



## SECURITIES AND FUTURES REGULATORY UPDATE

### MiFID II – an Analysis of the Commission Proposal

#### Introduction

On 20 October 2011, the European Commission published its proposals for the revision of the Markets in Financial Instruments Directive (“**MiFID I**”).<sup>1</sup> MiFID I was implemented in EU Member States in November 2007 and was intended to create a single market for investment services, increase competition and enhance investor protection throughout the EU. However, following new developments in financial services across the EU and in line with the review requirement in the MiFID I text the Commission has called for wide-ranging changes with a view to updating the MiFID framework.

Given that the Commission's proposals (referred to as “**MiFID II**”) must be debated between and agreed to by the European Parliament and Council, there is no definitive date yet for their entry into force; estimates for implementation range from 2014 to 2016.

#### Structure of MiFID II

The MiFID II proposals consist of an EU directive (the “**Directive**”)<sup>2</sup>, which requires transposition into national law in each Member State, and an EU regulation (the “**Regulation**”)<sup>3</sup>, which will be directly applicable without having to be transposed. The Directive covers the authorisation and regulation of trading venues, the scope of exemptions from MiFID requirements, organisational and conduct of business requirements, rules on algorithmic trading and powers available to national regulators including sanctions. The Regulation sets out new product intervention powers and contains requirements in respect of pre- and post-trade transparency, non-discriminatory access to clearing services and mandatory trading of derivatives on organised trading venues. Rules governing the access of third country firms to EU markets are split between the Directive and the Regulation.

#### Changes to trading venues

MiFID II introduces a new category of trading platform described as an “organised trading facility” or “**OTF**”, which will operate alongside the three existing categories of MiFID trading venues: regulated markets, multilateral trading facilities (“**MTFs**”) and systematic internalisers (“**SIs**”).<sup>4</sup> MTFs and regulated markets are quite similar in nature; both offer order-matching arrangements and are governed by predetermined, non-discretionary rules. SIs on the other hand, are generally investment banks which execute orders from their clients against their own books or against orders from other clients.

<sup>1</sup> Available at <http://eur-lex.europa.eu/LexUriServ/site/en/consleg/2004/L/02004L0039-20060428-en.pdf>.

<sup>2</sup> Available at [http://ec.europa.eu/internal\\_market/securities/docs/isd/mifid/COM\\_2011\\_656\\_en.pdf](http://ec.europa.eu/internal_market/securities/docs/isd/mifid/COM_2011_656_en.pdf).

<sup>3</sup> Available at [http://ec.europa.eu/internal\\_market/securities/docs/isd/mifid/COM\\_2011\\_652\\_en.pdf](http://ec.europa.eu/internal_market/securities/docs/isd/mifid/COM_2011_652_en.pdf).

<sup>4</sup> OTFs perform a similar function to Swap Execution Facilities (SEFs) under Title VII of the U.S. Dodd-Frank Act.

However, to date much trading has taken place outside of the official MiFID trading venues on unregulated arrangements such as broker-crossing systems and inter-dealer broker systems. In order to bring this unregulated activity within the scope of MiFID, the Commission has proposed that OTFs operate as a broad, “catch-all” venue designed to capture trading currently taking place on an over-the-counter basis but in an organised way. For example, it may capture voice and voice/electronic hybrid executed OTC product transactions which are not currently executed on regulated markets or MTFs.

Unlike MTFs and regulated markets, OTFs will have discretion over how transactions are executed, but OTF operators may not trade against their proprietary capital. Instead, the Directive provides that where an investment firm acts outside the structure of an MTF, OTF or regulated market and executes client orders against its own proprietary capital, it will be deemed to be a systematic internaliser. SIs have not generally been perceived as a success in relation to equities since relatively few firms opted to formally operate as SIs following the introduction of MiFID I. However, it seems that, under MiFID II, unless firms choose to operate as one of the other MiFID II trading venues they may have no option but to operate as an SI and to comply with the transparency and conduct of business obligations attached to that status. It remains to be seen whether the creation of the new OTF category will incentivise the migration of trading on existing MTFs and regulated markets to OTFs, on the basis that OTFs might end up being more lightly regulated. However, the Commission would be keen to avoid such potential arbitrage.

## Regulation of derivatives

While MiFID II proposes wide-ranging reforms to the regulation of derivatives in the EU, it forms only part of the Commission’s proposals for derivatives regulation and should be read alongside the proposed European Market Infrastructure Regulation (“EMIR”)<sup>5</sup>, which provides for mandatory clearing and reporting of OTC derivatives.

