MiFID II: Reform Framework Finalized, But Further Detail to Follow

By Natalie Kearney and Christiaan Smits

European policymakers have completed a major overhaul of the Markets in Financial Instruments Directive, a cornerstone of financial services regulation in the European Union. MiFID II, as the reform is known, includes a range of measures that will directly impact derivatives markets, including measures requiring open access to market infrastructure, a harmonized approach to third-country access, and new regulatory requirements for high-frequency trading.

When the European Commission launched its proposals to reform MiFID in October 2011, part of the reason was to implement some of the key principles of the reform program set out by the G20 leaders in response to the global financial crisis. Another reason was to carry out the scheduled post-implementation review of the original Directive—although it became clear that a number of problems not previously addressed would be tackled under the review.

Of primary concern were weaknesses in the legislative framework applicable to instruments other than equities, the need to provide better oversight and transparency in the commodity derivatives markets, the lack of end-user benefits that should have materialized under MiFID I, and the fragmentation of trade data due to the multiplicity of platforms created by MiFID I. The Commission also sought to address recent developments in the financial industry, such as the increased complexity of financial instruments and developments in technology.

Since the publication of the proposal in October 2011, it has taken until March 2014 to complete negotiations on the text with a view to publication in the EU's *Official Journal* in June this year. The European Parliament and Council are also required to adopt the agreed text formally; this will be done via a plenary vote in April 2014. Although the framework (known as 'Level 1') is now agreed, much work still remains to be done in order to finalize the details of specific provisions which will undergo a further process of consultation, drafting, scrutiny and subsequent publication (known as 'Level 2'). Despite this, a clear picture of the main pillars of the legislation has now emerged, the key elements of which are outlined in more detail below.

Non-Discriminatory Access to Trading and Clearing

Participant access and competition concerns have been recurrent themes in Europe, many of which were highlighted by the European Commission when it rejected the merger between Deutsche Börse and NYSE

Euronext in February 2012. In that context, EU Commissioner for Competition Joaquín Almunia stated, "There are major barriers to entry in these markets…due to the closed vertical silo…there is ample evidence that the opening of markets and an increase in competition has improved liquidity and has led to a drastic decrease in the cost of trading."

In line with this policy focus, the Commission proposed rules on open access to trading, clearing and index licenses as part of its MiFID II reform agenda. The proposed rules built on work started in MiFID I (which delivered open access for equities) and in the European Market Infrastructure Regulation (which delivers access to clearing and trading for OTC derivatives). MiFID II was designed to close the gap by covering all other financial instruments including exchange-traded derivatives.

Furthermore, the G20 commitments of September 2009 mandated clearing and trading of eligible OTC derivatives. In implementing this commitment, the Commission sought to encourage the diversification of risk across EU infrastructure in order to avoid activity gravitating towards the largest closed liquidity pools, which could lead to the enclosing of risks within silos. The Commission pointed out that open access provisions will reduce trading and post-trading costs, lower the barriers for entry and exit of new players, and support technical and product innovation coupled with investor choice.

The access provisions turned out to be one of the major political hurdles in the MiFID II negotiations. After lengthy discussions on the merits of granting such access, legislators decided to retain the open access provisions for trading venues and clearinghouses, albeit with a phased-in and transitional approach. Open access for cash instruments such as equities and bonds will commence in Q4 2016. Open access for exchange-traded derivatives will also commence in Q4 2016, but this could be extended to Q2 2019 if the Commission decides that a transitional period is required.

The non-discriminatory access regime will also apply to benchmarks for trading and clearing purposes, despite attempts to remove such provision on the basis of, amongst others, infringement of intellectual property rights. Currently, an index provider can link an index to a venue indefinitely, which it has been argued gives it a monopoly over access and pricing. Under the reforms, new benchmarks will have an obligation to license no later than two years after the financial instrument referencing that benchmark commenced trading or was admitted to trading.

Third Country Access

The questions around access of third country operators to EU markets are a recurring theme across numerous pieces of financial services legislation. With respect to the MiFID review, the proposed European Commission approach was one of the most hotly debated issues throughout negotiations, with the different institutions taking opposing stances. Until now, there has been no harmonized regime governing the access of third country firms to EU markets under MiFID I. Instead, Member States have been left discretion for such decisions subject only to the principle that they do not give third country firms more favorable treatment than European firms.

