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A Changing Landscape: The MiFID II Legislative Proposal

On 20 October 2011, the European Commission published its long-awaited legislative proposal to revise the Markets in Financial Instruments Directive (better known by its acronym MiFID). The proposal is divided into two parts, a Directive and a Regulation, both of which are expected to enter into force in 2013. Financial institutions and users of financial services will now need to prepare to negotiate a wider regulatory perimeter, which captures previously unregulated and more weakly regulated business areas. Pre-trade and post-trade transparency will apply to a broader scope of instruments. Firms should also be aware of the wider interventionist powers for EU and national regulators under contemplation.

Introduction

The original Markets in Financial Instruments Directive ("**MiFID**")[1] came into force almost four years ago, in November 2007. MiFID was intended to enhance investor protection, improve cross-border market access and promote competition in the financial markets across the EU.[2] Although MiFID has arguably achieved some of these aims, it is widely considered that the regime requires updating to reflect the lessons of the financial crisis and developments in the markets. The terms of MiFID itself anticipate a review in any event.[3] However, the financial crisis has undoubtedly led to a far more wide-ranging proposal than might otherwise have been expected.

The review of MiFID is one of a number of current European reforms aimed at strengthening the financial system. It will sit alongside the proposed European Market Infrastructure Regulation ("**EMIR**"),[4] which provides for mandatory clearing and

[1] Directive 2004/39/EC. Further requirements are also set out in the MiFID Implementing Directive (2006/73/EC) and Implementing Regulation (EC/1287/2006).

[2] See European Commission, Proposal for a Directive of the European Parliament and the Council on Markets in Financial Instruments repealing Directive 2004/39/EC of the European Parliament and of the Council (COM (2011) 656/4) (recast), (hereinafter, "**MiFID II**"), Explanatory Memorandum, p. 1.

[3] MiFID, Article 65.

[4] General Approach Document 13917/10 of 4 October 2011, Proposal for a Regulation of the European Parliament and of the Council on OTC derivative transactions, central counterparties and trade repositories 2010/0250 (COD).

reporting of over-the-counter ("**OTC**") derivatives,[5] and proposed amendments to the Market Abuse Directive ("**MAD**")[6] to reinforce the market abuse regime. The Commission also published its legislative proposals to amend MAD on 20 October 2011, and these proposals will be discussed in a separate client publication. The proposals of the European Commission (the "**Commission**") place a greater emphasis on improving the organisation, transparency and oversight of what are seen as under-regulated and opaque areas of the financial system, in line with G20 commitments.[7] Furthermore, the Commission intends to address trading phenomena (such as high-frequency trading) and issues that have come to the fore in large part due to the market fragmentation caused by MiFID. The Commission is also seeking to improve investor protection in various ways and to create a more even playing field for market participants.[8]

The EU's approach to dealing with issues in the G20 agreements contrasts with that of the US, which dealt with all issues through a single new piece of legislation – the Dodd-Frank Act.[9] In the EU, because issues such as the regulation of derivatives trading were already covered by MiFID, the G20 commitments in this area are primarily being implemented through amendments to existing legislation.

Outline of Proposed Changes

The MiFID II proposals have evolved from the amendments initially outlined in a consultation paper issued in December 2010 (the "**Consultation**").[10] It is proposed that there will be two separate pieces of European legislation:

- a revised directive ("**MiFID II**"), which will be an amendment and restatement of MiFID. This will cover a number of areas, including market structure, the scope of exemptions from financial regulation, organisational and conduct of business requirements for investment firms and trading venues, powers of national authorities, sanctions, and rules for third-country (non-EEA) firms operating through a branch; and
- a new regulation ("**MiFIR**"),[11] which sets out requirements for trade transparency, the mandatory trading of derivatives on organised venues and the provision of services by third-country firms without a branch; this regulation will also confer a number of new powers on European regulators.

