instrument or service;
  - d. visibility of risks; and
  - e. the use of product names that imply greater levels of safety and/or return than are actually

possible or likely.

- v. The particular features or underlying components of the financial instrument or transaction including any leverage a product or practice provides. Under this factor, more detailed elements to be considered could include, for example:
  - a. the leverage inherent in the product;
  - b. the leverage due to financing; and
  - c. the features of securities financing transactions.
- vi. The degree of disparity between expected return or benefit for investors and risk of loss in relation to the financial instrument, activity or practice. Under this factor, more detailed elements to be considered could include, for example:
  - a. the structuring and other costs;
  - b. the disparity in relation to issuer's risk (where retained by issuer); and
  - c. the risk/return profile.
- vii. The ease and cost for investors to switch or sell an instrument. Under this factor, more detailed elements to be considered could include, for example:
  - a. the bid/ask spread;
  - b. the frequency of trading availability;
  - c. the issuance size and size of the secondary market;
  - d. the presence or absence of liquidity providers or secondary market makers;
  - e. the features of the trading system; and
  - f. any other barriers to exit.
- viii. The pricing and associated costs. Under this factor, more detailed elements to be considered could include, for example:
  - a. the use of hidden or secondary charges; and
  - b. charges that do not reflect the level of service provided.
- ix. The degree of innovation of a financial instrument, an activity or practice. Under this factor, more detailed elements to be considered could include, for example:
  - a. the degree of innovation related to the structure of the financial instrument, activity or practice, e.g. embedding, triggering;

- b. the degree of innovation relating to the distribution model/length of intermediation chain, e.g. “originate-to-distribute”;
  - c. the extent of innovation diffusion, i.e. whether the financial instrument, activity or practice is innovative for particular categories of clients;
  - d. innovation involving leverage;
  - e. the opacity of underlying; and
  - f. the experience of the market with similar financial instruments or selling practices.
- x. The selling practices associated with the financial instrument. Under this factor, more detailed elements to be considered could include, for example:
- a. the communication and distribution channels used;
  - b. the information, marketing or other promotional material associated with the investment;
  - c. the assumed investment purposes; and
  - d. whether the decision to buy is secondary or tertiary following another purchase.
- xi. The situation of the issuer of a financial instrument. Under this factor, more detailed elements to be considered could include, for example:
- a. the credit-worthiness of the issuer or any guarantor; and
  - b. the transparency of the situation of the issuer or guarantor.
5. When considering factors in relation to a potential threat to the orderly functioning and integrity of financial markets or commodity markets and to the stability of the whole or part of the financial system, ESMA, EBA or NCAs should generally consider whether:
- i. there was insufficient, or insufficiently reliable, information about a financial instrument to enable market participants to which it was targeted to form their judgment, taking into account the nature and type of instrument;
  - ii. the financial instruments or activities pose a high risk to performance of transactions entered into by participants or investors in the market or product in question;
  - iii. the activities or practices would significantly compromise the integrity of the price formation process in the market concerned so that: a) the price or value of the financial instrument in question was no longer determined according to legitimate market forces of supply and demand; and/or b) market participants were no longer able to rely on the prices formed in the market or volumes of trading as a basis for their investment decisions;
  - iv. the characteristics of financial instruments make them particularly susceptible to being used for the purposes of financial crime. Under this factor, more detailed elements to be considered could include, for example whether the characteristics could favour the use of the financial in-

struments for:

- a. any fraud or dishonesty;
  - b. misconduct in, or misuse of information, relating to a financial market;
  - c. handling the proceeds of crime;
  - d. the financing of terrorism; or
  - e. facilitating money laundering;
  - v. activities or practices pose a particularly high risk to the resilience or smooth operation of markets and their infrastructure;
  - vi. a financial instrument or activity or practice would lead to a significant and artificial disparity between prices of a derivative and those in the underlying market;
  - vii. the financial instrument or practice or activity poses a high risk of disruption to financial institutions deemed to be important to the financial system of the EU or, in relation to NCAs' powers only, to the national financial system of the Member State of the NCA;
  - viii. a product or practice or activity poses particular risks to the market or payment systems infrastructure, including clearing and settlement and trading systems); and
  - ix. a financial instrument or practice would threaten the investors' confidence in the financial system.
6. While factors and criteria mentioned under paragraph 19 may be more relevant in assessing the threat to the orderly functioning and integrity of the financial market or commodity market and to the stability of the financial system, all the above listed factors and criteria (paragraphs 18 and 19) could be considered, depending on the circumstances, under each of the different product intervention prerequisites (significant concern on investor protection; threat to the orderly functioning and integrity of the financial market or commodity market; threat to the stability of the financial system).
7. The factors and criteria should not apply cumulatively – that is, not all factors would need to be present when ESMA or NCAs are determining whether to intervene. Depending on the severity of the issue, it may be that an intervention is justifiable where only one of these factors is present.
8. In accordance with the overall conditions for intervention specified under Articles 40, 41 and 42 of MiFIR, ESMA, EBA and NCAs should be able to intervene in new instruments or services or activities that may not meet these factors or criteria or, conversely, not necessarily intervene if given criteria are met but overall detriment is not foreseen or detected or the relevant proportionality test is not satisfied.

**Q107. Do you agree with the criteria proposed?**

**Q108. Are there any additional criteria that you would suggest adding?**



### 3. Transparency

#### 3.1. Liquid market for equity and equity-like instruments

##### Background/Mandate

###### Extract from the Commission's request for advice (mandate)

*ESMA is invited to provide technical advice on how to further specify the criteria under which an equity or a class of equity instrument should be considered to be liquid to ensure a uniform application of this Regulation. ESMA should take account of the criteria set out in Article 22 of Commission Regulation (EC) No 1287/2006, taking into account the need to extend these criteria to equity instruments other than shares and any need to develop these standards in light of market and technological developments.*

###### Article 2(2), MiFIR

*The Commission shall be empowered to adopt delegated acts in accordance with Article 50 to specify certain technical elements of the definitions laid down in paragraph 1 to adjust them to market developments.*

1. Article 2(1)(17)(b) defines 'liquid market' for the purposes of applying transparency measures to equity and equity-like instruments.

###### Article 2(1)(17)(b), MiFIR

*'liquid market' means:...*

*(b) for the purposes of Articles 4, 5 and 14, a market for a financial instrument that is traded daily where the market is assessed according to the following criteria:*

*(i) the free float*

*(ii) the average daily number of transactions in those financial instruments;*

*(iii) the average daily turnover for those financial instruments;*

2. The definition has implications for the transparency regime applicable to shares, depositary receipts, ETFs, certificates and other similar financial instruments. Articles 4 and 5 of MiFIR relate to the waivers for equity and equity-like instruments. Article 4 imposes different restrictions regarding the price at which a negotiated transaction can be executed under the rules of a trading venue, depending on whether there is a liquid market in the relevant instrument. Article 5 sets quantitative limits (the double volume cap mechanism) on the total volume of trading which can be carried out under the reference price waiver and to certain types of negotiated trades. Where there is a liquid market for an instrument, waivers to pre-trade transparency may apply to negotiated trades up to limits set under the double volume cap mechanism. However, the double volume cap mechanism does not apply to negotiated trades in shares, depositary receipts, ETFs, certificates or other similar financial instruments for which there is no liquid market. Therefore, NCAs may waive pre-trade transparency for negotiated transactions in illiquid instruments without reference to the double volume cap mechanism.

3. Article 14 of MiFIR sets the quoting obligations for systematic internalisers, which are driven by whether there is a liquid market for the instrument or not. The main requirement is to make public firm quotes on a regular and continuous basis for instruments for which there is a liquid market whereas for illiquid instruments, the obligations are less onerous and systematic internalisers need only disclose quotes to their clients upon request.
4. The concept of liquidity for equities already exists under MiFID I. Article 27 requires systematic internalisers to publish firm quotes for those shares admitted to trading on a regulated market for which there is a liquid market when dealing in sizes up to standard market size. Article 22(1) of Commission Regulation 1287/2006 specifies that a share is considered to have a liquid market if *‘the share is traded daily with a free float not less than €500m, and one of the following conditions is satisfied:*
  - i. *The average daily number of transactions in the share is not less than 500; and/or*
  - ii. *The average daily turnover for the share is not less than €2m.’*
5. Article 22(2) of the Commission Regulation permits a Member State to override the above criteria where the total number of liquid shares in its jurisdiction is less than five. In such circumstances, the Member State may specify additional shares as being liquid, even if they do not fulfil the above criteria under Article 22(1), providing that the number of shares deemed to be liquid through this route is not more than five. ESMA is considering whether this discretion for Member States to deem a limited number of shares as liquid is still appropriate under MiFID II and seeks feedback on this point.
6. The criteria under Article 2(1)(17)(b) of MiFIR although not setting specific thresholds, replicate the four factors (free float, average daily number of transactions, average daily turnover and daily traded) which must be used to determine whether there is a liquid market set under MiFID I. However, the role of liquidity is expanded significantly under MiFIR in two ways: firstly the concept of a liquid market applies to both equity and equity-like instruments including ETFs, certificates and depositary receipts and secondly, as discussed above, it will also drive certain transparency obligations for trading venues as well as the quoting obligations for systematic internalisers.

## **Analysis**

### *Equities*

7. The concept of liquid shares is important today under MiFID I and also under the Short Selling Regulation 236/2012/EC and in considering what should be the liquidity thresholds for equities, ESMA has looked at the existing levels under MiFID I. Whilst noting that the four liquidity criteria under MiFID I are replicated under MiFIR, under MiFID I only one of the two criteria - the average daily number of transactions or the average daily turnover criterion – must be met in addition to the free float and daily traded criteria. Also, under MiFID I Member States can, in respect of shares for which they are the most relevant market, decide that both conditions apply. In order to simplify and harmonise the regulatory regime, ESMA is of the view that all four of the criteria should be met for a share or depositary receipt to be deemed liquid. For that reason, and in order to ensure that a sufficient number of instruments remain subject to the transparency requirements ESMA is considering lowering the existing thresholds (e.g. average daily number of transactions in the share will be set at a level below 500) to ensure that the policy objective of greater transparency is met.

8. In setting the thresholds for equities and depositary receipts, ESMA is also mindful of the trading obligation for shares which requires, under Article 23 of MiFIR, that all shares admitted to trading on a RM or traded on a trading venue, must be traded on a RM, MTF, in a systematic internaliser or third country TV unless the transactions are (1) non-systematic, ad-hoc, irregular and infrequent, or (2) carried out between eligible and/or professional counterparties and do not contribute to the price discovery process. Given that systematic internalisers are permitted platforms under the trading obligation and that their quoting obligations depend on whether the instrument is liquid, it is of further importance that the liquidity thresholds are set at an appropriate level to ensure the objective of enhanced transparency is met regardless of whether the instrument is traded on a RM or MTF or in a systematic internaliser. Equally, it is necessary to ensure a level playing field exists between trading venues and systematic internalisers to the extent possible.
9. However, expanding the definition of what is liquid is likely to bring into the transparency regime a greater number of instruments which may be less liquid than those shares subject to the regime under MiFID I. This may pose challenges, for example, for less liquid shares, such as those of SMEs, if investment firms dealing in shares that do not trade continuously decide to abstain from trading in those instruments on their own account because they are unable to, or do not wish to, comply with the continuous quoting obligation under the systematic internaliser regime. This risks leading to a further reduction in liquidity for less liquid shares.
10. As a basis for setting the liquidity thresholds for shares, ESMA conducted a data analysis exercise, collecting post-trade data from EU RMs only, on 3,669 shares, with data for the same share traded on more than one RM aggregated at ISIN level, from 11 EU countries. The reference period was 1 January 2013 to 31 December 2013.
11. Table 1, Table 2, Table 3 and Table 4 below provide details on the distribution of the shares regarding the average number of trades per day, how frequently they trade, the average daily turnover and the free-float.<sup>80</sup>

**Table 1: Number of trades during the 1-year period distribution**

Average number of trades per day	Number of shares	% of shares
above 500	677	18.45%
between 100 and 500	486	13.25%
between 20 and 100	679	18.51%
between 10 and 20	342	9.32%
between 5 and 10	280	7.63%
between 1 and 5	1,041	28.37%
equal to 0	164	4.47%
<b>Total number of shares</b>	<b>3,669</b>	<b>100%</b>

<sup>80</sup> Expressed in EUR



**Table 2: Number of days traded during the 1-year period distribution**

Number of days traded	Number of shares	% of shares
above 250	2,190	59.69%
between 125 and 250	900	24.53%
between 60 and 125	206	5.61%
between 20 and 60	109	2.97%
between 1 and 20	100	2.73%
equal to 0	164	4.47%
<b>Total number of shares</b>	<b>3,669</b>	<b>100%</b>

**Table 3: Average daily turnover (€) distribution**

ADT	Number of shares	% of shares
above 2,000,000	680	18.53%
between 1,000,000 and 2,000,000	195	5.31%
between 500,000 and 1,000,000	243	6.62%
between 100,000 and 500,000	672	18.32%
between 50,000 and 100,000	303	8.26%
between 10,000 and 50,000	588	16.03%
below 10,000	824	22.46%
equal to 0	164	4.47%
<b>Total number of shares</b>	<b>3,669</b>	<b>100%</b>

**Table 4: Free-float (€) distribution**

Free float	Number of shares	% of shares
above 500,000,000	1,023	27.88%
between 200,000,000 and 500,000,000	368	10.03%
between 100,000,000 and 200,000,000	315	8.59%
between 50,000,000 and 100,000,000	258	7.03%
below 50,000,000	631	17.20%
n.a. 0	1,074	29.27%
<b>Total number of shares</b>	<b>3,669</b>	<b>100%</b>

12. The key findings from the above tables are:

- i. approximately 4.5% of shares did not trade during the period;



- ii. approximately 50% of shares trade, on average, more than 20 times per day [see Table 1].
  - iii. 84% of shares trade at least every 2 days and 60% trade every day [see Table 2];
  - iv. 49% of shares have an ADT above €100,000 and 19% of shares have an ADT above €2m [see Table 3]; and
  - v. 47% of shares have a free-float above €100m [see Table 4].
13. ESMA devised six scenarios using the liquidity criteria set out in the definition under Article 2(1)(17)(b) MiFIR but varying the liquidity criteria of size of free float, average daily number of transactions and average daily turnover (set out under line #1, #2 and #4 of the below table respectively-changes highlighted in red).

**Table 5: Scenarios using the liquidity criteria**

		BASELINE SCENARIO	SCENARIO#1	SCENARIO#2	SCENARIO#3	SCENARIO#4	SCENARIO#5	SCENARIO#6
(#1) Free float (€)	(>=)	500,000,000	500,000,000	500,000,000	500,000,000	100,000,000	100,000,000	100,000,000
(#2) Average # of trades per day	(>=)	500	500	250	500	500	250	100
(#3) Num of days traded during the 1-year period	(>=)	250	250	250	250	250	250	250
(#4) Average daily turnover (€)	(>=)	2,000,000	2,000,000	2,000,000	500,000	2,000,000	1,000,000	2,000,000
# of shares meeting all the above requirements		654	587	601	619	605	747	641
representing X% of the total # of shares		17.83%	16.00%	16.38%	16.87%	16.49%	20.36%	17.47%
Total turnover over 1 Year for this category		4,457,579,499,981	4,422,734,098,787	4,432,429,055,320	4,436,172,018,670	4,438,402,443,983	4,494,305,711,534	4,460,415,872,016
representing X% of the total 1Y-turnover for all shares		94.96%	94.22%	94.42%	94.50%	94.55%	95.74%	95.02%
Total trades over 1 Year for this category		480,225,235	473,202,451	474,614,964	477,846,269	477,913,226	493,905,183	480,432,640
representing X% of the total trades for all shares		89.80%	88.49%	88.76%	89.36%	89.37%	92.36%	89.84%

14. In summary, the key points from the results of the above scenarios are:

- i. In the baseline scenario, ESMA has applied the liquidity criteria currently set for shares under MiFID I and according to Article 22 of the MiFID Implementing Regulation, i.e. a share is considered to have a liquid market if it is traded daily, the free float is not less than € 500m, **and either** the average daily number of transactions in the share is not less than 500 **or** the average daily turnover (ADT)<sup>81</sup> is not less than € 2m. On the basis of these thresholds 18% of the shares, representing 95% of the turnover, qualify as liquid.
- ii. For scenario #1, ESMA has applied the same liquidity criteria as in the baseline scenario **but on a cumulative basis**. In this case, the percentage of shares qualifying as liquid decreases to 16% and the related turnover to 94%. This result indicates that in order to avoid a decrease in transparency, the liquidity thresholds should be slightly re-calibrated.
- iii. The parameters for the criteria of free float size, average daily number of transactions and average daily turnover do not display much sensitivity when adjusted individually and everything else being equal to the parameters in scenario #1. In other words, the number of shares qualified as liquid, as well as, their related turnover and number of trades, remain stable across scenarios 1 to 4.
- iv. When all of the parameters are reduced, as in scenarios #5 and #6, the percentage of shares qualified as liquid increases from 16% (representing 94% of turnover) in scenario #1 to 20%

<sup>81</sup> Calculated as the yearly turnover, divided by the number of trading days in the period excluding negotiated trades.



(representing 96% of turnover) in scenario #5 and to 17% (representing 95% of turnover) in scenario #6. In both scenarios #5 and #6 the percentage of turnover represented by the shares qualified as liquid is roughly the same 95-96%. However, there is a 3% difference in the percentage of shares deemed to be liquid.

- As a result, ESMA is considering proposing to the Commission that the liquidity thresholds for equities should be set at the following levels:

**Table 6: Equity levels**

Equities	Free Float	Average daily number of transactions	Average daily turnover
	€ 100,000,000	250	€ 1,000,000

#### Depositary Receipts

- Under Article 4(1)(45) of MiFID II depositary receipts are defined as:

*“those securities which are negotiable on the capital and which represent ownership of the securities of a non-domiciled issuer while being able to be admitted to trading on a regulated market and traded independently of the securities of the non-domiciled issuer”.*

- Today depositary receipts are traded on trading venues and OTC and used by firms located in other jurisdictions to facilitate cross-border trading. For investors, depositary receipts make securities issued in other countries more accessible and usually at a lower cost than if the investor were to buy directly the issued shares in the home country. A depositary receipt represents an ownership interest in the underlying security and is issued for a specified number of securities and ESMA considers that generally, depositary receipts are as liquid as the underlying securities. New depositary receipts can be created or cancelled depending on investor interest with new ones created where there is greater demand in the international market and cancelled when there is greater demand in the home market.
- Given the direct link between shares and depositary receipts, as each depositary receipt is backed by a specific number of shares or a fraction of such, ESMA believes the thresholds set for shares should be the same for depositary receipts. The free float for depositary receipts can fluctuate as they are created and cancelled. Therefore, ESMA considers the free float should be determined by the number of shares issued in the issuer’s home market.
- ESMA is considering proposing to the Commission that the liquidity thresholds for depositary receipts should be set at the following levels, which are the same as those proposed for equities:

**Table 7: Liquidity thresholds depositary receipts**

Depositary Receipts	Free Float	Average daily number of transactions	Average daily turnover
	€ 100,000,000	250	€ 1,000,000

#### Exchange Traded Funds

20. Under Article 4(1)(46) of MiFID II exchange traded funds are defined as “a fund of which at least one unit or share class is traded throughout the day on at least one trading venue and with at least one market maker which takes action to ensure that the price of its units or shares on the trading venue does not vary significantly from its net asset value and, where applicable, from its indicative net asset value”.
21. Today ETFs are not subject to post-trade transparency under MiFID I and therefore obtaining an accurate indication of the volume of ETFs traded in the Union is difficult to gauge. Equally, ESMA understands that currently a significant percentage of activity in ETFs is executed OTC.
22. As a basis for setting the liquidity thresholds for ETFs, ESMA conducted a data analysis exercise, collecting post-trade data from EU RMs on 1,646 ETFs, with data for the same ETF traded on more than one RM aggregated at ISIN level, from 11 EU countries. The reference period was 1 January 2013 to 31 December 2013. Most of the ETFs, approximately 70% included in the exercise, are listed on more than one EU RM.
23. Tables 8, 9 and 10 below provide details on the distribution of the ETFs regarding the average number of trades per day, how frequently they trade and the average daily turnover.

**Table 8: Number of trades during the 1-year period distribution**

Average number of trades per day	Number of ETFs	% of ETFs
above 500	11	0.67%
between 250 and 500	18	1.09%
between 125 and 250	32	1.94%
between 100 and 125	12	0.73%
between 50 and 100	91	5.53%
between 20 and 50	185	11.24%
between 1 and 20	1,215	73.82%
equal to 0	82	4.98%
<b>Total number of ETFs</b>	<b>1,646</b>	<b>100%</b>

**Table 9: Number of days traded during the 1-year period distribution**

Number of days traded	Number of ETFs	% of ETFs
above 250	788	47.87%
between 125 and 250	346	21.02%
between 60 and 125	141	8.57%
between 20 and 60	155	9.42%
between 1 and 20	134	8.14%
equal to 0	82	4.98%
<b>Total number of ETFs</b>	<b>1,646</b>	<b>100%</b>

**Table 10: Average daily turnover (€) distribution**

ADT		Number of ETFs	% of ETFs
above	2,000,000	147	8.93%
between	1,000,000 and 2,000,000	141	8.57%
between	500,000 and 1,000,000	176	10.69%
between	200,000 and 500,000	253	15.37%
between	100,000 and 200,000	191	11.60%
between	50,000 and 100,000	184	11.18%
below	50,000	472	28.68%
equal to	0	82	4.98%
<b>Total number of ETFs</b>		<b>1,646</b>	<b>100%</b>

24. The key findings from the above tables are:

- i. approximately 5% of the ETFs did not trade during the period;
- ii. approximately 79% of the ETFs (including those which did not trade during the period) on average trade less than 20 times per day [see Table 8];
- iii. 52% of ETFs (including those which did not trade during the period) trade at least every 2 days and 48% trade every day [see Table 9]; and
- iv. 55% of ETFs have an ADT above €100,000 and 43% of ETFs have an ADT above €500,000 [see Table 10].

25. ESMA devised six scenarios using the liquidity criteria set out in the definition under Article 2(1)(17)(b) of MiFIR but varying the thresholds (see the table below). For the first criterion of free float, ESMA considers that this concept is not suitable for ETFs as it is for shares given the redemption/creation process that is typical of the ETF market and therefore, ESMA has used a *de minimis* number of units issued for trading for ETFs as a proxy for free float. ESMA proposes to recommend that the Commission uses the number of units for the free float in the technical standards. The liquidity criteria of average daily number of transactions and average daily turnover (set out under line #2 and line #4 of the below table respectively) are the only two parameters which have been varied (changes highlighted in red) given the free float criterion remains a constant *de minimis* number of units.



**Table 11: Scenarios using the liquidity criteria**

		SCENARIO#1	SCENARIO#2	SCENARIO#3	SCENARIO#4	SCENARIO#5	SCENARIO#6
(#1) Num of units issued for trading (free float)	(>=)	100	100	100	100	100	100
(#2) Average # of trades per day	(>=)	500	500	250	100	50	20
(#3) Num of days traded during the 1-year period	(>=)	250	250	250	250	250	250
(#4) Average daily turnover (€)	(>=)	2,000,000	100,000	2,000,000	1,000,000	500,000	500,000
# of ETFs meeting all the above requirements		11	11	29	71	157	297
representing X% of the total # of ETFs		0.67%	0.67%	1.76%	4.31%	9.54%	18.04%
Total turnover over 1 Year for this category		85,824,546,029	85,824,546,029	154,617,845,394	224,397,972,545	279,229,413,072	337,162,320,305
representing X% of the total 1Y-turnover for all ETFs		20.84%	20.84%	37.55%	54.49%	67.81%	81.88%
Total num of trades for this category		2,728,596	2,728,596	4,266,558	5,855,459	7,331,746	8,473,073
representing X% of the total number of trades for all ETFs		26.72%	26.72%	41.78%	57.34%	71.80%	82.98%

26. In summary, the key points from the results of the above scenarios are:

- i. For scenario #1, ESMA has applied the liquidity criteria currently set for shares under MiFID I on a cumulative basis (shares are traded daily, the average daily number of transactions is not less than 500, the average daily turnover (ADT)<sup>82</sup> is not less than €2m). On the basis of these thresholds less than 1% of the ETFs, representing roughly 20% of the turnover, qualify as liquid.
- ii. Trading patterns for ETFs are characterised by few large-in-value trades as evidenced by comparing scenario #1 to scenario #2 above, where reducing the ADT threshold from €2m to €100,000 does not impact the results.
- iii. Halving the average number of trades per day from 500 to 250 (under scenario #3, everything else being equal to the parameters in scenario #1), results in the percentage of ETFs qualifying as liquid increasing slightly to 1.8%, representing roughly 40% of turnover.
- iv. In scenarios #4, #5 and #6 different combinations of thresholds for ADT and average number of trades per day were applied. The percentage of liquid ETFs doubles from 4% in scenario #4 to 10% in scenario #5 and to 18% in scenario #6. The percentage of turnover corresponding to the ETFs qualifying as liquid increases from 55% in scenario #4 to 68% in scenario #5 and to 82% in scenario #6.

27. Based on the above analysis, ESMA is considering proposing to the Commission that the liquidity thresholds for ETFs should be set at the following levels:

**Table 12: Liquidity thresholds for ETFs levels**

ETFs	Free Float (Number of units issued for trading)	Average daily number of transactions	Average daily turnover
	100	20	500,000

### Certificates

<sup>82</sup> Calculated as the yearly turnover, divided by the number of trading days in the period excluding negotiated trades.

28. Certificates are defined under Article 2(1)(27) of MiFIR as “those securities which are negotiable on the capital market and which in the case of a repayment of investment by the issuer are ranked above shares but below unsecured bond instruments and other similar instruments.”
29. ESMA conducted an analysis, similar to that presented above for shares and ETFs, as a basis for setting the liquidity thresholds for certificates. Having consulted 11 EU Member States, ESMA has identified to date only two types of instruments falling within the category of certificates: Spanish *Participaciones Preferentes* and German *Genussrechte/-scheine*. Post-trade data from RMs was collected for 84 certificates over the period from 1 January 2013 to 31 December 2013.

**Table 13: Number of trades during the 1-year period distribution**

Average number of trades per day	Number of certificates	% of certificates
above 500	0	0.00%
between 100 and 500	0	0.00%
between 20 and 100	3	3.57%
between 10 and 20	0	0.00%
between 5 and 10	2	2.38%
between 1 and 5	56	66.67%
equal to 0	23	27.38%
<b>Total number of certificates</b>	<b>84</b>	<b>100%</b>

**Table 14: Number of days traded during the 1-year period distribution**

Number of days traded	Number of certificates	% of certificates
above 250	1	1.19%
between 125 and 250	6	7.14%
between 60 and 125	14	16.67%
between 20 and 60	20	23.81%
between 1 and 20	20	23.81%
equal to 0	23	27.38%
<b>Total number of certificates</b>	<b>84</b>	<b>100%</b>

**Table 15: Average daily turnover (€) distribution**

ADT	Number of certificates	% of certificates
above 1,000,000	0	0.00%
between 500,000 and 1,000,000	2	2.38%
between 50,000 and 500,000	7	8.33%
between 10,000 and 50,000	11	13.10%
between 5,000 and 10,000	5	5.95%
between 1,000 and 5,000	17	20.24%
below 1,000	19	22.62%
equal to 0	23	27.38%
<b>Total number of certificates</b>	<b>84</b>	<b>100%</b>

30. The key findings from the above tables are:

- i. 27% of the certificates did not trade during the period [see Table 13, Table 14 and Table 15];
- ii. approximately 94% of the certificates (including those which did not trade during the period) on average trade less than 5 times per day [see Table 13];
- iii. over 99% of the certificates (including those which did not trade during the period) do not trade daily with approximately 75% of certificates (including those which did not trade during the period) trading every 4 days or less frequently [see Table 14]; and
- iv. 98% of certificates (including those which did not trade during the period) have an ADT below €500,000 [see Table 15].

31. Based on the above findings, ESMA devised four scenarios using the liquidity criteria set out in the definition under Article 2(1)(17)(b) of MiFIR but varying the thresholds (see table below).

**Table 16: Scenarios using the liquidity criteria**

	SCENARIO#1	SCENARIO#2	SCENARIO#3	SCENARIO#4
(#1) Free float (issuance size) (>=)	1,000,000	1,000,000	1,000,000	1,000,000
(#2) Average # of trades per day (>=)	500	20	20	50
(#3) Num of days traded during the 1-year period (>=)	250	250	250	250
(#4) Average daily turnover (€) (>=)	2,000,000	500,000	100,000	500,000
# of certificates meeting all the above requirements	-	1	1	-
representing X% of the total # of certificates	0.00%	1.19%	1.19%	0.00%
Total volume over 1 Year for this category	-	134,755,679	134,755,679	-
representing X% of the total 1Y-volume for all certificates	0.00%	23.48%	23.48%	0.00%

32. As for ETFs, ESMA considers that the concept of free float does not apply to certificates as it does to shares and therefore, ESMA has used a *de minimis* issuance size for certificates as a proxy for the free float.



33. In summary the key points from the results of the above scenarios are:
- i. For scenario #1, ESMA has applied the liquidity criteria currently set for shares under MiFID I on a cumulative basis (shares are traded daily, the average daily number of transactions is not less than 500, the Average Daily Turnover (ADT)<sup>83</sup> is not less than €2m). On the basis of these thresholds, no certificates qualify as liquid.
  - ii. In the other three scenarios, the liquidity thresholds were adjusted; however, lowering the average number of trades per day to either 20 or 50 and the ADT to either €100,000 or €500,000 does not change the initial result.
  - iii. On the basis of the above evidence, trading activity for certificates seems to be limited.
34. On basis of the above analysis, ESMA is considering proposing to the Commission that the liquidity thresholds for certificates should be set at the following levels:

**Table 17: Liquidity thresholds levels for certificates**

Certificates	Free Float (issuance size in euro)	Average daily number of transactions	Average daily turnover
		1,000,000	20

### Draft technical advice

1. An instrument must meet all of the four criteria listed under Article 2(1)(17)(b) of MiFIR, free float, average daily number of transactions, average daily turnover and daily traded, in order to be deemed to have a 'liquid market'. The four criteria shall apply cumulatively to establish a uniform and simplified regime.
2. As an exception to the above, where a Member State would be the most relevant market for fewer than five liquid instruments, the Member State may specify the number of liquid instruments for that Member State providing the total is no greater than five. The specification shall be made public.

#### *Equities*

3. An equity will be deemed to have a liquid market if it meets the following criteria:
  - i. free float of not less than €100m;
  - ii. the average daily number of transactions in the shares is not less than 250; and
  - iii. the average daily turnover for the shares is not less than €1m.

<sup>83</sup> Calculated as the yearly turnover, divided by the number of trading days in the period excluding negotiated trades.

#### *Depository Receipts*

4. The thresholds applied to depository receipts to determine whether an instrument has a liquid market shall be the same thresholds as those set for equities.
5. The size of the free float for a depository receipt shall be determined by the number of shares issued in the issuer's home market.

#### *Exchange Traded Funds*

6. An ETF will be deemed to have a liquid market if it meets the following criteria:
  - i. the free float for an ETF shall be set as a *de minimis* number of 100 units issued for trading;
  - ii. the average daily number of transactions in the ETF is not less than 20; and
  - iii. the average daily turnover for the ETFs is not less than €500,000.

#### *Certificates*

7. A certificate will be deemed to have a liquid market if it meets the following criteria:
  - i. a free float of not less than €1m;
  - ii. the average daily number of transactions in the certificates is not less than 20; and
  - iii. the average daily turnover for the certificates is not less than €500,000.

#### *Equities*

**Q109. Do you agree with the liquidity thresholds ESMA proposes for equities? Would you calibrate the thresholds differently? Please provide reasons for your answers.**

#### *Depository receipts*

**Q110. Do you agree that the free float for depository receipts should be determined by the number of shares issued in the issuer's home market? Please provide reasons for your answer.**

**Q111. Do you agree with the proposal to set the liquidity threshold for depository receipts at the same level as for shares? Please provide reasons for your answer.**

**Q112. Do you agree with the liquidity thresholds ESMA proposes for depository receipts? Would you calibrate the thresholds differently? Please provide reasons for your answers.**

#### *Exchange traded funds (ETFs)*



- Q113.** Do you agree that the criterion of free float could be addressed through the number of units issued for trading? If yes, what *de minimis* number of units would you suggest? Is there any other more appropriate measure in your view? Please provide reasons for your answer.
- Q114.** Based on your experience, do you agree with the preliminary results related to the trading patterns of ETFs? Please provide reasons for your answer.
- Q115.** Do you agree with the liquidity thresholds ESMA proposes for ETFs? Would you calibrate the thresholds differently? Please provide reasons for your answers, including describing your own role in the market (e.g. market-maker, issuer etc).

*Certificates*

- Q116.** Can you identify any additional instruments that could be caught by the definition of certificates under Article 2(1)(27) of MiFIR?
- Q117.** Based on your experience, do you agree with the preliminary results related to the trading patterns of certificates? Please provide reasons for your answer.
- Q118.** Do you agree with the liquidity thresholds ESMA proposes for certificates? Would you calibrate the thresholds differently? Please provide reasons for your answer.
- Q119.** Do you agree that the criterion of free float could be addressed through the issuance size? If yes, what *de minimis* issuance size would you suggest? Is there any other more appropriate measure in your view? Please provide reasons for your answer.

*Generic questions*

- Q120.** Do you think the discretion permitted to Member States under Article 22(2) of the Commission Regulation to specify additional instruments up to a limit as being liquid should be retained under MiFID II?



### 3.2. Delineation between bonds, structured finance products and money market instruments

#### Background/Mandate

##### Extract from the Commission's request for advice (mandate)

*ESMA is invited to provide technical advice to further specify the definition of money market instruments in order to set a clear delineation between bonds and structured finance products and money market instruments.*

#### Analysis

1. MiFID II and MiFIR contain the following three definitions for bonds, structured finance products and money-market instruments:

##### Article 4(1), MiFID II

[...]

(17) *'money-market instruments' means those classes of instruments which are normally dealt in on the money market, such as treasury bills, certificates of deposit and commercial papers and excluding instruments of payment;*

(44) *'transferable securities' means those classes of securities which are negotiable on the capital market, with the exception of instruments of payment, such as:*

[...]

(b) *bonds or other forms of securitised debt, including depositary receipts in respect of such securities;*

##### Article 2(1), MiFIR

[...]

(28) *'structured finance products' means those securities created to securitise and transfer credit risk associated with a pool of financial assets entitling the security holder to receive regular payments that depend on the cash flow from the underlying assets;*

2. The Commission can further specify some technical elements in respect of these definitions through their general empowerments in Article 4(2) of MiFID II and Article 2(2) of MiFIR. Specifying these definitions further is important due to the scope of the MiFIR non-equity transparency framework which 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 as they are a separate category of financial instrument under Annex I Section C2 of MiFID II while not being mentioned as a category to which transparency obligations under Articles 8 and 10 MiFIR apply.

