Almost four years since the Commission began its review of the original Markets in Financial Instruments Directive (MiFID), the final texts of MiFID2 and MiFIR are about to be published in the Official Journal. The protracted legislative process is testament to the scope and complexity of these comprehensive reforms. If, as expected, publication occurs in the second week of June, the new rules will enter into force in mid July 2014 and will start to apply to firms 30 months later, early in 2017.

Focusing on the Level 1 text, this briefing provides an overview of the structure and major features of this multi-faceted legislation, highlights key areas of concern and illustrates some of the implementation issues likely to face the market in coming months.

Prior to formal publication of the Level 1 text, ESMA has already begun the process of developing Level 2 measures, publishing two important documents on 22 May. The first ESMA document is a discussion paper that sets out ESMA's proposals in a number of areas where ESMA is empowered to draft technical standards including investor protection; transparency; data publication; micro-structural issues; data publication and access; requirements applying on and to trading venues; commodity derivatives and market data reporting. The objective of the discussion paper is to obtain initial stakeholder feedback before ESMA launches a separate consultation on these technical standards later in the year.

**MiFID2 in a nutshell – the main elements of the reforms**

**Market structure**
- Introduction of a new multilateral, discretionary trading venue, the Organised Trading Facility (OTF), for non-equity instruments
- Expanded scope of Systematic Internaliser (SI) category with increased transparency requirements
- Requirement for investment firms to trade listed equities on a Regulated Market (RM), Multilateral Trading Facility (MTF) or SI and effective limitation of “pure” over the counter business for cash equities
- New systems and controls requirements for organised trading venues
- Introduction of trading controls for algorithmic trading activities
- Obligation to trade clearable derivatives on organised trading platforms
- Introduction of a harmonised EU regime for non-discriminatory access to trading venues, CCPs and benchmarks

**Transparency and transaction reporting**
- Equity market transparency to be increased
- New transparency requirements for fixed income instruments and derivatives with scope of requirements calibrated for liquidity
- “Consolidated Tape” for trade data. Requirement to submit post-trade data to Authorised Reporting Mechanisms
- Widening scope of MiFID transaction reporting obligations

**Conduct, supervision and product scope**
- Increased conduct of business requirements to improve investor protection
- Regulatory perimeter extended to cover structured deposits
- Strengthened supervisory powers with new powers to ban products or services that threaten investor protection, financial stability or the orderly functioning of markets
- Strengthened administrative sanctions to ensure effectiveness and harmonisation

**Commodities**
- Change in scope of regulatory perimeter for commodities business
- Introduction of a harmonised position limits regime for commodity derivatives to improve transparency, support orderly pricing and prevent market abuse

**Third countries**
- Limited attempt to harmonise regime for access to EU markets by third country firms
The second recent ESMA document is a consultation paper in which ESMA sets out its draft advice to the Commission on all the topics on which the Commission has asked ESMA to provide technical advice for the adoption of delegated acts by the Commission (including in relation to conduct of business). The consultation paper is relevant to a range of firms engaged in the production and distribution of financial products, including structured deposits. ESMA is required to finalize its advice to the Commission by December 2014, following which the Commission will draft the relevant delegated acts and discuss them with the European Securities Committee before they are sent on to the Parliament and Council for adoption.

**Why is there new legislation?**

There were several driving forces behind MiFID2 and MiFIR. The starting point was the scheduled review of MiFID, two years after implementation. This routine review coincided with the financial crisis and resulted in aspects of the G20 reform agenda, most notably in relation to increased market transparency and trade execution of OTC derivatives, being included as part of the package of reforms. The financial crisis has clearly shaped the objectives of policy makers and MiFID2 has been framed with as much of an eye to the stability of the financial system as a whole as to the protection of the individual investor or conduct of an individual firm.

Other elements of the new legislation, such as controls on algorithmic trading, have been introduced as a direct response to market developments and technical innovations since MiFID. Overlaying these drivers was the desire for further harmonisation of the European financial regulatory framework in the wake of the de Larosière Report and further moves towards a single European rulebook. This multipart agenda has resulted in an extremely broad set of rules.

**Legislative structure**

The existing MiFID framework will be replaced by two pieces of legislation: a Directive (MiFID2), which will repeal and partly recast MiFID and a Regulation (MiFIR), which will partly replace MiFID. This Directive-Regulation split at Level 1 reflects a common approach in recent European legislative initiatives. The new directive covers many of the topics included in the original one, such as scope, authorisation, organisation and conduct of business rules, as well as some of the newer topics such as Organised Trading Facilities (OTFs) and commodity derivative position limits. The regulation, which will (unlike the directive) have direct effect, focuses mainly on the markets reform agenda in order to achieve maximum harmonisation.