Industry concerns have focused on the pre-requisite of an equivalence decision and the danger that it may not be outcome-based. Any strict equivalence of rules has caused fears of protectionism, although clearly a harmonized EU regime would present a number of benefits including a simplified single point of access to EU markets.

To overcome the divergences between national regimes, the Commission suggested an approach based on the principle of exemptive relief for non-EU firms based in jurisdictions with equivalent regulatory regimes. The cornerstone of the proposed regime is an equivalence decision to be adopted by the Commission regarding a third country legislative framework as a condition for access to EU markets.

Following negotiations it was agreed to introduce some degree of flexibility although the ambition of a harmonized approach is still built into the legislation through equivalence assessments of third country jurisdictions by the Commission. These equivalence assessments are vital to third country firms as they are binding on all EU Member States.

The regime however will only apply to the cross-border provision of investment services and activities provided to professional and eligible counterparties. If the Commission reaches a positive equivalence assessment of the third country regime, firms will be able to provide services to such clients without a branch. However, until a positive equivalence assessment is reached, national regimes will continue to apply for a period of three years after entry into force of the Directive. This goes some way to removing concerns that access for third country firms would be restricted.

National systems will remain for the provision of services by third country firms to retail investors and allow Member States some discretion over how the regime will apply and regarding the option to require a branch.

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Market Structure: Introduction of the OTF

MiFID II also introduces a new multilateral trading venue, the Organized Trading Facility. This type of venue is similar to the swap execution facility structure created by Dodd-Frank in the U.S. and can be used for the trading of non-equity instruments such as interests in bonds, structured finance products, emissions allowances or derivatives. Brokers and banks that operate broker crossing networks will therefore need to be reclassified as multilateral trading facilities. The Commission views the creation of this new category as ensuring a level playing field with regulated markets and MTFs. Furthermore, the neutrality of OTF operators is borne out through restrictions on the use of owned capital, including matched principal trading, and on discretion in their execution policy.

MiFID also introduces a trading obligation for derivatives that are eligible for clearing under EMIR and are sufficiently liquid. This is designed to move trading in these instruments onto multilateral and well-regulated platforms, in line with the G20 commitments.

Expanded Regulation of Commodity Markets

Periods of volatility and high prices in the commodities markets in recent years have created political anxiety and have led to a search for solutions at an international level. An aspect of this has been the assessment of possible enhancements to the regulation of commodities and commodity derivative markets and of trading or speculative activity. At the Cannes G20 Summit in October 2011, leaders endorsed IOSCO's "Principles for the Regulation and Supervision of Commodities Derivatives Markets" published that September. These principles related to contract design principles, the surveillance of commodity derivatives markets, addressing disorderly markets, enforcement and information sharing, and enhancing price discovery on derivatives markets. Many of these principles are reflected in EU legislation, including now in MiFID II and EMIR.

EMIR mandates the reporting and central clearing of all commodity derivatives including both OTC and ETD. Reporting began on Feb. 12, 2014 for both OTC and ETD commodity derivatives, and mandatory clearing is likely to begin in Q1 2015. REMIT—the Regulation on wholesale Energy Market Integrity and Transparency, which came into force in December 2011—imposes reporting requirements on physical power and gas market participants with the aim of preventing and detecting market manipulation and bringing greater overall transparency to a previously 'dark' physical market. REMIT will also use the definitions of inside information in the Market Abuse Regulation to expand regulation of insider trading in the wholesale energy markets.

MiFID II also expands the range of commodity derivatives within scope of the rules. Currently, under MiFID I, only commodity derivatives that are traded on a regulated market or multilateral trading facility are within scope. Under MiFID II, the only commodity derivatives that are now exempted from the regulation are power and gas forward contracts covered by the REMIT regulation and traded on an OTF which must be physically settled. Two recitals have been added to the text further aiming to define the meaning of 'must be physically settled' and giving details of possible additional legislation to amend the scope of REMIT from 2018 onwards. MiFID II provides for a three-year transition period following its entry into force, where physically settled coal and oil derivatives will be exempt from clearing obligations, clearing threshold and margin requirements under EMIR to allow a transition for these physical products into a more regulated environment.

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The new MiFID regime also provides that those commodity derivatives traded on regulated markets, multilateral trading facilities and OTFs will be subject to position limits.