3. The purpose of this further specification would be a clear delineation between instruments within and outside the MiFID II scope so it is clear to all stakeholders whether trading in an instrument is subject to transparency obligations.
4. Apart from being defined in MiFID II, money-market instruments are also mentioned in Recital 36 of the UCITS Directive 2009/65/EC and characterised as “*transferable instruments which are normally dealt in on the money market rather than on the regulated markets, for example treasury and local authority bills, certificates of deposit, commercial papers, medium-term notes and bankers’ acceptances*” and are defined in Article 2(1)(o) of the same directive as meaning ‘*instruments normally dealt in on the money market which are liquid and have a value which can be accurately determined at any time*”.
5. The Eligible Assets Directive 2007/16/EC (Articles 3<sup>84</sup> and 4) specifies further what characteristics money market instruments normally have. In particular, it is specified in this Directive that they have a maximum maturity of 397 days at issuance or residually.
6. In addition, the Regulation of the European Central Bank (EU) No 883/2011 amending Regulation (EC) No 25/2009 in its Article 1 (Section 2g) defines money market instruments as instruments normally traded on the money market which are liquid and have a value which can be accurately determined at any time.
7. ESMA considers that the regulatory purpose of the Eligible Assets Directive in the context of regulating UCITS is different. While ESMA considers the maximum maturity of 397 days as a useful guideline, for the purposes of MiFIR those 397 days should always be counted from issuance.
8. ESMA also considers that money market instruments for MiFIR purposes should be strictly limited to such instruments expressly stated to be treasury bills, certificates of deposit, commercial paper and other instruments with equivalent features.
9. ESMA consequently proposes that regarding financial instruments that are traded on a trading venue and have a maturity of 397 days or less, the only instruments that can be considered as money-market instruments, and therefore are not subject to non-equity transparency, are those for which the value can be determined at any time on either an amortised cost basis or in reference to the short term yield curve for the currency of the instrument.<sup>85</sup> In contrast debt securities bearing a Classification of Fi-

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<sup>84</sup> Article 3 Instruments normally dealt in on the money market [...]

2. The reference in Article 1(9) of Directive 85/611/EEC to money market instruments as instruments normally dealt in on the money market shall be understood as a reference to financial instruments which fulfil one of the following criteria:

(a) they have a maturity at issuance of up to and including 397 days;

(b) they have a residual maturity of up to and including 397 days;

(c) they undergo regular yield adjustments in line with money market conditions at least every 397 days;

(d) their risk profile, including credit and interest rate risks, corresponds to that of financial instruments which have a maturity as referred to in points (a) or (b), or are subject to a yield adjustment as referred to in point (c).

<sup>85</sup> Article 4 Liquid instruments with a value which can be accurately determined at any time [...]

2. The reference in Article 1(9) of Directive 85/611/EEC to money market instruments as instruments which have a value which can be accurately determined at any time shall be understood as a reference to financial instruments for which accurate and reliable valuations systems, which fulfil the following criteria, are available:

(a) they enable the UCITS to calculate a net asset value in accordance with the value at which the financial instrument held in the portfolio could be exchanged between knowledgeable willing parties in an arm’s length transaction;

(b) they are based either on market data or on valuation models including systems based on amortised costs.

3. The criteria referred to in paragraphs 1 and 2 shall be presumed to be fulfilled in the case of financial instruments which are normally dealt in on the money market for the purposes of Article 1(9) of Directive 85/611/EEC and which are admitted to, or dealt in on, a regulated market in accordance with points (a), (b) or (c) of Article 19(1) thereof, unless there is information available to the UCITS that would lead to different determination.



financial Instruments (CFI) identifier 'DY' for money market instruments should be treated as falling within the scope of non-equity transparency if the maturity at issuance of the instrument is greater than 397 days or if the market value cannot be determined in an objective and unbiased fashion.

10. A special case in this context is asset backed commercial paper which can be classified as a structured finance product as well as a money market instrument. Pointing at the legal precedent in Article 5(4)(e) of Commission Delegated Regulation (EU) No 448/2012, ESMA proposes classifying asset backed commercial paper as a structured finance product for the purposes of MiFIR.

#### **Draft technical advice**

1. Financial instruments that are categorised as money-market instruments and are therefore outside the scope of the non-equity transparency regime of MiFIR are limited to those instruments expressly stated to be treasury bills, certificates of deposit, commercial paper and other instruments with equivalent features and have the following characteristics:
  - i. they have a maturity at issuance of 397 days or less; and
  - ii. their value can be determined at any time on either an amortised cost basis or in reference to the short term yield curve for the currency of the instrument.
2. Asset backed commercial paper should be classified as a structured finance product for the purposes of MiFIR.

**Q121. Do you agree with ESMA's assessment concerning financial instruments outside the scope of the MiFIR non-equity transparency obligations?**



### 3.3. The definition of systematic internaliser

#### Background/Mandate

##### Extract from the Commission's request for advice (mandate)

*ESMA is invited to provide technical advice to further specify the quantitative elements of the definition of systematic internaliser by providing advice on the numerical thresholds to be used to assess the frequent, systematic and substantial basis.*

##### Article 4(1)(20), MiFID II

*Systematic internaliser means an investment firm which, on an organised, frequent, systematic and substantial basis, deals on own account by executing client orders outside a regulated market, an MTF or an OTF without operating a multilateral system.*

*The frequent and systematic basis shall be measured by the number of OTC trades in the financial instrument carried out by the investment firm on own account when executing client orders. The substantial basis shall be measured either by the size of the OTC trading carried out by the investment firm in relation to the total trading of the investment firm in a specific financial instrument or by the size of the OTC trading carried out by the investment firm in relation to the total trading in the Union in a specific financial instrument. The definition of systematic internaliser shall only apply where the pre-set limits for a frequent and systematic basis and for a substantial basis are both crossed or where an investment firm which chooses to opt-in under the systematic internaliser regime.*

1. Under Article 4(1)(7) of MiFID I a systematic internaliser is defined as an investment firm which on an organised, frequent and systematic basis deals on own account by executing client orders outside a regulated market or an MTF. The implementing regulation (Article 21 of Regulation 2006/1287/EC) complements the definition of systematic internaliser by providing a number of qualitative criteria for determining whether an investment firm is acting as a systematic internaliser.
2. In its technical advice<sup>86</sup> to the Commission in the context of the MiFID review, CESR (now ESMA) noted that the “*material commercial role*” in the qualitative criteria for determining whether an investment firm is acting as a systematic internaliser may have created problems regarding the applicability of the regime. For that reason CESR recommended introducing appropriate quantitative thresholds to determine whether the activity has ‘material commercial’ significance for the firm and for the market.
3. Article 4(1)(20) of MiFID II introduces a new definition of systematic internaliser which is based on quantitative criteria for assessing when the activity of dealing on own account by executing client orders is sufficiently frequent, systematic and substantial. While those quantitative criteria are relevant for determining when an investment firm is a systematic internaliser in a financial instrument, the new definition allows an investment firm to choose to opt-in under the systematic internaliser regime even when it doesn't meet all or any of the quantitative criteria, provided it complies in full with the applicable requirements.

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<sup>86</sup> CESR Technical Advice to the European Commission in the Context of the MiFID Review - Equity Markets (CESR/10-802)



4. Separately from the new definition, MiFID II extends the systematic internaliser regime so that from applying solely to shares, as is the case under MiFID I, it will apply to a much broader range of asset classes: equity-like instruments (depository receipts, ETFs, certificates and other similar financial instruments) and non-equity instruments (derivatives, bonds, structured finance products and emission allowances).
5. ESMA understands that the purpose of introducing quantitative criteria is to establish a clearer legal framework which will assist investment firms in assessing whether they are a systematic internaliser in a particular financial instrument and need to comply with the relevant pre-trade transparency obligations and other requirements for systematic internalisers.

### **Analysis**

6. In specifying the technical elements of the definition of systematic internaliser, ESMA intends to calibrate the thresholds for the frequent, systematic and substantial basis with the aim of preserving and enhancing the current level of transparency, in accordance with Recital 18 of MiFIR, while having regard to the different trading patterns of instruments within the scope of the regime.

### **Recital 18, MiFIR**

*In order to ensure that trading carried out OTC does not jeopardise efficient price discovery or a transparent level playing field between means of trading, appropriate pre-trade transparency requirements should apply to investment firms dealing on own account in financial instruments OTC insofar as it is carried out in their capacity as systematic internalisers in relation to shares, depository receipts, ETFs, certificates or other similar financial instruments for which there is a liquid market and bonds, structured finance products, emission allowances and derivatives which are traded on a trading venue and for which there is a liquid market.*

#### *Frequent and systematic*

7. Regarding what constitutes “*frequent and systematic*”, ESMA understands that the pre-set limit is meant to define a number of transactions carried out by the investment firm outside an RM, an MTF or an OTF when dealing on own account. In ESMA’s view, the threshold should be set at such a level that any activity above that level can reasonably be assumed to be carried out on a regular and continuous basis (in other words that the activity is not ad hoc or irregular). ESMA proposes, for liquid instruments, to set the threshold(s) as a percentage of the total number of trades calculated for each financial instrument. For illiquid instruments for which it would not be feasible to apply relative thresholds, ESMA is of the opinion that an absolute number of transactions should be used. This absolute number should be set at different levels depending on the liquidity of the financial instrument with higher absolute thresholds for instruments which trade more frequently during the day. In this regard, ESMA proposes to distinguish liquid instruments from illiquid instruments in accordance with the definition of ‘liquid market’ under Article 2(1)(17) of MiFIR.

#### *Substantial basis*

8. With regard to the “*substantial basis*” criterion, the definition requires the determination of two thresholds based on the size of the internalisation against two different benchmarks. Only one of the two thresholds must be breached for the substantial basis criterion to be met. The definition does not clarify which measure should be used in order to evaluate the size of internalisation activity. ESMA is





of the view that the turnover (i.e. quantity multiplied by price) is a valid and standard proxy for the size of internalisation activity.

9. The first threshold of the “*substantial basis*” criterion refers to the extent to which internalisation is substantial compared to the firm's total trading in a particular financial instrument. The definition does not specify what constitutes the total trading of the firm in a financial instrument as this may comprise (depending on the type of investment firms and investment services and activities the firm is authorised to carry out) transactions executed on behalf of clients or in a principal capacity. ESMA is of the opinion that the total trading of the investment firm should include all transactions executed in any capacity and executed on any trading venue or OTC. The second threshold for the “*substantial basis*” criterion refers to the size of the internalisation activity compared to the total trading in the Union for that instrument. ESMA understands that the size of total trading in the Union should include trading carried out OTC and on any EU trading venue for that financial instrument. ESMA is of the opinion that the level of the threshold should be set primarily by having regard to the efficiency of the price formation process in that instrument, i.e. that the systematic internaliser undertakes sufficient activity in a financial instrument that the price discovery process for that instrument is impacted.

#### *Equities and equity-like instruments*

##### *Frequent and systematic*

10. With respect to what is frequent and systematic, ESMA is minded to propose a threshold between 0.25% and 0.5% of the average number of trades calculated for each financial instrument. In setting the threshold ESMA has considered the current level of internalisation by existing systematic internalisers in shares admitted to trading on an RM. ESMA is of the preliminary opinion that the threshold is also appropriate for equity-like instruments - ETFs, depositary receipts, certificates and other similar financial instruments.

##### *Substantial basis*

11. For the first threshold of the “*substantial basis*” criterion, ESMA is of the view that client internalisation is substantial when it accounts for between 15% and 25% or more of the firm's total activity in a financial instrument. For the second threshold for the “*substantial basis*” criterion, as noted above, ESMA is of the opinion that the level of the threshold should be primarily set by having regard to the efficiency of the price formation process in that instrument. For that reason ESMA proposes a threshold between 0.25% and 0.5%.

##### *Calculation frequency and time frame*

12. An important aspect of the application of the frequent and systematic criterion and the substantial criterion is the relevant period for calculating the thresholds. ESMA is of the view that the relevant thresholds should be calculated over a period long enough to minimise the risk of capturing episodic internalisation and to give legal certainty to investment firms. For that reason ESMA proposes that investment firms should take into account the activity within each calendar quarter when calculating the relevant thresholds. ESMA also believes that one month provides sufficient time to establish all the arrangements necessary for complying with the regime.



## Draft technical advice

1. An investment firm shall be treated as a systematic internaliser in respect of each share, depositary receipt, ETF, certificate and other similar financial instrument if it meets the following criteria for the:

### *Frequent and Systematic*

- i. The investment firm internalises on a frequent and systematic basis if the number of OTC transactions executed by the investment firm on own account in liquid instruments is, during the most recent quarter, equal or larger than (between 0.25% and 0.5%) of the total number of transactions in the relevant financial instrument in the European Union during the same period.

For shares, depositary receipts, ETFs, certificates and other similar financial instruments for which there is not a liquid market as determined in accordance with Article 2(1)(17)(b) of MiFR the condition is deemed to be met when the investment firm deals on own account OTC on average at least on a daily basis during the most recent calendar quarter.

### *Substantial Basis*

- ii. The investment firm internalises on a substantial basis if the size of OTC trading carried out by the investment firm on own account is, during the most recent calendar quarter, equal or larger than either:
  - a. (between 15% and 25%) of the total turnover in that financial instrument executed by the investment firm on own account or on behalf of clients; or
  - b. (between 0.25% and 0.5%) of the total turnover in that financial instrument in the European Union.
2. The investment firm shall comply within a month with all requirements set in Articles 13, 14, 15 and 16 of MiFIR when the conditions (i) and (ii) above are both met for the most recent calendar quarter.

**Q122.** For the systematic and frequent criterion, ESMA proposes setting the percentage for the calculation between 0.25% and 0.5%. Within this range, what do you consider to be the appropriate level? Please provide reasons for your answer. If you consider that the threshold should be set at a level outside this range, please specify at what level this should be with justifications.

**Q123.** Do you support calibrating the threshold for the systematic and frequent criterion on the liquidity of the financial instrument as measured by the number of daily transactions?

**Q124.** For the substantial criterion, ESMA proposes setting the percentage for the calculation between 15% and 25% of the total turnover in that financial instrument executed by the investment firm on own account or on behalf of clients and between 0.25% and 0.5% of the total turnover in that financial instrument in the Union. Within these ranges, what do you consider to be the appropriate level? Please provide reasons for your answer. If



**you consider that the thresholds should be set at levels outside these ranges, please specify at what levels these should be with justifications.**

- Q125. Do you support thresholds based on the turnover (quantity multiplied by price) as opposed to the volume (quantity) of shares traded? Do you agree with the definition of total trading by the investment firm? If not please provide alternatives and reasons for your answer.**
- Q126. ESMA has calibrated the initial thresholds proposed based on systematic internaliser activity in shares. Do you consider those thresholds adequate for:**
- i. ETF;**
  - ii. depositary receipts; and/or**
  - iii. certificates?**
- Q127. Do you consider a quarterly assessment of systematic internaliser activity as adequate? If not, which assessment period would you propose? Do you consider that one month provides sufficient time for investment firms to establish all the necessary arrangements in order to comply with the systematic internaliser regime?**

#### *Non-equity instruments*

##### Introduction

13. According to Article 18 MiFIR, systematic internalisers for non-equity instruments will be subject to a pre-trade transparency regime on the basis of whether there is a 'liquid market' for the instrument and when dealing below the '*size specific to the instrument*', as identified for the purposes of the pre-trade transparency regime applicable to trading venues. Therefore, ESMA is of the opinion that the quantitative specification of what is frequent, systematic and substantial for non-equity instruments should be built on a common and consistent framework, in order to ensure that requirements for systematic internalisers are proportional and not more burdensome than those applying to the same instruments when traded on trading venues.

##### Frequent and systematic

14. As is the case for systematic internalisers for equity and equity-like instruments, the quoting obligations for systematic internalisers in non-equities differ depending on whether the instrument is liquid or illiquid. Under Article 18(1) systematic internalisers must make public firm quotes for instruments for which there is a liquid market where they are prompted for a quote by a client and agree to provide a quote whereas under Article 18(2) MiFIR, where there is no liquid market for an instrument, "*systematic internalisers shall disclose quotes to their clients on request if they agree to provide a quote*". Therefore, ESMA proposes to distinguish liquid instruments from illiquid instruments in accordance with the definition of "*liquid market*" under Article 2(1)(17)(a) of MiFIR.
15. With respect to what is "*frequent and systematic*", ESMA proposes adopting the same methodology as that for the equity systematic internaliser regime: the threshold(s) will be set as a percentage of the number of trades calculated for each financial instrument. This percentage will be obtained by dividing the number of OTC trades in a financial instrument executed by the investment firm by the total



number of trades in the same financial instrument in the European Union. This percentage shall be computed over the most recent calendar quarter.

#### Substantial basis

16. As for the threshold for “*systematic and frequent*”, ESMA proposes adopting the same methodology as that proposed for the equity systematic internaliser regime and to assess the “substantial basis” criterion through two thresholds (only one of the two thresholds must be breached for the substantial basis criterion to be met):
  - i. the size of the internalisation activity compared to the firm's total trading in a particular financial instrument; or,
  - ii. the size of the internalisation activity compared to the total trading in the Union for that instrument.
17. The non-equity universe in MiFID II and MiFIR is heterogeneous and includes diverse categories of financial instruments with different trading patterns. Therefore, ESMA is of the view that the thresholds (for both the ‘frequent and systematic basis’ and ‘substantial basis’ criteria) should be set at a different level per asset class (i.e. bonds, structured finance products, emission allowances and derivatives) and even at sub-asset class level, contrary to the equity systematic internaliser regime where one threshold is proposed for all equity and equity-like instruments. ESMA seeks market participants’ views on these issues.

#### Applying the thresholds to specific financial instrument

18. According to Article 4(20) of MiFID II, the thresholds for assessing whether an investment firm deals on its own account on both a “*frequent and systematic*” basis and a “*substantial basis*” have to be computed for each specific financial instrument. If the concept of “financial instruments” is relatively clear for bonds and structured finance products where the ISIN code can be used as a proxy, the concept appears to be less straight forward when it comes to derivatives and emission allowances which in general do not have ISINs.
19. With regard to bonds and structured finance products, ESMA is therefore of the view that the systematic internaliser thresholds should be understood as applying to products that share a common ISIN code.
20. With regard to emission allowances and derivatives, ESMA intends to use the segmentation of asset classes into sub-categories presented in Annex 3.6.1 of the DP (*financial instrument taxonomy*) in order to identify at what level the threshold for qualifying as a systematic internaliser should apply. For derivatives, ESMA notes that derivative markets, and in particular OTC derivative markets, often comprise tailor-made instruments to which it would not be feasible to apply thresholds. Thus, ESMA is of the view that the thresholds should apply to categories to be defined on the basis of the segmentation proposed in Annex 3.6.1 of the DP.
21. ESMA also notes that derivatives have additional MiFID II requirements attached to them which impact the obligations of the systematic internaliser regime.
22. The trading obligation for derivatives (discussed in detail in section 3.6 of the DP, *liquid market definition for non-equity financial instruments*) impacts the systematic internaliser regime. Deriva-

tives classed as 'OTC' under EMIR (i.e. traded outside an RM) which are subject to the EMIR clearing obligation and considered to be sufficiently liquid must be traded on a trading venue (i.e. an RM, an MTF or an OTF). Therefore, such derivatives are precluded from being executed either within a systematic internaliser or OTC. However, although rare, ESMA considers situations may arise where systematic internalisers could be required to meet pre-trade transparency requirements for liquid derivatives where the trading obligation does not apply, for example, due to timing between a derivative being declared subject to the clearing obligation and the assessment and approval of the subsequent RTS requiring the derivative to be subject to the trading obligation. Therefore, ESMA proposes that a threshold should be set for liquid derivatives.

#### Calculation frequency and time frame

23. An important aspect of the application of the frequent and systematic criterion and the substantial criterion is the relevant period for calculating the thresholds. As for the equity systematic internaliser regime, ESMA is of the view that the relevant thresholds should be calculated over a period long enough to minimise the risk of capturing episodic internalisation and to give legal certainty to investment firms. For that reason ESMA proposes that investment firms should take into account the activity within each calendar quarter when calculating the relevant thresholds.

#### Thresholds

24. ESMA has conducted some preliminary quantitative analysis to determine the thresholds to be used for assessing whether an investment firm should qualify as a systematic internaliser in a specific financial instrument. ESMA has also considered some qualitative criteria that were deemed relevant in this context.
25. With regard to the substantial basis criteria, the threshold should be set at a higher level than for the equity systematic internaliser regime given that it applies to turnover which is likely to be, for some liquid non-equity instruments, much lower than for equity. Consequently, internalising 25% (or 0.5% on an EU basis) of a low total turnover would be significantly easier to reach than for an instrument with high turnover.
26. Based on this preliminary analysis, ESMA considers proposing the thresholds below to the Commission for bonds, structured finance products and derivatives (ESMA has not analysed the emission allowance market yet):

**Table 18: Thresholds**

		Bonds	SFP	Derivatives	Emission allowances
<b>Frequent and systematic basis threshold (liquid instruments)</b>	Number of transactions executed by the investment firm on own account OTC / total number of transaction in the same financial instrument in the EU	2 to 3%	3 to 5%	2 to 4%	TBD
<b>Frequent and systematic basis threshold (illiquid instruments)</b>	Minimum trading frequency	at least once a week	at least once a week	at least once a week	TBD
<b>Substantial basis threshold Criteria 1</b>	Size of OTC trading by investment firm in a financial instrument on own account / total turnover in the same financial instrument executed by the investment firm	25%	30%	25%	TBD
<b>Substantial basis threshold Criteria 2</b>	Size of OTC trading by investment firm in a financial instrument on own account / total turnover in the same financial instrument in the European Union	0.5 to 1.5%	1.5 to 3%	1.5 to 3%	TBD

27. The thresholds presented here are set as percentages – except for the ‘frequent and systematic basis’ threshold for illiquid instruments. ESMA is investigating whether it would be more appropriate to set, for specific categories (e.g. for derivatives), thresholds in absolute numbers.

**Draft technical advice**

1. An investment firm shall be treated as a systematic internaliser if it meets the following criteria for the:

*Frequent and Systematic*

- i. The investment firm internalises on a frequent and systematic basis if the number of transactions executed by the investment firm on own account OTC in liquid instruments is, during the most recent quarter, equal or larger than (please refer to the table above) of the total number of transactions in the relevant financial instrument in the European Union during the same period.

For instruments for which there is not a liquid market as determined in accordance with Article 2(1)(17)(a) of MiFIR the condition is deemed to be met when the investment firm deals on own account OTC on average (please refer to the table above) during the most recent calendar quarter.

*Substantial Basis*

- ii. The investment firm internalises on a substantial basis if the size of OTC trading carried out by the investment firm on own account is, during the most recent calendar quarter, equal or larger

than either:

- a. (please refer to the table above) of the total turnover in that financial instrument executed by the investment firm on own account or on behalf of clients; or
- b. (please refer to the table above) of the total turnover in that financial instrument in the European Union.

- Q128.** For the systematic and frequent criterion, do you agree that the thresholds should be set per asset class? Please provide reasons for your answer. If you consider the thresholds should be set at a more granular level (sub-categories) please provide further detail and justification.
- Q129.** With regard to the ‘substantial basis’ criterion, do you support thresholds based on the turnover (quantity multiplied by price) as opposed to the volume (quantity) of instruments traded. Do you agree with the definition of total trading by the investment firm? If not please provide alternatives and reasons for your answer.
- Q130.** Do you agree with ESMA’s proposal to apply the systematic internaliser thresholds for bonds and structured finance products at an ISIN code level? If not please provide alternatives and reasons for your answer.
- Q131.** For derivatives, do you agree that some aggregation should be established in order to properly apply the systematic internaliser definition? If yes, do you consider that the tables presented in Annex 3.6.1 of the DP could be used as a basis for applying the systematic internaliser thresholds to derivatives products? Please provide reasons, and when necessary alternatives, to your answer.
- Q132.** Do you agree with ESMA’s proposal to set a threshold for liquid derivatives? Do you consider any scenarios could arise where systematic internalisers would be required to meet pre-trade transparency requirements for liquid derivatives where the trading obligation does not apply?
- Q133.** Do you consider a quarterly assessment by investment firms in respect of their systematic internaliser activity is adequate? If not, what assessment period would you propose?
- Q134.** Within the ranges proposed by ESMA, what do you consider to be the appropriate level? Please provide reasons for your answer. If you consider that the threshold should be set at a level outside this range, please specify at what level this should be with justifications and where possible data to support them.
- Q135.** Do you consider that thresholds should be set as absolute numbers rather than percentages for some specific categories? Please provide reasons for your answer.
- Q136.** What thresholds would you consider as adequate for the emission allowance market?

### 3.4. Transactions in several securities and orders subject to conditions other than the current market price

#### Background/Mandate

##### Extract from the Commission's request for advice (mandate)

*ESMA is invited to provide technical advice to develop the criteria specifying those transactions where execution in several securities is part of one transaction or those orders that are subject to conditions other than current market price as referred to in Article 15(3) of MiFIR. ESMA should take account of the criteria set out in Article 25(1) of the Commission Regulation (EC) No 1287/2006, taking into account the need to extend these criteria to equity instruments other than shares and any need to develop these standards in light of market and technological developments.*

#### Analysis

1. Article 15(2) of MiFIR requires a systematic internaliser to execute transactions in relation to shares, depositary receipts, exchange-traded-funds, certificates and other similar financial instruments, at the quoted prices at the time of the reception of the order. The requirement seeks to ensure that those prices provide meaningful information to clients and to the wider market by being firm up to the attached size.
2. However Article 14(3) of MiFIR allows systematic internalisers to execute orders they receive from their professional clients at prices different to the quoted ones without having to comply with the requirements established in Article 15(2) of MiFIR in respect of:
  - i. transactions where execution in several securities is part of one transaction; or
  - ii. orders that are subject to conditions other than the current market price.
3. The rationale of the provision is to allow certain transactions to be carried out on the systems provided by the systematic internaliser without having to comply with price restrictions, which would be impractical given the nature of those transactions.
4. With regard to when execution in several securities can be considered as part of one transaction, ESMA is of the view that the current definition of portfolio trade (i.e. a transaction in more than one financial instrument where those financial instruments are traded as a single lot against a specific reference price) involving 10 or more financial instruments remains valid. Similarly, and in line with the existing MiFID, a portfolio trade should also be considered as a transaction subject to conditions other than the current market price for the purpose of the execution of orders at prices different to the quoted ones.
5. With regard to other orders subject to conditions other than the current market price, ESMA is of the view that benchmark trades, securities financing transactions and all orders which are not market or limit orders should be considered as being subject to such conditions other than the current market price. In all those cases, the current market price is not the relevant benchmark against which those transactions are carried out. In a stock contingent trade, a simultaneous transaction combining a derivative and the underlying share, the price of the cash leg is determined on the basis of the price of the derivative contract rather than by the current market price for that share. In a securities financing





transaction, the transaction depends on market-wide borrowing costs rather than the current market price for the particular financial instrument.

### **Draft technical advice**

1. Execution in several securities shall be regarded as part of one transaction if that one transaction is a portfolio trade that involves 10 or more financial instruments. An order for the execution of several securities in a portfolio trade shall also be considered as subject to conditions other than the current market price.
2. An order shall be considered subject to conditions other than the current market price when:
  - i. the price is calculated over multiple time instances according to a given benchmark, including volume-weighted and time-weighted average prices;
  - ii. the order is part of a transaction involving the lending or borrowing of a financial instrument, a repurchase or reverse repurchase transaction or a buy-sell back or sell-buy back transaction; or
  - iii. it is neither for execution at the prevailing market price nor a limit order.

**Q137. Do you agree with the definition of portfolio trade and of orders subject to conditions other than the current market price? Please give reasons for your answer?**



### 3.5. Exceptional market circumstances and conditions for updating quotes

#### Background/Mandate

##### Extract from the Commission's request for advice (mandate)

*ESMA is invited to provide technical advice to develop the criteria specifying what can be considered as exceptional market conditions that allow for the withdrawal of quotes as well as the conditions for updating quotes as referred to in Article 15(1).*

#### Analysis

1. Article 15(1) of MiFIR allows systematic internalisers to temporarily withdraw their quotes under exceptional market circumstances. ESMA understands that the rationale of the provision is to protect systematic internalisers from being exposed to excessive risk as a result of the obligation to make available to clients firm quotes on a continuous basis. ESMA is of the opinion that requiring systematic internalisers to comply with the above obligation during disorderly market conditions or other exceptional circumstances would jeopardise the prudential stability of the investment firm and likely result in meaningless quotes.
2. ESMA appreciates that it is not possible to develop a comprehensive list of all circumstances, market-wide or instrument-specific, which can be deemed exceptional for the purpose of suspending the systematic internaliser quoting obligation. However, ESMA is of the view that a non-exhaustive list of circumstances which are deemed to be exceptional would enhance legal certainty and facilitate compliance with the systematic internaliser regime by investment firms.
3. In ESMA's view the above list encompasses instances where it would be problematic for a systematic internaliser to make a market in a financial instrument because of the lack of reliable market information or because of restrictions to the ability to manage an inventory of financial instruments.
4. With regard to the conditions for updating the quotes, ESMA notes that Article 15(1) of MiFIR already establishes that systematic internalisers are allowed to update their quotes at any time. ESMA is of the view that a systematic internaliser should be allowed to update its quotes anytime as market-wide or instrument-specific circumstances change or following any transaction executed with a client.

#### Draft technical advice

##### *Draft advice on specifying what can be considered as exceptional market conditions*

1. A systematic internaliser should be allowed to withdraw its quotes under exceptional market circumstances including when:
  - i. trading is halted in accordance with Article 48 MiFID on the most relevant market for that financial instrument;
  - ii. the most relevant market for that financial instrument allows market making obligations to be suspended;
  - iii. in the case of an exchange traded fund, a reliable market price is not available for a significant

number of instruments underlying the ETF or the index;

- iv. an NCA prohibits short sales in that financial instrument according to article 20 of the Short Selling Regulation (236/2012); or
- v. the total number and/or the volume of orders sought by clients exceeds the norm and the systematic internaliser decides to limit the number of transactions from different clients.

- 2. A systematic internaliser which withdraws its quotes shall immediately inform its NCA and its clients.

*Draft advice on specifying the conditions for updating quotes*

- 3. A systematic internaliser shall be able to update its quotes at any time provided that the quoted behaviour is consistent with genuine trading intentions and with non-discriminatory treatment of its clients. A systematic internaliser should be allowed to update its quotes as soon as market-wide or instrument-specific circumstances change or following any transaction executed with a client.

**Q138. Do you agree with the list of exceptional circumstances? Please give reasons for your answer. Do you agree with ESMA's view on the conditions for updating the quotes? Please give reasons for your answer.**



### 3.6. Orders considerably exceeding the norm

#### Background/Mandate

##### Extract from the Commission's request for advice (mandate)

*ESMA is invited to provide technical advice to develop the criteria specifying when the number and/or volume of orders sought by clients considerably exceed the norm as referred to in article 17(2). ESMA should take account of the criteria set out in Article 25(2) and (3) of Commission Regulation (EC) No 1287/2006, taking into account the need to extend these criteria to equity instruments other than shares and any need to develop these standards in light of market and technological developments.*

#### Analysis

1. By making bid and offer prices available for execution to clients, a systematic internaliser exposes itself to a number of risks, including market, counterparty and settlement risk. ESMA notes that the risk management policy of an investment firm depends on a variety of aspects, including the nature, scale and complexity of the activities undertaken and on the risk appetite of the investment firm itself.
2. For that reason ESMA believes that it is not advisable to rigidly prescribe for all investment firms acting as systematic internalisers the number and/or volume of transactions exceeding the norm. Rather, each investment firm should determine in advance, in an objective and non-discriminatory way and consistently with its risk management policy when the number or volume of orders shall be regarded as considerably exceeding the norm and expose the firm to undue risk.

#### Draft technical advice

1. The number or volume of orders shall be regarded as considerably exceeding the norm if a systematic internaliser cannot execute those orders without exposing itself to undue risk.
2. In order to identify the number and volume of orders that it can execute without exposing itself to undue risk, a systematic internaliser shall maintain and implement as part of its risk management policy a non-discriminatory policy which takes into account the volume of the transactions, the capital that the firm has available to cover the risk for that type of trade, and the prevailing conditions in the market in which the firm is operating.
3. Where an investment firm limits the number or volume of orders it undertakes to execute, it shall set out in writing, and make available to clients and potential clients, the arrangements designed to ensure that such a limitation does not result in a discriminatory treatment of clients.

**Q139. Do you agree that each systematic internaliser should determine when the number and/or volume of orders sought by clients considerably exceed the norm? Please give reasons for your answer?**



### 3.7. Prices falling within a public range close to market conditions

#### Background/Mandate

##### Extract from the Commission's request for advice (mandate)

*ESMA is invited to provide its technical advice the criteria specifying when prices fall within a public range close to market conditions as referred to in Article 15(2) of [MiFIR].*

#### Analysis

1. Article 27 of MiFID I and Article 26 of the MiFID Implementing Regulation impose certain price restrictions with regard to the execution of transactions by a systematic internaliser in sizes equal to or below the quoted size (provided it is lower than the standard market size). Systematic internalisers must execute orders they receive from retail clients at the quoted price; in justified cases orders from professional clients may be executed at a better price than the quote where the orders are of a size bigger than the retail size and provided that the price falls within a public range close to market conditions (i.e. larger than €7,500).
2. Article 15(2) of MiFIR requires a systematic internaliser to execute transactions at the quoted prices at the time of the reception of the order. The requirement seeks to ensure that by being firm up to the attached size, quoted prices provide meaningful information to clients and to the wider market with regard to the price formation process. However, in justified cases a systematic internaliser can execute a client order at a better price (i.e. buy at a higher price or sell at a lower price than the quoted prices) provided that the price falls within a public range close to market conditions.
3. ESMA notes that Article 14(3) of MiFIR requires that any bid and offer made public by a systematic internaliser in respect of shares, depositary receipts, ETFs, certificates and other similar financial instruments, shall reflect prevailing market conditions, which in ESMA's view means that they are close in price to comparable quotes for the same instrument in other trading venue. As a consequence ESMA is of the view that any price falling within the bid and ask spread quoted by the systematic internaliser would fall within a public range close to market conditions for that financial instrument and be consistent with meaningful quoting behaviour.

#### Draft technical advice

1. With respect to the execution of a transaction at a better price than the quoted one, a price falls within a public range close to market conditions when the price is within the bid and offer quotes of the systematic internaliser provided that those quotes reflect prevailing market conditions for that financial instrument.

**Q140. Do you agree that any price within the bid and offer spread quoted by the systematic internaliser would fall within a public range close to market conditions? Please give reasons for your answer.**



### 3.8. Pre-trade transparency for systematic internalisers in non-equity instruments

#### Background/Mandate

1. The current MiFID I regime for systematic internalisers with regard to pre-trade transparency is restricted to equities only. MiFIR now introduces new pre-trade rules that systematic internalisers trading in bonds, structured finance products, emission allowances and derivatives have to comply with.<sup>87</sup>
2. Article 18 of MiFIR establishes the general rule that systematic internalisers shall make public firm quotes and shall make these quotes available to other clients of theirs if they are prompted for a quote by a client and if they agree to provide such quotes.
3. At the same time MiFIR establishes a number of exemptions or modifications to this general rule affecting the obligation to publish quotes as well as the obligation to make them available to other clients.
4. A systematic internaliser does not have to publish firm quotes under the following circumstances:
  - i. if there is no liquid market in an instrument. In this case the quote shall only be disclosed to its clients upon their request in accordance with Article 18(2) of MiFIR; or
  - ii. if the internaliser deals in sizes above the size specific to an instrument determined in accordance with Articles 9(5)(d) and 18(10) of MiFIR.
5. A systematic internaliser does not have to make quotes available to and does not have to enter into transactions with other clients if the following conditions are fulfilled:
  - i. the number of transactions to be executed in respect of a specific quote exceeds the number established in accordance with Article 18(7) of MiFIR; or
  - ii. the quoted size exceeds the size specific to the instrument established in accordance with Article 19(2) of MiFIR.
6. Conversely, Article 18(6), subparagraph 1 means that systematic internalisers have to make quotes available to other clients if the quoted size is at or below a size specific to a financial instrument unless the financial instrument in question drops below the level of liquidity established in accordance with Article 9(4) (temporary suspension of liquidity obligations).
7. Article 19(2) specifies that:

#### **Extract from the Commission's request for advice (mandate)**

*ESMA is invited to provide technical advice on the sizes referred to in Article 18(6) at which a firm shall enter into transactions with any other client to whom the quote is made available. The size specific to the financial instrument shall be determined in accordance with the criteria set in Article 9(5)(d) for finan-*

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<sup>87</sup> Cf. Article 18 and 19 MiFIR and Section C of ANNEX I MiFID for the list of financial instruments.

