

MIFID II Proposals Issued

The European Commission (EC) has issued its official proposals for the MIFID II Directive on the 20 October. As anticipated from the consultation last year the text has a significant amount of amendments. Interestingly however it has also encased many of the provisions in a regulation issued alongside the Directive text, which is being referred to as MIFIR (Markets in Financial Instruments Regulation). The impact of MIFIR is that as a regulation it is directly applicable in Member states giving them little scope to make their own rules or guidance. It is a momentous step to the further centralising of regulation into a European rulebook giving new powers to the EC and ESMA to make rules and in the areas of supervision, from areas such as product intervention to limits on derivative positions. How these bodies decide to make further rules means there is still uncertainty in respect to the finer detail of these proposals. Implementation could therefore take some time and probably not happen before 2014.

The MIFID /MIFIR proposals have some significant changes particularly in relation to **Scope, Conduct of Business and Markets**.

MIFID II Widens its Scope

The scope has now been widened to incorporate products, services and activities previously excluded.

Products – Structured deposits and own issue financial instruments (e.g. bonds) will now come under MIFID regulation as it is the intention of the commission to bring consistency to the treatment of all retail packaged products. Issuing of financial instruments will be considered an execution of a client order.

Products – Emissions allowances market as a whole will come within scope which has arisen out of instances of fraud in the markets. The Market abuse directive will also be expanded to include them.

Services – Custody which involves the safekeeping and administration of clients' investments including related services such as cash / collateral management will become a MIFID service.

Services – Organised Trading Facilities operations e.g. broker crossing systems will now be subject to MIFID transparency rules that already apply to regulated markets and MTFs.

Firms – Limited Scope organisations currently providing investment advice and reception and transmission of orders and those with exemptions for own account dealers in commodities and commodity derivatives or other exemptions who may previously have dropped outside of scope may need to become authorised

Firms – Non EEA Firms will in future need to establish a branch in an EEA member states to conduct MIFID services with retail clients. In the case of dealing with eligible counterparties only it will not need a branch but will be required to register with ESMA. Registration and authorisation will depend on two tests of the third country, that of equivalence and reciprocity. Is there an equivalent regulatory regime in place and does that country recognise the EU framework for firms setting up there? If the country fails then firms will need to set up an EEA subsidiary and obtain authorisation.

MIFID II Toughens Conduct of Business Rules

Corporate governance is the focus of new and enhanced provisions imposed on non-bank investment firms with similar requirements under CRD 4. There will be a clear responsibility on board members to challenge the decisions of senior management, to commit sufficient time to discharging their duties with limits on executive and non-executive directorships. There will also be collective requirements for adequacy of knowledge,

experience, diversity and skills with larger firms required to have a nomination committee and a requirement to promote the integrity of the market.

Commission banned for providers of independent investment advice and portfolio managers. Independent advisers will be required to disclose the basis of their advice and where independent have surveyed a sufficiently large number of products available. They will be, along with portfolio managers, prohibited from receiving fees, commissions, or other monetary benefits from third parties in relation to the provision of that service to the client. These provisions are similar in nature to the UK's RDR regime however with some notable differences with respect to restricted advisers and portfolio managers.

Execution only business will apply to a much narrower band of investment products and the appropriateness test will need to apply to structured products and structured UCITS.

Client categorisation changes due to litigation cases surrounding the upgrading of local authorities will mean that this category of investor can no longer be treated as professional or eligible counterparties. The requirement to act honestly and professionally, with information being fair, clear and not misleading will be relevant to all categories of clients.

Tied agents can be appointed by firms in all member states but will not be allowed to hold client money or other financial instruments.

Bundled services provided by firms must be available and priced separately where this is possible.

Order execution policies will need to be clear, understandable by clients and detailed.

Banning financial products will now be within the power of ESMA and the authorities where certain practices, activities or products where there is a threat to investor protection, the functioning, stability or integrity of the market.

Limiting derivatives contracts and exposures will now be within the powers of the authorities who can seek information on positions held, request reductions in positions or impose limits to prevent the build up of risk.

Sanctions for MIFID breaches will be standardised in line with the Market Abuse Directive and be a maximum of E5M for an individual, 10% of a firm's turnover or twice the profits accrued. The authorities will have the power to apply sanctions to directors, the firm and other individuals involved.

MIFID II and the Market

Algorithmic trading and market protection issues have caused concerns about high frequency trading. There will be new requirements on regulated markets surrounding circuit breakers and systems resilience, obligations of firms to report their trading strategy and parameters to supervisors and the related risk /compliance controls. Regulated markets will need effective powers to stop trading and prohibit access to firms not authorised under MIFID.

SME Growth markets will be established under MTFs as a special regime to assist the needs of issuers and investors in this area.

Systematic Internalisers will now be expanded to cover dealings in bonds and structured finance products that are listed on a regulated market or has a prospectus, listed derivatives and emissions allowances. Thresholds that determine whether a firm is an SI are expanded and SIs will need to provide quotes in these instruments when requested.

Trading venue reporting will be required periodically on execution quality, prices, speed and execution quality.

Equity trade transparency will be expanded to cover equities dealt on an MTF or OTF and include equity like instruments such as depository receipts, exchanged traded funds, certificates and similar instruments.

Non equity transparency will be expanded for pre and post transparency obligations for bonds, structured finance products, derivatives and emissions on regulated markets, OTFs and MTFs. SIs will need to provide post trade transparency for these instruments although there will be deferral options and waivers available.

Transaction Reporting will be extended to a wider range of instruments in line with the Market Abuse Directive and will only exclude unlisted instruments and those instruments not impacting listed instruments. Instructions will need identifiers for clients and those responsible for the trade

Data consolidation arrangements are being streamlined with firms executing outside a trading venue required to publish post trade details on a regulated and approved provider. Trading venues will have to offer pre and post data for sale at reasonable rates and make all post trade data available free after 15 minutes. They also must retain data on orders for a period of 5 years.

Exchange trading of derivatives is the result of the G20 commitments to move OTC derivatives onto exchange. These proposals are a combined effort of MIFIR and EMIR (European market infrastructure regulation). ESMA will publish a list of these derivatives subject to these obligations.

FMConsult Services

FMConsult can assist in carrying out MIFID health checks and in helping you prepare for the MIFID changes. We offer training tailored to your needs and assistance in updating documentation and ongoing monitoring and oversight of outsourced parties in addition to ongoing financial promotions and advertising review services. Contact us to discuss your specific needs. If you would like to get regular MIFID updates please sign up to our monthly newsletter by emailing your details to us at www.fmconsult.ie