Unlike a directive, a regulation is directly applicable in the law of member states and does not require national implementing legislation. A regulation was considered appropriate for the elements of the reform proposals which involve the granting of

5 See Shearman & Sterling publications "OTC Derivatives Regulation and Extraterritoriality" and "A New Panorama for the Clearing and Recording of Over-the-Counter Derivatives in Europe: the Proposed European Market Infrastructure Regulation".

6 Directive 2003/6/EC. See Proposal for a Directive of the European Parliament and of the Council on criminal sanctions for insider dealing and market manipulation (COM (2011) 651/3) and Proposal for a Regulation of the European Parliament and of the Council on insider dealing and market manipulation (market abuse) (COM (2011) 651/3).

7 See G20 Pittsburgh Summit Declaration, 24-25 September 2009, G20 Toronto Summit Declaration, 26-27 June 2010 and Communiqué of Finance Ministers and Central Bank Governors of the G20, 14-15 October 2011.

8 See MiFID II, Explanatory Memorandum, p. 2.

9 The Dodd-Frank Wall Street Reform and Consumer Protection Act.

10 European Commission, Public Consultation, Review of the Markets in Financial Instruments Directive (MiFID), 8 December 2010.

direct powers to the European Securities and Markets Authority ("**ESMA**") and for minimising the scope for divergence in the interpretation of transparency and transaction reporting provisions across member states.[12] The differing methods of implementation between MiFID II (the directive) and MiFIR (the regulation) may have some practical implications for the entry into force of various provisions in some member states. It is hoped that the Commission will provide further indications as to how any transitional conflicts would be handled so as to enable firms and member states to prepare effectively for compliance with the new requirements.

Changes in Market Structure

The proposed legislation extends the reach of MiFID to capture additional trading activities and systems. A key change is the introduction of a new category of trading facility, an organised trading facility ("**OTF**"). Under MiFID II, an OTF will be a trading facility not falling within one of the following existing categories:

- Regulated Market ("**RM**");
- Multilateral Trading Facility ("**MTF**"); or
- Systematic Internaliser ("**SI**").[13]

Broadly speaking, an OTF will be any facility or system operated by an investment firm or operator (other than an RM or MTF) that, on an organised basis, executes or arranges transactions based on multiple third-party orders.[14] This is likely to include broker-crossing networks, inter-dealer broker systems and systems trading clearing-eligible derivatives. Facilities on which no trade execution or arranging takes place, such as order routing systems, and direct trades between counterparties on an ad hoc basis ("pure" OTC transactions) will remain outside the scope of this definition. OTF operators may not execute trades against proprietary capital. Investment firms executing client orders on an organised and regular basis against proprietary capital outside an RM, MTF or OTF will be treated as SIs.[15]

The SI regime was introduced to capture the matching of orders by brokers against their own account and imposes pre-trade transparency obligations on this order flow. To date, only a small number of firms are registered as SIs – 14 firms as of October 2011.[16] The lack of certainty as to what constitutes organised, frequent and systematic dealing (for the purposes of the relevant MiFID definition) and the ability to avoid being an SI through legal structuring, has allowed many firms to

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11 European Commission, Proposal for a Regulation of the European Parliament and the Council on Markets in Financial Instruments and amending Regulation [EMIR] on OTC derivatives, central counterparties and trade repositories (COM (2011) 652/4).

12 MiFIR, Explanatory Memorandum, p. 5. MiFIR will be directly applicable in the law of EU member states once published in the Official Journal of the European Union.

13 The categories of MTF, OTF and SI, taken together, are equivalent to the US concept of "swap execution facility".

14 The proposed definition of OTF is "any system or facility, which is not a regulated market or MTF, operated by an investment firm or a market operator, in which multiple third-party buying and selling interests in financial instruments are able to interact in the system in a way that results in a contract […]", MiFIR, Article 2(1)(7).