*cial instruments traded request-for-quote and voice trading systems. For financial instruments not traded on request-for-quote and voice trading systems ESMA is invited to provide technical advice on whether the same criteria should be used or whether alternative criteria should be developed.*

#### **Article 19(2), MiFIR**

*The Commission shall adopt delegated acts in accordance with Article 50, specifying the sizes referred to in Article 18(6) at which a firm shall enter into transactions with any other client to whom the quote is made available. The size specific to the financial instrument shall be determined in accordance with the criteria set in Article 9(5)(d).*

8. ESMA considers that this size needs to be calibrated for all asset classes encompassed by the quoting obligation. The end result to ensure legal certainty and practicability therefore needs to be a matrix where each financial instrument is automatically assigned a specific size based on certain parameters and characteristics.
9. Article 19(2) of MiFIR makes reference to the criteria used to determine the size specific to an instrument in Article 9(5)(d) of MiFIR where for certain trading systems (request for quote systems, voice trading systems) pre-trade transparency can be waived if it would expose liquidity providers to undue risk while taking into account whether relevant investors on the market are from the retail or wholesale sector. When determining whether a liquidity provider is exposed to undue risk the ability to hedge risks at the specific sizes for an instrument shall be taken into consideration.
10. ESMA considers that the situation of liquidity providers on request for quote and voice trading systems may not be identical but similar to that of systematic internalisers. The liquidity provider puts up its own capital in a way broadly comparable to a systematic internaliser. Establishing different sizes for liquidity providers, on the one hand, and systematic internalisers, on the other, would also put one or both at a competitive disadvantage. Therefore ESMA considers that the same sizes established for liquidity providers under Article 9(5)(d) shall also apply to systematic internalisers.
11. In practical terms this will mean that the results the Commission comes to when drafting its delegated act for Article 19(2) and the results ESMA comes to when preparing the technical standard in respect of Article 9(5)(d) should not just be determined in accordance with the same criteria, as Article 19(2) so requires, but also the results should be closely aligned if not identical.
12. ESMA therefore refers to its considerations in the DP concerning Article 9(5)(d)<sup>88</sup> and undertakes to cooperate closely with the Commission in particular on this issue to ensure that despite the different legal procedures of delegated act and RTS the outcome should be closely aligned in order not to create an unlevel playing field.
13. This approach would cover all financial instruments caught by Article 9(5)(d) which are those traded on request for quotes and voice trading systems. The future Commission delegated act could simply incorporate the thresholds set through the ESMA technical standard in respect of Article 9(5)(d) MiFIR by reference.

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<sup>88</sup> Please refer to section 3.10 of the DP (*size specific to the instrument*).



14. The Commission delegated act would only have to address those instruments separately and establish new sizes specific only in case the technical standard in respect of Article 9(5)(d) would not cover certain instruments due to them never being traded on the respective systems.

**Draft technical advice**

1. The Commission shall establish the size specific to the instrument for the purposes of Article 19(2) of MiFIR in close cooperation and closely aligned with ESMA establishing the size specific to the instrument for the purposes of Article 9(5)(d) of MiFIR.
2. For instruments traded on request for quote or voice trading systems the Commission Delegated Act shall establish the size specific to the instrument by reference to the ESMA technical standard establishing the size specific to the instrument for the purposes of Article 9(5)(d) of MiFIR.
3. For instruments not traded on request for quote or voice trading systems for which no size specific is established under the ESMA technical standard in respect of Article 9(5)(d) of MiFIR, the Commission shall establish sizes specific by using the same methodology as applied in the ESMA technical standard in respect of Article 9(5)(d) of MiFIR.

- Q141. Do you agree that the risks a systematic internaliser faces is similar to that of an liquidity provider? If not, how do they differ?**
- Q142. Do you agree that the sizes established for liquidity providers and systematic internalisers should be identical? If not, how should they differ?**



## 4. Data publication

### 4.1. Access to systematic internalisers' quotes

#### Background/Mandate

##### Extract from the Commission's request for advice (mandate)

*ESMA is invited to provide technical advice to develop [...] the criteria specifying when a quote is published on a regular and continuous basis and is easily accessible as referred to in Article 15(1), as well as the means by which investment firms may comply with their obligation to make public their quotes, which shall include the following possibilities:*

- i. through the facilities of any regulated market which has admitted the financial instrument in question to trading;*
- ii. through an APA;*
- iii. through proprietary arrangements.*

#### *Publication on a regular basis*

1. MiFIR establishes pre-trade transparency requirements for trading venues and for systematic internalisers, which might differ depending on the type of instrument (acting as systematic internaliser for equity and equity-like does not subject investment firms to the same requirements as non-equity instruments).
2. Article 14 MiFIR obliges systematic internalisers to make public quotes for the equity and equity-like instruments traded on a trading venue for which there is a liquid market. In case there is not a liquid market, SIs shall disclose quotes to their clients upon request. It is important to note that MiFIR differentiates here between both concepts: making information public and disclosing information to clients.
3. ESMA has to determine “*the criteria specifying when a quote is published on a regular and continuous basis and is easily accessible as referred to in Article 15(1) as well as the means by which investment firms may comply with their obligation to make public their quotes*”.
4. Article 27(3) of MiFID I establishes that systematic internalisers should make public their quotes on a regular and continuous basis during normal trading hours. So as to ensure that this obligation was accomplished, Article 27(4) imposed on NCAs the obligation to check that investment firms regularly updated bid and/or offer prices published and maintained prices reflecting prevailing market conditions.
5. The pre-trade transparency obligations for systematic internalisers were further clarified in Articles 21 to 24 of the MiFID I Implementing Regulation and “*normal trading hours*” were defined in Article 2(5) of the same regulation.



6. Under Article 14(7) of MiFIR, ESMA has to develop RTS specifying the arrangements for publication of a firm quote, as well as other matters. ESMA will ensure that its technical advice requested under Article 17 is consistent with the RTS it develops under Article 14.

### **Analysis**

7. ESMA has not been informed of any problems in relation to the Articles of the MiFID I framework mentioned above. Therefore, it proposes to maintain the existing regulatory approach in this regard.

### **Draft technical advice**

1. ESMA recommends considering that the publication of a quote as “*regular and continuous*” if it is available at all times during normal trading hours unless “*exceptional market conditions*” (MiFIR Article 15(1)) arise.
2. “*Normal trading hours*” for a systematic internaliser should be considered those hours which the systematic internaliser establishes in advance and makes public as its trading hours.
3. Systematic internalisers shall update regularly their quotes to ensure they reflect the prevailing market conditions.

**Q143. Do you agree with the proposed definition of “regular and continuous” publication of quotes? If not, what would definition you suggest?**

**Q144. Do you agree with the proposed definition of “normal trading hours”? Should the publication time be extended?**

#### *Easily accessible publication*

8. The obligation of systematic internalisers to make public their quotes on a regular and continuous basis during normal trading hours (Article 15 of MiFIR) is further developed by Article 17 with a two-fold purpose: ensuring the efficient valuation of shares, depositary receipts, ETFs, certificates and other similar financial instruments and maximising the possibility of investment firms to obtain the best deal for their clients.
9. In this topic, it is important to differentiate three different layers of publicity:
  - i. disclosure of a quote to an individual client (e.g. as in Article 18(1) of MiFIR: an investment firm may provide a quote upon request from a client when they agree to do so);
  - ii. disclosure of a quote to the firm’s clients, or a sub-set of them, according to the firm’s commercial policy and on a non-discriminatory basis (e.g. as in Article 18(5) of MiFIR: the quotes already provided under Article 18(1) of MiFIR shall be provided to other clients); and
  - iii. disclosure of a quote to the public, i.e. to other market participants on a reasonable commercial basis (e.g. Article 18(8) of MiFIR).



10. Article 14(1) (first paragraph and second paragraphs) and Article 15(1) of MiFIR prevent systematic internalisers on equity and equity-like instruments for which there is a liquid market from restricting the publicity of their quotes to their clients.
11. Disclosure of firm (i.e. executable) quotes has to ensure that trading carried out OTC does not jeopardise efficient price discovery or a transparent level-playing field between means of trading (Recital 18 of MiFIR). As a consequence, it is critical to ensure that quotes published by investment firms are consistent across all the publication arrangements, i.e. that market participants do not receive different information depending on the means used to publish the quote.
12. In relation to the publication according to the formats, data standards and technical arrangements prescribed by the Commission in development of Article 64(6) of MiFID II, ESMA is aware that the least cumbersome way to permit publication of quotes through trading venues and data reporting services is to permit these entities to “translate” the quotes sent by the investment firms in whichever format into the format of their own data stream. However, ESMA’s concern is that this “translation” process might take too long and create differences between the firm (i.e. executable) quotes published at the same time and in different environments. Under the current mandates in Articles 64(6) and 65(6) of MiFID II, ESMA is supposed to elaborate data formats and standards for post-trade transparency, but not for pre-trade transparency.
13. Finally, ESMA reminds that, as indicated in DP<sup>89</sup>, a quote would be considered as ‘machine-readable’ where the data meets all the following criteria:
  - i. it is in an electronic form that is designed to be directly and automatically read by a computer;
  - ii. it is in a location on a computer storage device where that location is known in advance by the party wishing to access the data. Data may also be located in a website, in which case it shall remain accessible by electronic means through an automated process; and
  - iii. it is in a format that is known in advance by the party wishing to access the data. Format includes in particular the type of files or messages, the rules to identify them, and the name and data type of the fields they contain. Instructions outlining how users can access the data shall be made easily and continuously available to all parties wishing to access the data.

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<sup>89</sup> Please refer to 5.3 of the DP (*Technical arrangements promoting and efficient and consistent dissemination of information – machine readability Article 64(6) of MiFID II*)

## Draft technical advice

4. ESMA considers a systematic internaliser on shares, depositary receipts, ETFs, certificates and other similar financial instruments has complied with the obligation to make public its quotes when the investment firm has proceeded in any of the following ways:
  - i. The quote is published through the facilities of a trading venue, as defined by Articles 4(1)(24) of MiFID II and 2(1)(16) of MiFIR: regulated markets, multilateral trading facilities (MTFs) and organised trading facilities (OTFs) where the instrument was effectively traded before the date of submission.
  - ii. In particular, where an investment firm is registered as a systematic internaliser for an instrument for which it is also registered as market maker, it is recommended that publication takes place in any case through the trading venue's arrangements.
  - iii. The quote is made public through a data reporting service located in one Member State of the European Union.
  - iv. The quote is published through the investment firm's own proprietary arrangements. Under the concept of "*proprietary arrangements*" should only be considered the investment firm's website.
  - v. The systematic internaliser should specify the arrangements through which it publishes its quotes. This information should be disclosed on its website and be kept updated.
5. ESMA considers that in the case where the quotes of a systematic internaliser are published through the facilities of a trading venue or through a data reporting service, these quotes should include the identity of the systematic internaliser so the market participants are able to direct their orders to it.
6. Quotes can be published through all the means mentioned above simultaneously, as long as the quotes published through the firm's own website are the same as those published through a data reporting services provider or a trading venue and are not outdated.
7. ESMA's preliminary view is that, ideally, systematic internalisers' quotes (and more generally, pre-trade transparency data) should be published according to harmonised standards and formats, so as to facilitate as much as possible the provision of consolidated information about trading opportunities.

**Q145. Do you agree with the proposal regarding the means of publication of quotes?**

**Q146. Do you agree that a systematic internaliser should identify itself when publishing its quotes through a trading venue or a data reporting service?**

**Q147. Is there any other mean of communication that should be considered by ESMA?**

**Q148. Do you agree with the importance of ensuring that quotes published by investment firms are consistent across all the publication arrangements?**



**Q149. Do you agree with the compulsory use of data standards, formats and technical arrangements in development of Article 66(5) of MiFID II?**

*Additional means to publish a quote other than the ones mentioned in Article 17(3) of MiFIR*

14. Excessive fragmentation of pre-trade transparency may make difficult finding liquidity. On that basis, the sole publication through the investment firm's website of quotes should be subject to more stringent requirements. To that end, ESMA considers that the quote should be published in a machine-readable manner and also in a way which is easily understandable for humans as well.
15. As for the publication of quotes through data reporting services and trading venues, investment firms publishing quotes in a machine-readable way should meet the same standards and requirements as established by the Commission in development of Article 66(5) of MiFID II.
16. However, in those cases where the firm has already published the information about the order through an APA or a CTP, publication in a machine-readable way will suffice.

**Draft technical advice**

8. Publication of quotes exclusively through the investment firm's own proprietary arrangements should be 'easily accessible' to all market participants (on a reasonable commercial basis), not only to investment firm's own clients.
9. For these purposes, ESMA considers that it should be considered that the publication of quotes through an investment firm's own website is 'easily accessible' when it meets the following requirements:
  - i. all market participants wishing to access those quotes may access them; and
  - ii. the quote shall be published in a 'human readable way' and also in a 'machine-readable way' in the investment firm's website according to the following criteria:
    - a. the order should be published in two different electronic formats: one designed to be read by a computer and another one understandable for a human average reader;
    - b. the order is in a location known in advance by the party wishing to access the data or in a computer storage device accessible to a party wishing to access the data without a cost. The publication in the "human readable way" should be displayed on a section of the firm's website which can be found following clear indications from the homepage; and
    - c. the order is in a format known in advance by the party wishing to access the data or accompanied by instructions outlining how users can access the information.
10. In those cases where the investment firm is publishing simultaneously the quote through a data reporting service or a trading venue, publication in a machine-readable way will suffice.
11. In any case, publication in a machine-readable way should meet the requirements determined by the Commission in development of Article 66(5) of MiFID II.



- Q150. Do you agree with the imposing the publication on a ‘machine-readable’ and ‘human readable’ to investment firms publishing their quotes only through their own website?**
- Q151. Do you agree with the requirements to consider that the publication is ‘easily accessible’?**



## 4.2. Publication of unexecuted client limit orders on shares traded on a venue

### Background/Mandate

#### Extract from the Commission's request for advice (mandate)

*ESMA is invited to provide technical advice on adaptations and further improvements to the procedures and arrangements which result in the prompt, fair and expeditious execution of client orders and the situations in which or types of transaction for which investment firms may reasonably deviate from prompt execution so as to obtain more favorable terms for clients as well as to the different methods through which an investment firm can be deemed to have met its obligation to disclose not immediately executable client limit orders to the market.*

1. In the context of the general obligation for investment firms authorised to execute orders on behalf of clients to “implement procedures and arrangements which provide for the prompt, fair and expeditious execution of client orders”, Article 28(2) of MiFID II sets out the obligation that “in the case of a client limit order in respect of shares admitted to trading on a regulated market or traded on a trading venue which are not immediately executed under prevailing market conditions, investment firms are, unless the client expressly instructs otherwise, to take measures to facilitate the earliest possible execution of that order by making public immediately that client limit order in a manner which is easily accessible to other market participants. Member States may decide that investment firms comply with this obligation by transmitting the client limit order to a trading venue. Member States shall provide that the competent authorities may waive the obligation to make public a limit order that is large in scale compared with normal market size as determined under Article 4 of MiFIR”. ESMA should define the different methods through which an investment firm can be deemed to have met its obligation to disclose not immediately executable client limit orders to the market.
2. This Article follows the same approach as Article 22(2) of MiFID I, which was implemented and further developed by Article 31 of the MiFID I Implementing Regulation, which sets out two methods an investment firm can use: “An investment firm shall be considered to disclose client limit orders that are not immediately executable if it **transmits the order to a regulated market or MTF that operates an order book trading system, or ensures that the order is made public and can be easily executed** as soon as market conditions allow”.

### Analysis

3. This section does not deal with the first part of the mandate quoted above[1] – which may be found in the section of this paper dedicated to client order-handling rules – focussing instead on the second part of the mandate, i.e., “the different methods through which an investment firm can be deemed to have met its obligation to disclose not immediately executable client limit orders to the market.”
4. ESMA considers that the submission of clients' limit orders to trading venues has fulfilled well the existing requirement. It should be adapted to MiFID II by adding OTFs to the venues to which an investment firm can transmit a non-executed order. But otherwise, ESMA does not currently perceive a reason to modify this possible way to meet MiFID's requirement.
5. At the moment ESMA lacks evidence regarding other means to make public this type of pre-trade transparency information under MiFID.



6. However, ESMA remains sceptical about the other two possible ways that can be envisaged for the facilitation of unexecuted orders under the MiFID II framework: publication through a data reporting service (whose main purpose is the publication of *post-trade information*) and the publication through the investment firm's own proprietary arrangements (as it seems unlikely that market participants track all firms' websites seeking this type of orders).
7. ESMA is of the view that submission of an unexecuted order to a trading venue should be reflected in the investment firm's best execution policy.
8. Investment firms may play different roles at the same time that may give rise to potential conflicts of interest. In the case of execution of a clients' orders, the main problem that regulators may envisage are:
  - i. the prioritisation of the investment firm's own venue or a venue which is part of the investment firm's group (RM, MTF or OTF) against more liquid markets; and
  - ii. the conflicts of interest amongst clients in the execution of orders in an OTF. In these cases, investment firms should be aware that they are subject to the prohibition to execute clients orders on shares against their own proprietary capital (Article 20(1) of MiFID II), and the obligation to identify and manage potential conflicts of interests, not only as OTF operators (Article 18 (4) of MiFID II) but also as investment firm (Article 23 of MiFID II).

#### **Draft technical advice**

1. ESMA considers that client limit orders which have not been immediately executed under prevailing market conditions shall be considered as being available to the public when the investment firm has submitted the order for execution to a trading venue, as defined by Article 2(1)(16) of MiFIR and Article 4(1)(24) of MiFID II: regulated markets, multilateral trading facilities (MTFs) and organised trading facilities (OTFs).
2. For client limit orders whose size exceeds the large in scale threshold set out in accordance with Article 9 of MiFIR, and where the NCA has waived the pre-trade transparency of these orders, disclosure of the order shall take place according to the discretion of the investment firm, unless the client has instructed otherwise.
3. For these purposes, trading venues should be prioritised according to the firm's best execution policy, to ensure execution as soon as market conditions allow. Execution in the investment firm's own facility should not contradict in any possible way its best execution policy and should not adversely affect the client's interests;
4. When the investment firm operates an organised trading facility, as defined by Article 2(1)(15) of MiFIR, it should only submit the limit order to its own system when the following conditions have been met:
  - i. that possibility is expressly envisaged in its best execution policy and has been accepted by the client; and
  - ii. the client has been made aware of how the investment firm, as operator of the organised trading facility, shall exercise discretion in the execution of orders, as prescribed by Article 20(6) of Mi-





FID II.<sup>90</sup>

- Q152. Do you think that publication of unexecuted orders through a data reporting service or through an investment firm's website would effectively facilitate execution?**
- Q153. Do you agree with this proposal. If not, what would you suggest?**

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<sup>90</sup> Article 20.1 MiFID already prevents the execution of client orders in an OTF against the firm's proprietary capital.



### 4.3. Reasonable commercial basis (RCB)

#### Background/Mandate

1. MiFID II and MiFIR contain a number of references to “*reasonable commercial basis*”, and there are five separate powers for the Commission to clarify what the phrase means through Delegated Acts.<sup>91</sup>
2. The Commission’s 2010 MiFID Review consultation<sup>92</sup> asked for views on “*reasonable commercial basis*”, arguing that prices for trading data were higher in the EU than, for example, in the US. Industry responses ranged from banks and buy side firms calling for prices to be fixed at marginal cost plus a reasonable profit margin, to exchanges arguing that their existing charging schemes were both reasonable and commercial, and disputing the evidence of relatively high prices in Europe.

#### Extract from the Commission’s request for advice (mandate)

*ESMA is invited to provide technical advice on what constitutes reasonable commercial in relation to the provision of data in accordance with Articles 64(1) and 65(1) of MiFID II and 13(1), 15(1) and 18(8) of MiFIR. In providing technical advice, ESMA shall ensure apply the same analytical framework set out in mandate 3.21.*

*In its technical advice ESMA should explore at least the following options and make a recommendation in terms of their net benefits. First, it should explore a “principle based approach” which is that of defining principles against which data providers and their customers could appreciate the reasonableness of data prices. Second, it should explore approaches for restricting charges by reference to appropriate benchmarks such as overall revenues or costs in order to ensure that the prices charged by data providers do not allow them to earn more than reasonable profit/return. Third, it should explore a combination of these two options.*

*The technical advice should further develop criteria to ensuring that charges are non-discriminatory. In providing technical advice ESMA should take into account the link to unbundling of data as per its regulatory technical advice in accordance with Article 12(2).*

*In providing technical advice, ESMA should have regard to the specificities of approved reporting arrangements and consolidated tape providers and provide an assessment of the implications of these specificities in terms of setting out the criteria for the application of the reasonable commercial basis test.*

3. In sections 3.19 and 3.22 introducing the above mandates, the Commission says that data charges in the EU are too high, and ESMA is required to give technical advice on the best way in which the Commission could use its power to make Delegated Acts to bring prices down to a reasonable level. ESMA is consulting on methods to do this, not on whether current price levels are or are not too high.
4. ESMA’s Secondary Markets Standing Committee discussed this issue with the Consultative Working Group on 6 September 2013. Reactions were mostly polarised into those who thought that price caps

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<sup>91</sup> Listed in Range of Markets section below

<sup>92</sup> *Public consultation: Review of the Markets in Financial Instruments Directive (MiFID)* – European Commission – 8 December 2010, [ec.europa.eu/internal\\_market/consultations/2010/mifid\\_en.htm](http://ec.europa.eu/internal_market/consultations/2010/mifid_en.htm)



would be the only effective method of regulation, and those who believed that the definition should be limited to broad principles.

5. Copenhagen Economics, commissioned by the Danish and Swedish Securities Dealers Association, sent ESMA a paper they published on 5 October 2012<sup>93</sup>. They recommended bottom-up price regulation based on expert knowledge/independent evaluation. Addressing the issue of setting appropriate prices for the wide range of bundles sold by trading venues, they recommended prescribing a price limit only for a complete supply of all raw data.
6. Oxera, commissioned by Deutsche Börse, Nasdaq OMX, NYSE Euronext and SIX Swiss Exchange, sent ESMA a paper<sup>94</sup> dated January 2014, and a subsequent note critiquing the Copenhagen Economics paper. Oxera's conclusion was that there was no justification for regulating venues' data prices; that regulating would be impracticable and would risk distorting the market; but that there might be benefits from more transparency about how venues recover their costs.

### **Analysis**

7. The main element of “reasonable commercial basis” is the prices charged for data, and that is the focus of the remainder of this section. But there is also the question of unbundling. As well as disaggregating within the data it sells, as considered in section<sup>95</sup>, it is important that members, users and participants should face sufficiently granular tariffs that enable them to access and pay for only those services they need. In particular, it should be possible to pay for trade data services without having to pay for other services that may not be wanted.
8. “Reasonable commercial basis” should include a measure of non-discrimination. Suppliers should offer the same prices, and other terms and conditions, to all customers who are in the same position according to published, objective criteria. These criteria should allow suppliers to discriminate between different types of customers where it is reasonable to do so. For example, an exchange might charge one set of prices for its trading data to data vendors or other entities who are going to sell it on or re-use it, another price to sell it direct to buy-side firms, and another lower price for individual retail investors.
9. ESMA has considered a wide range of options, falling into the following categories:
  - i. do nothing;
  - ii. general principles and enhanced transparency;
  - iii. limits on charging based on:
    - a. existing prices;
    - b. revenues; and

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<sup>93</sup> Copenhagen Economics, *Regulating access to and pricing of equity market data*, 5 October 2012, revised 12 September 2013, [www.copenhageneconomics.com/Website/Publications/Public-Finance---Financial-Markets.aspx?M=News&PID=2035&NewsID=538](http://www.copenhageneconomics.com/Website/Publications/Public-Finance---Financial-Markets.aspx?M=News&PID=2035&NewsID=538).

<sup>94</sup> <http://www.oxera.com/Latest-Thinking/Publications/Reports/2014/Pricing-of-market-data-services-an-economic-analys.aspx>

<sup>95</sup> Please refer to section 5.5 of the DP (*data disaggregation*)



- c. costs.
  - iv. quantitative price caps; and
  - v. mandating that all data should be provided for free.
10. We have rejected the first, fourth and last options above. Doing nothing and quantitative price caps are not compatible with the Commission mandate ESMA has received. Furthermore, the fourth option, quantitative price caps (e.g. limiting the price of level 1 data to €X per month per screen), would be difficult to calibrate appropriately, specifying individual limits for each relevant price in a supplier's catalogue, and could eventually risk preventing innovation and experimentation in pricing models. Quantitative price caps would also be difficult to square with the empowerment to clarify "reasonable commercial basis", as regulator-imposed prices would not be "commercial". Requiring data to be published for free is clearly not a "reasonable commercial basis".
11. As explained below, ESMA also found that basing limits on existing prices was not workable in this market. Therefore, ESMA analysed three main approaches:
- i. transparency and general principles;
  - ii. revenue-based controls; and
  - iii. cost-based controls.

#### Transparency and general principles

12. This aims at making prices fair, reasonable and non-discriminatory. It would involve defining principles against which venues and their customers could judge the reasonableness of data prices. This would take into account the value of the information to the customer, as well as the costs for the venue.
13. This approach is common in some other fields, including laws obliging owners of high technology patents to license them to their competitors.
14. In some jurisdictions for example there is a requirement in certain areas to publish prices which are important for the average consumer in a centralised location, so that they are easily comparable. One example is the system for publishing the prices of fuel charged by different petrol stations in Germany, which can be freely accessed including by mobile phone. This has led to greater confidence of the public in price setting, because overcharging becomes more easily recognisable.
15. As a first step venues could be required to publicly disclose their market data price lists on a website (e.g. the ESMA website) which could lead to full transparency of actual price lists including disclosure in case of price changes. This list would help users to identify more easily the general price level and recognise deviations. This list could also be combined with a historic overview, so that it would be transparent how prices developed over time and whether potential increases could be regarded as reasonable. A basic list could have the following features:
- i. full transparency of actual price lists;
  - ii. immediate updates and full disclosure in case of price changes;



- iii. availability of historic information; and
  - iv. easy access to information for the public as well as regulators.
16. Further metrics that could be required to be published in a centralised manner:
- i. number of instruments covered;
  - ii. total turnover of instruments covered;
  - iii. pre-trade / post-trade data ratio;
  - iv. information about value add information enclosed; and
  - v. date of last licence fee adaption for respective data product.

#### **Option A**

For a service to be supplied on a “*reasonable commercial basis*”, the supplier should set prices to be fair, reasonable and non-discriminatory. Suppliers’ price lists should be subject to full transparency, alongside other key metrics.

- Q154. Would these disclosure requirements be a meaningful instrument to ensure that prices are on a reasonable commercial basis?**
- Q155. Are there any other possible requirements in the context of transparency/disclosure to ensure a reasonable price level?**
- Q156. To what extent do you think that comprehensive transparency requirements would be enough in terms of desired regulatory intervention?**

#### Limits on charging

- 17. ESMA considered several approaches for setting controls on prices by reference to existing prices (the supplier’s own or a benchmark), to overall revenues, or to costs.
- 18. There are two ways of basing controls on existing prices. First is to ratchet down real prices by restraining increases in charges to a specified amount less than an appropriate price index (known as “price index minus X”). The principle behind this is to force the supplier to reduce costs by making progressive improvements in efficiency, and to pass the benefits on to customers. It is not appropriate in this instance as it assumes that existing prices are a reasonable starting point.
- 19. A second approach used in other markets is to limit charges made by a supplier by reference to some comparator business that is regarded as operating in a competitive environment. This is not appropriate in this instance as it depends upon identifying a comparator whose prices are accepted as being reasonable.
- 20. We considered a number of alternative measures of costs to use as the basis of pricing, including average variable cost (as a proxy for marginal cost), average avoidable cost, and average total cost,

and long-run incremental cost (LRIC). Average variable cost allows a supplier to recover only the extra costs incurred in the short term in providing a service, so that it would not enable it to recover any fixed costs dedicated to providing that service, nor any costs that were shared with other services or that were common to the entire undertaking. Average avoidable cost would be average variable cost plus any fixed costs solely used for that service, but would still exclude joint and common costs. Either of these measures would mean that a venue would be unable to recover joint costs of providing data and would in effect have to recover these costs from the sale of other products. On the other hand average total cost would allow venues to recover too large a share of their common costs through the sale of data, as all common costs would be attributed to this service.

21. LRIC allows a supplier to recover the difference between what it would cost to run a business without the incremental service (e.g. run an exchange without publishing data) and what it would cost to run the same business with the incremental service. It is designed to reflect the efficient costs of providing the service, but not in such a way that a supplier is forced to cross-subsidise the service from other income.
22. This paper therefore analyses further the cost-based option of LRIC, and the revenue-based option of limiting charges by setting a maximum share of revenues that can be represented by revenues from data sales.

#### Revenue share limitation

23. The option of controlling charges by limiting revenue share would involve imposing certain high-level limits. For example, market data services as a proportion of total revenues should not exceed a certain percentage<sup>96</sup>. If a trading venue wanted to exceed this limit, then it would have to consult its customers and explain the reasoning behind this change.
24. The assumption behind this limitation is that a situation in which data services account for say 90% of the total revenue of a trading venue *may* be an indicator that data is not being provided on a reasonable commercial basis. Such an imbalance in revenue streams might suggest that in one area prices could be less competitive than in another area. Also, it could be regarded as undesirable, if there appears to be some form of cross-subsidisation between different operations.
25. However, it would probably be too far-reaching to demand that all operations of a trading venue have to have exactly equal shares of the total revenue. Therefore, the proposed limit would take into account possible differences in different fields of operation and start on the higher side with the possibility to lower the limit, if results are not considered satisfactory.
26. ESMA is not aware of a limitation on revenue share having been used before to control costs in the financial services sector, or in any other sector. Critics may argue that it is difficult to find a revenue limit that can be convincingly justified, i.e. which percentage level of total revenues could be considered still reasonable.

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<sup>96</sup> FESE's [European Exchange Report 2012](#) published in August 2013 contains information on the revenues of its member exchanges. The weighted average share of information services and products (isp) (using as denominator the total of isp, listings, cash trading and derivatives) was 15%. In Prague the ratio was 77%. Elsewhere it varied between 0% and 40%. Ratios at the four largest exchanges were: NYSE-Euronext 12%, Deutsch Börse 21%, NASDAQ OMX Nordic 22% and BME 17%. Using a different data source, non-member LSE has a ratio of around 30%.

### Option B

It may be considered imposing certain high-level limits. For example, market data services as a proportion of total revenues should not exceed a certain percentage

**Q157. What are your views on controlling charges by fixing a limit on the share of revenue that market data services can represent?**

**Q158. Which percentage range for a revenue limit would you consider reasonable?**

#### Long-Run Incremental Cost plus (LRIC+)

27. As above, LRIC is more appropriate than other measures of cost for this purpose because it allocates to a service only those costs that are (efficiently) incurred and would not be sustained if the service included in the increment was no longer produced. As such it mimics the prices that would be observed in a competitive market. ESMA also believes that venues should be allowed a mark-up to allow recovery of an appropriate share of common costs. LRIC with such a mark-up is known as 'LRIC+'.
28. LRIC is used extensively in the telecommunications sector, including in EU regulation of fixed and mobile termination rates.<sup>97</sup> It is also used in various jurisdictions for other utilities, including gas and electricity supply, water supply, and airports. ESMA is unaware of any regulatory precedent for it being used in the financial services sector. In theory there is no reason why it should not be applicable, but the financial services sector has characteristics which are rather different from those utilities which are based around substantial physical infrastructure.
29. In applying LRIC, there are several choices and judgements to be made. The most fundamental is the size of the increment. If the increment was the supply of data to one further customer, that would correspond to the average variable cost and would be close to zero. At the other extreme, if the increment included a venue's transaction services as well as its data services, it would enable venues to continue to cross-subsidise within the increment. ESMA therefore suggests that the increment should be a venue's entire data publication services.
30. There are also two ways of calculating LRIC: top-down and bottom-up. Top-down calculation would use the venue's own accounting data to work out the incremental costs attributable to data publication services. Bottom-up would be based on a model of what a new data publication service would efficiently cost. The bottom-up method is preferred as it prevents venues from recovering the costs of their inefficiencies, and avoids there being an incentive to inefficient investment. Top-down modelling could be used as a supplementary check of the bottom-up results.
31. There are many other judgements to be made in building and applying a LRIC model, particularly estimating values for future investments, the reasonable share of joint and common costs to attribute

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<sup>97</sup> See Commission Recommendation [2009/396/EC](#) of 7 May 2009 on the Regulatory Treatment of Fixed and Mobile Termination Rates in the EU. Recital 13 begins:

*"Taking account of the particular characteristics of call termination markets, the costs of termination services should be calculated on the basis of forward-looking long-run incremental costs (LRIC). In a LRIC model, all costs become variable, and since it is assumed that all assets are replaced in the long run, setting charges based on LRIC allows efficient recovery of costs. LRIC models include only those costs which are caused by the provision of a defined increment. An incremental cost approach which allocates only efficiently incurred costs that would not be sustained if the service included in the increment was no longer produced (i.e. avoidable costs) promotes efficient production and consumption and minimises potential competitive distortions."*

to data publication services, and the reasonable cost of capital, including how capital expenditure should be depreciated or amortised. There is therefore a risk that it will not be applied consistently by suppliers. It would be possible for the Commission to prescribe detailed rules, but it would be very difficult to calibrate these in the absence of experience of applying the model to financial services businesses.

32. There would be significant costs for suppliers in creating and maintaining a LRIC+ model, which would have to be recovered (as allowable costs) from customers through charges. (There would also be increased costs for regulators as noted under ‘Enforcement’ below.)

### Option C

For a service to be supplied on a “*reasonable commercial basis*” the supplier should set prices so as to recover no more than the Long Run Incremental Costs (LRIC) of providing the service and the mark-up to allow recovery of an appropriate share of common costs (i.e. LRIC+). The calculation of LRIC+ should be forward-looking, ignoring historic costs, and assume the choice of the most efficient methods of providing the service.

In the context of a trading venue selling trading data, LRIC means the difference between the total long-run costs of the venue providing its full range of services and the total long-run costs the venue would incur if it did not publish trading data. This should be calculated on a bottom-up basis.

The Commission should review the operation of the definition of “*reasonable commercial basis*” after three years and consider whether it would be appropriate to modify or elaborate the definition in the light of experience.

Each supplier who charges for a service that has to be supplied on a reasonable commercial basis should build and maintain a model of its costs that will enable it to calculate the LRIC+ of providing the service.

The supplier should set prices so that forecast revenues will recover no more than LRIC+. The supplier should monitor actual revenues and lower prices if recovery is more than LRIC+.

- Q159. If the definition of “*reasonable commercial basis*” is to be based on costs, do you agree that LRIC+ is the most appropriate measure? If not what measure do you think should be used?**
- Q160. Do you agree that suppliers should be required to maintain a cost model as the basis of setting prices against LRIC+? If not how do you think the definition should be implemented?**

### Enforcement

33. These provisions, as any others, need to be enforced by national authorities. ESMA is conscious that price or revenue controls do not at present form a normal part of the work of national regulators of financial services, being more the expertise of competition or anti-trust authorities. For a NCA to include oversight of data charges in its normal supervision of trading venues would require it to develop new capacities, possibly including extra resources. In some jurisdictions it might be necessary for implementing legislation to extend the powers of the NCAs. Alternatively a Member State could take the option of having its competition authority oversee price-setting.





34. If enforcement is not carried out consistently, there is a risk of regulatory arbitrage.
35. The extra and novel work involved would be significantly greater if the LRIC+ option was pursued, as scrutinising a model based on many assumptions will involve more extensive time and skills than checking the elements of revenue to ensure that a percentage limit has not been exceeded.