### *Derivatives to be traded in trading venues*

Under the proposed Regulation, any class of derivatives which is identified by the Commission through subsequent “implementing measures” (*i.e.* subsidiary legislation) will be required to trade only through regulated markets, MTFs, OTFs or non-EU trading venues located in a country which imposes equivalent requirements to those in MiFID II. In line with the G20 commitments, all standardised derivatives will eventually become subject to this trading venue requirement; the Commission has stated that “only ad hoc trading in shares, bonds and non-standardised derivatives” will be allowed to continue trading OTC and outside of trading venues. The only other transactions escaping the trading venue requirement are transactions which do not involve any trade execution or arranging, *e.g.* electronic post-trade confirmation services.

However, in applying the trading venue requirement to specific classes of derivatives, the Commission must consider the liquidity of the class based on factors including average frequency and size of trades. The Commission’s precise approach is likely to be closely watched by traders dealing in more illiquid instruments, where the application of transparency requirements could result in private positions being revealed (through deduction or a process of elimination by interested persons). ESMA will have a significant role in determining whether a class of derivatives is sufficiently liquid for trading on trading venues.

EU counterparties will still be subject to the trading venue requirement when they enter into transactions with “third country” (*i.e.* non-EU) entities that would be subject to the EMIR clearing obligation if they were established in the EU. However, even where there is no involvement from an EU counterparty, third country entities will be subject to the trading venue requirement where (i) they would be subject to the EMIR clearing obligation if they were established in the EU; and (ii) the contract has a “direct, substantial or foreseeable effect within the EU”. This mirrors the scope of the clearing obligation in EMIR and Title VII of the U.S. Dodd-Frank Act, which also apply to OTC derivatives. It remains to be seen how these provisions will be enforced in practice given the complex jurisdictional issues involved.

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<sup>5</sup> <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52010PC0484:EN:NOT>.

### **Commodity derivatives**

The MiFID II proposals advocate substantially stronger supervision of the commodity derivatives market following concerns expressed by the G20 as to the effect of commodities speculation on consumer prices. The proposals aim to ensure that all firms specialising in trading commodities and commodity derivatives are brought within the scope of MiFID, although firms which are not part of a financial group and which simply use commodities to hedge risk should remain exempt, as should firms using commodity derivatives in the course of providing a services which is “ancillary” to a main business which is not investment business.

MiFID II requires trading venues on which commodity derivatives are traded to publish a weekly report giving details of aggregate positions in financial instruments held by the different categories of traders. Trading venues must also upon request provide competent authorities with a complete breakdown of the positions of all market participants.

Finally, trading venues which admit to trading or trade commodity derivatives must apply clear, transparent and non-discriminatory limits to the number of contracts which market participants can enter into over a specified period of time. However, the Commission may also choose to adopt “delegated acts” setting out limits applicable across the EU and in exceptional cases, national regulators may impose more restrictive limits for a period of six months.

### **Position management powers**

MiFID II gives Member State regulators the power to demand information from any person regarding the size and purpose of a derivative position. They may then require that person to reduce the size of the position. ESMA is to oversee actions taken by Member State regulators in this respect and ensure that they are taking a consistent approach.

ESMA also has the power to demand that any person reduce the size of a derivative position, although to take this step it must satisfy itself that Member State regulators have not already taken sufficient action.

## **Transparency**

The MiFID II proposals apply identical transparency requirements across OTFs, MTFs and regulated markets, although the requirements will be calibrated according to the different types of instrument traded on the three types of venue and also according to different types of trading (*e.g.* order-book and quote-driven systems as well as hybrid and voice broking systems).<sup>6</sup> Pre-trade transparency rules will require trading venues to publish prices and the depth of trading interests on a continuous basis during normal trading hours. Post-trade rules require that the price, volume and time of transactions be published as close to real-time as technically possible. For systematic internalisers, there is an obligation to publish firm quotes in debt and equity instruments and the introduction of post-trade transparency requirements identical to those applicable to the other trading venues.

Since the transparency regime is contained in the draft Regulation, it is intended to be directly applicable in all Member States. This will be helpful in eliminating the current divergence between Member States' approach to reporting requirements.

MiFID II also aims to reduce the cost and increase the quality of transparency data by requiring that investment firms publish details of transactions through an Approved Publication Arrangement (“**APA**”) and that transaction data gathered from trading venues be published through a Consolidated Tape Provider (“**CTP**”). Both of these entities will be required to provide information on a “reasonable commercial basis” and even then will only be allowed to charge for the first fifteen minutes. This should increase the liberalisation of market data but a restrictive interpretation of “reasonable commercial basis” could have an impact on the number of entities willing to perform this role on a standalone basis.