There is provision in many areas for the framework legislation to be supplemented by implementing measures. In contrast to MiFID implementation, it is likely that the bulk of the Level 2 measures, in particular the Regulatory Technical Standards (RTS)
and Implementing Technical Standards (ITS) will be issued as regulations, with a relatively limited role for national implementation. Consequently, at Level 3, there will be a greater need for ESMA guidance and FAQs. This has also been the case with the European Market Infrastructure Regulation (EMIR) and the Alternative Investment Fund Managers Directive (AIFMD), where a lack of clear guidance in some areas has caused practical implementation difficulties.

Implementation challenges
As outlined in the Level 1 text, the proposals present a number of implementation challenges. For example, firms will be faced with an array of strategic decisions – what businesses will they undertake in the new regime? How should firms help clients with implementation?

Systems implementation issues should not be underestimated. Where MiFID2 subjects businesses to totally new requirements (such as transparency requirements for fixed income) or brings a line of business firmly within the regulatory perimeter for the first time (for example certain commodities business) firms will have to undertake significant systems build ‘from scratch’. By contrast, even for business lines already accustomed to the MiFID regime (most notably equities) changes to market structure will have a profound impact on how firms interact with their clients, likely requiring the dismantling of existing systems and their replacement with new ones. These structural and operational challenges will have a knock-on effect on documentation and compliance procedures, with a degree of ‘re-papering’ inevitable. All firms affected by the legislation will face the added complication that the precise requirements (essential for effective implementation but largely dependent on Level 2 and Level 3 measures) may not be known until relatively late in the process – potentially leaving firms with relatively little time to implement and comply.

Finally, these new rules, in common with other recent regulatory reforms such as the EMIR and the AIFMD will have extra-territorial impact. This goes beyond the direct implications of third country access issues, to the broader question of Europe’s competitiveness compared with other locations – will financial services firms stay, move or be attracted to Europe as a result of the new rules?

Structure of the legislation

<table>
<thead>
<tr>
<th>Recast Markets in Financial Instruments Directive (MiFID2)</th>
<th>Markets in Financial Instruments Regulation (MiFIR)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Scope: instruments, services, exemptions</td>
<td>Definitions</td>
</tr>
<tr>
<td>Authorisation, controllers, governance, passporting, branches of third country firms</td>
<td>Pre- and post-trade transparency and waivers</td>
</tr>
<tr>
<td>Organisational and conduct of business rules</td>
<td>Platform trading obligations for shares and OTC derivatives</td>
</tr>
<tr>
<td>Obligations of MTFs, OTFs, regulated markets</td>
<td>Transaction reporting</td>
</tr>
<tr>
<td>Commodity derivatives position limits, management, reporting</td>
<td>Clearing of derivatives on regulated markets</td>
</tr>
<tr>
<td>Data reporting services providers</td>
<td>Access issues</td>
</tr>
<tr>
<td>Regulatory powers</td>
<td>Cross-border business by third country firms</td>
</tr>
<tr>
<td>Reviews, reports</td>
<td>Product/practices intervention powers</td>
</tr>
<tr>
<td></td>
<td>ESMA position management powers</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Delegated/implementing acts (regulations or directives):</th>
</tr>
</thead>
<tbody>
<tr>
<td>Drafted and adopted by Commission following advice from ESMA</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Regulatory/implementing technical standards (regulations):</th>
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</thead>
<tbody>
<tr>
<td>Drafted by ESMA and endorsed by the Commission</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>ESMA guidelines and ESMA/Commission FAQs</th>
</tr>
</thead>
</table>

<table>
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<tr>
<th>National implementation:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Primary or secondary legislation, regulatory rules</td>
</tr>
<tr>
<td>Penalty regimes</td>
</tr>
</tbody>
</table>
One of the key objectives of MiFID2 is to address perceived failings in market regulation in the period leading up to the crisis. Post 2007, use of MiFID transparency waivers had led to a substantial volume of equities activity migrating to ‘dark pool’ MTFs whilst fixed income and derivatives products were not subject to transparency requirements under MiFID at all. When the financial crisis hit, it was perceived that the prevailing market structure deprived regulators of the visibility required fully to appreciate risks in the financial system and that opacity in some markets may have frustrated their response to the crisis.

