Bloomberg BNA

WORLD SECURITIES LAW REPORT >>>

News and analysis of securities law developments around the world.
For the latest updates, visit www.bna.com

International Information for International Business

VOLUME 20, NUMBER 10 >>> OCTOBER 2014

The EU's MiFID 2: Key Changes for Investment Firms, Others Conducting Investment Activities

By Emma Radmore and Juan Jose Manchado, of Dentons UKMEA LLP, London.

Revision of the EU Markets in Financial Instruments Directive of 2004 (MiFID) was one of the major tasks for the European Commission (Commission) following the financial crisis and the recommendations of the G-20. Member states of the European Union had been operating under MiFID (which had been adopted in 2004) since late 2007. At the time, MiFID was a significant advance on its predecessor, the 1993 Investment Services Directive. Arguably, other reforms were more urgent, such as dealing with the risks of failing banks and over-the-counter derivatives trading, but MiFID was showing its age and its provisions were not keeping up with the changes in the market.

This Special Report examines the key changes the MiFID reform package introduces. While many of its requirements require further specification under EU delegated legislation and guidelines, businesses that fall within MiFID must start planning for the changes now.

What Is MiFID 2?

MiFID 2 comprises a directive, again called the Markets in Financial Instruments Directive (Directive 2014/65/EU) (MiFID 2), and a regulation, the Markets in Financial Instruments Regulation (Regulation 600/2014) (MiFIR). Both were adopted on May 15, 2014, and published in the EU Official Journal on June 12, 2014 (*see WSLR, July 2014, page 23*). Confusingly, they are also referred to collectively as MiFID 2.

There is an established hierarchy of EU legislation. "Level 1" legislation comprises directives and regulations. The key difference between the two is that regulations are directly applicable in EU member states and do not need to be transposed into the national legal framework of each member state. This should lead to complete consistency of law and interpretation. Directives, on the other hand, require that domestic legislators transpose them into national legislation, and will often allow member states to take advantage of options or discretions, such as deciding whether to implement certain provisions or not. Increasingly, the EU has moved away from "minimum harmonisation", where the Level 1 legislation would impose a minimum requirement but leave member states free to increase it if they wished, and towards "maximum harmonisation", where member states are not allowed to "gold plate" or be "super-equivalent" to the EU measures.

Increasingly, also, the Level 1 legislation sets a framework which is then detailed at Level 2, and MiFID 2 is no exception. Level 1 legislation explains the areas on which the Commission will make Level 2 measures, which will take the form of delegated and implementing acts, some of them containing technical standards. In adopting these acts, the Commission will act on the advice and draft technical standards of (but not always completely agree with) the EU supervisory authorities. In the case of MiFID 2, the relevant EU supervisory authority is the European Securities and Markets Authority (ESMA).

While many of the MiFID reform package's requirements require further specification under EU delegated legislation and guidelines, businesses that fall within MiFID must start planning for the changes now.

Currently, although MiFID 2 has been published and we know its provisions must be the law in EU member states from January 3, 2017, we await what should be several forests' worth of Level 2 measures. ESMA published a discussion paper and a consultation paper on May 22, 2014, which together ran to over 1,000 pages (*see WSLR, July 2014, page 23*). The response period is now closed, and ESMA will publish in December 2014 its final advice on some of the delegated acts the Commission must make, while consulting again the same month on the text of the technical standards due under the package. Then it will submit these to the Commission, some in June 2015 and some in December 2015. Member states are expected to put in place implementing measures (where they need to) by July 3, 2016. That means the final position on certain key implementation problems is some way off.

What Does MiFID 2 Cover?

The MiFID 2 directive covers:

- authorisation conditions for "investment firms" (as it defines them), including requirements on management bodies, controllers and specific requirements for firms that engage in algorithmic trading, high-frequency trading (HFT) or the provision of direct market access;
- authorisation and operation of regulated markets, as well as firms operating multilateral trading facilities (MTFs) or organised trading facilities (OTFs);
- organisational and operating conditions for investment firms, including requirements on conflicts management, record keeping and investor protection;
- the freedom of investment firms to provide investment services and activities throughout the EU by establishing a branch or through the provision of services;
- provision of investment services and activities by third country firms through establishing a branch in the EU;
- position limits and position management controls in commodity derivatives and reporting;
- authorisation and operation of data reporting services providers, with specific requirements for approved publication arrangements (APAs), consolidated tape providers (CTPs) and approved reporting mechanisms (ARMs); and
- supervision, cooperation and enforcement by competent authorities.