15 MiFID II, recital 13.

16 See register maintained by ESMA at http://mifiddatabase.cesr.eu/.

remain outside the category. It appears that the Commission intends to deal with this issue principally by amending MiFID implementing legislation to clarify the qualifying criteria for systematic internalisers.[17]

It is not clear that the new OTF category will provide significant additional investor protection, because OTF operators are already regulated as investment firms under MiFID and subject to transaction reporting requirements. Any applicant for authorisation as an OTF will be required to explain how its system is distinct from either an RM, MTF or SI, which implicitly recognises the scope for overlap between the categories.[18] Critically, however, other firms that use OTFs will be able to satisfy best execution obligations (see below) by executing client orders on such a platform. OTFs will be subject to the transparency and reporting requirements,[19] conduct of business rules, best execution requirements and client order handling obligations[20] applicable to RMs and MTFs. The draft legislation does not require broker-crossing networks that allow third-party access to be classified as MTFs, as originally proposed, which is a change likely to be welcomed by the industry. That said, the creation of a fourth category of trading facility may be seen to perpetuate an uneven playing field and to increase the opportunities for regulatory arbitrage between execution service providers.[21]

Safeguards to Orderly Functioning of Markets

In response to concerns that the increasing use of algorithmic, and in particular high frequency, trading may be detrimental to the maintenance of orderly markets, it is proposed that high frequency trading firms ("**HFTs**") should be regulated. Under the current MiFID, many HFTs rely on a particular interpretation of an exemption from regulation for firms which only trade on their own account. This exemption was originally intended to cover the treasury departments of corporates and other end-users of financial services, and will now be narrowed.

Under MiFID II, HFTs will be explicitly subject to financial regulation.[22] Brokerage firms offering sponsored access to markets and execution venues for HFTs will be required to have enhanced risk controls in place.[23]

Specific risk controls are also imposed for algorithmic traders, including requirements to:

- have appropriate trading thresholds and limits in place;
- ensure that systems cannot be misused for the purposes of market abuse; and
- establish a business continuity plan.[24]

17 MiFID II, Recital 13. It is proposed that this will be achieved through an amendment to the MiFID Implementing Regulation, Article 21.
18 MiFID II, Article 20(2).
19 MiFIR, Articles 3-10.
20 MiFID II, Articles 24, 25, 27 and 28.
21 Federation of European Securities Exchanges, Letter to Commissioner Barnier regarding MiFID, 8 April 2011.
22 MiFID II, Article 2(1)(d).
23 MiFID II, Article 17(4).
24 MiFID II, Article 17(1).

Algorithmic traders must make annual disclosure to national regulators of algorithmic trading strategies, trading parameters or limits and key compliance and risk controls.[25] An important new requirement will be to have in place a “circuit breaker” to stop trading in unusual conditions and prevent high frequency trading from exacerbating bubbles or crashes in prices.[26] Disclosure to regulators of the computer algorithms used in the execution of transactions will also be required in post-trade transaction reports.[27] Understandably, firms may be reluctant to disclose such confidential business information. Unless MiFID II harmonises confidentiality requirements applicable to regulators beyond preserving the overarching professional secrecy obligation, these requirements may encourage firms to be located in jurisdictions with more robust confidentiality or weaker freedom of information laws.

In the Consultation, the Commission proposed requiring HFTs executing a significant volume of trades in particular instruments to continue to provide liquidity in those instruments under similar conditions as those applying to market makers.[28] The proposition proved controversial among HFTs, which were concerned that the obligations would necessitate a substantial change to their business models.[29] A modified version of the Commission's original proposal has been included in the proposed legislation. This requires firms using algorithmic trading strategies (not only HFTs) to post firm quotes at competitive prices on a continuous basis during the trading hours of the relevant trading venue, with the result of providing liquidity on a regular and ongoing basis at all times, regardless of prevailing market conditions.[30] The extent to which this effectively imposes obligations akin to those of market makers is unclear, particularly in respect of those who engage in algorithmic trading which is not high frequency.