### **Extension of transparency regime to new instruments**

The scope of the existing transparency regime has been extended to cover equities traded on MTFs and OTFs, certain equity-like instruments (*e.g.* depository receipts), actionable indications of interest and non-equity instruments including

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<sup>6</sup> See Recital 14 of the Regulation.

bonds, derivatives, emission allowances and structured finance products. For bonds and structured finance products, transparency requirements will only apply where a prospectus has been published or where the instruments have been admitted to trading on a regulated market. For derivatives and emission allowances, the instruments must have been admitted to trading on an MTF or OTF.

There are concerns that although the MiFID transparency regime has worked well for equities, it may not be suitable for the bond market, particularly with respect to the more illiquid end of the market. Under the new proposals, few bond transactions will remain OTC and fall outside of the transparency requirements; the Commission has stipulated that to be OTC, trading should be ad-hoc and irregular or the design of the instruments should be bespoke. Nevertheless, the Commission has expressed a clear desire to calibrate transparency requirements according to the different characteristics of financial instruments (including liquidity).

Emission allowances are also being brought within the scope of MiFID in order to align regulation of emission allowances trading on the spot market with regulation already applicable to the emission allowances derivatives market. The Commission has the general aim of introducing a robust level of oversight in order to facilitate investment in the EU's transition to a low-carbon economy. In addition, the proposal is aimed at enhancing confidence in the carbon market following the recent discovery of frauds involving the spot carbon markets, including a large scale VAT fraud, which had a negative effect on confidence in the Emissions Trading System which had been established under the Emissions Trading Directive.<sup>7</sup>

### ***Waivers and deferrals***

Pre-trade transparency requirements may be waived by Member State regulators based on market model and the size and type of orders in the case of equity instruments. For debt instruments, they may be waived based on liquidity, market model and the specific characteristics of trading activity in a product.

At first glance, these categories appear fairly wide, leaving scope for discretion. However, under the Commission's proposals a Member State regulator must notify ESMA and other Member State regulators of any intended waiver. ESMA will determine whether the waiver is compatible with the requirements of MiFID, but even if ESMA decides that the grant of a waiver should go ahead, other Member States will have the power to refer it back for further consideration. Member State regulators could therefore find it more difficult to react quickly to changing market conditions by issuing waivers.

The Commission also has the power to adopt measures specifying the criteria under which waivers may be granted, which could result in the new waiver regime becoming more restrictive. Waivers which are already in existence are to be reviewed by ESMA during the two years following the adoption of MiFID II, and will only survive if they comply with the new regime. This clearly has implications for “dark pools” operating under the current waiver regime.

Subject to the consent of their competent authority, trading venues are to be given powers to defer the publication of post-trade transparency data based on the type and size of transactions. However, the Commission will again issue delegated acts setting out the conditions for authorising deferral.

## **Transaction reporting**

MiFID II has substantially extended the scope of transaction reporting in order to reflect the Market Abuse Directive, which is also in the process of being reviewed.<sup>8</sup> The only instruments escaping the MiFID II reporting requirement will be (i) instruments not admitted to trading nor traded on an MTF or OTF; (ii) instruments whose value does not depend on that of a financial instrument admitted to trading or traded on an MTF or OTF; and (iii) instruments the trading of which cannot have an impact on an instrument admitted to trading nor traded on an MTF or OTF.

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<sup>7</sup> Directive 2003/87/EC.

<sup>8</sup> The proposals for a new Market Abuse Directive and Regulation are available at [http://ec.europa.eu/internal\\_market/securities/docs/abuse/COM\\_2011\\_654\\_en.pdf](http://ec.europa.eu/internal_market/securities/docs/abuse/COM_2011_654_en.pdf) and [http://ec.europa.eu/internal\\_market/securities/docs/abuse/COM\\_2011\\_651\\_en.pdf](http://ec.europa.eu/internal_market/securities/docs/abuse/COM_2011_651_en.pdf), respectively.

The Commission has also proposed that the contents of transaction reports be harmonised and has set out requirements for the contents of reports, including designations identifying the clients on whose behalf the investment firm has executed the transaction and details of the persons and the computer algorithms within the investment firm responsible for the transaction.

## Open access to central counterparties

The MiFID II proposals require not only that trading venues provide open access to any central counterparty (“CCP”) wishing to clear financial transactions executed through that venue; they also stipulate that CCPs must accept transactions executed on any trading venue on a non-discretionary basis. CCPs owned by trading venues will therefore no longer be allowed to refuse to clear transactions executed on a rival trading venue. This will have clear implications for the vertical silo model adopted by certain trading venues which currently require all transactions to be cleared through a clearing house owned by the same company. A similar requirement had been the subject of significant lobbying and negotiation under EMIR.