Many of its provisions relating to the performance of investment activities apply not only to investment firms authorised under MiFID 2 but also to credit institutions authorised under the fourth EU Capital Requirements Directive and Regulation package (CRD 4), when they carry on investment activities, and when they conduct client business involving structured deposits.

What Does MiFIR Cover?

MiFIR also applies to investment firms and to credit institutions conducting investment services or activities. Certain of its provisions apply more widely — to catch financial counterparties as defined in the European Market Infrastructure Regulation (EMIR) when trading derivatives, central counterparties (CCPs) and firms with proprietary rights to benchmarks. It also applies to third country firms operating under a decision of "equivalence", which the Commission will have power to make.

It covers:

- disclosure of trade data to the public: requirements on pre- and post-trade transparency for equity and non-equity instruments applying on trading venues, systematic internalisers and investment firms trading over the counter;
- reporting of transactions to competent authorities;
- trading of derivatives on organised venues;
- non-discriminatory access to clearing venues, trading and benchmarks;
- product intervention powers for the EU supervisory authorities, and ESMA's powers on position management controls and position limits in commodity derivatives; and
- provision of investment services or activities by third country firms following an equivalence decision.

Key Distinctions between MiFID 1 and MiFID 2

We must be thankful that the legislators have repealed MiFID 1 and replaced it with the MiFID 2 package, rather than seeking to make a set of complicated additions and amendments. However, this does make it hard in places to assess the extent of change and therefore the likely impact on financial market participants. The ESMA discussion and consultation papers made the assessment yet harder. ESMA plans to make use of the many guidelines for national regulators it and its predecessor, the Committee of European Securities Regulators (CESR), developed to help national interpretation and consistent application of MiFID 1. Its discussion and consultation papers therefore address only the areas of change, but this is not always apparent from the proposals.

The main areas of change which will lead to greater regulation are:

- **Organisational requirements:** The changes here are wide ranging and essentially strengthen nearly all of MiFID's requirements. The changes will impose greater duties and responsibilities on the management bodies of investment firms, put in place requirements relating to product design and governance, introduce greater controls over the link between remuneration and sales, and impose better protection for client money and assets by restricting title transfer collateral arrangements;

- **Conduct of business:** The changes to these requirements are discussed in more detail below, but focus on inducements, restricting the circumstances for execution-only sales, adding new requirements on best execution and putting in place greater requirements relating to suitability and appropriateness of advice and the retail sales process;

- **Market structure:** MiFID 2 introduces a new trading venue, the OTF, which can operate only in relation to non-equity instruments, as well as changes to trading obligations, whether stemming from EMIR or otherwise;

- **Trade transparency:** Pre- and post-trade transparency will apply to a greater number of both equity and non-equity instruments, which will have significant effects on both traders and trading venues;

- **Algorithmic trading:** MiFID 2 introduces authorisation requirements and a requirement for algorithmic traders to enter into appropriate market making contracts with trading venues. It also imposes limits on tick sizes and requires trading venues to put in place trading limits and controls. These requirements and restrictions are likely to have a particularly marked impact on HFT;

- **Transaction reporting:** The scope of the requirement will extend to instruments traded on any trading venue, also in relation to financial instruments which track or have such instruments as an underlying. Among other changes, trading venues will have to report trades carried out on their systems by persons who are not subject to MiFIR; and

- **Commodity derivatives:** Participants in the commodity derivatives markets will see significant changes. More firms will be caught by the definition of "investment firm" because MiFID 2 removes some exemptions that were available under MiFID and adds new commodity-based investments to the list of MiFID investments. Added to this are the new requirements on position limits and position reporting.

Investor Protection and Conduct of Business Changes

The remainder of this Special Report provides further detail on improvements in the area of investor protection.

The discussion includes references to some of the Level 2 provisions that ESMA has proposed. Although their final content may differ from the original drafts consulted on by ESMA, given the political mandate and the scope of the work undertaken at Level 2, it is apparent that the impact of the provisions will be substantial, and firms should therefore start getting ready to adapt their systems and controls and conduct of business practices.