Pre- and Post-Trade Transparency Regime

The transparency regime in MiFID only applies to shares admitted to trading on an RM (including when those shares are traded on an MTF or over-the-counter). The pre-trade transparency rules require platforms to publish on a continuous basis (as close as possible to real time) current orders and quotes relating to shares admitted to trading on an RM.[31] Under the post-trade reporting requirements, a firm must make public specified information, including on price and volume, about transactions involving shares admitted to trading on regulated markets. This information must generally be made public as close as possible to real time and in any case within three minutes of the transaction taking place, although deferred publication is permitted for larger trades.[32]

[25] MiFID II, Article 17(2).
[26] MiFID II, Article 51.
[27] MiFIR, Article 23(3).
[28] Consultation, para. 2.3(e).
[29] See, for example, Bank of America Merrill Lynch, Response of Bank of America Merrill Lynch to the European Consultation on the Mifid Review, 2 February 2011, pp. 9-10.
[30] MiFID II, Article 17(3).
[31] MiFID, Articles 27, 29 and 44 and MiFID Implementing Regulation, Articles 17 and 29 -34.
[32] MiFID, Articles 27, 28, 30 and 45 and MiFID Implementing Regulation, Articles 29 -34.

All of the transparency rules are being revamped and moved from MiFID to MiFIR, so as to become directly applicable throughout Europe. The scope for avoiding these onerous requirements under the current legal architecture will be significantly reduced. Electronic trading and MiFID pre-trade transparency waivers have led to the increasing use of "dark pools" for professional markets, where pre-trade price and order volume information is not displayed in order to minimise market impact. There are regulatory concerns as to the effect that such arrangements could have on the quality of the price discovery mechanism on "lit" markets.[33] The Commission proposes to remove existing pre-trade transparency waivers,[34] and instead stipulate that trading venues may only operate dark pools by applying to national authorities for a waiver, which in each case would have to be approved by ESMA.[35] Concerns have been voiced that the restrictions would undermine the role played by "dark" venues in the efficient functioning of markets and the provision of liquidity.

In addition, the transparency regime will see its scope extended by MiFIR to apply to shares traded exclusively on MTFs or OTFs and beyond shares to certain other equity-like instruments, such as depositary receipts and exchange-traded funds. Transparency will also apply to actionable indications of interest, not just offers.[36] Still more controversial, perhaps, is the proposal that transparency requirements should also apply to non-equity instruments, including bonds and derivatives.[37]

Many responses from industry participants and market associations to the original Consultation argued that transparency requirements are not suited to the non-equity markets. Transparency is largely focused on consumer markets, to ensure that investment decisions can be made based on good, current pricing data. For professional markets, which the markets in non-equity products generally are, there are concerns that brokers would have a lesser role should prices become more transparent, and that forcing price disclosure will result in a reduction in liquidity.[38] Perhaps in recognition of such concerns, national authorities are to be given a discretion to waive the pre-trade transparency requirements for non-equity instruments based on the market model, the specific characteristics of trading activity in a product, and liquidity.[39] Pre-trade transparency for both equity and non-equity instruments may also be waived, and post-trade reports deferred, on the basis of the type of instrument or size of transaction.[40] ESMA approval will have to be sought in each case where national regulators wish to grant waivers. The potentially wide effect of the waivers for non-equity instruments raises questions as to whether it would be better for the requirements generally not to apply to non-equity markets, subject to regulators determining otherwise.

[33] Consultation, p.22.

[34] MiFID, Articles 29(1) and 44(2).

[35] MiFIR, Articles 4 and 8. As is currently the case, waivers will be based on market model, size and type of order. The Commission will be required to specify the scope of the waivers in delegated acts (MiFIR, Articles 4(3) and 8(4)).

[36] MiFIR, Articles 3-6.

[37] MiFIR, Articles 7-10.