## Stronger safeguards for algorithmic / high frequency trading

MiFID II aims to increase regulation of high frequency and automated trading, which is perceived by the Commission to be a risk to market stability on the basis that such trading may exacerbate volatility during times of market stress. The proposals target situations where a computer algorithm determines the timing, price or quantity of an order with limited or no human intervention (MiFID II uses the term “algorithmic trading”). This appears to exclude traders who simply use algorithms as an aid in making investment decisions rather than relying wholly on the algorithm's determination of whether to invest. However, all automated or high frequency traders currently relying on the MiFID I “dealing on own account” exemption will have to seek authorisation going forward, since the exemption will no longer be available to any member of a regulated market or an MTF.

Although there is no definition of “high frequency trading”, Recital 44 of the Directive states that “a specific subset of algorithmic trading is high frequency trading where a trading system analyses data or signals from the market at high speed and then sends or updates large numbers of orders within a very short time period in response to that analysis”. The proposed Directive sets out a number of risk controls to be put in place by algorithmic traders, including trading thresholds and limits and mechanisms to prevent the sending of erroneous orders. Firms which provide algorithmic traders with direct electronic access to trading venues must assess the traders' suitability and ensure that they abide by pre-set trading and credit thresholds.

Algorithmic traders must also make annual notifications to regulators disclosing details of their risk controls, trading parameters and algorithmic trading strategies. Regulators can ask for further details, at their discretion. Although MiFID II imposes a generic “professional secrecy” obligation on competent authorities, firms may understandably feel reluctant to disclose details of their algorithms without stronger assurances of confidentiality, given the proprietary nature of those algorithms.

A controversial proposal is the requirement that “algorithmic trading strategies” remain in continuous operation during trading hours and that they post firm quotes at competitive prices regardless of prevailing market conditions. The aim of this requirement is to provide market liquidity, but it is likely to cause concern amongst algorithmic traders given that it comes close to requiring them to perform a market making function.

Finally, MiFID II proposes the implementation of “circuit breakers” designed to temporarily halt trading or reject orders exceeding pre-set volume and price thresholds. Circuit breakers have already been implemented in the USA and are aimed at preventing high frequency trading from contributing to unusual market conditions or bubbles.

## Product intervention power

The Commission has proposed giving Member State regulators broad powers to prohibit or restrict any type of financial activity or the marketing, distribution or sale of any financial instrument. ESMA would be given similar powers, albeit that ESMA could only intervene for a period of three months. However, there is nothing in the

proposals to stop ESMA from renewing such a prohibition indefinitely. The scope of ESMA's powers is likely to be scrutinised carefully by the Member States, who are keen not to give open-ended powers to ESMA. This has been a consistent theme in several EU regulatory initiatives, including the AIFM Directive, the EU Short Selling Regulation and EMIR.

## **Investor protection**

### ***Information to clients***

MiFID I currently requires firms to provide appropriate information regarding financial instruments and proposed investment strategies. MiFID II expands on this requirement by providing that all information given to clients must explain clearly, in sufficient detail and in easily understandable terms, how orders will be executed by the firm for the client. Investment firms must also publish an annual list of the top five execution venues which they use to execute client orders.

### ***Inducements***

The MiFID II proposals prohibit independent advisors and portfolio managers from accepting monetary fees or commissions from third parties and, unlike under MiFID I, there will be no exemptions from the prohibition. However, non-independent advisors would be free to accept commission. There had been some concern that this approach potentially diverges from the UK's Retail Distribution Review, which seeks to ban commissions for restricted advisers as well as for independent advisers. However, the Commission and the UK Financial Services Authority have recently suggested the two regimes are broadly compatible. The ban on commissions also calls into question "soft dollar" arrangements whereby investment managers direct commission towards a third party in exchange for services that benefit of the client but are not client directed – it is unclear whether such arrangements would still be permitted for investment managers who are acting independently.

### ***Client classification***

Under MiFID II, some information and reporting requirements will now be applied to firms dealing with "eligible counterparties" (the most sophisticated category of clients) and they will become subject to an overarching obligation to act honestly and fairly; such a level of protection is not currently available under MiFID I for eligible counterparties. Also, local authorities will no longer be automatically classed as "professional clients" (*i.e.* they will be assumed to be retail clients), although they may request to be treated as such.

