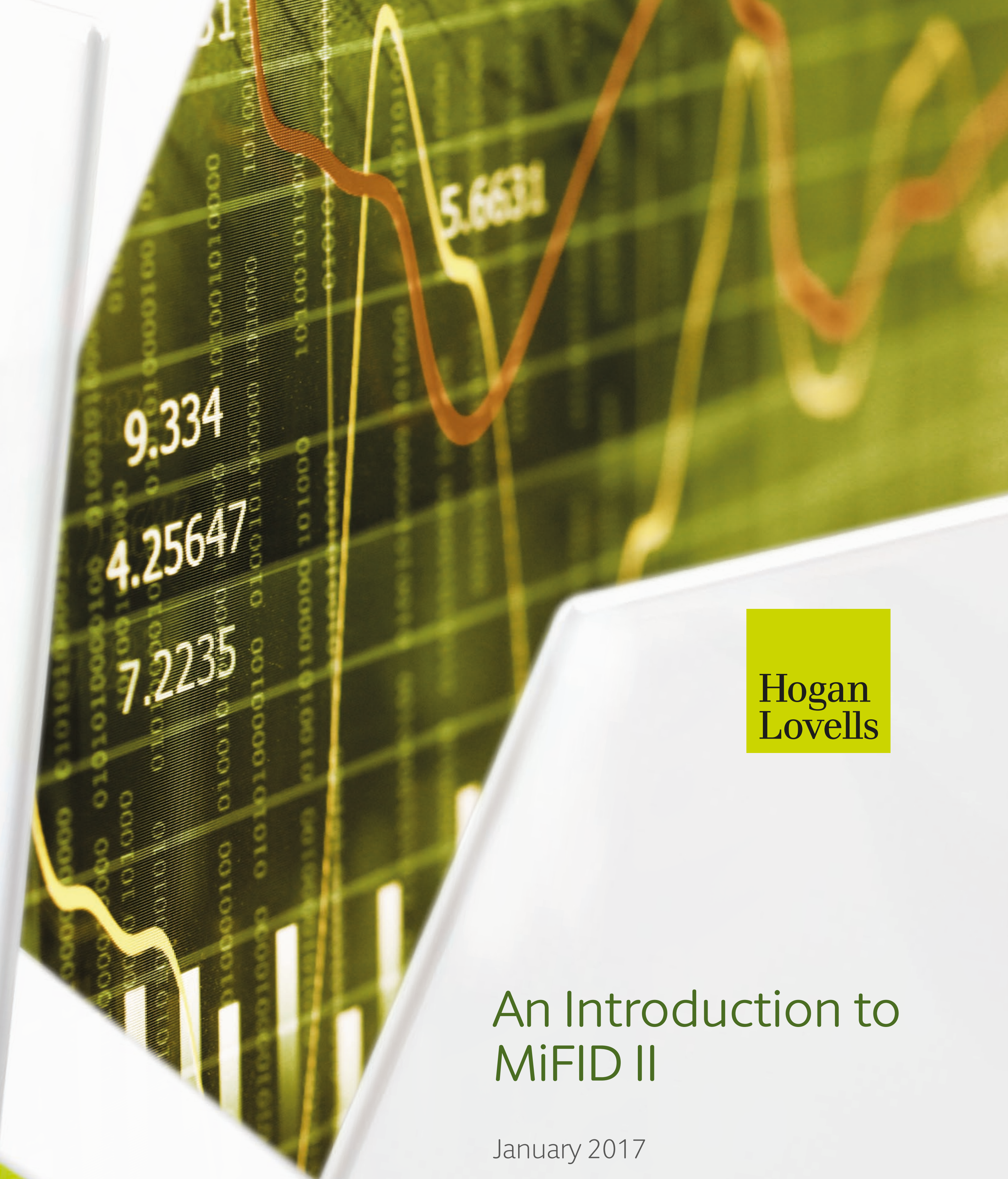

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An Introduction to MiFID II

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Contents

Overview

The original Markets in Financial Instruments Directive ("**MiFID**") became effective in November 2007.[1] It was intended as the cornerstone of the EU's Financial Services Action Plan, an ambitious and wide-ranging project to create a single European market in financial services. MiFID was intended to create a level playing-field for firms to compete in the EU's financial markets and to ensure a consistent level of consumer protection across the EU.

However, the pace of technological change, innovation in financial instruments and markets and increased fragmentation in markets and data, combined with calls for reform following the 2008-9 global financial crisis, have led to a new legislative package to replace the MiFID regime.

In October 2011, the European Commission adopted a legislative proposal for the revision of MiFID. The proposals took the form of a revised directive and a new regulation.

On 15 April 2014, otherwise known as "Super Tuesday", Europe's MEPs voted through the Markets in Financial Instruments Directive II (the "**MiFID II Directive**") as part of a raft of legislation to clear the way before the European elections in late May 2014.[2] The new directive was supplemented by a further Level 1 text, the Markets in Financial Instruments Regulation ("**MiFIR**").[3] The MiFID II Directive and MiFIR were published in the Official Journal of the European Union on 12 June 2014. Together with related delegated acts and guidance, the legislative package as a whole is commonly referred to as "**MiFID II**".