#### Range of markets

36. As noted above, there are five separate provisions in MiFID II and MiFIR that empower the Commission to clarify what “*reasonable commercial basis*” means through Delegated Acts. ESMA has considered mainly the power in Article 13(2) of MiFIR which relates to the publication of pre- and post-trade data by trading venues. This was the focus of the MiFID Review’s consideration of “*reasonable commercial basis*” and it is one where the Commission is clear that the prices charged by some venues are too high.
  37. In relation to trading venues’ data sales, the definition of “*reasonable commercial basis*” will constrain the data which is mandated to be published by Articles 3 to 11 of MiFIR. This includes all post-trade data, and pre-trade data to the extent prescribed by Technical Standards under Articles 4(6) and 8(5). The sale of more detailed data, or of data-based value-added products, will not be constrained by MiFIR.
  38. The remaining four powers also relate to the terms on which trading data is made available, according to whether it is published by:
    - i. systematic Internalisers in relation to equities (Article 15 (5) of MiFIR);
    - ii. systematic Internalisers in relation to non-equities (Article 19(3) of MiFIR);
    - iii. approved Publication Arrangements (Article 64 (7) of MiFID II); or
    - iv. consolidated Tape Providers (Article 65(7) of MiFID II).
  39. If in any of these four instances a provider has substantial market power and exploits it by charging excessive prices, then ESMA believes that it will be appropriate to apply one or a combination of the options outlined above. However, any that do not charge – as ESMA believes will be the case for some systematic internalisers and APAs – will not need to do any work to justify charges. And any that are subject to competition – as may be the case for CTPs – and so are unable to charge more than Average Variable Cost should be able to demonstrate that their prices are already reasonable.
  40. The definition of “*reasonable commercial basis*” should apply to all instances in MiFID II and MiFIR where suppliers appear to be exploiting substantial market power by charging excessive prices. Suppliers need not provide detailed evidence of compliance if they are able to demonstrate that their prices are no higher than Average Variable Cost.
- Q161. Do you believe that if there are excessive prices in any of the other markets, the same definition of “*reasonable commercial basis*” would be appropriate, or that they should be treated differently? If the latter, what definition should be used?**

#### *Consideration of options*

41. The market power that some venues have means that their data has a value much higher than the cost of producing it. The purpose of defining “*reasonable commercial basis*” is to constrain prices by relating them to costs as would be the result in a competitive market.
42. Option A (transparency) could improve the operation of the market in trading data. It could be combined with the other two options. ESMA invites views on whether it would be likely to be sufficient on its own.
43. Option B (Revenue share limit) and Option C (LRIC+) are different approaches to constraining charging. LRIC+ is more sophisticated in targeting results that are close to the pricing that would be seen in a competitive market, but – as explained above – it will involve significant extra resources for the suppliers that have to comply with it, and for their regulators. There is also room for many judgements in estimating LRIC, for example over shares of joint and common costs. Over time, standards and guidance might be developed, but in the early years, there could be variability in the way different suppliers approach similar issues.
44. Defining “*reasonable commercial basis*” through transparency and a maximum revenue share would be significantly simpler than LRIC. It will require some specification of what revenue is to be allocated in what way, and of which of a supplier’s revenues count towards the total revenue to be used as the denominator. But it will not require the complex modelling of LRIC. On the other hand, the application of a simple percentage limit will deliver an arbitrary restriction on prices, unrelated to what would happen in a commercial market. And it will apply in the same way to all suppliers, when there may be good reasons why e.g. one type of exchange should expect to recover more of its costs from data than another.
45. The following table summarises the advantages and disadvantages of options B and C.

**Table 19: Advantages and disadvantages of options B and C**

	<b>Revenue share limit</b>	<b>LRIC+</b>
Ad- vantages	<ul style="list-style-type: none"> <li>• Simpler and cheaper for venues</li> <li>• Simpler and cheaper for regulators</li> <li>• Limits prices</li> </ul>	<ul style="list-style-type: none"> <li>• Limits prices to what would be charged in a competitive market</li> <li>• Allows suppliers to recover incremental cost and a share of common costs</li> </ul>
Disadvantages	<ul style="list-style-type: none"> <li>• No precedent for regulatory use</li> <li>• Discretionary choice of percentage limit</li> <li>• Applying same percentage limit to all suppliers will not take account of specific circumstances (e.g. corporate structure of supplier)</li> <li>• If enforcement not carried out consistently a risk of regulatory arbitrage</li> </ul>	<ul style="list-style-type: none"> <li>• No precedent for regulatory use in financial services sector</li> <li>• Complex modelling required</li> <li>• Discretionary choice of the mark-up to allow recovery of a share (appropriate) of common costs</li> <li>• Judgements involved (e.g. shares of joint and common costs, cost of capital) may lead to inconsistent application</li> <li>• Supervision will require more resources</li> <li>• If enforcement not carried out consistently a risk of regulatory arbitrage</li> </ul>



46. ESMA is preliminarily considering taking one of the presented options or a suitable combination of the mentioned options.

**Q162. Within the options A, B and C, do you favour one of them, a combination of A+B or A+C or A+B+C? Please explain your reasons.**

**Q163. What are your views on the costs of the different approaches?**

**Q164. Is there some other approach you believe would be better? Why?**

*Per-user pricing model of market data*

47. The discussion above has so far focussed on the price level of data charges.

48. ESMA is aware of another aspect that plays a significant role in the cost of data in Europe, and would apply regardless of the three options proposed above.

49. As a matter of fact, market data is not always supplied directly from exchanges to end-users, but are very often purchased through data vendors or independent software vendors. In most cases, end-users are charged based on the number of devices receiving data. This information is subsequently reported by the vendors to the original market data provider (i.e. the exchange). For example, this means that a trader simultaneously having access to two different data vendors terminals and to a proprietary Application Programming Interface (API) also fed by the data stream from one of both vendors may end up paying four times for the same data.

50. ESMA is aware that some regulated markets now offer their clients a new user-based unit-of-count model allowing them basically to net part of the market data costs from a single source (e.g. one regulated market) across data vendors and across devices on a natural user level ('per-user' model). In the former example, the trader would be charged only once rather than three times. Under this model, the client reports data usage directly to the exchange, which is then in a position to perform the netting of the client usage.

51. The implementation of this pricing model/structure is however subject to prior approval by the exchange on a case by case basis, as the client has to demonstrate its ability to entitle, monitor and report the internal data usage within its organisation in a very stringent fashion. This important requirement may imply significant IT developments prior to the acceptance by the potential clients. As a matter of fact, only a limited number of clients have been qualified to benefit from this type of agreement so far. On the other hand, the more exchanges offer it, the bigger the incentive for each client to make the necessary developments, which are common for the various exchanges, and the more clients are likely to apply for this billing model.

52. As far as the exchange is concerned, this per-user model also increases its administrative burden (due to the need to engage in a labour-intensive approval process<sup>98</sup> and to monitor and net client usage, reported directly to the exchange and to the data vendors).
53. The data vendors, which consolidate market data from multiple exchanges within one desktop terminal in a single format, usually offer subscription to each exchange dataflow. Each subscription has its own price and in the usual 'per device' model, this price is generally higher than the exchange's own price charged to the data vendor, reflecting cost recovery by the data vendor of its formatting, provision system, add-on products, etc. The difference, or mark-up, constitutes the gross margin for the data vendor, as the vendor has to pay the exchange for the data on behalf of the end-user. With the new 'per user' pricing structure, the data vendor usually does not bill market data usage directly to its client and therefore does not add its normal mark-up. In this case, it charges a higher administrative fee to recover its service.
54. In order to address the issue of charging several times for the same information to a single user, ESMA is considering requiring trading venues to offer all their clients a 'per-user' based model. For avoidance of doubt, as this type of pricing structure is subject to acceptance conditions, it would be offered in addition to / alongside the existing model applicable to non-eligible clients.
55. ESMA is also aware that the 'per user' model will require trading venues offering it to incur significant administrative costs. As stated above, it may be the case that this model is appropriate for some, but not all customers.
56. This measure shall be considered separately from the three options above related to transparency and cap limits, which are general and do not concern any particular type of client (i.e. data vendors against their end user clients).

**Q165. Do you think that the offering of a 'per-user' pricing model designed to prevent multiple charging for the same information should be mandatory?**

**Q166. If yes, in which circumstances?**

#### **Draft technical advice**

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<sup>98</sup> These process may include audits to client sites, a parallel run 'pilot period', etc.

1. For determining reasonable commercial basis, ESMA is preliminarily considering taking one of the following options or a suitable combination thereof:
  - i. **Option A** - For a service to be supplied on a “reasonable commercial basis”, the supplier should set prices to be fair, reasonable and non-discriminatory. Suppliers’ price lists should be subject to full transparency, alongside other key metrics.
  - ii. **Option B** – It may be considered imposing certain high-level limits. For example, market data services as a proportion of total revenues should not exceed a certain percentage
  - iii. **Option C** – For a service to be supplied on a “reasonable commercial basis” the supplier should set prices so as to recover no more than the Long Run Incremental Costs (LRIC) of providing the service and the mark-up to allow recovery of an appropriate share of common costs (i.e. LRIC+). The calculation of LRIC+ should be forward-looking, ignoring historic costs, and assume the choice of the most efficient methods of providing the service. In the context of a trading venue selling trading data, LRIC means the difference between the total long-run costs of the venue providing its full range of services and the total long-run costs the venue would incur if it did not publish trading data. This should be calculated on a bottom-up basis. Each supplier who charges for a service that has to be supplied on a reasonable commercial basis should build and maintain a model of its costs that will enable it to calculate the LRIC+ of providing the service. The supplier should set prices so that forecast revenues will recover no more than LRIC+. The supplier should monitor actual revenues and lower prices if recovery is more than LRIC+.
2. The Commission should review the operation of the definition of “reasonable commercial basis” after three years and consider whether it would be appropriate to modify or elaborate the definition in the light of experience.
3. The definition of “reasonable commercial basis” should apply to all instances in MiFID II and MiFIR where suppliers appear to be exploiting substantial market power by charging excessive prices. Suppliers need not provide detailed evidence of compliance if they are able to demonstrate that their prices are no higher than Average Variable Cost.
4. In order to address the issue of charging several times for the same information to a single user, ESMA is considering requiring trading venues to offer their clients a “per-user” based model in addition to the existing model applicable to non-eligible clients.
5. This measure shall be considered separately from the three options above related to transparency and cap limits, which are general and do not concern any particular type of client.

## 5. Micro-structural issues

### 5.1. Algorithmic and high frequency trading (HFT)

#### Background/Mandate

##### Extract from the Commission's request for advice (mandate)

*ESMA is invited to provide technical advice to further specify on the definition of what should be considered algorithmic trading as opposed to high frequency algorithmic trading technique to ensure a uniform application of the authorization requirement for persons that engage in high frequency algorithmic trading technique taking into account the need to capture all genuine high frequency traders.*

1. The concepts of “algorithmic trading” and “high frequency algorithmic trading technique” are defined under Articles 4(1)(39) and (40) of MiFID II. It is important to distinguish clearly between these two concepts to ensure the uniform application of the authorisation requirement.
2. Recital 63 explains that it is desirable to ensure that all high frequency algorithmic trading firms be authorised to ensure they are subject to organisational requirements under the Directive and are properly supervised. Therefore, any further specification of the definition of “high frequency algorithmic trading technique” should be sufficiently broad to ensure that all genuine HFT traders will be caught and dynamic enough to cope with market and technological developments.

#### Analysis

3. Carving HFT out of algorithmic trading is complex. In practice, HFT is frequently equated to algorithmic trading but it is in fact a sub-set of algorithmic trading.
4. HFT is a special class of algorithmic trading in which computers make decisions to initiate orders based on information that is received electronically, before human traders are capable of processing the information they observe and of taking a decision in relation thereto. HFT specifically monitors the market for patterns that indicate trading opportunities; then places orders to take instant advantage of those opportunities. HFT systems place automated, (usually) small scale, probabilistic bets (e.g. puts orders on both directions, buy and sell).
5. Using HFT entails two main types of regulatory consequences under MiFID II: firstly, persons dealing on their own account using a high-frequency algorithmic trading technique fall under the scope of MiFID II and have to be authorised as investment firms, as prescribed by Article 2(1)(d)(iii) of MiFID II. Additionally, Article 17(2) of MiFID II last paragraph determines that an investment firm that engages in a high-frequency trading technique shall store in an approved form accurate and time sequenced records of all its placed orders, including cancellations of orders, executed orders and quotations on trading venues and shall make them available to the NCA upon request.
6. ESMA is considering two different approaches as regards the clarification of the HFT definition: option 1 and option 2 described below.
7. Under **Option 1**, it would be necessary to meet the following requirements regarding the infrastructure designed to minimise latency and the capacity to transfer data to the venue:

- i. the distance between the trading venue's matching engine and the server used by the investment firm on which the algorithms run; on that basis, the use of infrastructure designed to reduce latency would be presumed if the server on which the order messages are initiated, generated, routed, executed, amended or cancelled is directly proximate to the trading venue's matching engine; and
  - ii. the volume of data capable of being transferred through the connection per second (bandwidth). Most markets offer higher bandwidths for latency-sensitive traders, because such enable them to achieve faster messaging or executions. On the basis of the information currently available, a bandwidth in the range of 10 GBit/s would be considered among the fastest currently provided, and that maximum capacity would only be achieved in connection with co-location arrangements. However, ESMA is conscious of the fact that a high bandwidth is subject to technological change and therefore should rather be covered in a qualitative manner; and
  - iii. a trading frequency of 2 messages per second over the entire trading day should be considered as being generated by a machine/algorithm. On that basis, to determine the number of messages per trading day, it would be necessary to multiply the amount of seconds available per trading day (which may vary from market to market) by 2. The message volume should be determined on a rolling basis per trading day based on the previous 12-month period.
8. If this approach was followed, a significant volume of intra-day messages would be in the range of 75,000 messages or more per trading day on average over the year. The threshold should be calculated per trading venue according to the ISO 10383 Market Identifier Code. There have been made tests for 60,000 and 100,000 messages per trading day as well. The results have shown that the threshold of 75,000 messages per trading day seems fair according to the number of members defined as High-Frequency Traders using a direct approach.
  9. The sum of messages would be calculated for each trading day and the moving average thereof should be calculated on a daily basis using the last 250 trading days. Days where a particular member/trader did not send messages at all are considered as having zero messages if the respective venue was open for trading on that particular day.
  10. The message rate should not be calculated for participants who return the membership of a trading venue, as long as they do not continue trading on that venue as indirect participants.
  11. Since the threshold would be based on the volume of messages per trading day on average over the year, no exemption for periods of volatility seems necessary. This threshold would have to be regularly back tested and possibly adjusted, because of different volatility situations over time.
  12. ESMA considers that the references to 'messages' above should be interpreted strictly, i.e. considering as one message each content that needs independent processing. On that basis, the messages to be counted for these purposes are each new order or quote, each successful change to an order or quote and each successful deletion of an order or quote. In cases of bulk transactions, every single message is to be counted separately.
  13. For example, for an unexecuted "immediate-or-cancel" order, two messages should be counted: the order sent for immediate execution and also the cancellation order as the previous has not been totally fulfilled. A quote should also be counted as two messages: bid and ask. Messages originating from a

technical process where the trader was not able to influence their existence, e.g. messages resulting from a transaction are not counted as messages.

14. ESMA considers that the main advantage of this approach is that the identification of the parameters is straightforward.
15. On the other hand, it can be argued as well that the parameters are relatively easy to circumvent, that it would be necessary to review whether the parameters are in line with market practice, and some types of HFT might not be covered (in particular those which benefit from proximity hosting).
16. Under **Option 2**, each trading venue should periodically analyse the median daily lifetime of their orders which have been modified or cancelled and determine in which cases the median daily lifetime of the orders modified or cancelled by its members/participants fall below the median daily lifetime of orders modified or cancelled for the entire market (which means that these members/participants become HFT). ‘Daily’ means that orders with a lifetime longer than one day should not be considered for these purposes.
17. ESMA’s preliminary view is that the determination of the median daily lifetime of the orders submitted to the trading venue *by all members/participants* should only be made for liquid instruments, in which HFT is more frequent. Therefore, it is proposed that only orders regarding instruments considered as liquid following Article 2(1)(17) MiFIR should be considered for these purposes.
18. In order to calculate the median daily lifetime of the orders submitted *by each member/participant* it would be possible to consider either only those orders submitted for liquid instruments or all orders submitted to the trading venue (i.e. liquid and illiquid instruments, which might simplify the calculations because it would not be necessary to disentangle the activity of a member/participant relating to liquid instruments). ESMA welcomes the views of market participants in this regard.
19. Given that members or participants of trading venues may submit orders under the same ID but using different strategies (which may be HFT or not), the main advantage of using the median daily lifetime of orders being modified or cancelled against other parameters (such as the mean) is that it permits focusing on a consistent behaviour across a certain timeframe avoiding a potential bias due to extremely quick or slow orders.
20. ESMA’s preliminary view is that being considered as HFT in one market should determine being considered as such for all trading venues in the EU.
21. ESMA considers that some of the main advantages under Option 2 are: it relates to a calculation that trading venues regularly undertake nowadays; that by definition, this method cannot be easily circumvented; and, finally that it does not need to be revised frequently so as to keep pace with the latest technological developments.
22. This calculation system has to be read in conjunction with the MiFID II provisions, i.e. there has to be infrastructure to minimise latency (co-location, proximity hosting or high speed DEA) and system determination of order initiation, generation, routing or execution. Therefore, under this proposal, a trading venue that does not meet the Level 1 conditions would not be covered by either of the two options.





## Draft technical advice

1. **High frequency algorithmic trading technique:** ESMA is considering two different approaches as regards the clarification of the HFT definition:
2. **Option 1:** ESMA would consider that *all the following requirements* should be met:
  - i. There is an “*infrastructure intended to minimise network and other types of latencies*” in place when:
    - a. the server on which the algorithms initiate, generate, route, submit, execute, amend or delete messages is directly proximate to the trading venue's matching engine; and
    - b. a high bandwidth is used compared to the standard access offered by the respective trading venue; and
  - ii. The participant/member has a “*high message intraday rates*” when at least 2 messages per second are submitted to the trading venue over the trading day.
3. **Option 2:** establishing as a proxy to assess the “*high frequency nature of the message intraday rate*” the daily lifetime of orders (having been modified or cancelled), and thereafter considering that when the median daily lifetime of the orders (having been modified or cancelled) of one member/participant is shorter than the median daily lifetime of the orders (having been modified or cancelled) in a given trading venue, that member/participant should be considered as HFT.

Only instruments considered as liquid following Article 2(1)(17) of MiFIR should be considered for these purposes.

**Q167. Which would be your preferred option? Why?**

**Q168. Can you identify any other advantages or disadvantages of the options put forward?**

**Q169. How would you reduce the impact of the disadvantages identified in your preferred option?**

**Q170. If you prefer Option 2, please advise ESMA whether for the calculation of the median daily lifetime of the orders of the member/participant, you would take into account only the orders sent for liquid instruments or all the activity in the trading venue.**

23. Regardless of the option followed, ESMA considers that the identification of a high frequency trading technique has to be made at the member or participant level.
24. Given that the same member/participant may have several trading desks, each one with their own trading IDs for the venue where they trade and that, those trading desks may operate in several venues at the same time but with different IDs, the only feasible option is to consider that once one of those trading IDs has been identified as performing a high frequency trading technique, the mem-



ber/participant as an entity should be considered as such and, as a result, it will be considered as HFT.

**Draft technical advice**

*Identification of HFT technique at member or participant level*

4. MiFID includes within its scope of application members or participants carrying out a high frequency trading strategy. On that basis, and regardless of the option taken, ESMA considers if a member's or participant's strategy falls under the definition of high frequency trading strategy in one trading venue, that member/participant should be considered as subject to MiFID provisions across the EU.

**Q171. Do you agree with the above assessment? If not, please elaborate.**



## 5.2. Direct electronic access (DEA)

### Background/Mandate

#### Extract from the Commission's request for advice (mandate)

*ESMA is invited to provide technical advice to further specify the definition of Direct Electronic Access (DEA) to ensure a uniform application and encompasses all types of arrangements that meet this definition.*

1. Article 4(1)(41) of MiFID II defines 'Direct Electronic Access' (DEA) as an “*arrangement where a member or participant or client of a trading venue permits a person to use its trading code so the person can electronically transmit orders relating to a financial instrument directly to the trading venue*”. This definition includes arrangements which involve the use by the person of the infrastructure of the member or participant or client, or any connecting system provided by the member or participant or client, to transmit the orders (direct market access (DMA)) and arrangements where this infrastructure is not used by that person (sponsored access (SA)).

### Analysis

2. Given that the means to access a market are very diverse in the Member States, there is a need to further clarify this definition in order to ensure it is applied in a uniform way and encompasses all types of arrangements that meet this definition.
3. IOSCO's Principles for Direct Electronic Access to Markets<sup>99</sup> consider Automated Order Routing (AOR) systems to be within the DEA concept. AOR is defined as “*an arrangement where an intermediary, who is a market-member, permits its customers to transmit orders electronically to the intermediary's infrastructure (i.e. system architecture, which may include technical systems and/or connecting systems), where the order is in turn automatically transmitted for execution to a market under the intermediary's market-member ID (mnemonic)*”.
4. ESMA acknowledges that certain jurisdictions consider AOR as formally different from DEA<sup>100</sup>, however, in ESMA's view the definition of AOR arrangements as described above and MiFID's definition of DEA overlap. Given that AOR arrangements and DEA might pose the same risks to the markets ESMA requests the views of market participants on whether it would be appropriate to consider AOR as falling within the DEA definition.
5. Additionally, ESMA requests the views of market participants about how to further clarify the definition of DEA (and as a consequence, those of DMA and SA) to capture all types of arrangements that might meet this definition.

**Q172. Do you consider it necessary to clarify the definitions of DEA, DMA and SA provided in MiFID? In what area would further clarification be required and how would you clarify that?**

<sup>99</sup> IOSCO's Principles for Direct Electronic Access to Markets (<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD332.pdf>).

<sup>100</sup> For instance, see IIROC's Notice on Provisions respecting third-party electronic access to marketplaces ([http://www.iiroc.ca/Documents/2013/b65d657d-e162-48fe-8d20-32f95a140c75\\_en.pdf](http://www.iiroc.ca/Documents/2013/b65d657d-e162-48fe-8d20-32f95a140c75_en.pdf))

**Q173. Is there any other activity that should be covered by the term “DEA”, other than DMA and SA? In particular, should AOR be considered within the DEA definition?**

6. ESMA notes the proliferation of electronic order transmission systems provided to investors which have become more sophisticated over time. These systems permit clients to transmit orders to investment firms through those firms’ web-based interfaces. As such, this is just a type of order execution on behalf of the clients (i.e. intermediation), as appears in Annex I Section A of MiFID.
7. For these purposes the clients use a web based application, rather than individual direct connectivity with separate access.
8. On that basis, ESMA considers that such systems fall outside of the scope of the definition of DEA. This preliminary view corresponds with the IOSCO Consultation Report entitled ‘Policies on Direct Electronic Access’ (February 2009) which does not consider “trading models of a customer calling the intermediary or sending an internet order to the intermediary” as DEA because, as long as the customer’s trading is intermediated, it is not ‘direct access’.
9. However, given the improvement of technological capacities experienced in the last few years, ESMA is interested to know the views of market participants on whether it may be possible to use these interfaces to perform algorithmic or high frequency trading strategies.

**Draft technical advice**

1. In principle, ESMA considers systems that allow clients transmitting orders to an investment firm in an electronic format to be outside of the scope of DEA, as long as the electronic access to the market is shared with other clients through a common connectivity channel, no specific capacity and latency is provided to any particular client (e.g. web based applications).
2. ESMA requests the views of market participants about the potential for these electronic transmission systems to permit algorithmic trading techniques (i.e. automatic onward transmission under the investment firm’s trading ID to a specified trading venue) through them.

**Q174. Do you consider that electronic order transmission systems through shared connectivity arrangements should be included within the scope of DEA?**

**Q175. Are you aware of any order transmission systems through shared arrangements which would provide an equivalent type of access as the one provided by DEA arrangements?**



## 6. Requirements applying on and to trading venues

### 6.1. SME Growth Markets

1. One of the aims of MiFID II is to facilitate access to capital for SMEs and the development of specialist markets catering specifically for the needs of SMEs<sup>101</sup>. To that end MiFID II envisages establishing a regime for the registration of MTFs offering facilities to SMEs as ‘SME growth markets’ (SME-GMs), where they meet certain criteria specified by MiFID. This new category of MTF shall raise the visibility and profile of specialised SME markets and shall establish common pan-European standards while at the same time providing sufficient flexibility to be able to incorporate the existing current range of successful markets operating in that field.
2. The definition of an SME<sup>102</sup>, together with the proportion of issuers admitted to an SME-GM that need to constitute SMEs in order for it to qualify as a potential SME-GM, are dealt with at Level 1.
3. However, Article 33(8) of MiFID II envisages that the Commission will adopt delegated acts further specifying the requirements that a SME-GM will need to meet in order to be registered as such in respect of the various effective rules, systems and procedures SME-GMs have to comply with as established in Article 33(3) of MiFID II. ESMA has been asked for technical advice by the Commission on how best to design those specified requirements and has therefore established some initial views on which it is asking for stakeholders views.
4. The requirements to be met by an SME-GM<sup>103</sup> shall, according to MiFID II, take into account the need for the requirements to maintain high levels of investor protection to promote investor confidence in those markets while minimising the administrative burdens for issuers on the market so striking the correct balance between those two principles. The requirements are expressed to be without prejudice to the general obligations owed by the operator of an MTF under MiFID II<sup>104</sup>. In addition, the operator of an SME-GM would be permitted to apply requirements that go beyond the minimum MiFID II requirements.<sup>105</sup>

### Background/Mandate

#### Extract from the Commission’s request for advice (mandate)

*ESMA is invited to provide its technical advice on options as regards each of the requirements that a SME growth market will need to meet in accordance with Article 33(3) of the Directive.*

*With respect to requirements enacted in Article 33(3)(a) ESMA is notably invited to provide technical advice to specify how to apply the 50% criterion to various predictable situations including where no track record is available for newly created markets or issuers or in case of issuers of non-equity securities only.*

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<sup>101</sup> Cf. Recital 132 of MiFID II.

<sup>102</sup> Cf. Article 4(1)(13) of MiFID II.

<sup>103</sup> As specified by Article 33(3) and Recital 133 of MiFID II.

<sup>104</sup> For example, see Articles 18 and 19 of MiFID II.

<sup>105</sup> Cf. Article 33(4) of MiFID II.



*In addition, ESMA is invited to provide technical advice to specify rules governing the registration and the deregistration of the SME growth markets, it being specified that pursuant to Article 33(8) these measures shall ensure that refusal to register or de-registration do not occur as a result of a merely temporary failure to meet the SME growth markets eligibility criteria.*

### **Article 33(3)(a), MiFID II**

*at least 50 % of the issuers whose financial instruments are admitted to trading on the MTF are SMEs at the time when the MTF is registered as an SME growth market and in any calendar year thereafter;*

#### **Analysis**

5. Article 33(3)(a) of MiFID II requires that at least 50% of the issuers whose financial instruments are admitted to trading on the MTF registered as an SME growth market are small and medium-sized enterprises at the time when the MTF is registered as an SME growth market and in any calendar year thereafter.
6. SMEs are defined as companies with an average market capitalisation of less than € 200m on the basis of end-year quotes for the previous three calendar years in Article 4(1)(13) of MiFID II.
7. The aim of this Delegated Act is to further specify how the requirement of at least fifty per cent of issuers on an SME-GM being SMEs is to be applied.
8. The assessment whether at least 50% of issuers on an SME-GM are indeed SMEs shall be made on an annual basis and in a flexible way in order to ensure that a temporary failure to meet this criterion does not lead to an immediate deregistration or a refusal to be registered as an SME-GM in the first place.<sup>106</sup>
9. ESMA considers that the percentage of issuers whose financial instruments are admitted to trading and which can be classified as SMEs should be assessed on the basis of the number of issuers only, disregarding other factors (e.g. the size/turnover of the enterprise, the issuance size of the financial instruments or the number of different financial instruments issued by the same enterprise).
10. In the view of ESMA there are different possible options for assessing in a flexible way whether the composition of the issuers on an SME-GM meets the at least 50% requirement under Article 33(3)(a) of MiFID II.
11. In order for the assessment to be flexible, ESMA considers that the requirement shall be deemed fulfilled even if the percentage of SMEs falls below the relevant threshold for a period of time in order to provide clarity and legal certainty for the issuers whose instruments are traded on those markets and for the market operators.
12. Therefore checks on the composition of issuers shall be carried out on an annual basis based on the figures of 31 December of each year and ESMA considers the three following methods as feasible:
  - i. at least 50% of the issuers admitted to trading on the SME-GM on that day are SMEs; or

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<sup>106</sup> Cf. Recital 135 of MiFID II.

- ii. at least 50% of the issuers admitted to trading on the SME-GM were SMEs for a period of at least 180 days in that year; or
  - iii. at least 50% of the issuers admitted to trading on the SME-GM were SMEs based on an average of each month of the calendar year (the market capitalisation shall be checked at the end of each calendar month and an average shall be calculated on 31 December).
13. ESMA initially puts forward method iii as the preferred one, as it appears to be the most precise out of those methods. ESMA however is open to reconsider this initial assessment and would like to receive opinions from stakeholders as to their preferred choice of method.
14. In ESMA's view, the prospect of deregistration as a SME-GM should arise only if the SME-GM were to fall below the qualifying 50% threshold for a number of consecutive years, in order to provide sufficient certainty to operators of SME-GMs and the companies they admit to trading. ESMA considers that an appropriate period before deregistering a market as an SME-GM could be two or three consecutive years of falling below the threshold. ESMA initially puts forward the period of three consecutive years as the preferred option but again would like to receive opinions from stakeholders as to which period they would consider as appropriate.
15. Should an SME-GM, on the basis of the assessment conducted in accordance with paragraph 8, be deemed not to meet the qualifying 50% threshold in one year, ESMA is considering whether the SME-GM should disclose that fact to the market. Whilst there is a case for such disclosure, to make sure existing and prospective issuers were made aware of the position of the SME-GM, there are also drawbacks as this may deter SMEs from joining the market and therefore make recovery to the 50% threshold more difficult than it would otherwise be. ESMA therefore proposes not to require SME-GMs to disclose not meeting the threshold in one year to the public. This is another issue where ESMA invites views from stakeholders.
16. In the case of an entirely new market applying to become an SME-GM it shall be granted such authorisation if there is an expectation by the market deemed reasonable by the NCA that at least fifty per cent of the prospective issuers will be SMEs. ESMA considers this a necessary clarification through implementing measures. New markets would not have any issuers yet and so, under a very literal application, would not meet the 50% criterion and could not be granted the status of an SME-GM. However, ESMA considers that new markets specifically designed to cater for SME issuers should not be barred from being granted the SME-GM status from the outset and therefore they shall be deemed as meeting the 50% requirement if the market can reasonably expect that the issuers' constituency of the market will be comprised of at least 50% SMEs.
17. ESMA also considers that issuers should be counted as SMEs towards the 50% threshold if their market capitalisation upon commencement of trading or at the end of the first two years of trading is below €200m. This is another point that should be clarified through implementing measures because the SME definition in MiFID II refers to end-year quotes for the previous three calendar years which could be interpreted as excluding all SMEs with a lifespan of less than three years from counting towards the 50% threshold. However the SME-GM regime shall especially promote the access of young issuers which are likely to have a low market capitalisation so that such issuers should be taken into consideration when assessing whether the 50% threshold is met. ESMA therefore considers that as an expression of the flexible way of implementing the 50% criterion, SMEs with a history of less than three years should also be counted as SMEs if their market capitalisation upon commencement of trading or based on the end-year quote after the first year of trading or the average of the end-year quotes after the first two years of trading is below €200m.



18. ESMA is conscious that the Level 1 text refers to market capitalisation of issuers only which is a concept normally associated with equity issuers. There is a question therefore as to how non-equity issuers which would not have market capitalisation as such would feature when determining whether a market meets the “at least 50% must be SME issuers” criterion.
19. The more extreme alternatives of how to deal with this problem would be to either count all non-equity issuers as SME issuers (theoretically their market capitalisation could be considered to be zero) or to exclude all non-equity issuers when assessing the 50% criterion (again theoretically as non-equity issuers they could be considered not to have a market capitalisation below €200m).
20. An alternative could be to understand the term market capitalisation in a more general sense so that a non-equity issuer issuing debt securities only would be deemed an SME issuer if the overall outstanding nominal value of the debt securities issued would not exceed €200m. Other alternatives could be to move to a turnover-based definition for non-equity issuers where ESMA is considering using either an annual net turnover threshold of €300m or utilising the SME definition that is, for example, used in the Prospectus Directive which is based on annual net turnover not exceeding €50m but also on the average number of employees (less than 250) and the total balance sheet (not exceeding €43m).

### **Draft technical advice**

*Draft advice on further specifying the requirement laid down in Article 33(3)(a) of MiFID II (SME-Growth Markets Eligibility Criteria)*

#### The 50% criterion

1. The assessment whether at least 50% of issuers on an SME-GM are SMEs should be made on an annual basis.
2. The percentage of issuers whose financial instruments are admitted to trading and which can be classified as SMEs should be assessed on the basis of the number of issuers only, disregarding other factors (e.g., the size/turnover of the enterprise, the issuance size of the financial instruments or the number of different financial instruments issued by the same enterprise).
3. The composition of issuers should be checked based on the figures of 31 December of each calendar year in order to verify whether at least 50% of the issuers admitted to trading on the SME-GM were SMEs based on an average of each month of the calendar year.

#### Deregistration of SME-GMs

4. A temporary failure to meet the 50% criterion mentioned above should not lead to an immediate deregistration or a refusal to be registered as an SME-GM in the first place.
5. An SME-GM should only be deregistered as such if it were to fall below the qualifying 50% threshold for a number of three consecutive years.
6. An SME-GM, deemed not to meet the qualifying 50% threshold in one year or in two consecutive years, should not be required to disclose that fact to the market.



Application of the 50% criterion to new markets

7. An entirely new market applying to become an SME-GM should be granted such authorisation if there is an expectation that at least fifty per cent of the prospective issuers will be SMEs.

Application of the 50% criterion in the case of young SMEs

8. SMEs with a history of less than three years should also be counted as SMEs if their market capitalisation, upon commencement of trading or based on the end-year quote after the first year of trading or the average of the end-year quotes after the first two years of trading, is below €200m.

Application of the 50% criterion to non-equity issuers - Alternatives

9. Non-equity issuers would normally not have a market capitalisation and ESMA is looking for an alternative way of how to deal with them when assessing whether an SME-GM has at least 50% of SME issuers. ESMA is looking for views on the following options:
- i. All non-equity issuers should be considered as SMEs for the purpose of determining whether an SME-GM meets the requirement of having at least 50% SME issuers.
  - ii. All non-equity issuers should not be considered as SMEs for the purpose of determining whether an SME-GM meets the requirement of having at least 50% SME issuers.
  - iii. Non-equity issuers should be considered as SMEs for the purpose of determining whether an SME-GM meets the requirement of having at least 50% SME issuers if:
    - a. the overall outstanding nominal value of the debt securities issued by the issuer does not exceed €200m; or
    - b. the annual net turnover of the issuer based on the last published annual accounts does not exceed €300m; or
    - c. the issuer is classified as an SME pursuant to Article 2(1)(f) of the Prospectus Directive<sup>107</sup>.

**Q176. Do you support assessing the percentage of issuers on the basis of number of issuers only? If not, what approach would you suggest?**

**Q177. Which of the three different options described in the draft technical advice box above for assessing whether an SME-GM meets the criterion of having at least fifty per cent of SME issuers would you prefer?**

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<sup>107</sup> 'small and medium-sized enterprises' means companies, which, according to their last annual or consolidated accounts, meet at least two of the following three criteria: an average number of employees during the financial year of less than 250, a total balance sheet not exceeding €43 000 000 and an annual net turnover not exceeding €50 000 000.