MiFID2 deals with these concerns by:

- Creating a new venue for multilateral discretionary trading – the Organised Trading Facility (OTF)
- Widening the scope of the existing MiFID ‘Systematic Internaliser’ category (SI) and bolstering the transparency requirements for SIs across a range of instruments
- Requiring standardised derivatives to be traded on an organised and transparent venue i.e. on regulated markets (RM), Multilateral Trading Facilities (MTFs) or OTFs
- Requiring investment firms to trade listed equities on an RM or MTF or with an SI
- Enhancing transparency requirements for platform traded equities and introducing transparency requirements to fixed income markets
- Aligning requirements for RMs and MTFs

Organised Trading Facilities
In early drafts of MiFID2, the OTF appeared as a new venue specifically designed to to capture broker crossing networks for equities. However, in the

<table>
<thead>
<tr>
<th></th>
<th>RMs</th>
<th>MTFs</th>
<th>OTFs(^1)</th>
<th>SIs</th>
<th>OTC</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Operator</strong></td>
<td>Exchange</td>
<td>Exchange or Firm</td>
<td>Exchange or Firm</td>
<td>Firm</td>
<td>Firm</td>
</tr>
<tr>
<td><strong>Non-discretionary execution</strong></td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>Where quotes binding</td>
<td>No</td>
</tr>
<tr>
<td><strong>Conduct of business rules</strong></td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td><strong>Operator can use own capital</strong></td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td><strong>Access to facilities</strong></td>
<td>Transparent, non-discriminatory rules, objective criteria</td>
<td>Transparent, non-discriminatory rules, objective criteria</td>
<td>Transparent, non-discriminatory rules, objective criteria</td>
<td>Commercial policy (in objective, non-discriminatory way)</td>
<td>Commercial policy</td>
</tr>
<tr>
<td><strong>Admission to trading</strong></td>
<td>Clear, transparent rules (+ other criteria)</td>
<td>Transparent rules (+ adequate P]</td>
<td>Transparent rules (+ adequate PAI(^2))</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td><strong>Resilience, circuit breakers, tick size</strong></td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td><strong>Surveillance required (MAR)</strong></td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td><strong>Pre-trade transparency</strong></td>
<td>Yes (incl. non-equities)</td>
<td>Yes (incl. non-equities)</td>
<td>Yes (incl. non-equities)</td>
<td>Yes (incl. non-equities)</td>
<td>No</td>
</tr>
<tr>
<td><strong>Pre-trade waiver available</strong></td>
<td>Yes (incl. non-equities)</td>
<td>Yes (incl. non-equities)</td>
<td>Yes (incl. non-equities)</td>
<td>Yes</td>
<td>No/a</td>
</tr>
<tr>
<td><strong>Post trade transparency</strong></td>
<td>Yes (incl. non-equities)</td>
<td>Yes (incl. non-equities)</td>
<td>Yes (incl. non-equities)</td>
<td>Yes (incl. non-equities)</td>
<td>Yes (incl. non-equities)</td>
</tr>
<tr>
<td><strong>Publish execution quality data</strong></td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td><strong>Eligible OTC derivs platform</strong></td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td><strong>Authorities can suspend trading</strong></td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td><strong>Record orders</strong></td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

1. Non-equities only; 2. Publicly available information

“The financial crisis has shifted the objectives of policy makers... MiFID2 has been framed with as much of an eye to the stability of the financial system as a whole as to the protection of the individual investor or conduct of an individual firm.”
legislation’s final form equities are not permitted to be traded on OTFs. The category is framed broadly, to capture all forms of organised trading in non-equities that is not caught by the existing MiFID venue categories. OTFs will be subject to the same core requirements for the operation of a trading venue as the existing organised platforms. Order execution on an OTF must take place on a discretionary basis but the operator’s discretion is limited to the following circumstances: (a) when deciding to place or retract an order on the system they operate; and (b) when deciding not to match a specific client order with other orders available in the systems at a given time.

Operators of OTFs will be barred from committing their own capital to trades, although matched principal trading is permitted to a limited degree for non-equity instruments (but not for derivatives which are subject to the clearing obligation under EMIR) provided that the client has consented. The legislation also prohibits a firm from running an OTF and an SI in the same legal entity. The latter restriction could pose a substantial implementation challenge for firms, particularly in view of the likely increased importance of the SI category (see below).

**Systematic Internalisers**

MiFID introduced the concept of a “Systematic Internaliser” to describe a firm that executes client orders against its own book or other client orders. Ostensibly, the MiFID2 definition of an SI does not diverge much from its predecessor, now referring to “an investment firm which, on an organised, frequent systematic and substantial basis, deals on own account when executing client orders outside a regulated market, an MTF or an OTF without operating a multilateral system”.

Critically though, the definition is elaborated to provide more objective criteria against which to measure the “frequent and systematic basis” (by reference to the number of OTC trades in the financial instrument carried out by the investment firm on own account when executing client orders) and “substantial basis” (either by the size of the OTC trading carried out by the investment firm in relation to the total trading of the investment firm in a specific financial instrument or by the size of the OTC trading carried out by the investment firm in relation to the total trading in the Union in a specific financial instrument). These criteria will be set at Level 2.

Under the existing rules, these threshold criteria are framed in much more subjective terms and relatively few firms determined that they met them. In practice therefore, the changes heralded by MiFID2 mean that many more firms are likely to find that they meet the criteria. The SI category is also broadened in terms of product scope, capturing trades in a variety of instruments, including cash equities, depository receipts, ETFs and also non-equities such as bonds, structured financial products and derivatives.