[38] See, for example, Investment Management Association, Response to the MiFID consultation, 2 February 2011, p.18.

[39] MiFIR, Article 8(1).

[40] MiFIR, Articles 4, 6, 8 and 10.

Under the new regime, publication of post-trade reports would generally be required within one minute of execution, as opposed to the current deadline of three minutes.[41]

Market Data Consolidation

The Commission has proposed the following measures to improve the quality and consistency of market data:

- trading venues will be required to make post-trade information available, free of charge, 15 minutes after the execution of a transaction;[42] and
- firms must make public trades all executed outside organised trading venues, through an authorised approved publication arrangement.[43]

Proposed conditions for the emergence and authorisation of providers of a European "consolidated tape" are also set out.[44] The tape would show prices and volume of transactions in equity instruments (this may be extended to non-equity instruments after a review within two years), to capture post-trade data on an EU-wide basis. It is intended that this should resolve the data fragmentation resulting from competition between execution venues. Firms will also be required to record electronic and telephone communications.[45]

Commodity Derivatives

In response to political concerns expressed at G20 and EU level as to speculation and volatility in the commodity derivatives markets and the supposed effects of this on consumer prices,[46] more substantial controls are now being proposed. These include bringing a wider range of commodity derivatives traders within the scope of MiFID through the tightening and/or removal of current exemptions. As a result certain businesses, including energy firms, for example, will have to show that any trading activities are ancillary to their main business.[47] Under MiFIR, the trading of sufficiently liquid standardised derivatives on organised trading venues will become obligatory, complementing the mandatory clearing and reporting requirements proposed in EMIR.[48] The Commission and ESMA will define the list of eligible derivatives through technical standards.

[41] This will be implemented through an amendment to article 29 of the MiFID Implementing Regulation (see European Commission, Consultation, p.25).

[42] MiFIR, Article 12.

[43] MiFID II, Explanatory Memorandum, para. 3.4.12, and MiFID II, recital 77.

[44] MiFID II, Article 67.

[45] MiFID II, Article 16(7).

[46] See European Commission Press Release, Making derivatives markets in Europe safer and more transparent, 15 September 2010.

[47] MiFID, Article 2(1)(i) is modified by excluding those dealing on own account by executing client orders. The exemption for firms whose main business consists of dealing on own account in commodities and/or commodity derivatives under MiFID Article 2(1)(k) is deleted.

[48] MiFIR, Articles 24-27. See also parallel US reforms contained in the Dodd-Frank Act (Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010)).

Venues where commodity derivatives are traded will be required to:

- publish an aggregated weekly breakdown of the positions held by different types of market participant, including the clients of those not trading on their own behalf, and to make this available to the relevant national authority upon request; and
- impose position limits to support liquidity, prevent market abuse and support orderly pricing and settlement conditions.[49]

This compares with the current situation where position limits are handled by exchanges and clearing houses as a self-regulatory function. Heightened powers over derivative positions for national authorities include explicit powers to demand information from any person regarding the size or purpose of a position in commodity derivatives contracts and to require a reduction of the position.[50] ESMA will be given powers to coordinate national authorities' position management powers and will also have an equivalent power in its own right.[51] These measures tie in with amendments to MAD, also aimed at encompassing the commodity derivatives markets within that regime going forward.

Emission Allowances

The EU Emissions Trading System ("**ETS**"), set up by the ETS Directive,[52] is designed to reduce carbon emissions by capping EU carbon emission allowances ("**EUAs**"), which are units tradable among regulated industries as well as in the open market. Spot secondary markets in EUAs and in carbon emission reduction credits issued under the Kyoto Protocol, such as certified emission reductions and emission reduction units, have to date been largely unregulated. A range of fraudulent practices dating from 2010 have occurred in the spot carbon markets, including EUA thefts from member state registries in various "phishing" scams and hacking incidents. These have undermined trust in the ETS, particularly for trades recorded in national registries located in jurisdictions without robust property laws. The Commission has taken various steps to address such fears,[53] and is also looking into other ways of managing risks associated with the carbon market. It is proposed that MiFID II will apply to the spot trading of units recognised for compliance with the ETS Directive, which would include EUAs and Kyoto carbon emission reduction credits. Such instruments will be classified as financial instruments under MiFID II.[54] This would have the effect of bringing spot carbon trading within the scope of the MiFID II rules dealing with regulatory authorisations and transparency, as well as the EU market abuse regime, as is already the case with the derivatives markets.