- Q178.** Do you agree with the approach described above (in the box above), that only falling below the qualifying 50% threshold for a number of three consecutive years could lead to deregistration as a SME-GM or should the period be limited to two years?
- Q179.** Should an SME-GM which falls below the 50% threshold in one calendar year be required to disclose that fact to the market?
- Q180.** Which of the alternatives described above on how to deal with non-equity issuers for the purposes of the “*at least 50% criterion*” do you consider the most appropriate? Please give reasons for your answer.

### Background/Mandate

#### Extract from the Commission’s request for advice (mandate)

*With respect to requirements enacted in Article 33(3)(b) to (g), ESMA is invited to provide technical advice taking into account and ensuring consistency with other Union legislations.*

#### Article 33(3)(b) MiFID II

*appropriate criteria are set for initial and ongoing admission to trading of financial instruments of issuers on the market;*

### Analysis

21. In formulating this technical advice, ESMA undertook an extensive fact finding exercise with a range of stakeholders in SME-GM.<sup>108</sup>
22. Those discussions revealed that, among existing markets with a focus on SMEs, a broad spectrum of approaches exists in relation to the setting and application of issuer admission and disclosure requirements. Given this level of diversity, the preservation of an appropriate degree of flexibility for market operators under the supervision of NCAs, at member state level, is a central theme of ESMA’s advice.
23. Based on the evidence it has gathered, appropriate criteria for the initial and on-going admission to trading of an issuer’s securities could consist of a number of discrete elements. Examples of areas covered in the rules of existing markets are:
  - i. an issuer’s management and board;
  - ii. an issuer’s systems and controls enabling compliance with the rules of the MTF;
  - iii. the adequacy of an issuer’s working capital;
  - iv. the use of financial reporting standards, such as IFRS;
  - v. the maintenance of fair and orderly trading in an issuer’s securities; and

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<sup>108</sup> Including round table discussions with market operators and trade associations representing SME issuers, and site visits to liquidity providers in SME shares.



- vi. requirements for issuers carrying on specialist activities, such as mineral exploration.
24. Further, the systems of rules and arrangements through which such criteria are applied (referred to, collectively, as the market's 'operating model') differ significantly across markets.

*Findings on the operating model of an SME-GM*

25. ESMA considers that the investor protection objectives of the SME-GM regime could be met through the application of a number of different operating models. For example, the investment firm or market operator operating an SME-GM could make its own assessment of whether an issuer is able to demonstrate that it meets the relevant admission criteria. Alternatively, in line with existing practices on a number of growth company markets, the rules of an SME-GM could require this assessment to be made by a third party corporate finance adviser which the issuer appoints, where the SME-GM operates an appropriate oversight regime for such advisers.
26. ESMA considers that MiFID should remain neutral as to the operating model of an SME-GM, provided an NCA assesses it to be an effective way of applying the admission to trading requirements. In its view, any attempt to prescribe one or more acceptable operating models would reduce flexibility for SME-GMs to adopt the model best suited to issuers and investors in its particular jurisdiction. Furthermore, in the case that the SME-GM adopts the adviser model, ESMA considers that the nature of the oversight regime for the advisers should be left to the discretion of the venue.

*Findings on the appropriate criteria for the initial and ongoing admission to trading*

27. As an initial remark, ESMA considers that care should be taken in setting, at MiFID II level, requirements for SME-GMs which go beyond the general obligations of an MTF (as they will be reflected in Title II of MiFID II). ESMA notes that the existing regulatory environment has enabled a wide range of SME-GMs to develop, albeit without a common framework or identity.
28. For example, certain SME-focused MTFs have chosen to elaborate, within their rules, upon the particular steps necessary to meet the high level requirement for the maintenance of fair and orderly trading in an issuer's securities<sup>109</sup>. Given the breadth and diversity of market practices, ESMA considers that the decision to elaborate in this way should rest with the market operator under the supervision of its NCA. It is, however, appropriate to recognise that the fair and orderly trading obligations owed by the operator of an MTF extend to its particular functions as an SME-GM, where it is registered as such.
29. In addition, during ESMA's fact finding process, a clear consensus emerged for the avoidance of criteria that would supersede an issuer's national legislation or regulatory requirements by imposing one or more acceptable financial reporting standards. In particular, it was noted that the application of IFRS would be a source of significant additional cost for some issuers. ESMA does not therefore consider that such a requirement should be imposed.

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<sup>109</sup> Such elaboration can take the form of a requirement that the securities are freely transferrable (though often subject to certain exceptions); a requirement that there is sufficient public distribution of the securities to allow the orderly interaction of supply and demand (in some cases subject to a quantitative minimum free float such as 10%, or by requiring a minimum value for a capital raising accompanying the admission); or a requirement for the issuer to have made satisfactory arrangements for the efficient settlement of transactions (e.g. to allow the transfer of title to securities electronically). It may also be the case that some SME-GMs would require issuers to appoint a liquidity provider.

30. In reaching its findings, ESMA has focused on the particular features of SMEs and the associated risks posed to investors. ESMA notes that investors in SMEs place significant reliance on the competence and propriety of the individuals directing the affairs of the SME and trust that they will give due regard to the interests of all shareholders. Further, in making a transition from private to publicly-quoted issuer, many SMEs are likely to have their first experience of the disciplines of such markets, particularly as regards matters such as the identification and timely dissemination of price sensitive information. SME-GM issuers are also likely to operate less well established businesses than issuers admitted to Regulated Markets, and may be more dependent on external sources of finance while they develop their businesses towards profitability. In that context, ESMA has considered a possible role for requirements which address:
- i. the appropriateness of an SME-GM issuer's management and board to fulfil the responsibilities of a publicly quoted company; and
  - ii. the appropriateness of an SME-GM issuer's systems and controls in providing a reasonable basis for it to comply with its continuing obligations under the rules of the market; and
  - iii. the adequacy of an issuer's working capital.
31. ESMA has had regard to the treatment of issuers seeking admission to a Regulated Market, as a benchmark against which to consider the appropriate requirements for SME-GM issuers in these areas. As a general principle, a proportionate approach for SME-GMs should entail a set of standards which are not more burdensome than those for Regulated Markets. In that context, ESMA notes:
- i. The Prospectus Directive does not foresee specific corporate governance requirements for issuers as a pre-condition to the admission of their financial instruments to Regulated Markets. The Prospectus Directive requires an issuer to disclose whether or not it complies with its country of incorporation's corporate governance regime(s). In the event that the issuer does not comply with such a regime, a statement to that effect must be included in the Prospectus together with an explanation regarding why the issuer does not comply with such regime.
  - ii. MiFID does not require an issuer seeking admission to a Regulated Market to operate a prescribed set of systems and controls.
  - iii. In specific cases the Prospectus Directive requires a statement by an issuer seeking admission to a Regulated Market that, in its opinion, the working capital available to it will be sufficient for its present requirements or, if it is not, how it proposes to provide the additional working capital needed. Accordingly, where an issuer's due diligence reveals that it may not have sufficient working capital, it may still comply with the provisions of the Prospectus Directive provided it has a plan to address the shortfall and discloses this position to investors.
32. ESMA considers that an attempt to prescribe requirements in relation to corporate governance, systems/controls or working capital at a MiFID II level would diminish the flexibility afforded to market operators. Based on the evidence it has gathered, it appears that the optimal regulatory approach for any given SME market in these areas will be particularly sensitive to local factors. These factors have led existing markets which could be candidates for SME-GM registration to implement a range of different approaches.

33. Consequently, ESMA considers that it is inappropriate for MiFID II or its implementing measures to prescribe detailed eligibility criteria in relation to an issuer's corporate governance or framework of systems/controls. In the particular case of working capital, ESMA considers that the future Level 2 Regulation should align with the Prospectus Directive by taking a disclosure-based approach. In other words, to ensure appropriate investor protection, whilst balancing the need to create a proportionate regime for SME-GMs, ESMA considers it could be appropriate for an issuer on an SME-GM to be subject to a requirement to make a working capital statement in its admission document, disclosing whether or not it possesses sufficient working capital (and if not how additional capital would be provided). However, as an alternative option, the future Level 2 Regulation could stay silent on the question of working capital and ESMA would be interested to receive views on the merits of a disclosure-based approach.
34. More generally, ESMA considers that a requirement adopted for the purpose of Article 33(3)(b) of MiFID II, should oblige the operator of an SME-GM to satisfy its NCA that it sets and applies criteria which are effective in ensuring that issuers are 'appropriate' for admission to an SME-GM. In this way, an NCA will retain discretion to grant registration to MTFs exhibiting a broad range of approaches; subject always to a requirement to refuse registration to an applicant whose approach fails to provide a suitable filter against inappropriate companies, viewed holistically. Such a requirement therefore strikes a balance between flexibility and the provision of proper protection for investors.
35. ESMA also notes the existing rules of certain MTFs with a focus on SMEs make provision for specialist types of issuers (for example, investment companies whose strategy is to invest in other businesses/projects rather than to operate their own business, or to carry on specialist activities such as mineral exploration), and/or for the admission to trading of financial instruments other than shares. ESMA does not consider that MiFID II implementing measures should provide for any additional responsibilities in such cases, but that it would be appropriate for an SME-GM to consider the benefits of a tailored approach.

### **Draft technical advice**

*Draft advice on further specifying the requirement laid down in Article 33(3)(b) of MiFID II (appropriate criteria for initial and on-going admission to trading of financial instruments of issuers on the market)*

10. A market operator or investment firm operating an SME growth market should apply a regime which is effective in ensuring that issuers are appropriate for admission to the market.
11. An SME growth market should have an operating model which is appropriate for the performance of its functions.
12. An SME growth market should not be required to have rules prescribing the use of IFRS.
13. An SME growth market should have rules which are consistent with the maintenance of fair and orderly trading in compliance with the obligations owed by the operator of an MTF under Article 18 of MiFID.
14. An SME growth market should consider whether it would be appropriate to apply tailored



rules to issuers carrying on specialist activities, such as mineral exploration.

- Q181.** Do you agree that an SME-GM should be able to operate under the models described above, and that the choice of model should be left to the discretion of the operator (under the supervision of its NCA)?
- Q182.** Do you agree that an SME-GM should establish and operate a regime which its NCA has assessed to be effective in ensuring that its issuers are “appropriate”?
- Q183.** Do you agree with the factors to which a NCA should have regard when assessing if an SME-GM’s regulatory regime is effective?
- Q184.** Do you think that there should be an appropriateness test for an SME-GM issuer’s management and board in order to confirm that they fulfil the responsibilities of a publicly quoted company?
- Q185.** Do you think that there should be an appropriateness test for an SME-GM issuer’s systems and controls in order to confirm that they provide a reasonable basis for it to comply with its continuing obligations under the rules of the market?
- Q186.** Do you agree with i, ii or iii below?
- i.** An SME-GM issuer should be required to disclose whether or not it has sufficient working capital and if not how it proposes to make up this shortfall.
  - ii.** An SME-GM issuer should be required to have sufficient working capital to meet its needs for a minimum period.
  - iii.** The future Level 2 Regulation should remain silent on the adequacy of an issuer’s working capital.
- Q187.** Are there any other criteria that should be set for the initial and on-going admission of financial instruments of issuers to SME-GMs?

## **Background/Mandate**

### **Extract from the Commission’s request for advice (mandate)**

*With respect to requirements enacted in Article 33(3)(b) to (g), ESMA is invited to provide technical advice taking into account and ensuring consistency with other Union legislations.*

### **Article 33(3)(c) MiFID II**

*on initial admission to trading of financial instruments on the market there is sufficient information published to enable investors to make an informed judgment about whether or not to invest in the financial instruments, either an appropriate admission document or a prospectus if the requirements laid down in Directive 2003/71/EC are applicable in respect of a public offer being made in conjunction with the initial admission to trading of the financial instrument on the MTF;*



## Analysis

### Introduction

36. Under EU Regulation, an issuer seeking admission to an MTF is not required to produce a Prospectus under the Prospectus Directive unless it is undertaking a public offer of securities in connection with its application. However, in line with the responsibility of an MTF operator to “...provide, or [be] satisfied that there is access to, sufficient publicly available information to enable its users to form an investment judgement...” under MiFID II, a majority of primary market MTFs place minimum initial disclosure obligations on issuers, typically in the form of an ‘admission document’ or ‘information memorandum’, in circumstances where a Prospectus is not required.
37. Consistent with Article 33(3)(c) of MiFID II, an SME-GM issuer should be considered to meet its initial disclosure obligations where it is required to publish a Prospectus.
38. However, in line with current practices, Article 33(3)(c) of MiFID II recognises that the initial disclosure requirements should be deemed to have been fulfilled where an issuer publishes an “*appropriate admission document*”. The Article envisages that an admission document should contain “...*sufficient information...to enable investors to make an informed judgment about whether or not to invest in the instruments*”. In that context, ESMA considers that the Delegated Acts could elaborate upon Article 33(3)(c) of MiFID II by setting requirements for the content of an admission document and any processes for its approval or review.

### The content of an admission document

39. The regime established by the Prospectus Directive specifies, as a general principle, that a Prospectus must contain “...*all information which...is necessary to enable investors to make an informed assessment of the assets and liabilities, financial position, profit and losses and prospects of the issuer...*”. Issuers must accordingly consider this general principle alongside the detailed disclosure requirements mandated for a Prospectus.
40. In ESMA’s initial view, a similar general principle should govern the content of an SME-GM admission document at MiFID II level, such that NCAs retain discretion to assess whether the package of rules set by individual market operators achieve this outcome. The drafting of such a principle should converge with the intent of MiFID II to ensure there is “...*sufficient information published to enable investors to make an informed judgment about whether or not to invest in the instruments...*”. It should accordingly be expressed in the following terms: the admission document should, as a minimum, contain sufficient information for an investor to make an informed assessment of the financial position and prospects of the issuer, and the rights attaching to its SME-GM securities.
41. Existing primary market MTFs take different approaches to the initial disclosure of information by issuers. Certain markets take a ‘top down’ approach, under which market rules specify categories of disclosure required for a Prospectus that are dis-applied, or modified, for the purposes of an admission document. Other markets take a ‘bottom up’ approach, under which the rules provide a list of minimum information that must be included in the initial disclosure document.

42. In ESMA's initial view, it does not appear necessary to prefer the top down or bottom up approach as a means of achieving the general principle set out above. ESMA notes that both approaches are evident among the range of existing growth company markets.
43. Irrespective of whether a SME-GM were to take a top down or bottom up approach, ESMA has considered the benefits and drawbacks of elaborating upon the general principle, at MiFID II level, by specifying the detailed disclosures (or categories of disclosure) that would be necessary as a minimum to constitute a MiFID II-compliant admission document.
44. For the purpose of this consideration, ESMA notes that the Prospectus regime has recently been updated to incorporate, among other things, a proportionate disclosure regime for SMEs and companies with reduced market capitalisation. That regime, set out in Annexes XXV to XXVIII of Regulation 486/2012 ('the proportionate schedules'), allows certain limited dispensations for SMEs (for example, historical financial information is required only for the last two financial years). The proportionate schedules could provide a starting point for the design of a set of minimum disclosures for a SME-GM, further developing the general principle. If such a step were to be taken at MiFID II level, further work would be needed to evaluate which elements of the proportionate schedules would be appropriate for an admission document, noting in particular:
  - i. as reflected in ESMA's technical advice<sup>110</sup>, a cautious approach was taken to the proportionate schedules given that the proportionate regime would still form part of the disclosure framework for Regulated Markets. For example, market participants have previously noted that, on a quantitative basis, further significant cost savings could be made by examining the need for an operating and financial review and indebtedness statements;<sup>111</sup>
  - ii. existing primary market MTFs which take a 'top down' approach go beyond the proportionate schedules in dis-applying Prospectus requirements; and
  - iii. consistent with the drafting of Article 33(3)(c), an 'appropriate admission document' should be differentiated to an appropriate extent from a Prospectus, while providing sufficient information to investors.
45. In ESMA's view, the content of an admission document should, at MiFID II level, be governed by the general principle only, to recognise the plurality of existing approaches. ESMA does not therefore believe that the further work referred to in the paragraph above is necessary, or that MiFID's implementing measures should attempt to prescribe detailed disclosure requirements. However, ESMA would expect that, on a case by case basis, an NCA would consider whether the package of initial disclosures required by the specific rules of an individual market were such as to achieve the general principle, and to refuse registration to an operator whose approach was inconsistent with the proper information of investors. ESMA invites views on whether, in principle, the detailed disclosures (or categories of disclosure) required for an SME-GM admission document should be specified at MiFID II level, or alternatively (as ESMA believes) whether this should be left as a matter for market operators under the supervision of their NCAs.
46. As noted above, ESMA considers, subject to the views of market participants on the available options, that the admission document should contain a statement on the adequacy of the issuer's

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<sup>110</sup> See the discussion set out at section VIII.II of ESMA's technical advice of 4<sup>th</sup> October 2011 (ESMA/2011/323).

<sup>111</sup> See the Feedback Statement at section VII of the above technical advice.





working capital, stating whether the issuer has sufficient working capital and, if not, how it proposes to make up the shortfall.

#### *Responsibility for an admission document*

47. In the case of existing primary market MTFs, NCAs generally do not receive or approve admission documents. In certain cases, the admission document's compliance with market obligations forms part of the due diligence responsibilities placed on an issuer's professional adviser.
48. ESMA considers that the responsibility for ensuring that the information contained in an admission document is accurate should lie unequivocally with the issuer. Consequently, ESMA does not consider it appropriate to require that an admission document is formally 'approved' (by an NCA or market operator) with respect to the accuracy of the information it contains.
49. However, given that the initial admission document is likely to have a significant influence on investment decisions, ESMA considers it may be appropriate for an SME-GM to make arrangements for a draft admission document to be subject to an appropriate review, such as to ensure that it adequately addresses each of the minimum disclosure requirements (in other words, that it is complete). For the sake of clarity, ESMA does not believe that it should be necessary for the NCA of an SME-GM to be involved in that review, and expects that the operating model of the SME-GM would help determine the appropriate process (e.g. potentially forming part of the role of an issuer's professional adviser, where an adviser-based model is present).

#### **Draft technical advice**

*Draft advice on further specifying the requirement laid down in Article 33(3)(c) of MiFID II (appropriate criteria for the content of and responsibility for an admission document)*

15. An issuer which seeks admission of its financial instruments to an SME growth market should publish an appropriate admission document, or a prospectus that complies with the requirements of the Prospectus Directive.
16. The admission document should, as a minimum, contain sufficient information for investors to make an informed assessment of the financial position and prospects of the issuer, and the rights attaching to its SME growth market securities.
17. Provided that a Prospectus is not at any time required by the Prospectus Directive, the rules set by the operator of an SME growth market governing the content of an admission document should be permitted to take a 'top down' or 'bottom up' approach.
18. The admission document should contain a statement disclosing whether or not, in its opinion, the issuer possesses sufficient working capital for its present requirements, and if not how additional capital would be provided.
19. The responsibility for the admission document should lie with the issuer.
20. A market operator or investment firm operating an SME growth market should make arrangements for a draft admission document to be subject to an appropriate review, consistent with its operating model, such as to ensure that it adequately addresses each of the



minimum disclosure requirements.

21. An admission document should be regarded as having been published where a publication method that satisfies Article 33(3)(f) of MiFID II is followed. ESMA's advice on the acceptable methods for the public dissemination of regulatory information under Article 33(3)(f) of MiFID II is set out a below.

- Q188. Should the SME-GM regime apply a general principle that an admission document should contain sufficient information for an investor to make an informed assessment of the financial position and prospects of the issuer and the rights attaching to its securities?**
- Q189. Do you agree that SME-GMs should be able to take either a 'top down' or a 'bottom up' approach to their admission documents where a Prospectus is not required?**
- Q190. Do you think that MiFID II should specify the detailed disclosures, or categories of disclosure, that the rules of a SME-GM would need to require, in order for admission documents prepared in accordance with those rules to comply with Article 33(3)(c) of MiFID II? Or do you think this should be the responsibility of the individual market, under the supervision of its NCA?**
- Q191. If you consider that detailed disclosure requirements should be set at a MiFID level, which specific disclosures would be essential to the proper information of investors? Which elements (if any) of the proportionate schedules set out in Regulation 486/2012 should be dis-applied or modified, in order for an admission document to meet the objectives of the SME-GM framework (as long as there is no public offer requiring that a Prospectus will be drafted under the rules of the Prospectus Directive)?**
- Q192. Should the future Level 2 Regulation require an SME-GM to make arrangements for an appropriate review of an admission document, designed to ensure that the information it contains is complete?**

## **Background/Mandate**

### **Extract from the Commission's request for advice (mandate)**

*With respect to requirements enacted in Article 33(3)(b) to (g), ESMA is invited to provide technical advice taking into account and ensuring consistency with other Union legislations.*

### **Article 33(3)(d) MiFID II**

*there is appropriate ongoing periodic financial reporting by or on behalf of an issuer on the market, for example audited annual reports;*

## **Analysis**

50. ESMA notes that requirements concerning appropriate on-going periodic financial reporting for issuers on regulated markets are, at the European level, established by the Transparency Directive (Directive 2004/109/EC as amended by Directive 2013/50/EU). Under the rules imposed by the

Transparency Directive issuers on regulated markets are obliged to publish annual financial reports (Article 4) and half-yearly financial reports (Article 5) (the obligation to publish interim management statements was deleted in the recent review of the Directive).

51. ESMA also notes that the requirements in the Transparency Directive do not apply to issuers whose instruments are traded on MTFs only, although some national legislators may have decided to extend those requirements to MTFs. Therefore ESMA considers that on the one hand requirements applying to SME-GMs potentially should not be as onerous as the ones applying to regulated markets, while on the other hand, as the requirements applicable need to be of a standard “*to maintain high levels of investor protection to promote investor confidence in those markets*”<sup>112</sup>, therefore a middle ground should be found.
52. ESMA has looked at the rules applicable in existing markets which have a focus on issuers from the SME segment. While the rules applying when it comes to the detail quite naturally differ significantly, it seems that the majority of venues ask for the publication of annual and half-yearly reports. Therefore ESMA is inclined to, as a minimum requirement through implementing measures for issuers on SME-GMs, ask for the publication of annual and half-yearly reports. This would be with the intention of establishing a minimum standard which appears to be the prevailing best practice in existing markets. As to the content of financial reports, reference is made to the deliberations above in respect of financial reporting standards.
53. When it comes to establishing deadlines for publishing such reports, the Transparency Directive requires issuers on regulated markets to make public their annual reports at the latest four months after the end of each financial year and the half-yearly reports shall be made public at the latest three months after the relevant period.
54. Another precedent for establishing deadlines can be found in Article 26a(2) of the Regulation implementing the Prospectus Directive<sup>113</sup> where the circumstances are determined when an issuer admitted to an MTF can make use of a proportionate disclosure regime for rights issues. According to that provision issuers shall make public annual reports within six months after the end of each financial year and half-yearly financial statements within four months after the end of the first six months of each financial year. ESMA is considering if these more generous deadlines could be suitable for issuers admitted on SME-GMs.

### **Draft technical advice**

*Draft advice on further specifying the requirement laid down in Article 33(3)(d) of MiFID II (appropriate on-going periodic financial reporting)*

22. Issuers on SME growth markets should publish annual and half-yearly reports.
23. Issuers should make public annual reports within six months after the end of each financial year and half-yearly financial statements within four months after the end of the first six

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<sup>112</sup> Cf. Article 33(8) MiFID.

<sup>113</sup> COMMISSION DELEGATED REGULATION (EU) No 862/2012 of 4 June 2012 amending Regulation (EC) No 809/2004 as regards information on the consent to use of the prospectus, information on underlying indexes and the requirement for a report prepared by independent accountants or auditors.



months of each financial year.

- Q193. Do you agree with this initial assessment by ESMA?**
- Q194. In your view which reports should be included in the on-going periodic financial reporting by an issuer whose financial instruments are admitted to trading on an SME-GM?**
- Q195. How and by which means should SME-GMs ensure that the reporting obligations are fulfilled by the issuers?**
- Q196. Do you think that the more generous deadlines proposed for making reports public above (in the Box above, paragraph 23) are suitable, or should the deadlines imposed under the rules of the Transparency Directive also apply to issuers on SME-GMs?**

#### **Background/Mandate**

##### **Extract from the Commission's request for advice (mandate)**

*With respect to requirements enacted in Article 33(3)(b) to (g), ESMA is invited to provide technical advice taking into account and ensuring consistency with other Union legislations.*

##### **Article 33(3)(e) MiFID II**

*issuers on the market as defined in point (21) of Article 3(1) of Regulation (EU) No .../2014, persons discharging managerial responsibilities as defined in point (25) of Article 3(1) of Regulation (EU) No .../2014\* and persons closely associated with them as defined in point (26) of Article 3(1) of Regulation (EU) No .../2014.\* comply with relevant requirements applicable to them under Regulation (EU) No .../2014;*

#### **Analysis**

55. Consistent with the new Market Abuse Regulation (MAR), which extends the scope of the market abuse framework to any financial instrument admitted to trading on an MTF or on an OTF, as far as SME-GMs are concerned, Article 33(3)(e) of MIFID II states that issuers on an SME-GM and persons discharging managerial responsibilities in the issuer and persons closely associated with them shall comply with relevant requirements applicable to them under MAR.
56. Applying the new market abuse framework in an undifferentiated manner to all MTFs, including SME-GMs, however, may impose a significant burden on issuers on those markets,. The scope and size of the business of SME-GMs issuers is more restricted and the events giving rise to the need to disclose inside information typically reflects this.
57. MAR does take the situation of SME issuers into account to an extent as SME-GM issuers can disclose inside information in a modified and simplified market-specific way. Such inside information may be published by the SME-GMs, on behalf of their issuers, in accordance with a standardised content and format to be defined by ESMA implementing technical standards. In particular, according to Article 17(9) of MAR, inside information relating to issuers of a financial instru-



ment, whose financial instruments are admitted to trading on an SME-GM, may be posted by the trading venue on its website instead of on the website of the issuer where the trading venue chooses to provide this facility for issuers on that market. In that event such issuer is deemed to have fulfilled its obligation.

58. SME-GMs issuers are also exempt, under certain conditions, from the obligation to keep and constantly update insiders' lists. According to Article 18(6) of MAR, issuers of a financial instrument whose financial instruments are admitted to trading on an SME-GM shall be exempt from drawing up and regularly updating a list of all persons working for them, under a contract of employment or otherwise, who have access to inside information. However, if requested to do so by the NCA as part of the exercise of its supervisory or investigatory functions, that issuer shall provide the NCA with such a list.
59. ESMA deems sufficient the aforementioned requirements that MAR intends to introduce specifically for issuers on SME-GMs and therefore does not propose establishing any additional or different provisions or any additional relief for SME-GM issuers. On the contrary as far as potential market abuse is concerned ESMA considers it necessary to have a consistent and ambitious regime across all trading venues MiFID II envisages in order to have an adequate level of market integrity and investor protection.

#### **Draft technical advice**

*Draft advice on further specifying the requirement laid down in Article 33(3)(e) of MiFID II (Compliance with MAR)*

24. In the interests of consistent rules across all MiFID II trading venues, including SME growth markets, and taking into account the importance of efficiently combating market abuse on SME growth markets issuers on SME growth markets and persons discharging managerial responsibilities on behalf of the issuer as well as persons closely associated with them shall comply with the same rules as established in MAR, except for those specific cases where MAR already grants additional relief to SME growth market issuers.

**Q197. Do you agree with this assessment that the MiFID II framework should not impose any additional requirements/additional relief to those envisaged by MAR?**

#### **Background/Mandate**

##### **Extract from the Commission's request for advice (mandate)**

*With respect to requirements enacted in Article 33(3)(b) to (g), ESMA is invited to provide technical advice taking into account and ensuring consistency with other Union legislations.*

##### **Article 33(3)(f) MiFID II**

*regulatory information concerning the issuers on the market is stored and disseminated to the public;*



## Analysis

60. Once more the Transparency Directive is the benchmark for issuers whose instruments are admitted to trading on a regulated market. It specifies that regulated information which comprises all information as established in the Transparency Directive plus information to be disclosed under MAD I has to be disclosed in a manner ensuring fast access to the information and it has to be made available to the officially appointed storage mechanism.
61. ESMA considers that the rules on dissemination and storage under the Transparency Directive would be burdensome for issuers on SME-GMs and therefore a different approach needs to be adopted.
62. Having conducted a fact finding regarding existing markets and having had discussions with market operators and SME issuers ESMA considers that the primary means for publishing and also disseminating information should be the internet.
63. The pre-dominant current market practice appears to be that information needs to be published either on the website of the issuer, the website of the market or both. ESMA also notes that MAR (Article 17(9)) stipulates that inside information specifically can be posted on the website of the trading venue.
64. Therefore ESMA is considering as one option establishing as a minimum requirement for SME-GMs that regulatory information, where permitted under MAR, can be published on the website of either the issuer or the market operator, which should also be considered as dissemination for the purposes of this provision.
65. The alternative option ESMA is considering is that all regulatory information should always be published on the website of the market operator in order to use the market website as a natural point of convergence of information for investors on SME-GMs.
66. As far as the storage of information is concerned the ESMA fact-finding revealed that the requirements applicable in the existing markets mostly refer to a certain period of availability of the information on the website of the issuer.
67. Therefore ESMA is considering establishing as a minimum requirement that the information published and disseminated shall be available on the website of the issuer or the market operator – whichever has been used for publication – for a period of at least five years in order to provide investors with a sufficiently long history of published regulatory information. Alternatively ESMA is considering shortening this period to three years.

## Draft technical advice

*Draft advice on further specifying the requirement laid down in Article 33(3)(f) of MiFID II (storage and public dissemination of regulatory information concerning the issuers on the market)*

25. If so permitted under MAR, SME growth market issuers can publish regulatory information on the website of either the issuer or the market operator.
26. Such publication should also be considered as dissemination for the purposes of this provi-

sion.

27. The alternative option would be that all regulatory information should always be published on the website of the market operator in order to use the market website as a natural point of convergence of information for investors.
28. The information published and disseminated should be available on the website of the issuer or the market operator – whichever has been used for publication – for a period of at least five years.

- Q198. What is your view on the possible requirements for the dissemination and storage of information?**
- Q199. How and by which means should trading venues ensure that the dissemination and storage requirements are fulfilled by the issuers and which of the options described above do you prefer?**
- Q200. How long should the information be stored from your point of view? Do you agree with the proposed period of 5 years or would you prefer a different one (e.g., 3 years)?**

### **Background/Mandate**

#### **Extract from the Commission's request for advice (mandate)**

*With respect to requirements enacted in Article 33(3)(b) to (g), ESMA is invited to provide technical advice taking into account and ensuring consistency with other Union legislations.*

#### **Article 33(3)(g), MiFID II**

*there are effective systems and controls aiming to prevent and detect market abuse on that market as required under the Regulation (EU) No .../2014.*

### **Analysis**

68. MAR aims to ensure a level playing field among all trading venues and facilities within its scope by requiring them to adopt the necessary structural provisions aimed at preventing and detecting market manipulation practices.
69. According to Article 16 of MAR, any person who operates the business of a trading venue shall adopt and maintain effective arrangements and procedures (in accordance with Article 31 of MiFID II concerning MTFs and OTFs, and with Article 54 concerning RMs) aimed at preventing and detecting market abuse.
70. In addition to this, Article 16 MAR states that any person professionally arranging or executing transactions in financial instruments shall have systems in place to detect and report orders and transactions that might constitute insider dealing, market manipulation or an attempt to engage in market manipulation or insider dealing. If that person reasonably suspects that an order or transaction in any financial instrument, whether placed or executed on or outside a trading venue,



might constitute insider dealing, market manipulation or an attempt to engage in market manipulation or insider dealing, the person shall notify the NCA without delay.

71. In line with MAR, Article 33(3)(g) of MiFID II states that SME-GMs should have effective systems and controls aimed at preventing and detecting market abuse.
72. ESMA considers the aforementioned requirements envisaged by MAR to be adequate for the objectives to be pursued. In the interests of consistency and an adequate level of market integrity and investor protection no additional specifications at the MiFID level should be implemented for SME-GMs.

#### **Draft technical advice**

*Draft advice on further specifying the requirement laid down in Article 33(3)(g) of MiFID II (systems and controls aimed at preventing and detecting market abuse)*

29. In order to maintain an adequate level of consistency of rules applying across all MiFID II trading venues no additional specifications to the rules laid down in MAR and MiFID II for MTFs should be implemented specifically for SME growth markets.

**Q201. Do you agree with this assessment that the MiFID II framework should not impose any additional requirements to those presented in MAR?**





## 6.2. Suspension and removal of financial instruments from trading

### Background/Mandate

#### Extract from the Commission's request for advice (mandate)

*ESMA is invited to provide technical advice on a non-exhaustive list of situations constituting significant damage to the investors' interests and the orderly functioning of the market which could be the basis of a decision not to follow a suspension or removal notification.*

#### Article 52(2) MiFID II (the provision in Article 32(2) MiFID II is worded similarly)

*The competent authority, in whose jurisdiction the suspension or removal originated, shall require that other regulated markets, MTFs, OTFs and systematic internalisers, which fall under its jurisdiction and trade the same financial instrument or derivatives as referred to in points (4) to (10) of Section C of Annex I to this Directive that relate or are referenced to that financial instrument, also suspend or remove that financial instrument or derivatives from trading, where the suspension or removal is due to suspected market abuse, a take-over bid or the non-disclosure of inside information about the issuer or financial instrument infringing Articles 7 and 17 of Regulation (EU) No. .../2014 except where such suspension or removal could cause significant damage to the investors' interests or the orderly functioning of the market.*

### Analysis

#### Introduction

1. The aim of this Delegated Act is to specify the circumstances constituting significant damage to investors' interests or the orderly functioning of the market, which could then be the basis of a decision not to follow a suspension or removal notification.
2. ESMA is of the view that financial stability is a key component of orderly functioning of markets and *vice versa*. Article 52(1) of MiFID II empowers a Market Operator (MO) to suspend or remove from trading financial instruments which no longer comply with the rules of the regulated market, unless such a step would be likely to cause significant damage to investors' interests or the orderly functioning of the market.
3. Article 32 of MiFID II applies the same rules as outlined above where the operator of an MTF or OTF suspends or removes a financial instrument and/or related derivatives from trading. All the explanations and statements in this section in respect of Article 52 of MiFID II shall be read as applying to Article 32 of MiFID II as well.
4. According to Article 52(2)(2) of MiFID II the NCA in whose jurisdiction the suspension or removal originated has to decide whether one of the three reasons to start the EU-wide suspension process (suspected market abuse, a take-over bid or the non-disclosure of inside information about the issuer or financial instrument in breach of Article 7 and 17 MAR) is given. If the NCA comes to the conclusion that none of the three reasons apply the NCA is not required to expand the suspension or removal and to communicate its decision to ESMA and the NCAs of the other Member States.
5. In the event of a suspension by an MO, Article 52(2) of MiFID II details the process that must then be followed:

- i. The MO suspends the derivatives where this is necessary to support the objectives of the suspension or removal of the underlying financial instrument.
  - ii. The MO makes public its decision to suspend the financial instrument and any related derivatives and communicates relevant information to its relevant NCA.
  - iii. If the NCA comes to the conclusion that the suspension is due to suspected market abuse, a take-over bid or non-disclosure of inside information about the issuer or financial instrument in breach of Articles 7 and 17 MAR, the NCA orders suspension of the financial instrument and any related derivatives on other RMs, MTFs, OTFs and SIs in its jurisdiction trading the suspended instruments or any related derivatives, unless this could cause significant damage to investors' interests or the orderly functioning of the market.
  - iv. This NCA makes public such a suspension decision and communicates it to ESMA and other NCAs ('notified NCAs') including an explanation if the decision was not to follow the suspension.
  - v. The notified NCAs order suspension of trading on other RMs, MTFs, OTFs and SIs in their jurisdictions trading the suspended instruments or any related derivatives, unless this could cause significant damage to investors' interests or the orderly functioning of the market in the notified NCAs jurisdiction.
  - vi. The notified NCAs communicate their decision on whether to follow the suspension to ESMA and other NCAs, including an explanation if the decision was not to follow the suspension.
6. The process detailed above also applies – in general - in the case of removal of a financial instrument from trading and when a suspension is lifted, whereas a removal decision by the originating NCA does not necessarily lead to mandatory removal by the notified CA(s) but could lead to a 'suspension' as well.
7. Article 52(2) of MiFID II also stipulates that the above notification process applies in the case where the decision to suspend or remove a financial instrument from trading is taken by the NCA pursuant to Article 69(1) of MiFID II.