MiFIR contains pre-trade and post-trade transparency requirements for SIs in respect of both equity and non-equity instruments. On the equities front, pre-trade, investment firms will be required to make public firm quotes on shares, depositary receipts, ETFs, certificates and similar financial instruments traded on a trading venue for which they are SIs and for which there is a liquid market. The requirements apply to dealings up to the standard tick size.

In terms of fixed income instruments, investment firms will be required to make public firm quotes for bonds, structured finance products, emission allowances and derivatives traded on a trading venue for which they are an SI and for which there is a liquid market when prompted for a quote by a client and the SI agrees to provide the quote. When those criteria are fulfilled, the SI has to make the same quote available to other clients while also undertaking to deal at that price for trades below a specified size threshold. The legislation allows the SI to set limits on the number of transactions that they undertake to enter with their clients pursuant to any given quote as long as the limits that the SI sets are based on transparent and non-discriminatory criteria. Beyond threshold deal sizes calibrated for a particular fixed income instrument, the pre-trade transparency requirements for SIs will not apply.

Post-trade, all investment firms (including SIs) must make public the volume and price of those transactions traded on a trading
venue and the time they were concluded for both equities and non-equities.

**Equities trading obligation**
Under MiFIR, no investment firm may execute an equity trade unless it is on a RM, an MTF, with an SI or an equivalent third country trading venue. This trading obligation applies to all shares ‘admitted to trading on a regulated market or traded on a trading venue’ unless the trades are non-systematic, ad hoc, irregular and infrequent or carried out between eligible and/or professional counterparties and do not contribute to the price discovery process. In effect therefore, the obligation will substantially limit the ability of firms to trade equities on a “pure” OTC basis (other than as an SI).

“The imposition of the new category of OTFs, coupled with a wider scope for SIs, will result in a change to the composition of the market with more activity on SIs and OTFs and reduced activity in OTC markets.”

Coupled with the ban on equities trading on OTFs, these changes effectively shut broker crossing networks out of equities trading altogether. Equities order flow currently routed through firms’ broker crossing networks will have to find a new home, either by firms registering as MTFs or executing via SIs. This is not an accident. The clear intention is to close broker-crossing network for equity trading and drive as much equities business as possible onto rule-based trading venues or transparent SI execution. In certain respects then, the post-MiFID2 landscape for equities trading could resemble another era, with the increasingly important Systematic Internaliser of the post-MiFID2 world looking very much like the modern equivalent of the “jobber” of the pre-Big Bang age.

**Aligning the requirements for regulated markets and multilateral trading facilities**
The requirements for RMs and MTFs are being aligned as much as possible as RMs and MTFs are viewed as essentially similar, organised trading functionalities. This will affect requirements in a number of areas, for example conduct of business rules, access to facilities and surveillance.

**Equity markets transparency**
Although equity markets were a key focus of MiFID, further reforms are included in the new legislation, largely focused on increasing transparency. This is to be achieved primarily via the obligation to trade equities on organised venues (see above). However, the new legislation also augurs new pre- and post-trade transparency requirements for equities and equity like instruments such as ETFs and depository receipts whilst re-framing the terms of transparency waivers that currently apply to equities business. In response to the fragmentation of trade data that followed from the introduction of venue competition under the original MiFID, the new rules also contemplate the introduction of a consolidated tape for equities and equity like instruments.

**Pre- and post-trade transparency requirements for trading venues**
MiFID introduced harmonised pre and post-trade transparency requirements on shares admitted to trading on regulated markets. The transparency requirements have now been expanded to include equity instruments other than shares admitted to trading on trading venues including depositary receipts, ETFs, certificates and other similar financial instruments.

Pre-trade, trading venues will have to make public their current bid and offer prices, depth of interest information and actionable indications of interest on a continuous basis during normal office hours. The precise requirements will be calibrated to cater for different types of equity instruments. Much of the detailed requirements are to be specified in the implementing measures.

Post-trade, trading venues have to make public the price, volume and time of transactions in as close to real time as ‘technically possible’.

Waivers from pre-trade transparency will continue to be permitted, providing this does not cause competitive distortions and reduce the overall efficiency of the
orders large in scale, compared with financial instruments which are financial instruments where the derivatives not subject to the trading transparency requirements for non-MiFIR introduces pre- and post-trade transparency requirements for fixed income and derivative markets transparency.

MiFIR introduces pre- and post-trade transparency requirements for non-equities (e.g., bonds, structured finance products, emission allowances and derivatives). The introduction of transparency requirements for the fixed income and derivatives markets is a new concept and likely to pose implementation challenges for firms on an operational level. In addition, the comparative fragmentation and relative lack of liquidity in fixed income markets have already led to concerns about the implications (particularly for market makers and the price at which they can hedge) of the transparency requirements on fixed income markets. In this regard, Level 2 measures and Level 3 guidance that help to define the boundaries as to what fixed income instruments are considered liquid enough to be subject to the regime will be of critical importance.