1 Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC.

2 Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (recast).

3 Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012.

The majority of the requirements in MiFID II will become effective from 3 January 2018. Originally the MiFID II legislation was to come into force in January 2017. However, the European institutions agreed on a year-long-delay following concerns raised by the European Securities and Markets Authority ("**ESMA**") that it would not be able to install the technological systems necessary for the implementation of MiFID II by the proposed implementation date.

MiFID II: The basics

- MiFID is a key piece of European financial services regulation.
- The MiFID II legislative package will replace MiFID, which was introduced in 2007.
- The MiFID II package consists of the MiFID II Directive and MiFIR, delegated acts, technical standards, and guidance, all of which must be read together.
- The majority of the rules in MiFID II will become effective from 3 January 2018.

Background

Why was MiFID II necessary?

Several factors came into play as the MiFID II project expanded from its original remit of revising MiFID:

- the increasing pace of technological change (especially the rise of automated trading) and growth in new market structures
- the unexpected results of MiFID itself, in increasing data fragmentation and encouraging a shift towards more efficient trading technology
- calls for the radical reform of the financial services industry after the 2008 financial crisis and
- the "Europeanisation" of financial services regulation with the creation of new European super-regulators including ESMA, and the drive towards a single rule-book for the EU's financial markets.

MiFID II is the European Union's response to all of these trends, and as a result effectively represents a grab-bag of initiatives formed from hard-fought negotiations between competing interest groups.

These different influences on the legislative process help to explain why MiFID II has taken so long to develop, given that the MiFID review began in mid-2010. They also explain why the Level 1 texts for MiFID II are now well over twice the length of the equivalent text in MiFID.

What is the scope of MiFID II?

Although the impact of MiFID II is not expected to be as radical as that of MiFID, its scope will nevertheless be far-reaching. Part of the complexity of dealing with the new legislation will be the need to consider the wide range of initiatives covered by the MiFID II package, including:

- enhanced governance for trading venues
- on-exchange trading of standardised derivatives
- more intensive regulation of commodity derivatives
- improved pre- and post-trade transparency
- greater consolidation of market data
- more extensive transaction reporting
- enhanced regulation of algorithmic and high-frequency trading
- new investor protection requirements and
- a new framework for non-EEA firms to access EU markets.

How is MiFID II structured?

The legislative process for MiFID II has followed the Lamfalussy process. The Lamfalussy process was created in order to streamline the production of the EU's financial services legislation. It involves a four-stage legislative procedure:

Level 1

Level 1 consists of framework legislation, which may contain individual articles specifying matters on which the European Commission is delegated to adopt Level 2 measures.

The MiFID II Level 1 measures consist of:

- the MiFID II Directive; and
- MiFIR.

The MiFID II Directive will have to be transposed into national law by each Member State by 3 July 2017. When MiFIR comes into effect on 3 January 2018, it will be deemed to be directly effective in EU Member States. This means that MiFIR will not need to be transposed into national law or regulation.

Level 2

Level 2 implementing measures are drafted and adopted by the European Commission, following advice from the European Supervisory Authorities ("**ESAs**").

The Level 2 implementing measures for MiFID II were developed between 2014 and 2016:

- **Delegated acts:** An ESMA Consultation Paper in May 2014 set out ESMA's proposals for its technical advice to the European Commission on the proposed delegated acts, and in particular measures to modify the existing MiFID Implementing Directive.[4] The Consultation Paper dealt with most of the investor protection issues in MiFID II.[5] This was followed by ESMA Technical Advice which was published in December 2014.[6]

Between April and May 2016, the Commission published the following MiFID II delegated acts, which drew on ESMA's Technical Advice:

  - the MiFID II Delegated Directive
  - the MiFID II Delegated Regulation; and
  - the MIFIR Delegated Regulation.

- **Technical standards:** In contrast to the consultation on the delegated acts, the ESMA Discussion Paper explored more innovative and technically complex issues, and included most of the proposals on transparency, data reporting and market structure.[7] The ESMA Discussion Paper was followed by a further Consultation Paper with draft ESMA Technical Standards.[8] ESMA published most of its final draft Technical Standards between June and December 2015.

  During the summer and autumn of 2016, the Commission adopted Regulations containing regulatory technical standards ("**RTS**") and implementing technical standards ("**ITS**").

The MiFID II Delegated Directive will need to be transposed into national law by 3 July 2017. The Delegated Regulations and the RTS and ITS will have direct effect on 3 January 2018, and will not need to be transposed into national law or regulation.

Level 3

Level 3 consists of consultation and guidance published by the ESAs.

Current and proposed ESMA guidance and Q&As on MiFID II issued to date have included the following topics:

- complex debt instruments and structured products
- the assessment of knowledge and competence in investment advisers
- cross-selling of products and services
- transaction reporting, reference data, order record keeping and clock synchronisation
- the double volume cap
- product governance
- requirements for the boards of trading venues and data reporting service providers; and
- investor protection.