### ***Corporate governance***

The MiFID II proposals require that persons who direct the business of an investment firm must be of sufficiently good repute and sufficiently experienced. However, the draft Directive's Recitals also state that "management boards of investment firms should be sufficiently diverse as regards age, gender, provenance, education and professional background". If this stipulation survives in the final form of MiFID II it will be interesting to see how Member States interpret it and the weight that they place on it.

### ***Recording of telephone conversations***

The organisational requirements for investment firms now include a requirement that firms keep records of "telephone conversations or electronic communications" involving transactions concluded when dealing on own account and client orders when the firm is receiving and transmitting or executing orders on behalf of a client. Such records are to be kept for three years and provided to clients upon request. The UK introduced new telephone taping requirements on 1 November 2011; it remains to be seen whether the final MiFID II language will go beyond what the UK has just put in place.

## Non-EU firms providing services in the EU

Currently, Member States can decide the terms on which they are willing to allow third country (*i.e.* non-EU) firms to provide financial services in their individual jurisdictions. MiFID II instead proposes one harmonised access regime across the EU, which varies depending on the type of client the firm wishes to access:

- a) *Retail clients*: Third country firms wishing to carry on any type of investment business with retail clients in the EU would be required to operate from an authorised branch based in the EU. The authorised branch would have to comply with various MiFID obligations, including organisational requirements, post-trade disclosure requirements, transaction reporting requirements and conduct of business requirements. Once authorised, the branch would be allowed to “passport” its services across the EU on a cross-border services basis; this is a right which under MiFID I is available only to entities incorporated in the EU (*i.e.* affiliates rather than branches of third country firms).
- b) *Eligible counterparties*: Third country firms wishing to provide certain specified services to EU-based eligible counterparties would not need to establish a branch in the EU. They would be required to register with ESMA, but the MiFID II obligations would generally not apply to them. The issue that arises is that, under the MiFID framework, the only types of activities for which the concept of “eligible counterparties” applies are: (i) executing orders on behalf of clients; (ii) dealing on own account; and (iii) receiving and transmitting orders. This means that a non-EU investment manager would not be able to use this non-branch exemption to provide investment management services to eligible counterparties in the EU.
- c) *Professional clients*: Professional clients are not mentioned at all in the third country provisions either in the Directive or in the Regulation, and so the status of marketing to this category of clients is unclear. It is possible that this may simply be a drafting error given that the Commission’s FAQs<sup>9</sup> state that third country firms will be able to provide services directly to “professional investors” without establishing a branch. However, until the position is clarified, third country firms will be very concerned that they will not be able to provide investment services to professional clients at all, or have to provide them only through an EU branch.

In order for any third country firm to provide investment services in the EU (with or without a branch), the Commission must have made a declaration of “equivalence” in respect of the third country's supervisory regime. The bar for equivalence is set high (encompassing equivalent market transparency and integrity, regulatory capital and corporate governance requirements). This could affect firms operating out of numerous jurisdictions; for example, the requirement for sufficient capital resources could be problematic for U.S. based investment managers, as they are not subject to capital requirements under the U.S. regulatory regime.

In addition, there is a requirement that in order to be considered to be equivalent, a third country must provide “equivalent reciprocal recognition” of the prudential framework applicable to investment firms authorised under MiFID. This is likely to be controversial because the EU and other countries may be some years away from achieving the reciprocity standard.

The current transitional provisions provide that third country firms will be given four years to comply with the new requirements.

## Conclusion

The Commission has estimated that the MiFID review will result in on-off compliance costs of between €512 and €732 million and ongoing costs of between €312 and €586 million per year. This, it says, is a fraction of the costs imposed at the time of the introduction of MiFID. However, certain market participants will be subject to greater compliance costs than others under the new rules; for example, the fixed income business of banks and high frequency traders may

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<sup>9</sup> Available at:

<http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/11/716&format=HTML&aged=0&language=EN&guiLanguage=en>.

become subject to more onerous implementation and operating costs due to the expansion of the transparency and reporting framework to cover non-equities. At the same time, third country investment firms may find it difficult under the new third country regime to provide services to EU clients; conversely, EU residents may find it difficult to access the services of non-EU providers.

Finally, a key theme of the MiFID II proposals is the general increase in ESMA's oversight powers. This suggests that in future, ESMA's ability to create legally binding standards could be used as a means of moving EU financial regulation away from a principles-based regime to a more rules-based environment. However, it is likely that when formulating new rules and standards, ESMA will seek input from market participants – as such, it is vital that they take full advantage and enter into a constructive dialogue with it.

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