Pre- and post-trade transparency requirements for trading venues

Under MiFIR, RMs, MTFs and OTFs and firms operating these trading venues will have to publish bid and offer prices and ‘depth of trading interest’ information. They will also be required to disclose actionable indications of interest. It is worth noting that the data will have to be published on a continuous basis during normal trading hours. From an operational standpoint, that requirement could pose a significant implementation challenge.

“Until Level 2 measures are finalized, question marks may remain over the equivalence of the new European fixed income transparency regime with its US counterpart.”

The legislation sets out a set of waivers from the pre-trade transparency requirements. There are three grounds on which the waiver might be granted:

- Orders large in scale, compared with normal market size
- Indications of interest in requests for quotes and voice trading systems above a size specified for a particular instrument, such that disclosure would expose liquidity providers to undue risk
- Derivatives not subject to the trading obligation and for any instruments for which there is not a liquid market

The waiver regime is to be overseen by national regulators acting in consultation with ESMA. The scope and range of exemptions from fixed income transparency requirements stands in contrast to the narrower US exemptions. Until Level 2 measures are finalized, question marks may remain over the equivalence of the new European fixed income transparency regime with its US counterpart.

On the post-trade front, MiFIR requires publication of price, volume and time of trade data in as close to real time as possible. The legislation does contemplate a deferral regime which may be employed to ensure that the increased transparency requirements do not adversely impact market-making. Features of the regime include time delays and volume omissions to allow market-makers to avoid the risk of adverse price movements on the announcement of their trades. The regime for deferrals bears some similarities to the pre-trade waiver requirements, having three broad categories for deferral. However, the precise operation of the post-trade deferral regime will not be completely clear until the Level 2 legislation and Level 3 guidance has been issued.

Transaction reporting

MiFIR expands the original MiFID transaction reporting obligation. Under the new rules, which will also involve a significant increase in the volume of reportable data, investment firms that execute transactions in financial instruments must report complete and accurate details of the transactions to the competent authority as quickly as possible, and no later than the close of the working day following the trade. The obligation applies to the following types of instrument (though in each each case regardless as to whether or not the transaction was executed on the trading venue):

- financial instruments which are admitted to trading or traded on a trading venue or for which a request for admission to trading has been made
- financial instruments where the underlying is a financial instrument traded on a trading venue
financial instruments where the underlying is an index or a basket composed of financial instruments traded on a trading venue.

Transaction reports can be made to national competent authorities directly by the investment firm itself, via an approved reporting mechanism (ARM) or by the relevant trading venue. While investment firms generally have responsibility for the completeness, accuracy and timely submission of the reports, the rules provide that firms will not be responsible for failures in the completeness, accuracy or timely submission of the reports which are attributable to an ARM or trading venue (though firms are nevertheless obliged to take reasonable steps to verify the completeness, accuracy and timeliness of the transaction reports submitted on their behalf).

Derivatives trade execution

Under MiFIR, a class of OTC derivatives which is subject to the clearing obligations under EMIR may also be declared subject to mandatory platform trading obligations, requiring that class of derivative only be traded on an RM, MTF, OTF or an equivalent third country market. To become subject to this mandatory trading obligation the class of derivatives must be admitted to trading on at least one relevant trading venue and be sufficiently liquid. The mandatory platform trading obligation does not apply to transactions that are exempt from the EMIR clearing obligation under either the intragroup exemption or the EMIR transitional provisions regime.

OTC derivatives may become subject to the mandatory trading obligation via either a ‘top down’ or a ‘bottom up’ process. The latter is driven by a class of OTC derivatives becoming subject to the EMIR clearing obligation, following which ESMA will consult on whether to apply the mandatory trading obligation to that class (or a subset of it). Under the top down process, ESMA will monitor activity in OTC derivatives not yet subject to mandatory clearing to identify potential systemic risks or regulatory arbitrage and will notify the Commission of derivatives that ESMA thinks should be subject to the trading obligation but for which no CCP is authorised to clear the contracts or which are not yet admitted to trading on a platform.

ESMA will also be required to maintain a register of derivatives that are subject to the trading obligation, which venues they are to be traded on and the date on which the trading obligation came into effect. Level 2 and Level 3 measures will be important to the calibration of the mandatory derivative trading obligation so the precise details of the obligation may remain unclear for some time.

Unlike the majority of the other obligations under MiFID2 and MiFIR, the derivatives trading execution requirements do not apply only to investment firms. The mandatory trading obligation has a similar scope of application as the clearing obligation under EMIR, applying to financial counterparties and non-financial counterparties over the threshold, where they are dealing in mandatorily tradable derivatives, either with another financial counterparty or another non-financial counterparty over the threshold.