[49] MiFID II, Articles 59 and 60.
[50] MiFID II, Article 71(2)(i) and 72(1)(f).
[51] MiFIR, Articles 34 and 35.
[52] Directive 2003/87/EC.
[53] Principally through revisions to the ETS Directive (as amended by Directive 2009/29/EC) to increase legal certainty, remove unique serial numbers and improve security measures.
[54] MiFID II, Annex I, section C(4).

These proposals are controversial because various traders and advisers active in the spot carbon markets, many of whom have not previously been subject to financial regulation, would be regulated in the same way as investment firms.

Transaction Reporting

Under MiFID, all firms that execute trades in relation to a financial instrument traded on an RM (whether or not the transaction takes place on an RM) are required to report transactions to their home state regulator.

The Commission proposes to extend the MiFID transaction reporting requirements to a wider range of financial instruments. Under MiFID II, the only instruments outside the scope of the reporting requirement will be instruments:

- which are not admitted to trading on an RM or traded on an MTF or OTF;
- the value of which does not depend on a financial instrument admitted to trading on an RM or traded on an MTF or OTF; and
- the trading of which cannot have an impact on a financial instrument admitted to trading on an RM or traded on an MTF or OTF.[55]

A direct transaction reporting mechanism at EU level was proposed in the Consultation, to avoid the need for firms to report to a number of different national authorities. The draft legislation provides that this may be implemented following a review by the Commission two years after MiFIR comes into force.[56]

Investor Protection

Tightening of Exemptions

In the interests of providing identical protection to investors across the EU, the Commission proposes to amend the optional MiFID exemption[57] for firms that do not hold client money and whose services are limited to investment advice and/or arranging transactions. Under the new proposals, the exemption may only be granted where requirements equivalent to the MiFID II authorisation conditions, supervisory procedures and investor protection requirements are imposed on exempt firms by national regulators.

Execution-only Sales

"Non-complex" instruments currently include certain non-derivative instruments[58] such as shares, bonds and UCITS products.[59] The Commission has opted to amend the criteria for classification of products as "non-complex". Under MiFID,

55 MiFIR, Article 23(2).
56 MiFIR, Article 23(9).
57 MiFID, Article 3(1).
58 MiFID, Article 6, and MiFID Implementing Directive, Article 39.

firms are generally required to seek information from retail clients to determine whether the client has the knowledge and experience to understand the risks involved in the transaction or service being offered (known as the "appropriateness test"). However, no appropriateness test is required for sales of non-complex instruments. The Commission's concern is that, as a result, the risks of investing in such products may not be understood by certain customers. The new provisions of MiFID II make more detailed specifications as to the types of instrument that would be regarded as non-complex. Bonds and money market instruments must not incorporate a structure that makes it difficult to understand the risk involved.[60] Shares or units in UCITS are specified as non-complex, although structured UCITS[61] are expressly excluded and will not be able to be sold on an execution-only basis under the new proposals. In the Consultation, a more draconian alternative of prohibiting execution-only sales was proposed, but this is not found in the draft legislation.