We highlight only the more controversial proposed changes, although there are many others which would bear close analysis, in particular those related to information to investors.

Independent Investment Advice

There is a new rule in MiFID 2 to require firms that offer independent advice to assess a diverse range of instruments, which must go beyond the instruments issued or provided by entities with close links or relationships to the firm providing advice.

Under proposed Level 2 provisions, a firm would be allowed to claim it provides independent advice only if the selection of instruments:

- is diversified, proportionate to the scope of the advice service provided and representative of a substantial part of the market;

- is balanced as regards the proportion of instruments not issued by the firm itself or by closely linked entities and those issued by them; and

- is not biased and has taken into account all the relevant characteristics of the instruments and the clients.

If focused on certain classes or a specified range of instruments, the independent adviser would be allowed to market only to those clients with a preference for that class or range.

Firms offering independent and non-independent advice to retail clients should also:

- inform clients in good time before the provision of advice whether it will be independent or non-independent; and

- ensure that both types of advice and advisers are clearly separated from each other, and that an adviser does not provide both types of advice.

These requirements have caused uproar in certain jurisdictions. The U.K., however, is already ahead of this particular game, having implemented broadly similar changes in its Retail Distribution Review a couple of years ago.

Participants in the commodity derivatives markets will see significant changes.

Inducements

This is possibly the most controversial provision, certainly from the U.K. viewpoint. While ostensibly it is the same rule as in MiFID 1, it in fact introduces a full ban on monetary inducements for independent advisers and portfolio managers. Minor non-monetary inducements are acceptable only if they do not impair compliance with the duty to act in the client's best interest. Member states are allowed the discretion to introduce a total ban on commissions.

ESMA's technical advice will set out an exhaustive list of acceptable minor non-monetary benefits, which could include:

- information or documentation, both generic and personalised;
- training on a specific instrument or service; and
- hospitality.

Cross-subsidised research, whereby a firm receives tailored or rationed analysis in exchange for other services it contracts, would not constitute a minor non-monetary benefit. This would include privileged access to research analysts, facilitation of corporate access or provision of market data services. Where research is unbundled, the firm would need to ensure that such research is fairly priced and is set out in a contractual agreement separate to that concerning a client's transactions.

For all other investment firms, including non-independent advisers, the technical advice will set out a non-exhaustive list of inducements that do not meet a "quality enhancement test" and therefore breach the conflicts of interest and customer best interest rules. The list could include inducements that:

- pay for or provide goods or services that are essential for the firm in its ordinary course of business;
- do not facilitate higher quality service above the regulatory requirements; or
- are not related to the provision of an ongoing service.

Despite this list, the quality enhancement test would be met if the inducement enables the client to access a wider range of suitable instruments or to receive advice on an ongoing basis, so long as any such service is provided without bias or distortion.

All firms should keep records of payments and benefits received and of how they use them to enhance the quality of their services.

In the U.K., the regulators have already introduced tough restrictions, but industry strongly feels that ESMA's apparent desire for an overall draconian ban will disadvantage market participants and consumers alike.

The provision on inducements is possibly the most controversial provision, certainly from the U.K. viewpoint. While ostensibly it is the same rule as in MiFID 1, it in fact introduces a full ban on monetary inducements for independent advisers and portfolio managers.

Product Governance

The new rules require product manufacturers and distributors to anticipate possible investor protection issues, and not just address mis-selling risks at the point of sale.

Product manufacturers must:

- have a product approval process;
- specify a product's identified target market at sufficiently granular level and design the product accordingly;
- take reasonable steps to ensure the product is distributed to the target market;
- review regularly to ensure the instrument and distribution strategy remain appropriate; and
- provide information on the process to any distributor.

Distributors must:

- obtain the relevant information to understand the target market and products; and
- assess products' compatibility with the needs and interests of their clients.

Level 2 provisions could introduce requirements on product manufacturers to:

- factor in conflicts of interest when designing a product, in particular, remuneration aspects and situations where the client takes an exposure opposite to that of the firm;
- ensure staff possess necessary expertise before new products are manufactured;
- make the management body have effective control over the process, including information about the products in compliance reports;
- identify any groups of investors for whom the product is not suitable and undertake adverse scenario analysis;
- ensure the charging structure does not undermine returns; and

   ISSN 1357-0889

- consider stopping further issuance of the product where crucial events have occurred.

