

# New challenges. New solutions

## EMEA Regulatory Developments: MiFID 2

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### MiFID

The new version of MiFID<sup>1</sup> (MiFID 2), and the accompanying regulation, MiFIR<sup>2</sup>, were published on 20 October 2011. This followed a detailed public consultation at the beginning of 2011. At the time, many of the respondents to the consultation expressed regret that the consultation period was short and the scope of the consultation very wide-ranging.

MiFID replaced the Investment Services Directive. Its original objectives were to promote the integration, competitiveness and efficiency of financial markets.

The overarching provisions of the original MiFID<sup>3</sup> were to:

- prohibit Member States from requiring trading to take place on traditional exchanges, providing for competition between those exchanges and alternative venues;
- strengthen the passport for the provision of investment services;
- agree comprehensive rules to ensure investor protection. For example rules on inducements that helped to minimise potential conflicts of interest.

1. Markets in Financial Instruments Directive

2. Markets in Financial Instruments

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## MiFID (continued)

It is four years since MiFID came into force and much has changed in that time. The global crisis persuaded financial services policy makers that a thorough overhaul both of regulation and the regulatory architecture was required, and although a review of MiFID was on the cards before the crisis took hold, recent events have informed much of the direction and detail of the proposals for MiFID 2.

In terms of the achievements of MiFID, a study undertaken for the European Commission ('EC' or 'Commission') by Oxera<sup>4</sup> found that there has been an overall decrease in transaction costs and an increase in integration, exemplified by more competition between trading venues and greater choice for investors. According to this study, costs of using trading platforms has decreased significantly across all financial centres, with trading platforms' costs for on-book trading in equities falling by 60%. In addition, there has been a decrease of 73% in the costs of using infrastructure for post-trading services. These headline statistics, while impressive, mask the fact that although the cost per transaction on trading platforms has fallen in all financial centres, the costs expressed in terms of value of trading have increased in some centres, such as France, Germany, Italy and Spain, due to a growing trend for smaller transaction sizes. Thus it seems that whilst trading costs have fallen overall, this has not necessarily benefitted end investors. This is reflected in the results of an IMA<sup>5</sup> survey that indicate that almost 60% of buy-side firms have seen no reduction in trading costs since the introduction of MiFID.<sup>6</sup> A further challenge for the buy-side is that with a proliferation of trading venues and absence of a consolidated tape, tracking what is happening to a stock is costly.

In reviewing MiFID, the Commission cites a number of new problems that have emerged, for example that competition has led to fragmentation and complexity; that market and technological change has outpaced MiFID, risking undermining of transparency; and that the benefits of increased competition 'have not always been passed on to the end investor'. In addition, the Commission is required, as a result of the financial crisis and its G20 commitments, to address the regulation of financial instruments other than shares, e.g. OTC derivatives.

## MiFID 2: So What's New?

**So what's new? MiFID 2 includes new rules on transparency, and extending the scope of pre- and post-trade data to be made public.**

Key aspects are:

- It has interesting provisions on independent advice echoing the provisions on the UK's RDR,<sup>7</sup> and limiting tied agents to a single product provider.
- It eliminates discriminatory barriers to access to clearing facilities and requires mandatory trading of derivatives on organised venues.
- MiFID 2 also introduces a new category of trading venue, the organised trading facility, or OTF, which does not fit into any of the three existing categories, namely regulated markets, multilateral trading facilities and systematic internalisers.
- High frequency and algorithmic trading has been a concern to regulators and these activities are brought firmly within the MiFID scope with requirements for operational safeguards and risk control.
- Esma<sup>8</sup> has an enhanced role, including powers of intervention.
- There are also limits on the provision of services by third country firms (i.e. countries outside of the EU) without a branch.

All of these will have specific impacts on the way business is coordinated in the future. We focus here on issues that we feel are of specific interest to asset managers.

3. MiFID Framework Directive 2004/39/EC; MiFID Implementing Directive 2006/73/EC; MiFID Implementing Regulation 1287/2006

4. Monitoring prices, costs and volumes of trading and post-trading services (MARKT/2007/02/G) May 2011

5. Investment Management Association

6. Asset Management in the UK 2010-2011 The IMA Annual Survey

7. Retail Distribution Review

8. European Securities Markets Authority

## Transparency: expansion of scope

### SHARES, DEPOSITARY RECEIPTS, ETFs, CERTIFICATES, AND NON-EQUITIES

The issue of transparency in non-equity markets has been the subject of fierce debate. The draft rules of MiFID 2 extend the equity transparency requirements to equity-like instruments, such as depositary receipts and ETFs. Inclusion of ETFs is likely to be broadly welcomed by the fund industry because it is widely thought that, with limited data on trading activity available in Europe, many investors have steered clear of ETFs due to concerns about liquidity.