The mandatory trading obligation for derivatives also has important implications for financial counterparties and non-financial counterparties dealing with third country entities that would have been subject to the obligation if they were in the EU and for third country firms dealing with other non-EU firms. If the transaction has a direct, substantial and foreseeable effect in the EU, or if it is necessary or appropriate to prevent evasion, ESMA can also apply the mandatory trading obligation to a transaction between two third country entities, much in the same way that the EMIR clearing obligation can apply to trades between two such entities.

In terms of identifying the permitted platforms for derivatives subject to the obligation, the Commission will be responsible for determining the equivalence of third country venues, making its assessment against criteria such as the third country rules on venue authorisation and supervision, disclosure and transparency rules as well as the market abuse regime.
Algorithmic and high frequency trading

The MiFID2 requirements on algorithmic trading have been driven by developments in the market and as a response to incidents such as the infamous ‘flash crash’ that struck in May 2010 in the United States. Regulators believe that algorithmic trading causes systemic risks and, in order to address this, MiFID2 establishes a series of requirements for investment firms who use algorithmic trading and for trading venues where algorithmic trading or high-frequency algorithmic trading takes place.

The requirements cover:

- Extension of licensing to investment firms that are members of RM s or MTFs, have direct electronic access to trading venue systems or apply high frequency algorithmic trading techniques
- Enhanced information requirements by regulators, for example on the strategies of algorithmic traders
- Stricter checks on direct electronic access/sponsored access to trading venue systems
- Investment firms engaged in algorithmic trading pursuing a market making strategy to have appropriate systems and controls for such activity and to have a liquidity provision obligation
- Trading venues to have circuit breakers and robust controls in place

To ensure consistency, the requirements for algorithmic trading interact with those of the Market Abuse Regulation and the Market Abuse Directive 2, where the definition of market manipulation will expressly refer to certain algorithmic or high frequency trading strategies.

Open access

Another key feature of the MiFID2 market reforms is open access, requiring all trading venues (RM s, MTFs and OTFs) to establish transparent and non-discriminatory rules on accessing the facility. The new rules also contemplate that investment firms should have access to clearing and settlement systems throughout the EU, regardless as to whether transactions have been concluded through regulated markets in the member state concerned.

The new rules aim to foster competition amongst trading venues and CCPs. Trading venues are to have non-discriminatory and transparent access to CCPs. Venues are also entitled to enjoy non-discriminatory treatment by CCPs in terms of collateral, the netting of economically equivalent contracts and cross-margining with correlated contracts cleared by the same CCP, as well as non-discriminatory clearing fees. In addition, CCPs are to have rights to clear instruments traded on trading venues on a non-discriminatory basis and trading venues and CCPs are to have non-discriminatory access to information and licences from benchmark proprietors. However, there are extensive transitional provisions, in particular for exchange traded derivatives, new CCPs and benchmark proprietors.
Part 2 – Firm Regulation

Third country firms – branch and cross border regime

Currently, there is no harmonised regime governing access by third country (i.e. non-EU) firms to EU markets. Instead, each member state operates its own regime, subject to the general principles of the EU treaties. MiFID2 and MiFIR make a limited attempt to introduce a more harmonised framework for business targeted towards certain types of client.

The new rules allow (but do not compel) member states to require third country firms to establish branches when providing services to retail or elective professional clients. If a member state does impose a branch requirement, then authorisation criteria and conduct of business rules will apply. Alternatively, member states may choose to allow services to be provided on the basis of existing national rules.

In addition to the third country branch regime, MiFIR introduces a harmonised third country equivalence regime, which will allow access by third country firms to the EU when providing services to professional investors and eligible counterparties. A third country firm is able to provide services to eligible counterparties. Member states may choose to allow services to be provided on the basis of existing national rules.

The main requirements are:

- Third country firms must register with ESMA to provide services on a cross-border basis
- The Commission must have decided that the third country has rules and safeguards ‘equivalent’ to those in the EU
- Reciprocity by the third country is necessary
- Regulatory cooperation agreements must be in place between ESMA and the competent authorities of the third country

The Commission will determine whether a particular third country is equivalent, based on whether the third country’s regulatory and supervisory framework achieves the same objectives as EU legislation. The third country’s framework also needs to provide for an effective, equivalent system for the recognition of investment firms authorised in other jurisdictions, i.e. there must be reciprocity in the treatment of EU firms.

Once the Commission has adopted an equivalence decision with respect to a particular country and ESMA has established cooperation agreements with the competent authorities there, investment firms from that country will be able to provide services on a cross border basis to per se professional clients and eligible counterparties, provided that they have registered beforehand with ESMA.