Meanwhile, distributors would likely be required to:

- ensure their clients' interests are not compromised as a result of distributors' commercial or funding pressures;
- review their offer regularly, to assess whether the product and distribution strategy remain appropriate;
- provide the manufacturer with sales information; and
- involve compliance and management in reviewing and endorsing the products and services offered.

There will also be associated issues, such as:

- whether requirements will also apply to distribution of products on the secondary markets;
- whether provision of information by a third country manufacturer should be subject to a written agreement;
- whether specific actions will be prescribed in the case of distribution outside the target markets or misjudgement of the target market;
- how the requirements for exchange of information will apply where there is no relationship between the producer and the distributor; or
- what the allocation of manufacturing liability will be where the product is designed by one firm but issued by another.

Remember also the product intervention powers mentioned above, which will enable regulators to step in if a product is deemed inherently dangerous.

Bundling

There is a new requirement on firms to inform investors whether it is possible to buy the different services in a package separately, and to provide separate evidence of costs and charges and a description of the way in which interaction between the bundled services modifies the risks.

Suitability and Appropriateness

MiFID 1 rules are carried forward with the following changes:

- the suitability assessment in investment advice and portfolio management must consider risk tolerance and the ability to bear losses;
- before making an advised transaction, the firm must provide a statement of suitability;
- where advice is ongoing, the periodic report shall contain an updated statement of suitability;
- execution-only services may be provided in respect of structured deposits, with the exclusion of those with a structure that hinders understanding of the risk or cost to clients;
- execution-only is not available where the firm is granting credits or loans to investors; and
- natural persons providing advice will be expressly required to have knowledge and competence, as established by national regulators.

Proposed Level 2 provisions would expand the requirements in the MiFID 1 Implementing Directive to clarify that, as regards the suitability assessment, firms should:

- apply it to recommendations other than to buy an instrument;
- have policies and procedures to ensure that they understand the instruments selected and that they assess whether alternative financial instruments, less complex or with lower costs, could meet their client's profile;
- not make a recommendation where an instrument from the firm's limited range is not suitable for the client;
- undertake an analysis of the costs and benefits of any switching, to prove benefits are greater than the costs;
- have procedures to maintain up-to-date information about the client where the service is ongoing;
- ensure tools employed are fit for purpose, and that questions used in the process are likely to be understood by clients and capture clients' views and needs accurately;
- when advising the representatives of a legal entity or the persons belonging to a group, agree with them who should be subject to the suitability assessment; and
- where advising the representative of a natural person or a small entity, assess the situation and objectives of the underlying client, and also the knowledge and experience of the representative.

Suitability reports to retail clients should include an outline of the advice given and of the reasons why it is suitable. Subsequent periodic reports for ongoing services can refer back to the original report while covering any changes to the instruments or the client's circumstances. Firms providing periodic suitability assessments should consider carrying out those reviews at least annually.

Regarding the appropriateness test, a product would be deemed complex where:

- it incorporates a clause, condition or trigger that can fundamentally alter its nature; and
- includes exit charges that make it illiquid in practice.

Conclusion

MiFID 2 brings significant changes to many participants in the financial markets. Investment firms will need to conduct detailed gap analyses to assess necessary changes to systems and controls, conduct of business and compliance procedures. Trading venues will need to consider their status, their systems and their practices.

We await much detail at Level 2, but, in the meantime, all firms should be assessing the likely impact of the changes on their business.

The text of 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 (MiFID 2) is available at http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2014.173.01.0349.01.ENG.

The text of 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 (MiFIR) is available at http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2014.173.01.0084.01.ENG.

The text of ESMA's May 2014 discussion paper on MiFID 2 and MiFIR is available at http://www.esma.europa.eu/system/files/2014-548_discussion_paper_mifid-mifir.pdf.

The text of ESMA's May 2014 consultation paper on MiFID 2 and MiFIR is available at http://www.esma.europa.eu/system/files/2014-549_-_consultation_paper_mifid_ii_-_mifir.pdf.

Emma Radmore is a Managing Associate and Juan Jose Manchado is an Information Assistant in Dentons UKMEA LLP's Financial Services and Funds Practice in London. They may be contacted at emma.radmore@dentons.com and juanjose.manchado@dentons.com.

   ISSN 1357-0889