#### *Implementing Measures Envisaged in MiFID II*

8. Article 52 of MiFID II contains three empowerments for implementing measures in Level 2. The first one in Article 52(3) of MiFID II requires ESMA to develop implementing technical standards to determine the format and timing of all the communications and publications that are the object of a separate consultation process. The second one requires ESMA to specify such derivatives sufficiently related to the initially suspended instrument which should also be suspended. Such standards are discussed in the ESMA DP on technical standards.
9. The third empowerment in Article 52(4) of MiFID II empowers the Commission to adopt delegated acts in order to specify a list of circumstances constituting significant damage to investors' interests and the orderly functioning of the market which could then be the basis of a decision not to follow a suspension or removal notification.
10. Article 32 of MiFID II contains a parallel set of empowerments for MTFs and OTFs. Therefore all the proposals should be read as applying to regulated markets, MTFs and OTFs.

*Exceptional circumstances constituting damage to the investors' interest or to the orderly functioning of the market*

11. A suspension or removal is mandatory for the originating and notified NCAs where the suspension/removal is due to suspected market abuse, a take-over bid or non-disclosure of inside information about the issuer or financial instrument in breach of Articles 7 and 17 MAR.
12. As mentioned above, originating and notified MOs and NCAs may only abstain from the decision to remove or suspend a financial instrument from trading in cases where this would be likely to or could cause significant damage to the investors' interest or the orderly functioning of the markets. According to Articles 32(4) and 52(4) of MiFID II, the Commission shall be empowered to adopt delegated acts to specify the list of circumstances constituting significant damage to the investors' interests and the orderly functioning of the market referred to in Articles 52(1) and (2) and Articles 32(1) and (2) of MiFID II.
13. Convergence in the understanding of this exception will help to ensure that market participants in a Member State where trading in financial instruments has been suspended or financial instruments have been removed are not disadvantaged in comparison to another Member State, where trading is still on-going. However, ESMA recognises that a rigid ex ante list of situations meeting the exception would fail to allow for all the factors which could be relevant to determinations in individual cases. In addition, ESMA, upon consulting the legislative material from the trilogues and the way the legislative text has developed, considers that setting-up a non-exhaustive list was intended by the European co-legislators.
14. Therefore, ESMA considers that the optimum approach would be to set up a non-exhaustive list of situations which satisfy the criteria, to act as a framework for the exercise of judgement by NCAs.
15. The number of cases since the application of MiFID I where a notified NCA has not followed the suspension by an originating NCA has been extremely limited even though ESMA acknowledges that that number could go up due to the emergence of OTFs and due to the new legal framework in MiFID II where suspensions and removals need to be followed by notified NCAs regardless of the type of trading venue where the suspension originates.. On balance, not following suspensions does not seem to be a major regulatory concern and setting-up a non-exhaustive list of examples leaving a necessary degree of flexibility seems to suffice in order to attain a satisfactory degree of harmonisation in this area.
16. ESMA considers that the examples constituting the non-exhaustive list with the exception of the rather technical reason not to follow a suspension in paragraph 4(i) to be of a severe nature with potentially grave consequences for particular market participants, such as the shareholders of an issuer, or for the market as a whole. This underlines that not to follow a suspension requires the risks posed to investors' interests or the market to be significant and any situation not covered by the examples listed would need to be just as severe.
17. When determining if an exception applies, an NCA's assessment should focus specifically on whether a similar action in its jurisdiction would be likely to or could cause significant damage to the investors' interest or the orderly functioning of the markets. The costs or risks posed to markets, and to their market participants, are likely to be more significant where those markets are more relevant in terms of liquidity (and therefore may be relied upon to a greater extent for trading and price formation purposes) than the market in which the initial decision was made. The result of the assessment must ensure that the level playing field between markets is not affected.

18. In addition, actions with a sustained or lasting impact on the ability of investors to trade a financial instrument on trading venues, such as removals, are likely to have a greater impact on investors than other actions.
19. Also ESMA considers that the knock-on effects of a suspension or removal on derivatives, indices or benchmarks for which the removed or suspended instrument serves as an underlying or constituent should be taken into consideration as well as the effects of a suspension on the interests of market end users from the real economy, such as entities trading in financial instruments to hedge commercial risks.
20. ESMA accordingly considers that an NCA should pay due regard to all factors relevant to a suitably comprehensive assessment of potential market impacts, such as those set out above, when considering if significant damage could arise in any particular case.

### **Draft technical advice**

*Draft advice on the specification of a list of circumstances constituting significant damage to investors' interests and the orderly functioning of the market, which could then be the basis of a decision not to follow a suspension or removal notification – Articles 52(4) and 32(4) of MiFID II.*

1. The optimum approach for further specifying when a suspension or a removal from trading of a financial instrument which is traded in several countries, is likely to cause significant damages to the investor's interest or to the orderly functioning of the market would be to set up a non-exhaustive list of situations, to act as a framework for the assessment to be made by the NCAs.
2. A non-exhaustive list will impose the necessary level of convergence, while at the same time enabling notified NCAs to take into account potential new cases which cannot be foreseen from the outset and offer a degree of flexibility necessary in dynamic market circumstances.
3. The exceptions apply, in general terms, if following the suspension or removal would cause significant damage to the investors' interests, or the orderly functioning of the markets in the notified jurisdiction.
4. The following circumstances could in ESMA's view cause such significant damage to investors' interests and the orderly functioning of the market:
  - i. the reason for the suspension was momentary and has elapsed when the relevant notification would be acted upon;
  - ii. the same set of circumstances does not exist in the notified jurisdiction (such as where inside information about an issuer whose instruments are traded on a MTF or OTF has been properly disclosed in the notified jurisdiction or where the structure of a takeover or other corporate transaction has been fully disclosed to investors in the notified jurisdiction);
  - iii. following the suspension would create a systemic risk undermining financial stability (such as where the need exists to unwind a dominant market position, or where settlement obligations would not be met in a significant volume);

- iv. where the continuation of trading on the market is necessary to perform critical post-trade risk management functions when there is a need for the liquidation of financial instruments due to the default of a clearing member under the default procedures of a CCP and a CCP would be exposed to unacceptable risks as a result of an inability to calculate margin requirements; and
  - v. the financial viability of the issuer would be threatened (such as where it is involved in a corporate transaction or capital raising).
5. An NCA deciding not to follow on a suspension or removal basing the decision on circumstances not covered by the non-exhaustive list in the paragraph above should make sure that the damage to investors' interests or the orderly functioning of the market is at least as severe as in the situations listed in the paragraph above.
6. For determining whether a suspension or a removal would be likely to cause significant damage to the investors' interest or the orderly functioning of the markets in any particular case, NCAs should consider all relevant factors, including:
  - i. The relevance of the market in terms of liquidity, as the consequences of the actions are likely to be more significant where those markets are more relevant in terms of liquidity (and therefore may be relied upon to a greater extent for trading and price formation purposes) than in other markets.
  - ii. The nature of the envisaged action, as actions with a sustained or lasting impact on the ability of investors to trade a financial instrument on trading venues, such as removals, are likely to have a greater impact on investors than other actions.
  - iii. The knock-on effects of a suspension or removal of sufficiently related derivatives, indices or benchmarks for which the removed or suspended instrument serves as an underlying or constituent.
  - iv. The effects of a suspension on the interests of market end users who are not financial counterparties, such as entities trading in financial instruments to hedge commercial risks.
7. These principles should also be taken into consideration whenever an NCA decides not to follow on a suspension or removal basing the decision on circumstances not listed above.

**Q202. Do you agree that an approach based on a non-exhaustive list of examples provides an appropriate balance between facilitating a consistent application of the exception, while allowing appropriate judgements to be made on a case by case basis?**

**Q203. Do you agree that NCAs would also need to consider the criteria described in paragraph 6 iii and iv, when making an assessment of relevant costs or risks?**

**Q204. Which specific circumstances would you include in the list? Do you agree with the proposed examples?**



### 6.3. Substantial importance of a trading venue in a host Member State

#### Background/Mandate

##### **Extract from the Commission's request for advice (mandate)**

*ESMA is invited to provide advice on how to establish the criteria under which the operations of a trading venue in a host Member State could be considered as being of substantial importance for the functioning of the securities markets and the protection of the investors in that host Member State in order to determine under which circumstances proportionate cooperation arrangements are required to be put in place between the respective Member States in accordance with Article 79(2) of the Directive. These criteria should take into account the nature and scale of the impact on the securities markets and the investor protection in the other Member State. ESMA should take account of the criteria set out in Article 17 of the Commission Regulation (EC) No 1287/2006, taking into account any need to develop these standards in light of market and technological developments.*

##### **Article 79(2), MiFID II**

*When, taking into account the situation of the securities markets in the host Member State, the operations of a trading venue that has established arrangements in a host Member State have become of substantial importance for the functioning of the securities markets and the protection of the investors in that host Member State, the home and host competent authorities of the trading venue shall establish proportionate cooperation arrangements.*

#### Analysis

1. Article 79(2) of MiFID II requires home and host NCAs to establish proportionate cooperation arrangements if a trading venue that has established arrangements in a host Member State has become of substantial importance for the functioning of the securities markets and the protection of investors in that host Member State.
2. Article 79(8) of MiFID II empowers the Commission to adopt delegated acts establishing the criteria under which a trading venue in a host Member State could be considered to be of such substantial importance. Furthermore, that provision requires ESMA to develop draft implementing technical standards to establish standard forms, templates and procedures for cooperation between NCAs.
3. Article 56 of MiFID I already encompassed a similar set of provisions (rule in paragraph 2, empowerment for implementing measures in paragraph 5) which was applicable to regulated markets only. Article 16 of Regulation (EC) No 1287/2006 specified the following criteria for determining the substantial importance of a regulated market in a host Member State:

##### **Article 16 (Article 56(2) of MiFID I) Determination of the substantial importance of a regulated market's operations in a host Member State**

*The operations of a regulated market in a host Member State shall be considered to be of substantial importance for the functioning of the securities markets and the protection of investors in that host State where one of the following criteria is met:*

*(a) the host Member State has formerly been the home Member State of the regulated market in question;*

*(b) the regulated market in question has acquired through merger, takeover, or any other form of transfer the business of a regulated market which had its registered office or head office in the host Member State.*

4. A fact-finding exercise among NCAs revealed that the supervisory experience with applying Article 16 of Regulation (EC) 1287/2006 is very limited indeed. A majority of NCAs considered the criteria set by Article 16 of Regulation (EC) 1287/2006 as still appropriate and did not see a need for changing them for regulated markets.
5. As a result any move or acquisition of a regulated market triggers the right of the host Member State to benefit from proportionate cooperation arrangements automatically based on the assumption that due to the important functions regulated markets serve for capital markets any change in their status will always be a sensitive issue for the then host Member State which will want to remain closely involved and kept up-to-date regarding the future development of the regulated market.
6. For MTFs and OTFs, ESMA considers it important that not any move or acquisition of an economically insignificant MTF or OTF automatically triggers the establishment of the cooperation arrangements envisaged in Article 79(2) of MiFID II.
7. Therefore ESMA proposes a test requiring the MTF or OTF to have a market share of at least 10% of trading in terms of total turnover in monetary terms in on-venue trading in the host Member State in at least one asset class subject to MiFIR transparency obligations at the time of the move or acquisition of the MTF or OTF. This test should ensure that only markets with a significant economic importance in asset classes which MiFIR considers important enough for the orderly functioning of markets to put them under a wide ranging set of transparency requirements.
8. In addition, an MTF registered as an SME-GM shall be deemed to be of substantial importance. The intention of the SME-GM concept is to help SME financing and SMEs traded on such Growth Markets will tend to be almost exclusively issuers based in the host Member State. Given that SMEs are the backbone of many European economies and that facilitating their access to capital markets is a major concern for most Member States ESMA considers it as justified to also let host Member States benefit from the Article 79(2) of MiFID II proportionate cooperation arrangements in the case of an SME-GM moving or being acquired.

### **Draft technical advice**

*Draft advice on measures to establish the criteria under which the operations of a trading venue in a host Member State could be considered as being of substantial importance for the functioning of the securities markets and the protection of the investors in that host Member State.*

1. The criteria for determining when the operations of a regulated market become of substantial importance in a host Member State in Article 16 of Regulation (EC) 1287/2006 are still relevant and should be maintained.
2. Those criteria should also be applied in the cases of MTFs and OTFs following the application

of MiFID II, however, for MTFs and OTFs there should be an additional test in order to ensure that the cooperation arrangements envisaged by Article 79(2) of MiFID II are not automatically triggered in the case of small and therefore economically not highly significant MTFs and OTFs.

3. Therefore a trading venue should be deemed to be of substantial importance for the functioning of the securities markets and the protection of investors in a host Member State in one of the two following cases:
  - i. the host Member State used to be the home Member State of the trading venue in question; and
  - ii. the trading venue in question has acquired through a merger, a takeover or any other form of transfer of the whole or part of the business of a trading venue which was previously operated by a market operator or investment firm registered in the host Member State.
4. If the trading venue subject to one of the cases described in paragraph 3 is an MTF or an OTF, it should only be deemed to be of substantial importance if at least one of the following criteria apply:
  - i. before one of the cases described in the paragraph above occurred it had a market share of at least 10% of trading in terms of total turnover in monetary terms in on-venue trading and systematic internaliser trading in the host Member State in at least one asset class subject to MiFIR transparency obligations; and
  - ii. it is registered as an SME growth market.

**Q205. Do you consider that the criteria established by Article 16 of MiFID Implementing Regulation remain appropriate for regulated markets?**

**Q206. Do you agree with the additional criteria for establishing the substantial importance in the cases of MTFs and OTFs?**





## 6.4. Monitoring of compliance – information requirements for trading venues

### Background/Mandate

#### Extract from the Commission's request for advice (mandate)

*ESMA is invited to provide its technical advice on a non-exhaustive list of circumstances that would trigger the information requirement referred to in Articles 31(2) and 54(2).*

#### Article 54(2) MiFID II (Article 31(2) MiFID II is worded similarly)

*Member States shall require the market operators of the regulated markets to immediately inform their competent authorities of significant infringements of their rules or disorderly trading conditions or conduct that may indicate behaviour that is prohibited under Regulation (EU) No .../2014 or system disruptions in relation to a financial instrument.*

*The competent authorities of the regulated markets shall communicate to ESMA and to the competent authorities of the other Member States the information referred to in the first subparagraph.*

1. According to Article 54(2) of MiFID II, Member States shall require the market operators of the regulated markets to immediately inform their NCAs of significant infringements of their rules or disorderly trading conditions or conduct that may indicate abusive behaviour that is prohibited under MAR or system disruptions in relation to a financial instrument. The same requirement applies to MTFs and OTFs (Article 31(2) of MiFID II).
2. A similar provision can already be found in Article 43(2) of MiFID I which states that Member States shall require the operators of the regulated markets to report significant breaches of their rules or disorderly trading conditions or conduct that may involve market abuse to the NCA of the regulated market.
3. Whereas MiFID I neither specified the circumstances which trigger the information requirement nor included a corresponding empowerment of the Commission to adopt implementing measures, the Commission is now – pursuant to Articles 31(4) and 54(4) of MiFID II – empowered to adopt delegated acts for further clarification.
4. The following proposals have been developed by working groups of the Secondary Markets Standing Committee (SMSC) and the Market Integrity Standing Committee (MISC) of ESMA. The analysis and technical advice under the following Section covering the issues “significant infringements of rules”, “disorderly trading conditions” and “system disruptions” have been discussed with the SMSC working group, whereas the analysis and technical advice on “conduct that may indicate abusive behaviour that is prohibited under MAR” under the next section have been discussed by the MISC working group.

### Analysis

5. The information requirements under Articles 54(2) and 31(2) of MiFID II shall ensure that NCAs can fulfil their regulatory tasks and are informed in a timely manner about relevant incidents which may have a negative impact on the functioning and integrity of the markets. NCAs shall be

provided with the necessary information to identify and assess risks for the markets and their participants as well as to react efficiently and to take action if necessary.

6. In general, ESMA considers that it would not be appropriate to set up an exhaustive list of circumstances, but to outline the rationale of this information requirement and to give some examples in which this information requirement should be assumed in order to give market operators a guideline regarding supervisory expectations. In this context ESMA considers, as a general principle, it to be prudent for market operators to consult with their NCAs on a regular basis on the NCAs' expectations of what should be reported.

#### *Significant infringements of rules*

7. Pursuant to Articles 54(2) and 31(2) of MiFID II the information requirement is triggered when trading venues observe significant infringements of their rules. In ESMA's view the term rule should be understood in a broad sense and should comprise all rules, rulings, orders as well as general terms and conditions of contractual agreements between the trading venue and its participants which contain the conditions for trading and admission to the trading venue.
8. As the information requirement is only triggered in cases of significant infringements, not all infringements would have to be reported, but only those which are of significant importance from the perspective of the NCAs. The essential question in this regard is to what extent the orderly functioning and integrity of the trading venue are impaired and whether significant interests of other market participants could seriously be affected.
9. In ESMA's view an infringement should be considered significant if the underlying rule aims to protect the market integrity, the orderly functioning of the market or the ability of market participants to interact on a fair and properly informed basis, for example: infringements may concern the rules for the admission to trading of financial instruments on the market or rules, if given, governing the ongoing periodic reporting of financial information which are essential for investors to make an informed investment decision. As market makers and liquidity providers can play an essential role in facilitating and supporting the trading in certain instruments on a trading venue, market integrity may also be concerned if those persons do not comply, on a regular or sustained basis, with their obligations to provide liquidity into the market. Infringements of the venue's rules designed to safeguard against the potential risks posed by algorithmic trading and direct electronic access (DEA) including Sponsored Access (SA) should also be considered significant. It is also relevant, for the assessment of 'significant', to consider whether a rule has been infringed on an incidental manner, continuously or intentionally.
10. Where a trading venue considers that an infringement is of sufficient severity or impact to justify consideration of disciplinary action, it should generally inform its NCA.

#### *Disorderly trading conditions*

11. Under MiFID II, trading venues are required to have rules and procedures that provide for fair and orderly trading. However, in certain circumstances, the proper functioning of the trading protocols and/or transparency arrangements facilitating such fair and orderly trading can break down, leading to potentially disorderly trading conditions.
12. In ESMA's view, such disorderly trading conditions would exist in all cases where the ability for supply and demand to interact in an orderly way in a venues' systems, according to its transparent

rules and procedures, is seriously compromised: this could be a result of difficulties with the venue operator's own systems or controls, such as the performance of its trading platform, or issues resulting from the behaviour of market participants on the venue. ESMA notes that irrespective of the cause of the incident, the trading venue will need to make a notification if disorderly trading conditions occur.

13. Notification should only be required in cases of significant events which have the potential to jeopardise the role and function of trading venues as part of the financial market infrastructure. This is, for example, the case when the capacities of the trading systems are reached or exceeded, or it is otherwise unable to receive and process orders/quotes in a timely way in accordance with its rules and pre-trade risk controls, leading to interference with the price discovery process over a significant period of time. In these cases the continuity and regularity of the performance of the trading venue may no longer be ensured and the need for further action may arise. An extraordinary decline in the price of a financial instrument does not, as such, automatically indicate the existence of disorderly trading conditions (for example, where it can be explained as a reaction to price sensitive information). Another reason for concern could be repeated claims of mis-trades by market makers as these raise the question of whether the venues are organised appropriately to fulfil their obligation to provide the market with liquidity on a continuous and reliable basis.
14. ESMA would like to emphasise that the proposed implementing measures under Article 48 of MiFID II also make reference to disorderly trading conditions. In that section of the ESMA DP they are defined as referring to a market where the maintenance of a fair, orderly and transparent execution of trades is compromised. The way the MiFID II system is set-up to work is that under Article 48 of MiFID II organisational measures are designed to prevent disorderly trading conditions. Should they occur nonetheless trading venues have to inform NCAs under Articles 31 and 54 of MiFID II. Therefore such an information obligation is triggered if critical mechanisms in the context of Article 48 of MiFID II which are designed to protect the trading venue against the risks of algorithmic trading break down or fail.

#### *System disruptions*

15. Furthermore trading venues are required to immediately inform their NCAs of system disruptions. Whereas the disorderly trading conditions as described above primarily comprises circumstances in which the trading functionality is concerned, systems disruptions should not be narrowly read and limited to disruptive incidents which lead to a trading interruption as such but should also include situations in which major malfunctions of systems occur which are directly related with the trading.
16. The information requirement should furthermore be triggered if a major malfunction or breakdown of the systems to monitor and control the trading activities of the market participants occur, such as the systems of the trading surveillance to monitor and prevent market abuse as well as the systems applied for position management controls with regard to the commodity derivatives trading on a trading venue.
17. As the market relies and depends on the pre- and post-trade transparency data and other relevant data published by trading venues in accordance with their obligations under MiFID II and MiFIR, system disruptions should furthermore be assumed if trading venues encounter major malfunctions or breakdowns of their systems to publish and disseminate such market data.

18. As trading venues are required to have arrangements to facilitate the efficient and timely finalisation of the transactions executed under their systems, such venues should also be required to inform their NCA about major malfunctions and breakdowns of their links with CCPs and CSDs that provide clearing/settlement services to their participants, if these incidents have a repercussion on the trading system of the trading venue.

### **Draft technical advice**

*Draft technical advice to determine circumstances that trigger the requirement of operators of trading venues under Article 54(2) and 31(2) of MiFID II to immediately inform its NCA of significant infringements of their rules or disorderly trading conditions or system disruptions in relation to a financial instrument.*

1. The information requirements shall ensure that NCAs can fulfil their regulatory tasks and are informed in a timely manner about relevant incidents which may have a negative impact on the functioning and integrity of the markets. NCAs shall be provided with the necessary information to identify and assess risks for the markets and their participants as well as to react efficiently and to take action if necessary.
2. Notification should only be required in cases of significant events which have the potential to jeopardise the role and function of trading venues as part of the financial market infrastructure.
3. ESMA considers that it would not be appropriate to set up an exhaustive list of circumstances, but to give some examples in which this information requirement should be assumed in order to give market operators a guideline regarding supervisory expectations. In this context ESMA considers, as a general principle, it to be prudent for market operators to consult with their NCAs on a regular basis on the NCAs' expectations of what should be reported.

### **Annex**

#### *Significant Infringements of the Rules of a Trading Venue*

1. Significant infringements triggering an information requirement should be assumed if:
  - i. market participants infringe rules of the trading venue which aim to protect the market integrity, the orderly functioning of the market or the significant interests of the other market participants; and
  - ii. a trading venue considers that an infringement is of sufficient severity or impact to justify consideration of disciplinary action.

#### *Disorderly Trading Conditions*

2. Disorderly trading conditions triggering an information requirement should be assumed if:
  - i. the price discovery process is interfered with over a significant period of time;
  - ii. the capacities of the trading systems are reached or exceeded;

- iii. market makers/liquidity providers repeatedly claim mis-trades;
- iv. break down or failure of critical mechanisms under Article 48 of MiFID II and its implementing measures which are designed to protect the trading venue against the risks of algorithmic trading;
- v. any major malfunction or breakdown of the trading system (e.g. due to a technical problem which restrains a relevant percentage of the market participants from venue access over a specific period of time).

*System Disruptions*

- 3. Systems disruptions triggering an information requirement should be assumed if:
  - i. any major malfunction or breakdown of the systems for the dissemination of pre- and post-trade transparency and other relevant data published by trading venues in accordance with their obligations under MiFID II and MiFIR;
  - ii. any major malfunction or breakdown of the systems of the trading venue to monitor and control the trading activities of the market participants; and
  - iii. any major malfunction or breakdown in the sphere of other interrelated services providers, in particular CCPs and CSDs, that has repercussions on the trading system.

**Q207. Which circumstances would you include in this list? Do you agree with the circumstances described in the draft technical advice? What other circumstances do you think should be included in the list?**



## 6.5. Monitoring of compliance with the rules of the trading venue - determining circumstances that trigger the requirement to inform about conduct that may indicate abusive behaviour

### Background/Mandate

#### Extract from the Commission's request for advice (mandate)

*ESMA is invited to provide its technical advice on a non-exhaustive list of circumstances that would trigger the information requirement referred to in Articles 31(2) and 54(2).*

#### Article 54(2), MiFID II (Article 31(2) is worded similarly)

*Member States shall require the market operators of the regulated markets to immediately inform their competent authorities of significant infringements of their rules or disorderly trading conditions or conduct that may indicate behaviour that is prohibited under Regulation (EU) No .../2014 or system disruptions in relation to a financial instrument.*

*The competent authorities of the regulated markets shall communicate to ESMA and to the competent authorities of the other Member States the information referred to in the first subparagraph.*

*In relation to conduct that may indicate behaviour that is prohibited under Regulation (EU) No .../2014\*, a competent authority shall be convinced that such behaviour is being or has been carried out before it notifies the competent authorities of the other Member States and ESMA.*

### Analysis

1. Under Articles 31(4) and 56(4) of MiFID II, ESMA is mandated to provide technical advice to the Commission to determine circumstances that trigger the requirement of operators of a RM, a MTF or an OTF to immediately inform its NCA of conduct that may indicate abusive behaviour within the scope of MAR.

#### General approach and considerations

2. In order to assist trading venues in fulfilling their information requirement duty, ESMA considers it is useful to draw up an indicative and non-exhaustive list of signals of market abuse behaviours.
3. This list has been prepared mainly on the basis of the existing 1st set of CESR guidance on the application of MAD I (CESR/04-505b) applied from the perspective of trading venues. In particular, unlike investment firms, a trading venue has no knowledge of the exact identity of the client and what is the client's profile neither can they be aware of the size of the position held by the client. The second basis is the ESMA guidelines on systems and controls in an automated trading environment for trading platforms, investment firms and NCAs (ESMA/2012/122) (HFT guidelines). Along the same lines, ESMA also adapted some of the indicators listed in Annex I of MAR. The list also takes into account the more extensive scope of MAR compared to MAD I.
4. This list is intended to provide indications of orders, transactions or behaviours that may indicate a possible market abuse conduct. These "*possible signals of market abuse*" do not trigger by themselves the "*duty to immediately inform the NCA*", being just indications to be taken into consideration, within the more general framework of MAR, in order to fulfil that duty. The list is neither exhaustive

(a particular order, transaction or behaviour may be reportable even if it matches none of the indications) nor determinative (an order, transaction or behaviour may not necessarily be reportable simply because it matches one or more of the indications). Operators of trading venues will have to exercise judgment before deciding to inform the relevant NCAs; they shall give particular attention to deviations from what is usual on the trading characteristics of the financial instruments listed/traded on their markets.

5. A proportionate approach with respect to the above mentioned signals should be followed by the operators of trading venues to take into account conditions and characteristics of the market of a particular financial instrument: market size, number of participants, liquidity.... In particular, this approach should take into account the rules of the relevant trading venues, that should be assessed and approved by the NCAs, as particular signals may refer to transactions that are legitimate trades when carried out in conformity with the rules of the relevant trading platform (e.g. crossing trades).
6. ESMA also considers that operators of trading venues should inform the relevant NCAs when they have identified a conduct that may indicate abusive behaviour affecting related financial instruments, both when these instruments are traded on the same venue or when they are traded on several venues operated by the same operator. For example, financial instruments which are traded on the same trading venue may be targets for cross-product market manipulation in which orders or transactions in one financial instrument are used to influence the price of another financial instrument (e.g., financial instruments relating to the same underlying such as an equity share and a subscription right or a structured bond. Transactions or orders to trade may also be undertaken in an underlying financial instrument in order to influence the price of the derivative in another trading venue. Therefore, ESMA is including particular signals in the list.
7. As highlighted in Recital 62 of MiFID II and despite the benefits it provides, algorithmic trading or high frequency algorithmic trading techniques can lend themselves to certain forms of abusive behaviour if misused. Therefore, the proposed list contains indicators relating to the specificities arising in an automated trading environment. As set out in the ESMA “HFT guidelines”, different types of manipulation strategies can be implemented using algorithms (such as spoofing, layering and quote stuffing). In such situations the signals relate to orders entries, updates and/or cancellation. However, these signals are not intended to suggest that the same strategies carried out by non-automated means would not also be abusive.
8. In addition, it should also be noted that trading venues have different levels of information available or accessible depending on their nature (e.g. trading capacity of the member client versus own account; detailed information about the issuer...). In particular, this includes the inside information disclosed by an issuer of a SME-GM when the operator of such a market provides the publication facility referred to Article 12(6) of MAR.
9. Finally, even if a particular potentially abusive conduct is difficult to spot, the operator of a trading venue that comes to know of a conduct that may indicate an abusive behaviour by whatever means or ways should report that conduct to the relevant NCA in accordance with MiFID II requirements.

*List of possible signals indicating abusive conduct*

10. In the list of signals proposed by ESMA, reference to a trading venue should be understood as a reference to a regulated market, a MTF or an OTF, and financial instruments are meant to also include emission allowances. In addition, reference to order to trade is meant to encompass all sorts of



orders, modifications and cancellations of orders, irrespective of whether there is an intention to trade or not.

11. The list presented in the draft advice intends to cover:
  - i. possible signals of insider dealing or market manipulation;
  - ii. possible signals of insider dealing, a specific signal in relation to research or investment recommendation; and
  - iii. possible signals of market manipulation including signals for cross-product across different trading venues or not as well as signals particularly relevant in an automated trading environment though not exclusively related to such trading.

#### *Particular signals to consider*

12. ESMA has identified particular issues where signals could be useful for operators of trading venues or other possible signals, though their inclusion in the list of signals needs to be further assessed.

#### *Signal relating to position reversal*

13. The following signal of market manipulation is identified in the CESR 1st set of Guidance (Point 4.8 d) for authorised intermediaries other than trading venue operators:

*“The extent to which orders to trade given or transactions undertaken show evidence of position reversals in a short period and represent a significant proportion of the daily volume of transactions in the relevant financial instrument on the regulated market concerned, and might be associated with significant changes in the price of a financial instrument admitted to trading on the trading venue”.*

14. ESMA is considering its extension to the context of trading venues although acknowledging that in many circumstances such a signal will be difficult to spot from the perspective of the operator of a trading venue since it might not have all the objective elements - details of the members trading activity - to suspect or determine that a position reversal at a beneficial owners' level is occurring. Thus this assessment should be done on a best knowledge basis.

#### *Signal relating to improper matched orders by different members/participants*

15. Another possible signal of false or misleading transactions could be defined as follows:

*Transactions carried out as a result of the entry of buy and sell orders to trade at or nearly at the same time, with the same quantity and the same price by different members/participants.*

16. However, at trading venue level, such a signal, potentially resource intensive in terms of implementation, could have the undesirable outcome of generating a number of false positives (incidental triggers).

#### *Signal in relation to research or investment recommendation*

17. CESR 1st set of guidance (Point 4.9 b) currently states that:



*“Article 5 of the same Directive [Implementing directive 2003/124/EC] sets out the following non-exhaustive signals of transactions:*

- i. Whether orders to trade given or transactions undertaken by persons are preceded or followed by dissemination of false or misleading information by the same persons or persons linked with them;*
- ii. Whether orders to trade are given or transactions are undertaken by persons before or after the same persons or persons linked to them produce or disseminate research or investment recommendations which are erroneous or biased or demonstrably influenced by material interest”.*

18. From a trading venue operators’ perspective, these signals may not be appropriate as currently drafted as they are not in the capacity to assess whether the information is false or misleading, or, the research or investment recommendation is erroneous, biased or influenced by material interest.
19. However, in relation to research or investment recommendation, it can be proposed to refocus the possible signal towards an insider dealing perspective:

*“Whether orders to trade are given or transactions are undertaken by a market member before or shortly after that member or persons publicly known as linked to that member produce or disseminate research or investment recommendations that are made publicly available”.*

20. Some assumptions have though to be made:

- i. the trading venue has access to the research or investment recommendation to conduct the monitoring; and
- ii. the published research or investment recommendation has had a price impact.

#### *‘Front running’ behaviour*

21. Front running (i.e. trading ahead of a client order) is a practice that can be enforced on the ground of the rules of conduct applicable to investment firms but can constitute under certain circumstances a market abuse.
22. In some instances, a client’s pending order can constitute inside information (CESR 2nd set of Guidance; CESR/06-562b) and therefore a market member trading ahead of its client’s pending order can constitute insider dealing (as by acquiring or disposing of, for its own account financial instruments to which the information relates).
23. ESMA acknowledges that in many circumstances such a signal will be spotted by the market operator provided that it has available through the order book the information about whether the order is placed for own account of the member or on behalf of a member’s client.

#### **Draft technical advice**

*Draft advice on determining the circumstances that trigger the requirement of operators of trading venues to immediately inform its NCA of conduct that may indicate abusive behaviour within the scope*

*of MAR*

1. In this advice, reference to ‘order to trade’ is meant to encompass all types of orders, modifications and cancellations of orders, irrespective of whether there is an intention to trade or not and irrespective of the means used to access the trading venue
2. The list set out in the Annex contains a set of indicators/signals of insider dealing and market manipulation that should be taken into account by operators of trading venues to determine whether they should inform the relevant NCA of a conduct that may indicate abuse behaviour within the scope of MAR.
3. This list is neither exhaustive nor determinative of market abuse. Transactions and/or orders to trade meeting one or more signals may be conducted for legitimate reasons and/or in compliance with the rules of the trading venue, and, therefore not give reasonable grounds for suspicion of an abusive conduct.
4. The points xiv, xv, xvi, xvii and xviii of the Annex identify the signals of market manipulation that are particularly relevant in a context of an automated trading environment.
5. The operator of a trading venue, or of several trading venues, where a financial instrument and/or related financial instrument are traded needs to exercise judgment on the indicators/signals triggered before deciding to inform the relevant NCAs taking into account:
  - i. the deviations from the usual trading pattern of the financial instruments admitted to trading or traded on their trading venue; and
  - ii. the information available or accessible to them, whether be internally as part of the operations of the trading venue or publicly available.
6. Irrespective of any signal being triggered, the operator of a trading venue that comes to know of a conduct that indicates abusive behaviour by whatever means or ways should report that conduct to the relevant NCAs.

**Annex**

*Signals of possible insider dealing or market manipulation*

1. Unusual concentration of transactions and/or orders to trade in a particular financial instrument with one member/participant or between certain members/participants.
2. Unusual repetition of a transaction among a small number of members/participants over a certain period of time.

*Signals of possible insider dealing*

3. Unusual and significant trading or submission of orders to trade in the financial instruments of a company by certain members/participants before the announcement of important corporate events or of price sensitive information relating to the company; orders to trade/transactions resulting in sudden and unusual changes in the volume of orders/transactions and/or prices before public an-

nouncements regarding the financial instrument in question.

4. Whether orders to trade are given or transactions are undertaken by a market member before or shortly after that member or persons publicly known as linked to that member produce or disseminate research or investment recommendations that are made publicly available.