For three years after an equivalence decision is made, member states can continue to apply national rules. National rules will also continue to apply until such time as an equivalence decision is taken.

The new cross-border provisions relate to per se professional clients and eligible counterparties. Member states will continue to apply national rules with respect to retail clients. This might include a requirement for the third country firm to establish a branch, as described above, but it is important to note that this is entirely optional and the member state may continue to operate its existing rules.

To this extent, the rules around third country access, especially as they relate to retail investors are not harmonised. It may also be some time before we see the practical effects of the new provisions, as underpinning the new cross border regime is the equivalence assessment by the Commission, which in turn depends on reciprocity. Experience with EMIR has shown that these decisions may not be issued speedily and might not be issued at all. In any event, member state rules on cross border business will continue to apply for three years, even after an equivalence decision has been reached and it is only after that period has expired that ESMA-registered third country firms can provide services to eligible counterparties and professionals throughout the EU on the basis of their own home state rules. As a result, it is likely that the provision of services on a cross-border basis will continue along current lines for the foreseeable future.

Conduct of business and investor protection

The conduct of business provisions of MiFID2 are the primary means by which the directive achieves improvements in investor protection. These provisions have been subject to heated debate and constant evolution during the legislative process, in response to a litany of different mis-selling scandals. The result is something of a ‘patchwork’ of modifications to existing rules. In common with other parts of MiFID2, much of the detail on the new conduct of business rules will not be known until the Level 2 and Level 3 measures are available.

The main changes to conduct of business rules relate to:

- Extending the scope of the conduct of business rules to include structured deposits
- Product design
- Title transfer with retail clients
- Conflicts of interest
- Execution only business
- Best execution performance and public disclosure

Structured deposits

Many of the conduct of business requirements under MiFID will be extended to cover structured deposits, so that investor protection requirements will now apply when a firm sells or advises in respect of structured deposits (i.e. deposits where repayment is linked to an index, MiFID instrument, commodity or other non-fungible asset or FX rate).
**Product design**

These provisions are clearly a response by EU lawmakers to recurrent mis-selling scandals. The legislation imposes a new set of requirements firms that manufacture investment products, covering:

- Pre-sale internal approval processes
- Identification of target market to ensure all relevant risks assessed
- Distribution strategies – they must be consistent with the identified target market (retail and/or professional)
- Requirements for periodic reviews
- Ensuring distributors have information on product design and intended markets

The recitals to the legislation make clear that the new rules are not intended to put the burden of responsibility exclusively on the manufacturer. The new rules do not eliminate responsibilities of distributors, but rather increase the significance of the manufacturer’s regulatory obligations.

**Title transfer with retail clients**

The directive establishes a requirement for investment firms holding client funds and assets to make adequate arrangements to safeguard clients’ ownership rights, especially in the event of the investment firm’s insolvency, and to prevent the use of a client’s financial instruments on the firm’s own account except with the client’s express consent. The directive also introduces a prohibition on investment firms entering into title transfer financial collateral arrangements with retail clients.

**Conflicts of interest**

Conflicts of interest is one of the major business rules that has been expanded under MiFID2. Now, the focus is on more stringent rules in respect of inducements and remuneration structures within firms. The extent to which these requirements apply to professional clients, in addition to retail, will be a key consideration.

The main requirements include:

- Firms to ensure that remuneration and third party inducements do not constitute conflicts (for example, firms will not be able to operate sales targets for retail clients that could lead to an omission to offer a more suitable product)
- Inducements disclosures must explain how the benefit is to be transferred to client
- Disclosure to the client as to whether or not investment advice is provided on an independent basis;
- Regard to the requirements of the intended target market when marketing and distributing financial products;
- Aggregation of all cost and charging information (and provision of a detailed breakdown to the client on request) to allow the client to understand the overall cost as well as the cumulative effect on return of the investment
- Prohibition on accepting and retaining inducements from third parties, other than minor non-monetary benefits
- Where investment services are bundled, informing the client whether the different components can be purchased separately

**Execution only business**

Under the new legislation the scope of activities that can be carried out on an ‘execution only’ basis and hence without a suitability assessments has been narrowed considerably in relation to certain products e.g. margin trading, embedded derivatives, complex structures and structured UCITS.

**Best execution performance – public disclosure**

Under MiFID2, the key development in relation to best execution is a requirement that firms disclose publicly, on an annual basis, information on which are the top five execution venues by volume in respect of a particular type of instrument used by that firm. The new rules also require trading venues and systematic internalisers to publicly disclose information on the quality of execution they provide, including details about price, cost, speed and likelihood of execution.

**Regulatory intervention powers and administrative sanctions**

As part of its objective to raise the bar for investor protection standards, MiFIR extends very wide ranging regulatory powers in the arena of product intervention, authorising ESMA, the EBA and national regulators to impose temporary bans or restrictions on the marketing, distribution or sale of certain financial instruments (including structured deposits) or types of financial activity or practice. The ability to impose limits on “a type of activity or practice” appears to be a very broad power indeed, with scope to impact not only the regulated activities of firms but potentially the activities of their customers as well.