Level 4

Level 4 involves the supervision and enforcement of the requirements, in particular by individual Member States.

4 Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive.

5 ESMA, Consultation Paper: MiFID II/MiFIR, 22 May 2014 (ESMA/2014/549).

6 ESMA, Final Report: ESMA's Technical Advice to the Commission on MiFID II and MiFIR, 19 December 2014 (ESMA/2014/1569).

7 ESMA, Discussion Paper: MiFID II/MiFIR, 22 May 2014 (ESMA/2014/548).

8 ESMA, Consultation Paper: MiFID II/MiFIR, 19 December 2014 (ESMA/2014/1570).

Regulation of trading venues will be stepped up

Market infrastructure under MiFID

MiFID established a regulatory framework for the trading of financial instruments across the EU. Under MiFID, trading venues are currently divided into:

- Regulated markets ("**RMs**"): These are defined as multilateral systems operated and/or managed by a market operator that bring together multiple third-party buying and selling interests in accordance with non-discretionary rules and in a way that results in a contract. This category covers "traditional" exchanges such as the London Stock Exchange.
- Multilateral trading facilities ("**MTFs**"): These are alternative trading venues that bring together multiple third-party buying and selling interests in accordance with non-discretionary rules and in a way that results in a contract. Typically MTFs involve electronic trading systems that are operated by investment banks or other market operators.
- MiFID also introduced the category of systemic internalisers ("**SIs**"), which are investment firms dealing on their own account by executing client orders outside a regulated market or an MTF on an organised, regular and systematic basis. This category covers large investment firms that execute client orders outside trading venues by matching their clients' buy and sell orders in-house.

The MiFID regime contained a number of deficiencies which MiFID II is intended to address:

- the MiFID rules appear to give a competitive advantage to MTFs, which have a lighter regulatory burden than RMs;
- the SI regime has not been successful as few firms have registered as SIs; and
- alternative trading models, such as broker crossing networks and dark pools, are not covered by the MiFID I framework.

Changes to market infrastructure under MiFID II

MiFID II aims to improve the coverage of the MiFID regime for trading venues through:

- enhanced regulatory and governance requirements for RMs and MTFs[9]
- a new category of trading venue: the organised trading facility ("**OTF**"). An OTF is defined as a multilateral system that is not an RM or MTF, and in which multiple third-party buying and selling interests in non-equities (bonds, structured finance products, emissions allowances or derivatives) are able to interact in the system to execute trades[10] and
- greater take-up of the SI model by including additional objective criteria to determine when a firm is an SI. This is likely to lead to firms becoming SIs for the first time.[11]

9 The MiFID II requirements for RMs can be found in MiFID II Directive, Articles 44-56. The specific requirements for MTFs are in MiFID II Directive, Article 19.

10 Following extensive negotiations between the EU institutions, it was agreed that the OTF category

11 MiFID II Directive, Article 4(1)(20).

Key points

- MiFID II is intended to lead to more intensive regulation of trading venues, with enhanced governance, systems and controls, and regulatory reporting requirements.
- MIFID II will create a new category of trading venue: the organised trading facility.
- It is also intended to encourage greater take-up of the systematic internaliser model.

SME growth markets

A particularly interesting initiative in MiFID II is the facility whereby the operator of an MTF can apply to have that MTF registered as a specialised market for small and medium-sized enterprises ("**SMEs**").[12] These SME markets will be subject to simplified regimes. This is intended to allow growth markets (e.g. in small-cap stocks) to flourish under a looser regulatory regime.

12 MiFID II Directive, Recitals (132)-(135) and Article 33.

Trading of standardised derivatives will move on-exchange

The MiFID II agenda for derivatives reform

MiFID II implements commitments given by the G20 group of major economies in 2009, by requiring certain standardised derivatives which have sufficient liquidity to be traded on exchanges or electronic trading platforms. This is intended to encourage derivatives trading to move from over-the-counter ("**OTC**") trades to trading on exchanges. This will aid transparency in the derivatives market. MiFID II recognises that a role remains for bespoke contracts for which it would be difficult to mandate exchange-trading, so the reform is aimed only at standardised contracts.

The MiFID II framework for derivatives trading is interrelated with the derivatives regime under the European Market Infrastructure Regulation ("**EMIR**").[13]

The trading obligation in MiFID II

Article 28(1) of MiFIR requires relevant counterparties to execute certain derivatives transactions only on RMs, MTFs, OTFs, or certain third country (i.e. non-EU) trading venues. This trading obligation will only apply to derivatives contracts concluded between:

- financial counterparties ("**FCs**"): generally speaking, FCs are investment firms, credit institutions, certain pension schemes established in the EU, alternative investment funds ("**AIFs**") and UCITS funds; and
- certain non-financial counterparties ("**NFC+s**").

Intragroup transactions and transactions with certain pension scheme arrangements which currently benefit from an exemption under EMIR are not subject to the trading obligation.