*Signals of possible market manipulation*

5. The signals described below in points xiv, xv, xvi, xvii and xviii are particularly relevant in an automated trading environment.
  - i. Orders to trade given or transactions undertaken which represent a significant proportion of the daily volume of transactions in the relevant financial instrument on the trading venue concerned, in particular when these activities lead to a significant change in the price of the financial instruments.
  - ii. Orders to trade given or transactions undertaken by a member/participant with a significant buying or selling interest in a financial instrument which lead to significant changes in the price of the financial instrument on a trading venue.
  - iii. Orders to trade given or transactions undertaken which are concentrated within a short time span in the trading session and lead to a price change which is subsequently reversed.
  - iv. Orders to trade given which change the representation of the best bid or offer prices in a financial instrument admitted to trading or traded on a trading venue, or more generally the representation of the order book available to market participants, and are removed before they are executed.
  - v. Transactions or orders to trade by a market/participant with no other apparent justification than to increase/decrease the price or value of, or to have a significant impact on the supply of or demand for a financial instrument, namely near the reference point during the trading day, e.g. at the opening or near the close.
  - vi. Orders to trade which are given, or transactions which are undertaken at or around a specific time when reference prices, settlement prices and valuations are calculated and lead to price changes which have an effect on such prices and valuations (e.g. marking the close).
  - vii. Transactions or orders to trade which have the effect of, or are likely to have the effect of increasing/decreasing the weighted average price of the day or of a period during the session.
  - viii. Transactions or orders to trade which have the effect of, or are likely to have the effect of, setting a market price when the liquidity of the financial instrument or the depth of the order book is not sufficient to fix a price within the session .
  - ix. Execution of a transaction, changing the bid-offer prices when this spread is a factor in the determination of the price of another transaction [whether or not on the same trading venue].
  - x. Entering orders representing significant volumes in the central order book of the trading system a few minutes before the price determination phase of the auction and cancelling these orders a few seconds before the order book is frozen for computing the auction price so that the theoretic-

cal opening price might look higher or lower than it otherwise would do.

- xi. A transaction or series of transactions which are shown on a public display facility to give the impression of activity or price movement in a financial instrument (Painting the tape).
- xii. Transactions where both buy and sell orders are entered at or nearly at the same time, with the same price and quantity by the same market member working for the same proprietary desk (where the trading venue has access to this type of information) (improper matched orders) or by different market members/participants apparently working in concert.
- xiii. Transactions, series of transactions, orders to trade or series of orders to trade which have the effect of, or are likely to have the effect of bypassing the trading safeguards of the market (e.g. as regards volume limits; price limits; bid/offer spread parameters; etc).
- xiv. Entry of orders to trade or a series of orders to trade intended to start or exacerbate a trend and to encourage other participants to accelerate or extend the trend in order to create an opportunity to unwind/open a position at a favourable price (Momentum ignition).
- xv. Submitting multiple orders to trade often away from the touch on one side of the order book with the intention of executing a trade on the other side of the order book. Once that trade has taken place, the manipulative orders will be removed (Layering and Spoofing).
- xvi. Entry of small orders to trade in order to ascertain the level of hidden orders and particularly used to assess what is resting on a dark platform (Ping order).
- xvii. Entry of large numbers of orders to trade and/or cancellations/updates to orders to trade so as to create uncertainty for other participants, slowing down their process and to camouflage their own strategy (Quote stuffing)
- xviii. Posting of orders to trade to attract other market participants ('slow traders'), employing traditional trading techniques ('slow traders') that are then rapidly revised onto less generous terms, hoping to execute profitably against the incoming flow of 'slow traders' orders to trade ('Smoking')
- xix. The extent to which, to the best knowledge of the operator of a trading venue, orders to trade given or transactions undertaken show evidence of position reversals in a short period and represent a significant proportion of the daily volume of transactions in the relevant financial instrument on the trading venue concerned, and might be associated with significant changes in the price of a financial instrument admitted to trading or traded on the trading venue.

*Signals for cross-product market manipulation, including across different trading venues*

- 6. The signals described below should be particularly considered by the operator of a trading venue where both a financial instrument and related financial instruments are admitted to trading or traded or where the above mentioned instruments are traded on several trading venues operated by the same operator.
  - i. Transactions or orders to trade which have the effect of, or are likely to have the effect of increasing/decreasing/maintaining the price of a financial instrument during the days preceding the is-

sue of a related derivative/convertible;

- ii. Transactions or orders to trade which have the effect of, or are likely to have the effect of maintaining the price of the underlying financial instrument below or above the strike price, or other element used to determine the pay-out (e.g. barrier), of a related derivative at expiration date;
- iii. Transactions which have the effect of, or are likely to have the effect of modifying the price of the underlying financial instrument so that it surpasses/not reaches the strike price, or other element used to determine the pay-out (e.g. barrier), of a related derivative at expiration date;
- iv. Transactions which have the effect of, or are likely to have the effect of modifying the settlement price of a financial instrument when this price is used as a reference/determinant, namely, in the calculation of margins requirements;
- v. Orders to trade given or transactions undertaken by a member/participant with a significant buying or selling interest in a financial instrument which lead to significant changes in the price of the related derivative or underlying asset admitted to trading on a trading venue;
- vi. Transactions on an underlying financial instrument which have the effect of, or are likely to have the effect of improperly influencing the price of a related financial instrument
- vii. Creating or enhancing arbitrage possibilities between a financial instrument and another related financial instrument by influencing reference prices of one of the financial instruments can be carried out with different financial instruments (like rights/shares, cash markets/derivatives markets, warrants/shares, ...). In the context of rights issues, it could be achieved by influencing the (theoretical) opening or (theoretical) closing price of the rights

**Q208. Do you support the approach suggested by ESMA?**

**Q209. Is there any limitation to the ability of the operator of several trading venues to identify a potentially abusive conduct affecting related financial instruments?**

**Q210. What can be the implications for trading venues to make use of all information publicly available to complement their internal analysis of the potential abusive conduct to report such as managers' dealings or major shareholders' notifications)? Are there other public sources of information that could be useful for this purpose?**

**Q211. Do you agree that the signals listed in the Annex contained in the draft advice constitute appropriate indicators to be considered by operators of trading venues? Do you see other signals that could be relevant to include in the list?**

**Q212. Do you consider that front running should be considered in relation to the duty for operators of trading venues to report possible abusive conduct? If so, what could be the possible signal(s) to include in the list?**



## 7. Commodity derivatives

### 7.1. Financial instruments definition - specifying Section C 6, 7 and 10 of Annex I of MiFID II

#### Background/Mandate

##### Extract from the Commission's request for advice (mandate):

*ESMA is invited to provide technical advice on specifying the derivative contracts referred to in Section C.6 of Annex I that have the characteristics of wholesale energy products as defined in Article 2(4) of Regulation (EU) No 1227/2011 that must be physically settled and "C.6 energy derivative contracts" defined in Article 4 (2), point (16) of this Directive, in particular specifying the notion of must be physically settled taking into account the criteria listed in recital 10.*

##### Article 4(1)(2), MiFID II

*The Commission shall adopt delegated acts in accordance with Article 89 measures specifying:*

*(a) the derivative contracts referred to in Section C.6 of Annex I that have the characteristics of wholesale energy products that must be physically settled and C.6 energy derivative contracts;*

##### Article 4(1)(16), MiFID II

*'C6 energy derivative contracts' means options, futures, swaps, and any other derivative contracts mentioned in Section C.6 of Annex I relating to coal or oil that are traded on an OTF and must be physically settled;*

##### Article 4(1)(58), MiFID II

*'wholesale energy product' means wholesale energy products as defined in point (4) of Article 2 of Regulation (EU) No 1227/2011;*

#### Analysis

1. ESMA's understanding of MiFID II text in relation to the definition of C 6 is as follows:
2. The definition of Section C 6 of Annex I under MiFID I has been changed significantly under MiFID II by classifying options, futures, swaps and other derivative contracts relating to commodities that can be physically settled and are traded on an OTF as financial instruments, in addition to those instruments that trade on MTFs and RMs.
3. However, Section C 6 of Annex I excludes wholesale energy products within the scope of REMIT that are traded on an OTF and that must be physically settled. Therefore, these excluded wholesale energy products do not qualify as financial instruments and are consequently outside the scope of MiFID, EMIR and the CRD IV package.

4. Wholesale energy products within the scope of REMIT which are derivatives contracts, and therefore are within the scope of this exemption, are derivatives with electricity (or power<sup>114</sup>) or natural gas as the underlying.
5. In addition, Article 95 of MiFID II establishes a transitional regime for “*C 6 energy derivatives contracts*” which, upon agreement by a NCA, can be exempted from the EMIR clearing obligation and risk mitigation technique requirements and do not count towards the clearing threshold for non-financial counterparties for a transitional period of 6 years after MiFID II enters into force.
6. C 6 energy derivatives contracts are defined as options, futures, swaps, and any other derivatives with coal or oil as an underlying and which are traded on an OTF and must be physically settled. While derivative contracts with coal as an underlying appear to be an easily identifiable section of instruments in ESMA’s view, the same does not hold true for contracts with oil as an underlying. Here the question arises whether only different grades of crude oil would qualify as C6 energy derivatives contracts or whether also other contracts where the underlying is derived from crude oil (i.e. contracts related to refined oil products) are within the scope of the exemption<sup>115</sup>. ESMA at this stage has not yet decided on where exactly the line should be drawn and is seeking input from stakeholders on this particular point.
7. ESMA also notes that this exemption should expressly be narrow in its scope to avoid a loophole leading to regulatory arbitrage<sup>116</sup>.
8. ESMA’s technical advice focuses on further clarifying the notion of “*must be physically settled*” which should then be applied to wholesale energy contracts traded on OTFs which may benefit from the permanent exemption foreseen in Section C 6 of Annex 1 and the temporary exemption for *C 6 energy derivatives contracts* from certain EMIR obligations only, foreseen in Article 95 of MiFID II.
9. At the same time ESMA would like to take the opportunity of this consultation to ask market participants to provide ESMA with concrete examples of contracts which they consider to be within the scope of the two exemptions provided by MiFID II.
10. In respect of the notion of “*must be physically settled*” ESMA notes that Section C of the MiFID II Annex specifies a number of options for settlement in cash or physically (as discussed further below in this chapter) which serve as prerequisites for characterising contracts as financial instruments under the various definitions of Section C.
11. As per Recital 10 of MiFID for further specifying the meaning of what “*must be physically settled*” ESMA has to take into account at least the creation of an enforceable and binding obligation to physically deliver, which cannot be unwound and with no right to cash settle or offset transactions except in the case of a *force majeure* event or other *bona fide* inability to settle physically.
12. ESMA considers that an enforceable and binding obligation to physically deliver exists if the party to the contract entitled to receive the underlying commodity has an unrestricted and unconditional right to physical delivery. There must be no option for either party to the contract to replace physical deliv-

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<sup>114</sup> The terms ‘power’ and ‘electricity’ are used interchangeably in this paper.

<sup>115</sup> Definitions of oil and petroleum products are given on pages 38-42 of the Energy Statistics Regulation <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:02008R1099-20130314&qid=1396893804389&from=EN>

<sup>116</sup> Cf. Recital 10.

ery with cash settlement or to cancel out the contractual obligation for physical delivery by netting against other contractual obligations.

13. ESMA notes that “operational netting” is a specific form of settlement in power and gas markets that is characterised by a third party, such as a transmission system operator, requiring the parties to the contract to net the flows at the point of delivery for operational efficiency and balancing of network capacity. “Operational netting” is distinct from cash settlement as the contracts still result in physical delivery, albeit on a net basis. The participants have to have all operational arrangements and approvals in place to make and take physical delivery as though it were taking place on a gross basis. ESMA is looking for input from stakeholders on how these operational netting arrangements work in practice and will then decide how they should be treated in the MiFID II context.
14. ESMA notes in the case of *force majeure* that no instrument can be a 100% accurately described as “*must be physically settled*”, as practically all instruments appear to contain such *force majeure* provisions that would prevent physical delivery.
15. Therefore ESMA considers that the existence of *force majeure* provisions should not prevent a contract from being characterised as “*must be physically settled*” for the purposes of further specifying wholesale energy products under Section C 6 and C 6 energy derivative contracts. The same applies to other *bona fide* inability to perform the contract on a physical settlement basis. ESMA is interested in market participants’ views on what “other *bona fide*” reasons there may be for being unable to settle physically with a view to establishing a common understanding and application to the extent possible.
16. ESMA is of the view that the term “*physically settled*” has to be further specified as well by clarifying that it can incorporate a broad range of delivery methodologies including:
  - i. physical delivery of the relevant goods themselves;
  - ii. delivery of a document giving rights of an ownership nature to the relevant goods or the relevant quantity of the goods concerned (such as a bill of lading or a warehouse warrant); or
  - iii. another method of bringing about the transfer of rights of an ownership nature in relation to the relevant quantity of goods without physically delivering them (including notification, scheduling or nomination to the operator of an energy supply network) that entitles the recipient to the relevant quantity of the goods.
17. ESMA has developed its advice in this context based on the following considerations in respect of the concepts of what “*can*” and what “*must be physically settled*”, by looking at Sections C 5 to C 7 and the various alternatives described in those sections and by explaining in more detail how those concepts work together and how the various sections apply:
  - i. C5 covers commodity derivatives “*that must be settled in cash or may be settled in cash at the option of one of the parties*” and consequently, defining what “*can be physically settled*” under C6 and C7 will set parameters on what falls within scope of C5 with respect to “*what may be settled in cash*”.



- ii. ESMA's view is that there is no overlap between commodity derivatives under C5 which “*may be settled in cash at the option of one of the parties*<sup>117</sup>” and commodity derivatives under C6 and C7 which “*can be physically settled*”. ESMA considers that the boundary between the definitions is the following:
- a. Contracts which **must be settled in cash** fall under C5;
  - b. Contracts which **may be settled in cash at the option of one of the parties** fall under C5. This means that a C5 contract may be physically settled if the party with the option to settle in cash does not exercise this option.
  - c. Contracts which **must be physically settled** fall under C6 or C7, depending upon the place of execution.
  - d. Contracts that **can be physically settled** in all cases fall under C6 or C7, depending on the place of execution, except for where there is an option, at one of the parties' behest, to cash settle. This means a C6 or C7 contract could be cash settled provided it **is by mutual consent of the counterparties**. Where there is not mutual consent to cash settle, the contract must result in being physically settled for it to be a C6 or C7 instrument.

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<sup>117</sup> Also note this phrase is used under Article 38(3)(a) of MiFID I regulation 1287/2006/EC in relation to definition C10.

## Draft technical advice

1. Contracts must be physically settled if:
  - i. the party to the contract entitled to receive the underlying commodity has an unrestricted and unconditional right to physical delivery;
  - ii. there is no option for either party to replace physical delivery with cash settlement;
  - iii. the obligations under the contract cannot be cancelled out against obligations from other contracts between the parties concerned.
2. The existence of *force majeure* provisions do not prevent a contract from being characterised as “*must be physically settled*” for the purposes of further specifying wholesale energy products under Section C 6 and C 6 energy derivative contracts.
3. The existence of other *bona fide* clauses rendering it impossible to perform the contract on a physical settlement basis do not prevent a contract from being characterised as “*must be physically settled*” for the purposes of further specifying wholesale energy products under Section C 6 and C 6 energy derivative contracts.
4. Contracts that are physically settled have a broad range of delivery methods including the following:
  - i. physical delivery of the relevant goods themselves;
  - ii. delivery of a document giving rights of an ownership nature to the relevant goods or the relevant quantity of the goods concerned (such as a bill of lading or a warehouse warrant); or
  - iii. another method of bringing about the transfer of rights of an ownership nature in relation to the relevant quantity of goods without physically delivering them (including notification, scheduling or nomination to the operator of an energy supply network) that entitles the recipient to the relevant quantity of the goods.

**Q213. Do you agree with ESMA’s approach on specifying contracts that “must” be physically settled and contracts that “can” be physically settled?**

**Q214. Which oil products in your view should be caught by the definition of C6 energy derivatives contracts and therefore be within the scope of the exemption? Please give reasons for your view stating, in particular, any practical repercussions of including or excluding products from the scope.**

**Q215. Do you agree with ESMA’s approach on specifying contracts that must be physically settled?**

**Q216. How do operational netting arrangements in power and gas markets work in practice? Please describe such arrangements in detail. In particular, please describe the type and**

**timing of the actions taken by the various parties in the process, and the discretion over those actions that the parties have.**

- Q217. Please provide concrete examples of contracts that must be physically settled for power, natural gas, coal and oil. Please describe the contracts in detail and identify on which platforms they are traded at the moment.**
- Q218. How do you understand and how would you describe the concepts of “force majeure” and “other bona fide inability to settle” in this context?**

### **Background/Mandate**

#### **Extract from the Commission’s request for advice (mandate).**

*ESMA is invited to consider whether any amendments to Article 38 of the MiFID I Commission Regulation N° 1287/2006 are necessary, in particular whether the list of criteria contracts that are not spot contracts should satisfy to be classified as financial instruments needs to be amended taking into account the introduction of the new OTF trading venue category and bearing in mind that the clearing and margining requirement should be removed.*

#### **Article 4(1)(2), MiFID II**

*The Commission shall adopt delegated acts in accordance with Article 89 measures specifying:*

*(b) the derivative contracts referred to in Section C.7 of Annex I that have the characteristics of other derivative financial instruments;*

### **Analysis**

19. The aim of the Delegated Act is to specify options, futures, swaps, forwards and other contracts relating to commodities, that can be physically settled not otherwise mentioned in Section C 6 of Annex I of MiFID II and not being for commercial purposes, which have the characteristics of other derivative financial instruments.
20. ESMA notes that Section C 7 of Annex I of MiFID II was already included in MiFID I but with slightly different wording as the last half sentence of the provision (“*having regard to whether, inter alia, they are cleared and settled through recognised clearing houses or are subject to regular margin calls*”) has been deleted in MiFID II.
21. ESMA also notes that Section C 7 of Annex I of MiFID I was already further specified in Article 38 of Regulation (EC) No 1287/2006 the relevant sections of which are displayed below.

#### **Article 38, Regulation (EC) No 1287/2006**

##### **Characteristics of other derivative financial instruments**

*1. For the purposes of Section C(7) of Annex I to Directive 2004/39/EC, a contract which is not a spot contract within the meaning of paragraph 2 of this Article and which is not covered by paragraph 4 shall be considered as having the characteristics of other derivative financial instruments and not being for commercial purposes if it satisfies the following conditions:*

*(a) it meets one of the following sets of criteria:*

*(i) it is traded on a third country trading facility that performs a similar function to a regulated market or an MTF;*

*(ii) it is expressly stated to be traded on, or is subject to the rules of, a regulated market, an MTF or such a third country trading facility;*

*(iii) it is expressly stated to be equivalent to a contract traded on a regulated market, MTF or such a third country trading facility;*

*(b) it is cleared by a clearing house or other entity carrying out the same functions as a central counterparty, or there are arrangements for the payment or provision of margin in relation to the contract;*

*(c) it is standardised so that, in particular, the price, the lot, the delivery date or other terms are determined principally by reference to regularly published prices, standard lots or standard delivery dates.*

*2. A spot contract for the purposes of paragraph 1 means a contract for the sale of a commodity, asset or right, under the terms of which delivery is scheduled to be made within the longer of the following periods:*

*(a) two trading days;*

*(b) the period generally accepted in the market for that commodity, asset or right as the standard delivery period.*

*However, a contract is not a spot contract if, irrespective of its explicit terms, there is an understanding between the parties to the contract that delivery of the underlying is to be postponed and not to be performed within the period mentioned in the first subparagraph.*

*[...]*

*4. A contract shall be considered to be for commercial purposes for the purposes of Section C(7) of Annex I to Directive 2004/39/EC, and as not having the characteristics of other derivative financial instruments for the purposes of Sections C(7) and (10) of that Annex, if it is entered into with or by an operator or administrator of an energy transmission grid, energy balancing mechanism or pipeline network, and it is necessary to keep in balance the supplies and uses of energy at a given time.*

22. In summary a contract qualifies as a financial instrument under this provision if the conditions in paragraph 1 are fulfilled on a cumulative basis and the contract is neither a spot contract as defined in paragraph 2 nor for commercial purposes as defined in paragraph 4. Based on feedback from regulators and market participants alike ESMA considers that this provision has provided clarity in respect of the application of Section C 7 of Annex I in practice and therefore takes the view that one approach would be to include some or most of the factors of this provision again in the future MiFID II Delegated Act.

*Spot Contract and Commercial Purpose*

23. ESMA considers that the definition of a spot contract in paragraph 2 of the provision above as well as the definition of a contract being for commercial purposes in paragraph 4 are still valid and therefore advises the Commission to include them in the future MiFID II Delegated Act.
24. However, ESMA is aware that the definition of a contract being for commercial purposes is rather narrowly framed and is limited to the energy sectors. ESMA therefore asks stakeholders if there are other contracts that could be considered to be for commercial purposes only.
25. The other factors listed in Article 38(1) Regulation (EC) No 1287/2006, i.e. the conditions in relation to the trading, the clearing and the degree of standardisation, require closer inspection.
26. In that context, ESMA notes that since the entry into force of MiFID I other pieces of legislation have either taken effect already or are in the process of being finalised for which the scope of MiFID I and II, as defined by the Delegated Act contemplated here, is important and has a direct effect.
27. The first one is the Market Abuse Regulation (MAR) which will replace the existing Market Abuse Directive<sup>118</sup> and which will become applicable 6 months before MiFID II except for those provisions which explicitly depend on MiFID II.
28. The new MAR predominantly applies to financial instruments; however, it also expressly extends the scope of the market manipulation and insider trading prohibitions to spot commodity contracts where any transaction or order in them or any behaviour in relation to them is likely to have an effect on the price or value of a financial instrument.<sup>119</sup> For such contracts the classification as a financial instrument or a spot commodity contract *prima facie* does not seem to be that crucial as the main pillars of an anti-market abuse regime would apply in both cases.
29. However there is a difference with regard to the ability of financial supervisors to detect market abuse because the transaction reporting regime in MiFID I and II only applies to financial instruments whereas spot commodity contracts remain outside the scope of the MiFID I and II transaction reporting regime. ESMA also notes that the extension of the market manipulation and insider trading prohibitions in MAR will expressly exempt “wholesale energy products” as defined in Article 2(4) of REMIT.
30. This observation leads to the second piece of legislation which it is important to take into consideration when designing this Delegated Act. Regulation (EU) No 1227/2011 (REMIT) on wholesale energy market integrity and transparency establishes a framework applying to wholesale energy products encompassing spot and derivative contracts in electricity and gas<sup>120</sup>.
31. While the REMIT obligation to publish inside information applies to both spot and derivative contracts in electricity and gas<sup>121</sup>, the prohibitions of insider trading and market manipulation do not apply to financial instruments (i.e. derivatives in electricity and gas) where at the moment the Market Abuse Directive, in the future MAR, prevail and financial regulators are the competent authorities. In short, this combination of exemptions can be summarised by stating that wholesale

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<sup>118</sup> Directive 2003/6/EC.

<sup>119</sup> Article 2 (2a) MAR.

<sup>120</sup> Cf. Article 2(4) REMIT.

<sup>121</sup> Article 4 REMIT.

energy products are exempted from the scope of MAR, except for the prohibitions of market manipulation and insider trading in electricity and gas derivatives where REMIT declares MAR as applicable.

32. The combination of exemptions highlights the importance of determining whether an instrument is classified as a financial instrument according to the Delegated Act contemplated here because, depending on whether market abuse occurs in a spot contract or a derivative contract in electricity or gas (outside the exemption under Section C6), a different set of rules applies (REMIT versus MAR), along with different authorities being responsible for market monitoring, investigation and enforcement (ACER and national energy regulators versus national financial regulators).
33. Therefore ESMA recognises the importance of the definition of financial instrument as specified in this Delegated Act setting out clear and dependable rules for market participants and regulators alike so that the regime applying in cases of market abuse can be easily determined.

#### *Article 38(1)(b) of MiFID I – The Clearing Criterion*

34. The third relevant piece of legislation is EMIR. EMIR establishes a number of obligations applying to derivatives with derivatives being defined by reference to Sections C 4 to C 10 as implemented by Article 38 and 39 of Regulation (EC) No 1287/2006.<sup>122</sup> Therefore any change to the scope of the definitions of derivatives in MiFID will have a direct effect on the scope of EMIR.
35. One of the most prominent regulatory measures EMIR establishes is the clearing obligation for derivatives<sup>123</sup> according to which OTC derivative contracts, if certain conditions are fulfilled, have to be cleared by authorised European CCPs or recognised third-country CCPs. ESMA considers that the existence of the clearing obligation in EMIR has an impact on how to design the future Delegated Act due to the interdependence of MiFID I and II and EMIR.
36. In simplified terms, EMIR says that commodity derivatives as defined in MiFID I have to be cleared if certain conditions are fulfilled. If MiFID II were to then continue defining commodity derivatives as instruments which are (already) cleared, as it currently does in Article 38(1) Letter b of Regulation (EC) No 1287/2006, this would establish a circularity between the two pieces of legislation. As a consequence ESMA considers that the future Delegated Act should not include any criteria requiring instruments to be cleared in order to be considered as commodity derivatives. The change to the Level 1 text in Section C 7 of Annex I (deletion of “*having regard to whether, inter alia, they are cleared and settled through recognised clearing houses or are subject to regular margin calls*”) also indicates that the existence of clearing arrangements shall not be taken as an indicator of whether an instrument is a financial instrument anymore.

#### *Article 38(1)(c) of MiFID I – The Standardisation Criterion*

37. Article 38(1) Letter c of Regulation (EC) No 1287/2006 states that a contract must also be standardised to be considered as having the characteristics of other derivative financial instruments. ESMA considers standardisation as an important indicator of classifying contracts as derivatives in the MiFID sense, i.e. as financial instruments.

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<sup>122</sup> Cf. Article 2(5) EMIR.

<sup>123</sup> Cf. Article 4 EMIR.



38. ESMA notes that standardisation of derivatives is also an important feature of the EMIR clearing obligation where a certain degree of standardisation, including for example whether OTC derivative contracts incorporate common legal documentation, is to be taken into account when determining whether a specific class of OTC derivatives shall be subject to the clearing obligation<sup>124</sup>.
39. While EMIR is about the degree of standardisation of OTC derivatives the prerequisites listed in Article 38(1)(c) are about whether to qualify a contract as a derivative in the first place. Maintaining Article 38(1)(c) would therefore not establish a circularity between MiFID II and EMIR but rather one would supplement the other by MiFID II having abstract standardisation criteria for establishing whether a contract is a derivative while EMIR looks at degrees of standardisation of contracts already classified as financial instruments.
40. Therefore ESMA considers that Article 38(1)(c) of Regulation (EC) No 1287/2006 should be maintained in the future Delegated Act.

#### *Article 38(1)(a) of MiFID I – The Trading Criterion*

41. Regarding the trading criterion as expressed in Article 38(1)(a) of Regulation (EC) No 1287/2006 ESMA notes that the three alternatives listed are intended to cover situations where (i) a contract is traded on a third country facility, (ii) is conducted bilaterally and is then brought on venue (negotiated trade) or (iii) where a contract off-venue is expressly stated to be the equivalent of an on-venue contract. Article 38(1)(a) needs to be read in conjunction with Section C6 of the MiFID II Annex which already classifies all contracts traded on one of the MiFID trading venues (except for certain OTF contracts) as financial instruments.
42. ESMA considers that the first two of the three above-mentioned alternatives of the trading criterion are still useful indicators for determining whether to qualify a contract as a financial instrument and proposes to maintain them in the new Delegated Act.
43. However ESMA has not come to a firm view yet on whether the third alternative where a contract has been expressly declared to be the equivalent of an on-venue contract should be maintained. ESMA is looking for an alternative which is more objective, does not depend on the choices of the two counterparties concerned and is accordingly proposing a new draft on which it is asking stakeholders for views.
44. ESMA notes that the emergence of the OTF as a new MiFID trading venue needs to be taken into account in the new Delegated Act, in particular the exception for some OTF contracts as described in Section C6 of the Annex of MiFID II. ESMA also suggests using the term “third country trading venue” as it appears in Article 28 of MiFIR in this context for describing third country facilities in order to have a consistent terminology across the MiFID II framework.

#### **Draft technical advice**

*Draft advice on specifying derivative contracts mentioned in Section C 7 of Annex 1 that have the characteristics of other derivative financial instruments*

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<sup>124</sup> Article 7 Commission Delegated Regulation (EU) No 149/2013.

5. A contract should be considered as having the characteristics of other derivative financial instruments if it is standardised and if it trades in line with conditions outlined in the following paragraphs. The contract must neither be a spot contract nor a contract for commercial purposes only in line with the conditions outlined below.
6. A contract should be considered as standardised if parameters such as the price, the lot, the delivery date or other terms are determined principally by reference to regularly published prices, standard lots or standard delivery dates.
7. A contract should be considered as traded in such a way as having the characteristics of other derivative financial instruments if:
  - i. it is traded on a third country trading venue that performs a similar function to a regulated market, an MTF or an OTF as far as contracts within the scope of Section C 6 of Annex I to Directive [new MiFID] are concerned;
  - ii. it is expressly stated to be traded on, or is subject to the rules of, a regulated market, an MTF, an OTF as far as contracts within the scope of Section C 6 of Annex I to Directive [new MiFID] are concerned or such a third country trading venue; or
  - iii. it is equivalent to a contract traded on a regulated market, an MTF, an OTF contract within the scope of Section C 6 of Annex I to Directive [new MiFID] or such a third country trading venue, with regards to the price, the lot, the delivery date or other terms.
8. A spot contract should be defined as a contract for the sale of a commodity, asset or right, under the terms of which delivery is scheduled to be made within the longer of the following periods:
  - i. two trading days;
  - ii. the period generally accepted in the market for that commodity, asset or right as the standard delivery period.
9. A contract should not be classified as a spot contract if there is an understanding between the parties to the contract that delivery of the underlying is to be postponed and not to be performed within two trading days or the period generally accepted in the market. This rule should apply irrespective of the explicit terms contained in the contract.
10. A contract should be considered to be for commercial purposes if:
  - i. it is entered into with or by an operator or administrator of an energy transmission grid, energy balancing mechanism or pipeline network and it is necessary to keep in balance the supplies and uses of energy at a given time,
  - ii. it is... (ESMA will consider adding other examples of contracts for commercial purposes following the consultation).





- Q219.** Do you agree that Article 38 of Regulation (EC) No 1287/2006 has worked well in practice and elements of it should be preserved? If not, which elements in your view require amendments?
- Q220.** Do you agree that the definition of spot contract in paragraph 2 of Article 38 of Regulation (EC) 1287/2006 is still valid and should become part of the future implementing measures for MiFID II? If not, what changes would you propose?
- Q221.** Do you agree that the definition of a contract for commercial purposes in paragraph 4 of Article 38 of Regulation (EC) 1287/2006 is still valid and should become part of the future implementing measures for MiFID II? If not, what changes would you propose? What other contracts, in your view, should be listed among those to be considered for commercial purposes?
- Q222.** Do you agree that the future Delegated Act should not refer to clearing as a condition for determining whether an instrument qualifies as a commodity derivative under Section C 7 of Annex I?
- Q223.** Do you agree that standardisation of a contract as expressed in Article 38(1) Letter c of Regulation (EC) No 1287/2006 remains an important indicator for classifying financial instruments and therefore should be maintained?
- Q224.** Do you agree with the proposal to maintain the alternatives for trading contracts in Article 38(1)(a) of Regulation (EC) No 1287/2006 taking into account the emergence of the OTF as a MiFID trading venue in the future Delegated Act?

## Background/Mandate

### Extract from the Commission's request for advice (mandate)

*ESMA is invited to consider whether any amendments to Article 38(3) and Article 39 of the MiFID I Commission Regulation N° 1287/2006 are necessary, in particular to reflect the addition of the OTF as a new type of trading venue on which these instruments may be traded and taking into account that clearing and margining requirement should be removed as a criteria. ESMA is also invited to consider whether the list of derivative contracts in Article 39 is still comprehensive or needs to be supplemented.*

### Article 4(1)(2), MiFID II

*The Commission shall adopt delegated acts in accordance with Article 89 measures specifying:*

*(c) the derivative contracts referred to in Section C.10 of Annex I that have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are traded on a regulated market, an MTF or an OTF;*

## Analysis

45. The aim of the Delegated Act is to specify options, futures, swaps, forward rate agreements and other contracts relating to climatic variables, freight rates, inflation rates, other official economic statistics that have to be or can be settled in cash as well as contracts relating to assets, rights, obligations, indices and measures not otherwise mentioned in Section C 10 of Annex I, which have



the characteristics of other derivative financial instruments. Here the Delegated Act shall have regard to whether the instruments are traded on one of the MiFID trading venues.

46. ESMA notes that Section C 10 of Annex I was also already included in MiFID I and the MiFID II text has changed Section C10 by adding the OTF as one of the trading venues these instruments may be traded on as well as deleting the last half sentence whereby other instruments were to be assessed by looking at the existence of clearing arrangements (“*are cleared and settled through CCPs or are subject to regular margin calls*”).
47. ESMA also notes that Section C 10 of Annex I was already further specified in Articles 38 and 39 of Regulation (EC) No 1287/2006 the relevant sections of which are displayed below.

**Article 38, Regulation (EC) No 1287/2006**  
**Characteristics of other derivative financial instruments**

*1. For the purposes of Section C(7) of Annex I to Directive 2004/39/EC, a contract which is not a spot contract within the meaning of paragraph 2 of this Article and which is not covered by paragraph 4 shall be considered as having the characteristics of other derivative financial instruments and not being for commercial purposes if it satisfies the following conditions:*

*(a) it meets one of the following sets of criteria:*

*(i) it is traded on a third country trading facility that performs a similar function to a regulated market or an MTF;*

*(ii) it is expressly stated to be traded on, or is subject to the rules of, a regulated market, an MTF or such a third country trading facility;*

*(iii) it is expressly stated to be equivalent to a contract traded on a regulated market, MTF or such a third country trading facility;*

*(b) it is cleared by a clearing house or other entity carrying out the same functions as a central counterparty, or there are arrangements for the payment or provision of margin in relation to the contract;*

*(c) it is standardised so that, in particular, the price, the lot, the delivery date or other terms are determined principally by reference to regularly published prices, standard lots or standard delivery dates.*

*[...]*

*3. For the purposes of Section C(10) of Annex I to Directive 2004/39/EC, a derivative contract relating to an underlying referred to in that Section or in Article 39 shall be considered to have the characteristics of other derivative financial instruments if one of the following conditions is satisfied:*

*(a) that contract is settled in cash or may be settled in cash at the option of one or more of the parties, otherwise than by reason of a default or other termination event;*

*(b) that contract is traded on a regulated market or an MTF;*

*(c) the conditions laid down in paragraph 1 are satisfied in relation to that contract.*

**Article 39, Regulation (EC) No 1287/2006**  
**Derivatives within Section C(10) of Annex I to Directive 2004/39/EC**

*In addition to derivative contracts of a kind referred to in Section C(10) of Annex I to Directive 2004/39/EC, a derivative contract relating to any of the following shall fall within that Section if it meets the criteria set out in that Section and in Article 38(3):*

*(a) telecommunications bandwidth;*

*(b) commodity storage capacity;*

*(c) transmission or transportation capacity relating to commodities, whether cable, pipeline or other means;*

*(d) an allowance, credit, permit, right or similar asset which is directly linked to the supply, distribution or consumption of energy derived from renewable resources;*

*(e) a geological, environmental or other physical variable;*

*(f) any other asset or right of a fungible nature, other than a right to receive a service, that is capable of being transferred;*

*(g) an index or measure related to the price or value of, or volume of transactions in any asset, right, service or obligation.*

48. Based on feedback from market participants and regulators the existing MiFID I Level 2 provisions have for the most part worked well in practice. Therefore ESMA considers that the existing parameters in Article 38(3) of Regulation (EC) No 1287/2006 should be kept and updated as necessary.
49. As explained for Section C 7 of Annex I of MiFID II the existence of clearing arrangements will no longer be considered as an indicator for determining whether an instrument is a financial instrument due to the circularity this creates with EMIR and to the change in the MiFID I text described above where the reference to clearing arrangements has been deleted.
50. This would mean cash settlement or the option to settle a contract in cash (Article 38(3) Letter a) shall remain a condition for classifying the instruments in Section C 10 as having the characteristics of other derivative financial instruments.
51. The condition of trading the contract on a regulated market or MTF in Article 38(3) Letter b would need to be supplemented by trading a contract on an OTF if the contract is within the scope of Section C 6 of Annex I of MiFID II.
52. The condition imposed by reference to the existing Article 38(1) in Article 38(3)(c) would be maintained in the new Delegated Act and automatically be updated due to the changes to the former provision as described in the previous section.