Client Classification

Under the current MiFID client classification regime, different rules apply to firms' treatment of clients depending on whether they fall into one of three categories: retail, professional and eligible counterparty. Various apparently minor modifications are proposed here, but the results may be far-reaching and costly to implement. For example, it is proposed that the scope of the more liberal rules applying to eligible counterparties will be tightened by extending information and reporting requirements for transactions and imposing a high-level standard of fair conduct to dealings.[62] An amendment to the definition of an eligible counterparty is intended to exclude local governments. However, the proposed legislation does not alter the current presumption that professional clients have the necessary knowledge and experience to enter into transactions (as was proposed in the Consultation).[63]

Inducements

Under MiFID, firms are currently prohibited from making or receiving payments or other non-monetary benefits in connection with any investment or ancillary services provided to professional clients or retail clients, unless those payments or benefits fall into a specified exception.[64] There is also a high-level duty for firms to act honestly, fairly and professionally in accordance with the best interests of their clients.[65] An exemption for third-party inducements is available where (i) clear, prior disclosure of the inducement has been made to the client, (ii) the inducement has been designed to enhance the quality of the service to the underlying client of the firm, and (iii) the payment or benefit does not impair compliance with the firm's duty to act in the client's best interests.[66] It is proposed that, under MiFID II, accepting third- party inducements will be

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59 See the UCITS Directive (2009/65/EC).
60 MiFID II, Article 25(3)(a).
61 As defined in Commission Regulation 583/2010, Article 36(1)(2).
62 MiFID II, Article 30(1).
63 Directive 2006/73/EC, Articles 35(2) and 36.
64 MiFID Implementing Directive, Article 26.
65 MiFID, Article 19(1).
66 MiFID Implementing Directive, Article 26(b).

completely prohibited for portfolio managers and independent investment advisers.[67] This reflects a concern that inducements are incompatible with the provision of the independent exercise of discretion and independent advice.

Best Execution

The current MiFID best execution regime provides that, when executing orders, a firm must take all reasonable steps to obtain the best possible result for the client, taking into account execution factors such as: price, costs, speed, likelihood of execution and settlement, size and nature. In order to comply with the best execution obligations, firms must establish and implement an order execution policy. Clients must be provided with "appropriate information", which may be in the form of a summary of the policy.[68]

There are concerns that these disclosures have become general, formulaic and uninformative. Under the new proposals, the "appropriate information" requirement is clarified by the additional provision that the information should explain clearly, in sufficient detail and in a way that can be easily understood, how orders will be executed by the firm for the client. Firms will also be required to summarise and make public the top five execution venues where they executed client orders for each class of financial instruments in the preceding year. Execution venues would also be required to publish data on execution quality.[69]

International Regulatory Convergence

The access of third country firms to EU markets was not harmonised under MiFID and is therefore subject to national laws. In practice, national regulators impose equivalent requirements on third country firms operating in their territories, as they do not wish to apply more favourable treatment to third-country firms than to EEA firms. Member states have the discretion not to apply the MiFID regime to branches of third country firms authorised in their home state, provided they are subject to prudential requirements at least equal to those applicable in the EU. National exemptions may be available for firms operating on a cross-border basis, such as the "overseas persons" exclusion available under the UK regulatory regime for firms not operating from a permanent place of business in the UK.[70] Third country firms do not currently have the right to "passport" their authorisation from one EU member state into other EU member states.

Under the proposed legislation, a strict equivalence regime is to be introduced for third country firms. EU market access for third country firms will only be permitted where the Commission has made a declaration of equivalence in relation to the regulatory and tax regime of the third country firm's home state. Third country firms wishing to offer investment services to retail and professional clients will only be able to request to do so through the establishment of a branch in an EU member

[67] MiFID II, Article 24(5) and (6).
[68] MiFID, Article 21 and MiFID Implementing Directive, Articles 44 and 45.
[69] MiFID II, Article 27(2),(4) and (5).
[70] Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, Article 72.

state, under the procedure set out in MiFID II.[71] They will then be able to conduct business throughout the EEA under a cross-border passport. Firms offering services only to eligible counterparties will be able to do so without establishing a branch in an EU member state subject to registration with ESMA under a new procedure set out in MiFIR.[72] For a third country regulatory regime to be considered equivalent, investment firms must be subject to authorisation, effective supervision and enforcement, equivalent capital requirements, equivalent requirements in the areas of corporate governance, internal organisation and internal control functions, and the regime must protect market transparency and integrity by preventing market abuse including insider dealing and market manipulation.[73] From an international perspective, these proposals may have an adverse impact. It is feared that such steps could result in reciprocal measures being introduced by international regulators, particularly US authorities, making it more difficult for EU-based entities to access overseas markets.