The trading obligation will only apply to those classes of derivatives that have been declared to be subject to the clearing obligation under EMIR. EMIR requires certain OTC derivatives to be cleared through a central counterparty ("**CCP**"). After a class of derivatives has been declared to be subject to the clearing obligation under EMIR, ESMA will then have six months to decide whether that class of derivatives should also be required to be traded on a trading venue when traded by relevant counterparties.

Key points

- MiFID II requires certain standardised derivative contracts to be traded on a trading venue.
- This obligation only applies to those classes of derivatives that are cleared through a central counterparty ("CCP") and that also are sufficiently liquid.
- ESMA will assess which classes of derivatives should be exchange-traded.

13 Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories..

In order to be subject to this trading obligation, the class of derivatives (or relevant interest) must satisfy both of the following conditions:

– the "venue test": the particular class of derivatives contract must be admitted to trading or traded on at least one trading venue; and
– the "liquidity test": there must be sufficient buying and selling interest in the particular class of derivatives for it to be characterised as "sufficiently liquid" to trade on trading venues.

Taken together, these tests determine which of those classes of derivatives subject to the clearing obligation under EMIR should also be subject to the MiFID II trading obligation. This means that not all derivatives required to be cleared under EMIR will be required to be traded on a trading venue under MiFID II.

If ESMA decides that a particular class of derivatives should be subject to the trading obligation, it must present a draft RTS to the European Commission stating this, and confirming the date when the trading obligation will apply.

Commodity derivatives will be subject to more intensive regulation

Expanded scope of commodity derivatives

The range of financial instruments which are within the scope of MiFID II is broader than those covered by MiFID I. In particular:

- Emissions allowances and derivatives relating to them have been included in the list of MiFID II financial instruments
- The MiFID category of financial instruments relating to options, futures, swaps and any other commodity derivative contract that can be physically settled provided that they are traded on a RM or MTF has been expanded to also include such derivatives where they are traded on an OTF (although wholesale energy products traded on an OTF that must be physically settled are excluded)
- The existence of clearing arrangements are no longer an indicator of whether a derivative is a financial instrument and therefore within the scope of MiFID.

Key points

- An expanded range of commodity derivatives will be brought within the scope of regulation.
- Exemptions for firms dealing in commodity derivatives will be narrowed significantly.
- Mandatory position limits on firms dealing in commodity derivatives will be introduced, with an exemption for non-financial firms.
- Operators of trading venues will be required to report positions in commodity derivatives.

More restricted exemptions for trading in commodity derivatives

MiFID currently applies to commodity derivatives, but includes a significant exemption for persons whose main business is dealing on own account in commodities and/or commodity derivatives. This commodity firms exemption will be removed in MiFID II. Other key exemptions which are at present available under MiFID in relation to commodity derivatives will be rationalised, narrowing the scope of exempted activities.

Under MiFID II a specific “ancillary activity exemption” will be available where a firm’s activities relating to commodity derivatives are ancillary to its main business, provided that the firm does not use high-frequency algorithmic trading techniques and does not belong to a group which has investment services or banking services as its main business.

Position limits and position management

MiFID II will require national competent authorities to establish and enforce limits on the size of a net position which a person can hold at any time in commodity derivatives traded on a trading venue or economically equivalent OTC contract.[14]

Operators of trading venues on which commodity derivatives are traded will also be required to apply transparent and non-discriminatory position management controls.[15] Their position management powers will include:

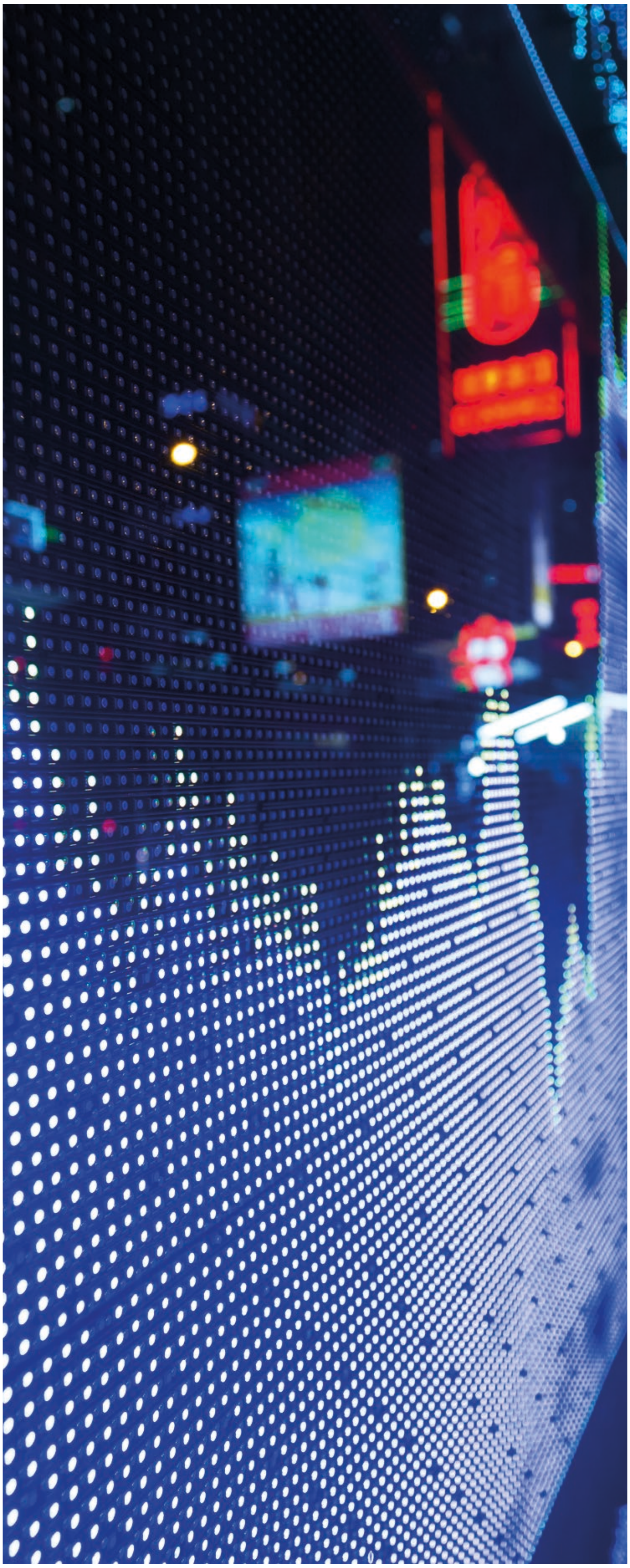
14 MiFID II Directive, Article 57.