53. ESMA considers the list of additional derivative contracts in Article 39 of Regulation (EC) No 1287/2006, to be close to comprehensive and proposes to maintain it.
54. ESMA is however considering one addition to the list which is in relation to derivative contracts relating to actuarial statistics.

### **Draft technical advice**

*Draft advice on specifying derivative contracts mentioned in Section C 10 of Annex I that have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are traded on a regulated market, OTF, or an MTF*

11. Derivative contracts relating to an underlying in Section C 10 of Annex I should be classified as having the characteristics of other derivative financial instruments if they fulfil one of the following conditions:
  - i. they are settled in cash or may be settled in cash at the option of one or more of the parties to the contract, other than by reason of default or other termination event;
  - ii. they are traded on:
    - a. a regulated market;
    - b. an MTF; or
    - c. an OTF if the contract is within the scope of Section C 6 of Annex I;
  - iii. they fulfil the conditions imposed for derivative contracts under Section C 7.
12. Derivative contracts relating to the following underlyings should also be considered as derivative contracts within the scope of Section C 10 of Annex 1 if they meet the criteria established in that Section and those established in the paragraph above.
  - i. telecommunications bandwidth;
  - ii. commodity storage capacity;
  - iii. transmission or transportation capacity relating to commodities, whether cable, pipeline or other means;
  - iv. an allowance, credit, permit, right or similar asset which is directly linked to the supply, distribution or consumption of energy derived from renewable resources;
  - v. a geological, environmental or other physical variable;
  - vi. any other asset or right of a fungible nature, other than a right to receive a service, that is capable of being transferred;
  - vii. an index or measure related to the price or value of, or volume of transactions in any asset, right,



service or obligation; and

viii. actuarial statistics.

- Q225.** Do you agree that the existing provision in Article 38(3) of Regulation (EC) No 1287/2006 for determining whether derivative contracts within the scope of Section C(10) of Annex I should be classified as financial instruments should be updated as necessary but overall be maintained? If not, which elements in your view require amendments?
- Q226.** Do you agree that the list of contracts in Article 39 of Regulation (EC) No 1287/2006 should be maintained? If not, which type of contracts should be added or which ones should be deleted?
- Q227.** What is your view with regard to adding as an additional type of derivative contract those relating to actuarial statistics?
- Q228.** What do you understand by the terms “reason of default or other termination event” and how does this differ from “except in the case of force majeure, default or other bona fide inability to perform”?



## 7.2. Position reporting thresholds

### Background/Mandate

#### Extract from the Commission's request for advice (mandate)

*ESMA is invited to provide technical advice on the thresholds referred to in respect both the number of persons and their open positions which if exceeded means that the last subparagraph of paragraph 1 of Article 58 does not apply.*

#### Article 58, MiFID II

1. *Member States shall ensure that an investment firm or a market operator operating a trading venue which trades commodity derivatives or emission allowances or derivatives thereof:*
  - (a) *make public a weekly report with the aggregate positions held by the different categories of persons for the different commodity derivatives or emission allowances or derivatives thereof traded on their trading venue, specifying the number of long and short positions by such categories, changes thereto since the previous report, the percentage of the total open interest represented by each category and the number of persons holding a position in each category in accordance with paragraph 4 and communicate that report to the competent authority and to ESMA; ESMA shall proceed to a centralised publication of the information included in those reports;*

[...]

*The obligation laid down in point (a) shall only apply when both the number of persons and their open positions exceed minimum thresholds.*

[...]

6. *The Commission shall be empowered to adopt delegated acts in accordance with Article 89 to specify the thresholds referred to in the second subparagraph of paragraph 1 of this Article, having regard to the total number of open positions and their size and the total number of persons holding a position.*

### Analysis

1. Article 58(6) of MiFID II requires ESMA to advise the Commission on the minimum thresholds that are referred to in Article 58(1). These thresholds are the levels above which the aggregate Commitment of Trader Reports that have been prepared by trading venues and also collected by ESMA will be published.
2. In determining the appropriate thresholds for publication, the Commission will have regard to:
  - i. the total number of persons that hold a position in the relevant instrument; and
  - ii. the total size of their open positions.



3. The second subparagraph of Article 58(1) of MiFID II sets out that the Commitment of Trader Report under Article 58(1)(a) of MiFID II should only be published when both the thresholds above are exceeded.
4. It is essential that an appropriate balance is struck between the two competing objectives of providing transparency to market stakeholders, and ensuring the prevention of market abuse and preservation of confidentiality by not disclosing details of position holders to the extent that they may be identifiable. It is also essential for the arrangements to be efficient and effective to generate timely and meaningful reports.
5. For the avoidance of doubt, the thresholds only apply to the publication of Commitment of Traders Report. The reporting of positions in commodity derivatives, emission allowances, and derivatives of emission allowance must continue to be made, regardless of whether reports are subsequently published or not.

#### *Position Holders*

6. ESMA proposes that the number of position holders across all five categories of persons is set at a total of 30. This figure aims to set a balance between setting the threshold too low which might undermine market integrity if the persons holding individual positions could be identified and setting the threshold too high which might reduce transparency to the market.
7. In proposing this number of position-holders, ESMA has had regard to the position reporting regimes that are established in other jurisdictions. ESMA notes that where jurisdictions have determined the number of position-holders to be at a lower level than 30, there are fewer categories into which the position-holders are placed. ESMA therefore considers that the level proposed for the Article 58 of MiFID II regime strikes a comparable balance between transparency and confidentiality when taken across all categories.

#### *Size of Open Positions*

8. ESMA proposes that publication of Commitment of Traders reports takes place when the absolute value of the gross long or short volume of total open interest, expressed in the number of lots of the relevant commodity derivative, exceeds a level of four times the deliverable supply in the same commodity derivative. This threshold would apply to the contract as a whole, covering both spot and forward months.
9. ESMA believes that this measure, made in relation to deliverable supply, offers market participants transparency and certainty. The multiple selected is intended to be effective in providing transparency of commodity derivatives where there is significant trading interest and indication that the volume of trading exceeds that necessary to provide sufficient liquidity to support participants that ultimately require physical delivery or engage in trading for commercial risk management purposes,
10. The calculation for the option positions will be expressed on a delta-equivalent basis converted to a future on the same commodity derivative. For simplicity, ESMA proposes the trading venues' publicly published delta calculation values should be applied to all option positions. If a trading venues' delta calculation values are not publicly published then a standard delta of 0.5 should be applied to all option positions.



11. Therefore, a Commitment of Trader Report would only need to be published under Article 58(1)(a) of MiFID II, for a commodity derivative, emission allowance, or a derivatives thereof traded on a trading venue, when: a) 30 or more persons hold a position in that commodity derivative and b) when the value of the gross long or short volume of total open interest of their positions for that commodity derivative exceeds four times the deliverable supply in that commodity derivative.

#### *Application of Reporting Thresholds*

12. ESMA proposes that positions should be reported for a period of three months after a contract exceeds both the thresholds for the number of position holders and the value of open contracts. In the event of a contract not exceeding the threshold during the period, the requirement to report positions for that contract should cease.
13. ESMA considers that such an approach would be preferable to contracts being reported on a sporadic basis in the event of such contracts intermittently exceeding both thresholds.
14. Such an approach means that the number of position holders may, from time to time, fall beneath the reporting threshold of 30 persons. Therefore, ESMA proposes that in such cases, in order to reduce the confidentiality risks to such position holders, and in a similar manner to existing position reporting regimes, that where there are 4 or fewer position holders active in a given category, the number of position holders in that category is not reported, but that the position holders in the other categories are.





## Draft technical advice

1. The obligation for a trading venue to make public a weekly position report for commodity derivatives or emission allowances or derivatives thereof will apply when the following two thresholds must be met:
  - i. 30 open position holders are active in a given contract on a given trading venue; and
  - ii. the absolute value of the gross long or short volume of total open interest, expressed in the number of lots of the relevant commodity derivative, exceeds a level of four times the deliverable supply in the same commodity derivative.
2. These thresholds are cumulative and both must be met before the obligation to make public a report applies. The thresholds shall apply separately to each commodity derivative that is listed on a trading venue.
3. The 30 position holders threshold shall apply in aggregate across all of the categories and there does not have to be a minimum number of position holders in any single category.
4. However, where there are four or fewer position holders active in a given category, the number of position holders in that category shall not be reported
5. Where the thresholds above are triggered for the first time, that trade venue shall seek to publish its first weekly report as soon as it is feasibly practical, but in any event no later than 3 weeks from the date on which the thresholds are first triggered.
6. Where the thresholds are no longer being met, that trading venue shall continue to publish the weekly report for a period of three calendar months after which, if the thresholds have not been met during the period, publication of the report for that contract may cease.

**Q229.** Do you agree with the proposed threshold for the number of position holders? If not, please state your preferred thresholds and the reason why.

**Q230.** Do you agree with the proposed minimum threshold level for the open interest criteria for the publication of reports? If not, please state your preferred alternative for the definition of this threshold and explain the reasons why this would be more appropriate.

**Q231.** Do you agree with the proposed timeframes for publication once activity on a trading venue either reaches or no longer reaches the two thresholds?



### 7.3. Position management powers of ESMA

#### Background/Mandate

##### **Extract from the Commission's request for advice (mandate):**

*ESMA is invited to provide technical advice on:*

- *the existence of a threat to the orderly functioning and integrity of financial markets, including commodity derivative markets in accordance with the objectives listed in Article 57(1) of Directive .../.../EU\* and including in relation to delivery arrangements for physical commodities, or to the stability of the whole or part of the financial system in the Union as referred to in Article 45 paragraph 2(a) taking account of the degree to which positions are used to hedge positions in physical commodities or commodity contracts and the degree to which prices in underlying markets are set by reference to the prices of commodity derivatives;*
- *the appropriate reduction of a position or exposure entered into via a derivative referred to in Article 45 paragraph 1(b);*
- *the situations where a risk of regulatory arbitrage as referred to in Article 45 paragraph 3(b) could arise.*

*Those criteria and factors shall take into account the regulatory technical standards referred to in Article 57(3) of the Directive and shall differentiate between situations where ESMA takes action because a competent authority has failed to act and those where ESMA addresses an additional risk which the competent authority is not able to sufficiently address pursuant to Article 69(2)(j) or (o) of the Directive.*

#### **Article 45(10), MiFIR**

*The Commission shall adopt in accordance with Article 50 delegated acts to specify criteria and factors to determine:*

- (a) the existence of a threat to the orderly functioning and integrity of financial markets, including commodity derivative markets in accordance with the objectives listed in Article 57(1) of Directive .../.../EU\* and including in relation to delivery arrangements for physical commodities, or to the stability of the whole or part of the financial system in the Union as referred to in paragraph 2(a) taking account of the degree to which positions are used to hedge positions in physical commodities or commodity contracts and the degree to which prices in underlying markets are set by reference to the prices of commodity derivatives;*
- (b) the appropriate reduction of a position or exposure entered into via a derivative referred to in paragraph 1(b) of this Article;*
- (c) the situations where a risk of regulatory arbitrage as referred to in paragraph 3(b) of this Article could arise.*

*Those criteria and factors shall take into account the regulatory technical standards referred to in Article 57(3) of Directive .../.../EU and shall differentiate between situations where ESMA takes action because a competent authority has failed to act and those where ESMA addresses an additional risk which*



*the competent authority is not able to sufficiently address pursuant to Article 69(2)(j) or (o) of Directive .../.../EU.*

1. One of the stated aims of MiFID II is to implement the 2009 G20 commitment to improve the regulation, functioning and transparency of financial and commodity markets to address excessive commodity price volatility (Recital 125, MiFID II). In November 2009, the G20 also endorsed IOSCO's *Principles for the Regulation and Supervision of Commodity Derivatives Markets* and called for market regulators to have formal position management powers.
2. For the first time, mandatory position limits and position reporting will be introduced across the EU and NCAs, who will supervise the adherence to these position limits, will be granted a minimum set of powers in relation to: requiring information on commodity derivative positions; requesting a person to reduce the size of a position and having the ability to limit a person from entering into a commodity derivative.
3. Under Article 45 of MiFIR, ESMA is granted comparable position management powers to NCAs and Article 45(1) specifies that ESMA, in specific circumstances and subject to certain conditions, has the power to:
  - i. request relevant information from any person on their derivative positions;
  - ii. require the reduction or elimination of those positions; and
  - iii. as a last resort, limit the ability of a person from entering into a commodity derivative.
4. ESMA's position management powers are to be used in exceptional circumstances and only where there exists both an emergency situation and a failure or inability of a NCA to take appropriate action. Article 45(2) of MiFIR sets out that ESMA will only be able to exercise these powers if they:
  - i. *“address a threat to the orderly functioning and integrity of financial markets, including commodity derivative markets in accordance with the objectives listed in Article 57(1) of Directive .../.../EU and including in relation to delivery arrangements for physical commodities, or to the stability of the whole or part of the financial system in the Union; [and]*
  - ii. *a competent authority or competent authorities have not taken measures to address the threat or the measures taken do not sufficiently address the threat.”*
5. Article 45(10) of MiFIR envisages that the Commission will adopt delegated acts further specifying the criteria and factors which must be taken into account when determining whether it is appropriate for ESMA to use its position management powers. ESMA has been asked for technical advice by the Commission on those criteria and factors and has therefore established some initial views on which it seeks feedback.

## **Analysis**

6. The requirements under Articles 45(10)(a), 45(10)(b) and 45(10)(c) of MiFIR (see above) and the requirement that ESMA considers how to differentiate between situations where ESMA takes action because an NCA has failed to act and those where ESMA addresses an additional risk which the NCA is not able to sufficiently address, are discussed in sequence below. In further analysing such circumstances, it is important to note the following points in relation to ESMA's use of these powers:



- i. ESMA's powers to request information and to require the reduction or elimination of a position are not restricted to commodities derivatives and the definition of an emergency situation is not restricted to factors directly connected with commodities; and
- ii. the "threat" in the context of derivatives markets to the stability of the financial system in the EU or to the orderly functioning and integrity of the market (financial and commodities) is not necessarily caused by the activity in those derivatives markets.

*45(10)(a) of MiFIR threat to the orderly functioning and integrity of financial markets, including commodity derivatives markets in accordance with the objectives listed in article 57(1) of MiFID II and including in relation to delivery arrangements for physical commodities, or to the stability of the whole or part of the financial system in the Union...*

7. In addressing this requirement, ESMA notes that it is granted powers to act in exceptional circumstances elsewhere in EU legislation which require consideration of factors that are very similar to, or mirror, those under Article 45(10) MiFIR. Under Article 40 of MiFIR, ESMA may temporarily prohibit or restrict in the EU the marketing, distribution or sale of certain financial instruments or a type of financial activity or practice when there is a significant investor protection concern or "*threat to the orderly functioning and integrity of financial markets or commodity markets and to the stability of the whole or part of the financial system in the Union*".
8. Article 24(1) and (3) of the Short Selling Regulation (No 918/2012 of 5 July 2012) already makes reference to various scenarios which may constitute "*a threat to the orderly functioning and integrity of financial markets or to the stability of the whole or part of the financial system in the Union*". These are, in summary:
  - i. serious financial, monetary or budgetary problems which may lead to financial instability concerning a Member State or a bank and other financial institutions deemed important to the global financial system;
  - ii. a rating action or a default by any Member State or banks and other financial institutions deemed important to the global financial system;
  - iii. substantial selling pressures or unusual volatility causing significant downward spirals in any financial instrument related to any banks and other financial institutions deemed important to the global financial system;
  - iv. any relevant damage to the physical structures of financial institutions from a natural disaster or terrorist attack; and
  - v. any relevant disruption in any payment system or settlement process, in particular when it is related to interbank operations.
9. ESMA's preliminary view is that the factors and criteria set out in the Short Selling Regulation, presented in points (i.) to (v) above, are relevant criteria for determining the existence of a threat to the stability of the (whole or part of the) financial system in the EU. There may, however, be other factors to consider. ESMA also believes that these circumstances may be of different relevance for the financial and commodities derivatives.

10. ESMA believes the orderly functioning and integrity of financial, commodity derivatives and physical markets are endangered whenever such markets are no longer able to efficiently fulfil their economic function. The function of the markets can be defined as:
  - i. allowing for an efficient and fair method of price discovery through the matching of supply and demand;
  - ii. providing a mechanism for physical delivery of a given commodity (where relevant) or financial underlying;
  - iii. providing (commercial) participants with the ability to hedge physical commodity market exposure / exposure on the spot market; and
  - iv. allowing for a common inter-linkage and convergence between physical and financial commodity markets or the derivatives and spot financial markets.
11. ESMA has primarily identified the following factors and criteria to determine the existence of a threat to the orderly functioning and integrity of financial markets or commodity markets:
  - i. disruption to the supply of a commodity, leading to a significant reduction of deliverable supply (through, for example, a production outage);
  - ii. significant and abrupt rise in the demand of a commodity;
  - iii. a significant position in a certain commodity held by one person, or persons acting in concert, in one or several trading venues, through one or several market members; and
  - iv. *de facto* inability by a trading venue to exercise its own position management powers because a business continuity event prevents it from carrying on business in the normal way.
12. In weighting the factors mentioned above, particular attention will be given to the extent to which there is a necessity for third parties to obtain that commodity (e.g. some agricultural commodities).
13. The objectives of setting position limits, enumerated under Article 57(1) of MiFID II, are to prevent market abuse and to support orderly pricing and settlement conditions, including preventing market distorting positions and ensuring convergence between prices of derivatives in the delivery month and spot prices for the underlying commodity. ESMA considers that the above factors and criteria for commodity derivatives markets are also appropriate indicators in relation to when these objectives for commodity derivatives markets are under threat.
14. When considering the existence of a threat to the integrity and functioning of financial markets, commodity derivatives markets and delivery arrangements for physical markets, ESMA must also take account of “*the degree to which positions are used to hedge positions in physical commodities or commodity contracts and the degree to which prices in underlying markets are set by reference to the prices of commodity derivatives.*” ESMA is of the view that this consideration is sufficiently taken into account in the above factors where its definition of a functioning market explicitly covers “*providing (commercial) participants with the ability to hedge physical commodity market exposure / exposure on the spot market*”.

## Draft technical advice

1. In describing those scenarios which may constitute “a threat to the orderly functioning and integrity of financial markets or to the stability of the whole or part of the financial system in the Union”, the scenarios under Article 24(1) and (3) of the Short Selling Regulation (No 918/2012 of 5 July 2012) should be taken into account and alignment between the two pieces of legislation effected to the extent possible. The following factors and criteria set out in the Short Selling Regulation are relevant criteria for determining the existence of a threat to the stability of the (whole or part of the) financial system in the Union.
  - i. serious financial, monetary or budgetary problems which may lead to financial instability concerning a Member State or a bank and other financial institutions deemed important to the global financial system;
  - ii. a rating action or a default by any Member State or banks and other financial institutions deemed important to the global financial system;
  - iii. substantial selling pressures or unusual volatility causing significant downward spirals in any financial instrument related to any banks and other financial institutions deemed important to the global financial system;
  - iv. any relevant damage to the physical structures of financial institutions from a natural disaster or terrorist attack; and
  - v. any relevant disruption in any payment system or settlement process, in particular when it is related to interbank operations.
2. The above list of circumstances is not exhaustive and may be of different relevance for the financial and commodities derivatives markets. Therefore, in addition to the above circumstances enumerated under the Short Selling Regulation, the following factors and criteria should also be considered as relevant in determining the existence of a threat to the orderly functioning and integrity of financial markets and commodity derivative markets:
  - i. disruption to the supply of a commodity, leading to a significant reduction of deliverable supply (through, for example, a production outage);
  - ii. significant and abrupt rise in the demand of a commodity;
  - iii. a significant position in a certain commodity held by one person, or persons acting in concert, in one or several trading venues, through one or several market members; and
  - iv. de facto inability by a trading venue to exercise its own position management powers because a business continuity event prevents it from carrying on business in the normal way.



- Q232. Do you agree that the listed factors and criteria allow ESMA to determine the existence of a threat to the stability of the (whole or part of the) financial system in the EU?**
- Q233. What other factors and criteria should be taken into account?**
- Q234. Do you agree with ESMA’s definition of a market fulfilling its economic function?**
- Q235. Do you agree that the listed factors and criteria allow ESMA to adequately determine the existence of a threat to the orderly functioning and integrity of financial markets or commodity derivative market so as to justify position management intervention by ESMA?**
- Q236. What other factors and criteria should be taken into account?**
- Q237. Do you consider that the above factors sufficiently take account of “the degree to which positions are used to hedge positions in physical commodities or commodity contracts and the degree to which prices in underlying markets are set by reference to the prices of commodity derivatives”? If not, what further factors would you propose?**

*45(10)(b) of MiFIR: Appropriate reduction of a position or exposure*

15. ESMA, under Article 45(10)(b) of MiFIR and for the purpose of adoption of delegated acts, has been mandated by the Commission to provide advice specifying the criteria and factors to determine the appropriate reduction of a position or exposure entered into via a derivative.
16. After analysing the necessary information regarding the size and purpose of a derivatives position, ESMA may require the “*appropriate reduction of a position or exposure*” entered into via a derivative. Exactly what “*appropriate*” is may differ according to the particulars of each case, but, the type and size of the market participant that holds the position, and the related commodity market in which this is held, will be taken into account.
17. Further, Article 45(3) of MiFIR specifies that ESMA may only require a person to reduce the size or to eliminate their position or exposure if:
  - i. it does address the threat to the stability of the financial system in the EU or to the orderly functioning and integrity of markets;
  - ii. it does not create regulatory arbitrage; and
  - iii. it does not detrimentally impact markets by reducing liquidity, creating uncertainty or being disproportionate.
18. ESMA considers that “appropriate” action may differ on a case by case basis and has identified the following factors and criteria that could be relevant:
  - i. Nature of the holder of the position (e.g. producer, consumer, financial institution, etc.);

- ii. Size of the position vis-a-vis the size of the market in the relevant derivatives;
  - iii. Size of the position vis-a-vis the market in the physical market, e.g. deliverable supply;
  - iv. The direction of the position (short/long);
  - v. The purpose of the position (hedging or financial exposure);
  - vi. The experience of a position holder in holding positions of a given size, and, if applicable, of making/taking delivery of a given commodity;
  - vii. Other positions held by the position-holder in the underlying market (related physical positions) or in different maturities of the same derivative; and
  - viii. Method of delivery.
19. In weighting the factors mentioned above, particular attention will be given to the extent to which there is a necessity for third parties to obtain that commodity (e.g. some agricultural commodities).

#### **Draft technical advice**

3. In relation to ESMA requiring “*the appropriate reduction of a position or exposure entered into via a derivative*”, “appropriate” action may differ on a case by case basis. The following factors and criteria are relevant indicators when determining what is “*appropriate*”:
- i. nature of the holder of the position (e.g. producer, consumer, financial institution, etc.);
  - ii. size of the position vis-a-vis the size of the market in the relevant derivatives;
  - iii. size of the position vis-a-vis the market in the physical market, e.g. deliverable supply;
  - iv. the direction of the position (short/long)
  - v. the purpose of the position (hedging or financial exposure);
  - vi. the experience of a position holder in holding positions of a given size, and, if applicable, of making/taking delivery of a given commodity;
  - vii. other positions held by the position-holder in the underlying market (related physical positions) or in different maturities of the same derivative; and
  - viii. method of delivery.

**Q238. Do you agree that the listed factors and criteria allow ESMA to determine the appropriate reduction of a position or exposure entered into via a derivative?**

**Q239. What other factors and criteria should be taken into account?**





**Q240. Do you agree that some factors are more important than others in determining what an “appropriate reduction of a position” is within a given market? If yes, which are the most important factors for ESMA to consider?**

*45(10)(c) of MiFIR: Situations where risk of regulatory arbitrage could arise*

20. ESMA, under MiFIR Article 45(10)(c) and for the purpose of adoption of delegated acts, has been mandated by the Commission to provide advice specifying the criteria and factors to determine the situations where a risk of regulatory arbitrage could arise.
21. ESMA must ensure that any measure taken does not create a risk of regulatory arbitrage. Such arbitrage typically arises in uneven playing fields, i.e., where different rules apply to participants in essentially the same or substantially similar cases.
22. ESMA’s preliminary view is that regulatory arbitrage could arise from:
  - i. applying restrictions in relation to some derivatives and not correlated ones, i.e., inconsistent approaches to interrelated markets; or
  - ii. applying restrictions with the result that certain participants face limitations on their activity and other similar participants do not.
23. Therefore, in order to determine the situations where a risk of regulatory arbitrage could arise ESMA has identified the following preliminary criteria and factors:
  - i. Whether the same contract is traded in a different venue, as a result of fragmentation of liquidity across different trading venues, or OTC;
  - ii. Whether a substantially equivalent contract is traded on a different venue or OTC (similar and interrelated, but not considered part of the same fungible open interest);
  - iii. The effects of the decision on the market of the underlyings;
  - iv. The effects of the decision on markets and participants not subject to ESMA’s position management powers: and
  - v. Likely impact on the orderly functioning and integrity of the markets if no decision were taken (do-nothing-scenario).

**Draft technical advice**

4. The following criteria and factors are relevant when determining the situations where a risk of regulatory arbitrage could arise:
  - i. whether the same contract is traded in a different venue, as a result of fragmentation of liquidity across different trading venues, or OTC;
  - ii. whether a substantially equivalent contract is traded on a different venue or OTC (similar and in-

terrelated, but not considered part of the same fungible open interest);

- iii. the effects of the decision on the market of the underlyings;
- iv. the effects of the decision on markets and participants not subject to ESMA's position management powers; and
- v. likely impact on the orderly functioning and integrity of the markets if no decision were taken (do-nothing-scenario).

**Q241. Do you agree that the listed factors and criteria allow ESMA to adequately determine the situations where a risk of regulatory arbitrage could arise from the exercise of position management powers by ESMA?**

**Q242. What other criteria and factors should be taken into account?**

**Q243. If regulatory arbitrage may arise from inconsistent approaches to interrelated markets, what is the best way of identifying such links and correlations?**

*Differentiate between situations where ESMA takes action because an NCA has failed to act and those where ESMA addresses an additional risk which the NCA is not able to sufficiently address pursuant to Article 69(2)(j) or (o) of MiFID II*

- 24. ESMA, under Article 45(10) of MiFIR and for the purpose of adoption of delegated acts, has been mandated by the Commission to provide advice specifying how ESMA would differentiate between those situations where ESMA takes action because an NCA has failed to act and those where ESMA addresses an additional risk which the NCA is not able to sufficiently address pursuant to Article 69(2)(j) or (o).
- 25. ESMA considers that it will principally distinguish between situations caused by a NCA's failure to act as opposed to its inability to sufficiently address a threat through an analysis of the powers available to the NCA. If the NCA has at its disposal sufficient regulatory powers to address fully the threat at that time, without further reference to another NCA, but does not take such action ESMA will consider this to be a strong indicator that the NCA has failed to act.
- 26. The key differences between the scope of the position management powers under MiFID II for ESMA and the NCAs are:
  - i. ESMA can request from any person information regarding the size and purpose of a position and exposure in a derivative under Article 45(1)(a) of MiFIR whereas an NCA can require or demand such information but only in relation to a commodity derivative under Article 69(2)(j). However, ESMA notes that in the transposition of the MiFID II Directive, Member States may decide to extend the power of NCAs to request information on an exposure to all derivatives, in which case this difference in scope will not always apply.
  - ii. NCAs will be limited to exercising their powers to persons operating within their Member State whereas ESMA will have the ability to use its powers across the whole of the EU.



27. Given these differences, in practice, ESMA believes that an NCA may be unable to address fully a threat where one or more of the factors listed pursuant to Article 45(1)(a) of MiFID II occur in one or more other jurisdictions as well as in its own jurisdiction.
28. In such a case, ESMA intervention will be a more complimentary action whereas ESMA intervention due to an NCA's failure to act implies an overriding of an NCA.

**Draft technical advice**

5. Situations caused by an NCA's failure to act as opposed to its inability to sufficiently address a threat should be distinguished principally by analysis of the powers available to the NCAs. If the NCA has at its disposal sufficient regulatory powers to address fully the threat at that time, without further reference to another NCA, but does not take such action this will be considered a strong indicator that the NCA has failed to act. Where one or more of the factors listed pursuant to Article 45(1)(a) occur in one or more other jurisdictions as well as in its own jurisdiction, it should be considered that an NCA may be unable to address fully a threat rather than has failed to address the threat.



## 8. Portfolio compression

### Background/Mandate

1. MiFIR defines portfolio compression, and rules that should apply to the investment firms when providing compression.
2. The Commission is required to specify through delegated acts the elements of portfolio compression and the information to be published.
3. In order to prepare for this delegated act, the Commission has requested ESMA to provide it with a technical advice. ESMA has built on the work performed when developing the EMIR technical standards on portfolio compression in the scope of EMIR order for the purpose of preparing this consultation.

### Extract from the Commission's request for advice (mandate)

*ESMA is invited to provide technical advice on the elements of portfolio compression and the information to be published pursuant to paragraph 2 of Article 31 of this Regulation, in such a way as to make use as far as possible of any existing record keeping, reporting or publication requirements (Article 31 par. 4 of the Regulation).*

*For this purpose, ESMA is first invited to provide technical advice specifying further the criteria of the definition of portfolio compression set out in Article 2(1)(47), including further specifications for the process whereby derivatives are wholly or partially terminated and replaced by a new derivative in particular the steps of the process, the legal documentation as well as the economic outcome of the process.*

*ESMA is also invited to provide technical advice on the further the measurements for determining that, following portfolio compression, the combined notional value is less than the combined notional value of the terminated derivatives.*

*Finally, ESMA is invited to provide technical advice on the appropriate scope of the publication requirement pursuant to Article(2)as well as time limits within which publication shall be made by applying the time limits specified in Article 10. In its advice, ESMA should consider the need to make use as far as possible of any existing record keeping, reporting or publication requirements.*

### Article 31, MiFIR

1. *When providing portfolio compression, investment firms shall not be subject to the best execution obligation in article 27 of Directive.../.../EU, the transparency obligations in articles8, 10, 18 and 21 of this Regulation and the obligation in Article 1(6) of Directive .../.../EU. The termination or replacement of the component derivatives in the portfolio compression shall not be subject to Article 28 of this Regulation.*
2. *Investment firms and market operators providing portfolio compression shall make public through an APA the volumes of transactions subject to portfolio compressions and the time they were concluded within the time limits specified in Article 10.*

3. *Investment firms and market operators providing portfolio compressions shall keep complete and accurate records of all portfolio compressions which it organises or participates in. These records shall be made available promptly to the relevant competent authority or ESMA upon request.*
4. *The Commission may adopt, by means of delegated acts in accordance with Article 51, measures specifying the following:*
  - (a) *the elements of portfolio compression.*
  - (b) *the information to be published pursuant to paragraph 3,*

*In such a way as to make use as far as possible of any existing record keeping, reporting or publication requirements.*

### **Analysis**

4. The delegated Act required from the Commission specifies 1) the elements of portfolio compression and 2) the information to be published by the investment firms and market operators providing compression regarding the volumes of transactions subject to portfolio compression and the time when the transactions were concluded.

#### *Elements of portfolio compression*

5. Elements of portfolio compression to be developed will need to take into consideration the fact that portfolio compression can be performed on a bilateral or on a multilateral basis. These elements should include criteria for portfolio compression and the legal documentation of compression.

#### Legal documentation

6. Compression will result in some derivative transactions to be reduced or terminated and replaced by other transactions with a reduced notional value. It means that the relationship between the counterparties to the transactions for bilateral compression and between the participant to compression and its service provider for multilateral compression should provide for compression and its legal effects.
7. The relevant legal documentation shall therefore be in place between the parties for bilateral compression and between the participant to compression services and the service provider for multilateral compression in order to ensure, at the minimum, that the compression exercise will allow to amend or terminate the compressed transaction and to replace them by the transactions resulting from the compression exercise.

#### Criteria for compression

8. Compression allows counterparties to reduce the notional value of their derivative portfolio. In order to achieve this reduction, the risk management framework of the counterparties should be respected. It is therefore important that the service provider allows the participant to apply the criteria set in its risk management framework when performing compression.
9. For this purpose, before the compression exercise is initiated, for each compression exercise, the investment firm and market operator providing portfolio compression should allow the participant to provide criteria including at least a limit to counterparty risk, a limit to market risk, a cash payment

tolerance as well as updates to the mark-to market value of the transaction, unless a formulae allowing the investment firm to update it has been agreed upon.

10. For bilateral compression, counterparties should exchange their respective criteria when they analyse the interest of compression and at the latest before starting the compression exercise.
11. When the investment firm and market operator providing portfolio compression has established links between transactions submitted for compression, it should provide to the participant a rehearsal unwind proposal that includes at the minimum the identification of the counterparties, the mark-to-market value of the transaction proposed by the counterparties, the valuation of the counterparty risk, the valuation of the market risk, the variation compared with the cash payment tolerance. This rehearsal unwind proposal would allow the participant to have a view on the outcome of the compression exercise and to adapt some criteria in order to maximise the efficiency of the compression exercise within the respect of its risk framework.
12. In case of bilateral compression, counterparties should exchange simulation of the compression outcome so that each counterparty can ensure that its risk framework would be complied with.
13. It is proposed that the investment firm and market operator which provide portfolio compression would give at least one business day to the participant to add transactions that would increase the pool of trades eligible for termination, to adjust the limit to the counterparty risk, to market risk, the cash payment tolerance, and update the mark-to-market value of the selected transactions, to obtain an updated rehearsal unwind considering such adjustments. This framework would aim at maximising the efficiency of the compression exercise.
14. For bilateral transactions, counterparties should be able to also add transactions or perform adjustments in order to maximise the volume of transactions for compression and comply with their risk policy.
15. Finally, in order to finalise the compression exercise, the investment firm and market operator should provide a final unwind proposal for the acceptance of each participant on the day following the deadline to close the updated rehearsal unwind proposal. Participants would then have a short given timeframe in order to accept the final proposed unwind and finalise the compression exercise.
16. The Timeframe applicable to bilateral compression could be shorter as the exercise is expected to be less complex than when multiple counterparties are involved.

**Q244. What are your views on the proposed approach for legal documentation and portfolio compression criteria?**

*Information to be published*

17. Investment firms and market operators that are providing portfolio compression services are required to publish the volumes of transactions subject to portfolio compression and the times they were concluded within the time limit specified in MIFIR i.e. for the purpose of post-trade transparency “market operators and investment firms operating a trading venue shall make details of all such transactions public as close to real-time as is technically possible”.
18. Regarding the volume, it can be expressed in number of transactions and in value. Given that the information is provided by the firm providing portfolio compression and that it aims at decreasing the

notional amount of derivatives, it is proposed that value be expressed in notional amount. Indeed although the marked-to-market value would be relevant, it differs with time and depending on counterparties and may therefore not be considered an appropriate measure of the volume for the purpose of post-trade transparency.

19. In view of the above, it is proposed to consider the value and number of transactions submitted for compression, of replacement transaction and of transactions reduced. Each time, the value and number would be provided per compression exercise, per product type, per type of participants and per currency.
20. The TA should also specify the time when transactions subject to portfolio compression were concluded within the time limits specified in Article 10 of MIFIR i.e. as close to real time as is technically possible. In this respect, several options are open to specify that time. Among open options, only those where the information related to timing is known by the firm providing portfolio compression should be retained as it is in charge of making that information public.
21. One option is to refer to the time when the compression proposal is accepted by all participants to the compression exercise. Another could be to refer to the time when the firm is confirming to all participants that the compression is finalised. That information is known by the firm providing portfolio compression as it is the one respectively receiving the acceptance and informing participants. It could be provided by reference to a compression exercise, per product type, per type of participants, per currency.
22. The time when transactions are reflected in the books of the participants cannot be used as a reference as it is not known by the firm providing the portfolio compression services and may depend on each participant.

**Q245. What are your views on the approach proposed by ESMA with regard to information to be published by the compression service provider related to the volume of transactions and the timing when they were concluded?**