“In the post MiFID2 world… there is likely to be much more regulatory scrutiny – and potentially regulatory challenge – even before a product reaches the market.”

There are a number of conditions for product or activity intervention including that the intervention addresses a significant investor protection or financial stability concern and that existing requirements inadequately address the threat. Interventions are also subject to a proportionality requirement.

Firms are already familiar with regulation at the point of sale, such as rules relating to financial promotions, selling practices, product disclosures etc. However, the MiFIR intervention powers are novel and at
this stage, it remains uncertain what an intervention might look like in practice. In the post-MiFID2 world though, there is likely to be much more regulatory scrutiny - and potentially regulatory challenge – even before a product reaches to the market.

New regulatory intervention powers will present a range of questions and concerns for firms: will pre-approval for products be required? What is required in terms of systems, documentation and compliance? What is the best marketing strategy? Will different national interventions fragment from single market? What is already clear, however, is that firms will need to review their systems and controls and look at product governance strategies in a lot more detail in the future.

In response to quite wide disparity of scope and level of sanctioning powers used by national regulators across different member states, the new rules also seek to encourage a more harmonised approach to administrative sanctions, requiring competent authorities to have regard to relevant circumstances when setting the type and level of an administrative sanction, including (but not limited to) the gravity of infringement, the financial strength of the person responsible, the importance of profits gained or losses avoided and any previous infringements. Sanctions are also required to be sufficiently dissuasive and it is envisaged that in future, regulatory fines should be high enough to offset any benefit of an infringement, in some cases up to 10% of consolidated turnover.

Commodity derivatives
The MiFID2 package of reforms marks a step change in the regulation of commodity derivatives in the EU. The main developments relate to:

- Scope – MiFID2 will bring more commodity derivatives within the regulatory perimeter
- A reduction in the number of exemptions available for commodities dealers
- Introduction of position limits and position management controls for commodity derivatives

**Scope**
Currently, under MiFID, contracts traded on an RM or MTF that can be physically settled are within scope as “MiFID instruments”. Under MiFID2, this is expanded to cover physically settled commodity derivatives traded on an OTF as well. There will however, be an exemption for certain energy contracts.

**Exemptions for commodities dealers**
The existing exemptions have been narrowed to increase regulatory oversight and transparency. The current exemption in Article 2(1)(k) of MiFID (for dealers whose main business consists of own account dealing in commodities or commodity derivatives) has been deleted, effectively bringing many commodities dealers who currently rely on this exemption within the regulatory perimeter for the first time. Additionally, the Article 2(1)(d) exemption (which currently

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**Scope – what is a commodity derivative?**

- **C(5)**
  - Cash settled commodity derivatives
  - Cash settled forwards now expressly included

- **C(6)**
  - Physically settled commodity derivatives traded on a regulated market, MTF or OTF
  - Carve-out for wholesale energy products under REMIT traded on an OTF that must be physically settled*

- **C(7)**
  - Other derivatives on commodities
  - Not for commercial purposes, which have the characteristics of other derivative financial instrument […]

* Plus competent authorities can give temporary exemption from EMIR clearing/clearing threshold for physically settled oil/coal derivatives traded on an OTF. The definition of commodity derivative is also extended to include commodity derivative warrants and similar instruments and certain other derivatives on non-financial underlyings (C10).

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provides conditional exemption for certain firms who do not provide any investment services apart from own account dealing) has been amended so as not to apply to dealers in commodity derivatives, emissions allowances and derivatives in emissions allowances. The remaining exemption, currently in Article 2(1)(i) is retained for ‘ancillary activities’, albeit reduced in scope: the exemption won’t be available if executing client orders, market making, or employing high frequency or algorithmic trading strategies for commodities.

**Position controls for commodities derivatives**

MiFID2 introduces a new regime of position limits for commodity derivatives, outlined in the diagram below.

The imposition of position limits is likely to cause significant implementation issues. Competent authorities regulating the trading venues will impose position limits on the net position held at any time in commodity derivatives traded on trading venues and economically equivalent OTC contracts. The limits are to be set on the basis of all positions held by a person and those held on its behalf at the group level. A group wide position limit is likely to require complex calculations, which may differ by delivery month. This represents a major implementation requirement for any firm which trades in these markets.

Another significant aspect to the legislation relates to the obligation for trading venues to report aggregate positions by class of persons, including daily breakdowns of positions (e.g. by participants, clients, clients of clients) to competent authorities. Firms have to be able to provide that information to the trading venue; a participant may have to get that information from its clients to be able to pass that on, posing a substantial operational burden.