15 MiFID II Directive, Article 58(8).

- monitor participants' open interests
- access information and documentation in relation to participants' exposures
- require that positions be reduced or terminated; or
- require participants to provide liquidity back to the market on a temporary basis.

Trading venues will be required to make public weekly reports on the aggregate positions held by different categories of trader in relation to the different kinds of commodity derivative.[16] Venues will also have to submit a daily report to the national competent authority with a complete breakdown of the positions held by all persons on the venue.[17]

ESMA will have emergency powers to require a person to reduce or eliminate derivative positions (and also, as a last resort, to limit the person's ability to enter into commodity derivatives).[18]



16 MiFID II Directive, Article 58(1)(a).
17 MiFID II Directive, Article 58(1)(b).
18 MiFIR, Article 45.

Obligations for pre- and post-trade transparency are set to increase

The MiFID II regime substantially expands the pre-trade and post-trade transparency regime for financial instruments traded in the European Union. The MiFID transparency requirements are limited to equities admitted to trading on regulated markets.

Changes to the MiFID II transparency regime

MiFID II will expand the pre- and post-trade transparency regime:

Key points

- The existing MiFID I transparency regime, which only relates to shares admitted to trading on regulated markets, will be extended to encompass other equity-like instruments (depositary receipts, exchange traded funds, certificates and similar instruments) and non-equity instruments.
- It will also be expanded to cover instruments traded or advertised through MTFs and OTFs (regardless of whether they are admitted to trading on regulated markets).
- The new volume cap mechanism will limit the number of trades in equities or equity-like instruments which can take place under waivers.
- There will be new waiver provisions specific to non-equities.
- Trading venues will be required to unbundle pre- and post-trade data and further disaggregate the data.

- It will extend the scope of the transparency framework to cover an expanded range of financial instruments. This includes not only shares but also equity-like instruments, as well as non-equity instruments
- The requirements will expend to instruments traded on MTFs and OTFs
- Under MiFID II an expanded set of pre-and post-trade transparency obligations will also be imposed on SIs and other investment firms trading in OTC financial instruments.[19]

Waivers

National competent authorities will continue to be able to waive pre-trade transparency obligations subject to certain criteria (for instance, for orders that are large in scale compared with normal market size). A reference price waiver and negotiated price waiver will continue to be available for equities, and will also be available for equity-like instruments. However these waivers will be subject to a "volume cap mechanism", limiting the amount of trading that can take place under waivers. In particular the volume of trading in any share or equity-like instrument that can be carried out under the reference price waiver and the negotiated price waiver will be capped at:

- 4% per trading venue; and
- 8% in aggregate across the EU.[20]

Requirements for publication of pre- and post-trade data

Operators of trading venues must make pre-trade and post-trade transparency data separately on a reasonable commercial basis, and must ensure non-discriminatory access. The information must be available free of charge 15 minutes after publication (reducing to 5 minutes from 2020).

19 MiFIR, Article 3(1).
20 MiFIR, Article 5(1).

Data publication will be formalised and co-ordinated

Data publication under MiFID

MiFID was intended to improve the quality and consistency of trading data in the EU. It established rules on pre- and post-trade transparency. In particular, MiFID required firms to make public specific information on transactions in shares admitted to trading on a regulated market. At the same time, MIFID sought to increase competition among trading venues by breaking the monopoly of regulated markets in the EU and creating the new categories of the MTF and the SI.

However, the production of market data remains fragmented and the quality of data is still inconsistent. MiFID II is therefore intended to formalise reporting channels and to ensure consistent formats for data reporting.