Under MiFID II, several tailored provisions for commodity derivatives trading have been amended. MiFID II aims to clarify what trading on one's own account means. The definitions of ancillary and market making have been expanded upon. Persons will be exempt from MiFID II if they are trading on their own account, but only if that business is an ancillary part of their business. Trading houses will not be exempt from MiFID II if they are trading for their own account as their main business. High frequency trading firms will not be able to use MiFID exemptions for market making, nor will firms who make markets and offer investment services.

Automated Trading

The agreement reached in January sets out a number of new requirements with respect to automated trading which covers both algorithmic and high-frequency trading. These requirements mark the first time that the EU has regulated such activities. The requirements apply not only to investment firms engaging in algorithmic and high-frequency trading but also firms that provide access to trading venues on behalf of other firms, referred to as direct electronic access. The legislation defines algorithmic trading as trading that takes place where a computer algorithm automatically determines individual parameters of orders, such as whether to initiate the order, the timing, price or quantity.

Any firms engaging in such activities will need to have in place monitoring systems and risk controls. Any algorithms being used will also need to be tested on venues and subsequently authorized by national regulators. Furthermore, records of all orders including cancellations must be stored and made available to the national competent authority upon request. Regulated markets are obliged to put in place appropriate procedures and arrangements to manage the risks associated with such trading and to mitigate any system stress. Direct electronic access will only be permitted if the firms in question have appropriate systems and controls including pre-trade filters – naked market access is banned.

Regulated markets will have the option of adjusting their fees for any orders placed which are subsequently cancelled and will be able to impose fees on cancelled orders and on participants placing a high ratio of cancelled orders as well as on firms engaging in high-frequency techniques to "reflect the additional burden on system capacity." In addition, market makers are required to continuously carry out their activities during the specified period of the trading venues' trading hours. This will be governed by a binding written agreement that will specify the market making obligations of investment firms with the trading venue. There is some degree of flexibility, however, as such an obligation may not need to be fulfilled in "exceptional circumstances."

Further details will be specified at the Level 2 stage via implementing measures. Under the provisions on algorithmic trading, the European Securities and Markets Authority is required to set out implementing measures covering the detailed organizational requirements for investment firms engaging in algorithmic and high-frequency trading. ESMA and the European Commission also will be required to draw up the specific circumstances in which investment firms would be obliged to enter into market making agreements as well as the content of the agreements and those situations deemed "exceptional circumstances" with regard to the continuous quoting requirement. Furthermore, national regulators will also need to pronounce themselves on the details of regulated markets' systems that are designed to ensure resilience, capacity, order-to-trade ratios, direct electronic access controls and further detail regarding fee structures. Further implementing measures will also be drawn up to detail arrangements for market making schemes and measures for algorithm testing on venues.

Next Steps

The rules in MiFID II are split into a Directive and a Regulation. The provisions contained in the Directive will need to be adopted and published by Member States as national legislation 24 months after publication in the *Official Journal*. The Regulation on the other hand will not need to be transposed into national law and will enter into force once published in the *Official Journal* (expected this June). The provisions laid out in the Regulation will however only become applicable 30 months following publication.

The focus of the work will now turn to the Commission and to ESMA, which will have to develop technical implementing standards. ESMA is bound by the provisions laid out in the Level 1 text and must deliver its advice based on public consultations as well as hearings subject to a fixed timescale. ESMA is expected to deliver an initial discussion paper setting out policy options in May or June 2014 which will be followed up by individual consultations on particular areas. The majority of its advice must be delivered to the Commission 12 months after publication in the *Official Journal*, which is likely to be in June 2015. ESMA will also draft and issue Level 3 guidance to national regulators on how they should interpret Levels 1 and 2, thus ensuring consistent application of the legislation across the EU.

All of this will be very challenging, not only for industry but also for regulators. In addition to the time pressure constraints on ESMA, the agency is also restricted by human resources. ESMA's 2014 work program highlights the lack of resources at its disposal compared with the deliverables asked of it for the year ahead. This year's budget accounts for 133 full-time ESMA staff, compared with 121 in 2013. However, ESMA's work program for this year estimates required resources at 195 full-time staff. This also shows there is a clear case for industry—both directly, but also coordinated through the various industry bodies—to stay very close to the process and maintain a constructive dialogue with the regulators in order to achieve a workable outcome across the many issues outlined above. FI

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