New Powers

National authorities are given enhanced supervisory powers and the ability to impose sanctions, including a product intervention power enabling the prohibition or restriction of sales, marketing or distribution of certain products or types of activity within their territory.[74] ESMA has the same powers in respect of the entire EU.[75] This, together with the position management powers in relation to derivatives (see above) indicates the potential for a much more interventionist approach at EU level, which is a prospect that firms and trading venues may view with some apprehension.

Impact of the Proposed Measures

As would be expected, industry support for all the proposals in MiFID II and MiFIR has not been unqualified. It therefore remains to be seen which of these measures will end up in the final legislation. There is a perception that some of the proposed measures may result from an over-hasty desire to implement the G20 recommendations and are potentially detrimental to market functioning in general. Many of the proposed changes appear to have little to do with the financial crisis, with the increased focus on transparency and the placing of limitations on the use of dark pools by trading venues being cases in point. In reality, however, the Commission's increased emphasis on transparency must be viewed as part of a global regulatory trend. US regulators, for example, are also considering measures to tighten the regulation of dark trading.[76]

71 MiFID II, Articles 41-46.

72 MiFIR, Articles 36-39.

73 MiFID II, Article 41 and MiFIR, Article 37.

74 MiFIR, Article 32. The UK has proposed granting a similar power to the new Financial Conduct Authority to be established under the reforms of the financial regulatory framework. See Shearman & Sterling publication "The Proposed Restructuring of the UK Financial Regulatory Framework".

75 MiFIR, Article 31.

76 See Regulation of Non-Public Trading Interest, Exchange Act Release No. 34-60997.

The creation of more closely aligned requirements for RMs and MTFs is seen as enhancing fairness and creating a more level playing field for those trading platforms. It is to be hoped, however, that this does not lead to a reduction in competition and innovation, given that the existence of differing regimes allows for flexibility and increased choice for investors. Similarly, while the compulsory trading of standardised derivatives contracts on organised platforms is seen by many as a positive development, there is concern that the requirements may be overly prescriptive and fail adequately to take into account the diversity of the derivatives market or permit innovation.[77] This will, to a large extent, depend on which derivatives will eventually become subject to the trading obligation, which will be set out in technical standards, and whether waivers from the reporting requirements will be required before anyone trades new products, which is a point that is not addressed.

Some of the reforms originally proposed, particularly in relation to conduct of business, were seen as imposing a disproportionately heavy burden on regulated firms.[78] The Commission appears to have taken this into account and now proposes some more limited modifications compared with those originally set out in the Consultation. This seems an appropriate response, given that eligible counterparties and professional clients have the option, under the current regime, to request additional protection where they consider that this is required.[79]

MiFID II and MiFIR are currently only at the stage of Commission proposals and will be subject to further amendment by the European Parliament and European Council during the EU legislative process, which makes it impossible accurately to predict the precise scope of the final reforms at this time. However, we now have a clear picture of what is proposed and the challenges that will be faced.

[77] See, for example, International Swaps and Derivatives Association, Inc., ISDA's response to the European Commission's Public Consultation on the Review of the Markets in Financial Instruments Directive (MiFID), 31 January 2011, pp. 10-11.

[78] See Alternative Investment Management Association, AIMA's response to the European Commission's Public Consultation "Review of the Markets in Financial Instruments Directive", 9 February 2011, p.9.

[79] MiFID, Annex II.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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