Project for a consolidated tape for all EU equity and equity-like trades

MiFID II is intended to introduce an EU-wide consolidated tape of trade reports for shares, depositary receipts, exchange-traded funds, certificates and other similar financial instruments.[21] This data will be available free of charge 15 minutes after publication.[22]

A firm that provides a consolidated tape will have to be authorised as a Consolidated Tape Provider ("**CTP**").[23] In practice, due to commercial considerations, no data provider has so far created an EU-wide consolidated tape. As a result, Article 90 of the MiFID II Directive states that ESMA may have to initiate a public procurement process to appoint a consolidated tape provider.

MiFID II also includes the aspiration for a consolidated tape for non-equity instruments.[24]

21 MiFID II Directive, Recital (117).
22 MiFID II Directive, Article 64(1).
23 MiFID II Directive, Article 59.
24 MiFID II, Recital (118).

Post-trade publication through Approved Publication Arrangements ("APAs")

MiFID allowed firms to publish trades through trading venues, a third party or proprietary arrangements. MiFID II will formalise this system by requiring third parties that publish trade data to be approved as APAs, in a manner similar to the existing system of supervision for Trade Data Monitors used by the United Kingdom's Financial Conduct Authority.[25]

Data reporting services

Data reporting services such as CTPs and APAs require authorisation and will be subject to organisational requirements under MiFID II.[26]

25 MiFID II Directive, Article 59.
26 MiFID II Directive, Article 59.

Key points

- Post-trade data reporting services will need to be authorised as Approved Publication Arrangements.
- A consolidated tape is intended to provide access to a single source containing all of the trading data for the EU.

Transaction reporting

Transaction reporting under MiFID

Under MiFID, firms are required to report transactions to national competent authorities. This supplies regulators with the data which they need for:

- market abuse investigations and enforcement action
- broader market surveillance, including the identification of unusual trading patterns and systemic risks; and
- the exchange of information with other national competent authorities in the EEA.

MiFID requires that a transaction in any financial instrument admitted to trading on an RM has to be reported to the home country supervisor.

Key points

- MiFID currently requires investment firms to report transactions to national competent authorities.
- More comprehensive transaction reporting requirements will be introduced under MiFID II, requiring greater amounts of information on transactions in a wider range of financial instruments.
- MiFID II will formalise reporting channels by requiring third parties that report on behalf of firms to be authorised as Approved Reporting Mechanisms ("ARMs").

Changes to transaction reporting under MiFID II

The effect of MiFID II is to:

- extend the MiFID transaction reporting requirements to a broader range of financial instruments[27]
- harmonise the content of transaction reports by creating a common EU transaction report template;[28] and
- require transaction reports to be kept for five years.[29]

Transaction reporting via an ARM

Under MiFIR, transaction reports can be made either by:

- the investment firm itself
- a third party reporting on the firm's behalf; or
- the trading venue where the transaction was executed.

Firms can report directly to a third party which will then report on behalf of the firms to the regulators. These third parties will have to be authorised as ARMs and will be subject to organisational requirements (see above on the regime for data reporting services more generally).

Double reporting under EMIR and MiFID II

If a firm has already reported an OTC contract to a trade repository or competent authority in accordance with the trade reporting obligations under EMIR,[30] there is no need to report under MiFID II. However, trade repositories under EMIR will need to be approved as ARMs under MiFID II.

27 MiFIR, Article 26.

28 MiFIR, Article 27.

29 MiFIR, Article 25(2).

30 Regulation (EU) No. 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories.

Algorithmic trading and high-frequency trading is an area of special concern

Systems and controls requirements for algorithmic and high-frequency trading

MiFID II provides for the regulatory treatment of algorithmic trading in the EU.[31] It will require firms to have in place effective and resilient systems, as well as appropriate risk controls. Firms must ensure these systems are tested, and that they have in place business continuity arrangements. There must be appropriate order limits to prevent erroneous orders and orders that could create a disorderly market from being entered. This will include provision for the use of circuit breakers to halt or limit trading temporarily.[32]

There are also provisions to limit volatility by managing the volume of algo trades, imposing higher fees on orders which are later cancelled (especially if they are cancelled quickly after the order) and on traders who have a high volume of cancellations.[33]

Direct electronic access

MiFID II seeks to ban the provision of direct electronic access ("**DEA**") to markets by investment firms for their clients where such access is not subject to proper systems and controls. Trading venues must also:

- have effective systems and controls in place to manage DEA; and
- assess the suitability of clients before allowing them to use DEA.

Key points

- MiFID II introduces closer regulation of algorithmic and high-frequency trading.
- Firms providing direct electronic access must have effective systems and controls.

31 MiFID II Directive, Recitals (59)-(68).

32 MiFID II Directive, Article 48.

33 MiFID II Directive, Articles 49(1), 48(6) and 48(9).

Investor protection requirements will be strengthened

Compliance function

MiFID II will maintain the high-level MiFID requirement for firms to establish adequate policies and procedures sufficient to ensure compliance. Compliance functions will be required to carry out a compliance risk assessment, establish a permanent risk-based monitoring programme, and report directly to the management body whenever a significant compliance risk is detected.

Complaints handling

MiFID II will replace the high-level MiFID approach to complaints handling with more detailed requirements. In addition, the complaints handling requirements will apply to all clients, including professional clients, regardless of whether they are per se or elective professional clients.

Key points

- MiFID II aims at strengthening protection for investors. It will be particularly important for firms that deal with retail customers to be aware of these changes to the rules.
- MiFID II will tighten existing restrictions on inducements.
- The investor protection rules will be extended to structured deposits.
- Enhanced disclosure obligations, especially in relation to costs to the customer and best execution.
- Some investor protection rules will apply to eligible counterparties.

Recording of telephone calls and emails

MIFID allows member states the discretion to choose whether or not to require firms to record telephone conversations and emails relating to client orders. In contrast, this recording obligation will become mandatory on firms under MiFID II. The records must be kept for five years but, if requested by an NCA, may be kept for up to seven years.

Structured deposits

The investor protection rules will be extended to structured deposits; that is, deposits where repayment is linked to an index, a financial instrument, commodity or other non-fungible asset, or a foreign exchange rate.[34] MiFID II will not apply in its entirety to structured deposits. Instead, the MiFID II Directive specifies certain provisions that will apply to structured deposits; this will include the investor protection rules.

Product governance

Firms that design financial products will be subject to enhanced requirements, including a process for pre-sale internal approvals, a requirement to identify the target market for the product, the type of client for whom the product is intended (e.g. retail and/or professional), and to assess all relevant risks.[35]

Client assets

MiFID II is intended to strengthen the protection of client assets for retail clients. Currently, MiFID allows firms to have title transfer arrangements in place whereby a firm may receive the full ownership of client assets to cover a particular client's obligations.[36] This can lead to disputes over the ownership of client assets. In order to protect clients' interests, MiFID II will prohibit the use of title transfer arrangements with retail clients.[37]

34 MiFID II Directive, Article 1(4).
35 MiFID II Directive, Recital (71) and Article 24.
36 MiFID I Directive, Recitals (26)-(27).
37 MiFID II Directive, Article 16.

Client categorisation

All investors should be treated honestly, fairly and professionally by firms.[38] Under MiFID II, there is a trend towards ensuring that professional clients and eligible counterparties receive greater protection.[39] For example, MiFID II will remove the presumption that municipalities and local authorities will be professional clients, although they may request to be treated as such.[40]

Conflicts of interest

Firms will have to ensure that remuneration and third party inducements do not create conflicts of interest with their duties towards their clients.[41] Disclosures of conflicts of interest to clients will also need to be sufficiently detailed to enable the clients to take informed decisions. Firms will also be required to periodically review their conflict policies and address deficiencies.

Remuneration

MiFID II will require firms to have a remuneration policy for persons providing services to clients.[42]

Information for clients

MiFID II will require communications with clients to be fair, clear and not misleading.[43] It has also proposed standardised formats (including specified forms of tables) for the disclosure of costs and charges to clients.[44] Costs will need to be aggregated to show the overall costs and their cumulative effect on the return of the investment. Costs will also need to be itemised where so requested by the client.[45]

Independent versus restricted advice

MiFID II will require firms to disclose whether their advice is given on an independent or a restricted basis.[46]

Inducements

Independent advisers and portfolio managers will be prohibited from accepting and retaining inducements (including fees, commissions or monetary or non-monetary benefits) from third parties, other than "minor non-monetary benefits".

Suitability and appropriateness

MiFID II will enhance the requirements for reporting and disclosure to customers in relation to the client suitability rules. Under MiFID, firms providing investment advice or portfolio management are required to assess their clients' suitability for products. In addition, MiFID II will require firms to issue a suitability report to retail clients explaining the advice given and how it meets the preferences, objectives and other characteristics of the client.[47] Firms will have to provide greater quantities of information to retail clients generally, including the basis of the firm's judgement of the suitability of the proposed investment services and financial instruments for the client. Firms will be required to consider the client's risk tolerance and ability to bear losses.[48]

Cross-selling

Where firms offer an investment service, together with another product or service as part of a package, they will need to inform the client whether it is possible to buy the different components separately, and provide evidence on the costs and charges of each component. Where the risks resulting from the package are different from those of the separate products, the firm will need to provide an adequate description of the different components and the way in which their interaction modifies the risks.[49]

38 MiFID II Directive, Recital (86).

39 See for example MiFID II Directive, Recital (104).

40 MiFID II Directive, Annex II.

41 MiFID II Directive, Article 23(1).

42 MiFID II Directive, Article 9(3)(c).

43 MiFID II Directive, Article 24(3).

44 MiFID II Directive, Article 24(5). Article 24(4) clarifies the disclosure of costs and charges.

45 MiFID II Directive, Article 24(4).

46 MiFID II Directive, Recital (73) and Articles 24(4) and 24(7).

47 MiFID II Directive, Article 25(6).

48 MiFID II Directive, Article 25(2).

49 MiFID II Directive, Recital (81) and Article 24(11).

Execution-only business

MiFID II will narrow the scope of execution-only business that can be sold without first carrying out an appropriateness assessment. In particular, it will no longer be possible to sell structured UCITS and some structured deposits on an execution-only basis unless an assessment of the appropriateness of the product for the client is performed.[50]

Reporting best execution

Trading venues and investment firms will be required to publish data on the quality of execution for each financial instrument traded. Investment firms will have to make public their top five execution venues, while trading venues and SIs must publish data on the quality of their execution.[51]

Product intervention

MiFID II will give new powers to ESMA, the European Banking Authority and national competent authorities to intervene to prohibit or restrict the marketing, distribution or sale of financial products in order to protect consumers.[52] The powers are exercisable in cases where there is significant investor protection concern or a threat to financial stability or the orderly functioning and integrity of the markets.[53] The criteria and factors that must be taken into account when the relevant authority decides whether to act will include:

– the complexity of the product, especially given the type of client to whom it will be marketed and sold

– how many such products will be issued, and their total value

– how innovative the product is; and

– the leverage that the product provides.

50 MiFID II Directive, Recital (80) and Article 25(4). UCITS or "undertakings for the collective investment in transferable securities" are a category of investment fund that may be marketed across the EU. A structured UCITS involves the use of financial derivative instruments.

51 MiFID II Directive, Articles 27(3) and 27(6).

52 MiFIR, Articles 40-43.

53 MiFIR, Articles 40(2), 41(2) and 42(2).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Third country access to the EU

Key points

- MiFID II will allow third country (i.e. non-EU) firms to provide cross-border services in relation to per se professional clients and eligible counterparties from outside the EU without setting up a branch.
- A member state may require a non-EU firm to establish a branch in order to have access to retail clients and elective professional clients in its territory. This branch would be unable to provide services to retail or elective professional clients in the rest of the EU. However, the branch would be allowed to provide services to per se professional clients and eligible counterparties across the EU.
- Third country trading venues and CCPs will be permitted access to EU CCPs and trading venues, provided that foreign trading venues and CCPs have equivalent access in those third countries. In addition, third country trading venues will only be allowed access to the EU if the European Commission has confirmed that the third country's legal and supervisory framework for trading venues is equivalent to that required by MiFIR. Furthermore, third country CCPs must be recognised under EMIR before being permitted access to the EU.

Negotiations over the MiFID II regime for access by third country firms to the EU's markets led to intensive lobbying and debate. The MiFID II rules on third country firm access were harmonised in relation to per se professional clients and eligible counterparties. In contrast, member states may apply national rules in relation to marketing to retail clients and elective professional clients. However, MiFID II will provide a regime for retail clients and elective professional clients that member states may choose to apply.

Providing cross-border services into the EU

Under MiFIR, a non-EU firm will be able to provide cross-border services from outside the EU to per se professional clients and eligible counterparties established in the EU without establishing a branch, provided that:

- the EU deems the regulatory regime of the firm's home jurisdiction to be equivalent to the EU; and
- ESMA agrees to include the firm on its register of permitted firms.[54]

There is no provision in MiFID II that allows non-EU firms a right to provide cross-border services to retail clients or retail clients who have elected to become professional clients. Consequently, where a non-EU firm wishes to provide services to these categories of clients, it might be necessary to create a branch in each member state in which the firm wishes to provide services.[55]

54 MiFIR, Recital (42) and Article 46(1).

55 MiFID II Directive, Recital (109).

Establishing branches in the EU

A member state may require a non-EU firm wishing to provide services to retail clients or to elective professional clients to establish an authorised branch in that member state. The member state must require any such branch to be authorised by that member state.[56]

If a non-EU firm has established a branch in a member state for the purposes of Article 39 of the MiFID II Directive then, if that firm is established in a jurisdiction deemed to be equivalent to the EU, it can provide services to per se professional clients and eligible counterparties, without establishing new branches in each state, provided that it complies with the MiFID II information requirements that apply to the passporting of services[57].

Access by third country CCPs and trading venues

A trading venue in a third country will be able to request access to EU CCPs, provided that the European Commission has adopted a decision stating that the legal and supervisory framework for trading venues in that third country ensures that the trading venue complies with legally binding requirements that are equivalent to the requirements for trading venues under the MiFID II Directive,[58] MiFIR and the new Market Abuse Directive , and that trading venues in that country are subject to effective supervision and enforcement in that third country. Similarly, a CCP in a third country will be able to request access to a trading venue in the EU, provided the CCP is recognised under EMIR.[59]

CCPs and trading venues in third countries will only be permitted to take advantage of their rights to non-discriminatory access to trading venues and CCPs inside the EU if the Commission has adopted a decision to the effect that the legal and supervisory framework of the relevant third country is considered to provide for an effective equivalent system for permitting CCPs and trading venues authorised under foreign regimes access to CCPs and trading venues established in that third country.[60]

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56 MiFID II Directive, Article 39(1).

57 MiFIR, Article 47(3).

58 Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse.

59 MiFIR, Article 38.

60 MiFIR, Article 38.

Further information

Please visit our MiFID II microsite at
http://www.hoganlovells.com/en/knowledge/topic-centers/mifid-ii.

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