Whilst voluntary reporting was introduced by LSE and Deutsche Börse, it is estimated by iShares that around 60% of OTC trading in ETFs still goes unrecorded. Post-trade transparency in ETFs should fuel activity to mirror more accurately the US experience where daily on-exchange turnover is twenty times higher than in Europe against an asset base that is only three times bigger.

Extension of MiFID's transparency provisions to ETFs should thus lead to improved liquidity and a narrowing of spreads which is a much better deal for investors. Whether the market will consolidate is a big question; the problem of fund proliferation may be an enduring one.

The draft rules define ETFs that are to be captured by the transparency requirements as 'units in those collective investment schemes which are freely negotiable on the capital markets and in most cases track the performance of an index'. As Efama pointed out in its response to the consultation the definition needs to be carefully calibrated to ensure that other non-ETF UCITS are not ensnared in these requirements.

Extension of transparency requirements beyond equities and equity-like instruments has been widely debated and the industry consensus was that the transparency regime applicable to equity trading should not extend to the non-equity space. Cesr's<sup>9</sup> consultation on MiFID reached the same conclusion because markets in fixed income securities and derivatives are significantly different from those for equities and it was accepted that imposing similar transparency requirements could be harmful to liquidity and price formation. In spite of this, the industry's view has been rejected. Thus, within MiFIR, the transparency requirements for bonds, traded derivatives and structured products are essentially the same as for equities, as are the rules on waivers.

The transparency waiver regime has also been changed, with national regulators now required to notify Esma and other regulators of any proposed pre-trade waiver six months in advance. In addition, the Commission, by way of delegated acts will determine the scope of waivers in terms of the size or type of orders for which pre-trade disclosure may be waived by class of financial instrument. The post-trade rules indicate that as near-real time publication of details of all transactions is required, deferral of publication can be granted by Member State regulators. In this latter case, Esma will monitor and report annually to the Commission. All of this seems very cumbersome.

In its effort to address data costs, MiFID 2 requires that all trade data should be made available free of charge within fifteen minutes, and that live data can be sold on a 'reasonable commercial basis' – the definition of this is yet to be determined by the Commission.

## Non-discriminatory access to clearing

The issue of non-discriminatory access to clearing has been exercising the fund management community, because of the cost impact of monopolistic silos. This issue is relevant both to MiFID and EMIR. It looks as if the lobby has been successful but some Member States continue to champion existing models.

9. Committee of European Securities Regulators, the predecessor organisation to Esma

## Advice and distribution

Under the original MiFID, the provision of investment advice became an investment service subject to authorisation and conduct of business requirements. MiFID 2 seeks to strengthen the advice regime by requiring investment advisors to clarify their service, and in particular whether advice is provided on an independent basis and whether the service includes an ongoing assessment of suitability. When independent advice is provided, firms will be required to assess ‘a sufficiently large number of financial instruments available on the market ... which shall be diversified with regard to type and issuers or product providers and should not be limited to financial instruments issued or provided by entities having close links with the investment firm.’

In addition, inducements will be curtailed in respect of investment advice and the services of portfolio management; i.e. the only permitted inducement will be non-monetary benefits such as product training. Fees and commissions from third parties will be abolished. In respect of execution only services, these will not be permitted to be offered in conjunction with the granting of credit or a loan, and will not be permitted for ‘complex’ financial instruments, including UCITS which embed derivatives or are structured in a way in which it would be difficult for an investor to understand the relevant risks.

## Other

The new MiFID also proposes to limit title transfer collateral arrangements where retail clients’ assets are concerned.

Article 9 of MiFID 2 introduces limits on the activities of members of the management body of an investment firm, in that they may ‘not combine more than one of the following combinations:

1. One executive directorship with two non-executive directorships
2. Four non-executive directorships’

although Member State regulators may permit a derogation.

In addition, it is also proposed that in order to strengthen the management of investment firms, and to promote the integrity of the market and interests of investors, management boards should be sufficiently diverse as regards age, gender, provenance, education and professional background. Gender balance is emphasised as of specific import and investment firms will be required to include diversity as one of the criteria for selection of members of the management body. All these new requirements will be addressed in standards to be drafted by Esma.

Under MiFID, it was possible to waive the conduct of business rules in respect of transactions between eligible counterparties. In MiFID 2 this has been revoked and particular emphasis has been given to excluding local authorities from the list of eligible counterparties and only permitting them to be treated as professional investors on request.

A complete overhaul of the third country regime is proposed. Currently, third country firms are subject to national regimes and requirements; it is proposed that harmonisation should only permit the provision of services by a third country firm when the Commission is satisfied that the regulatory and supervisory framework in the third country provides comparable protection. Furthermore, MiFID 2 will require third country firms servicing retail clients to establish a branch within the EU and that the branch will be authorised and supervised within the EU. It is envisaged that such authorisation will enable a firm to avail itself of a passport for cross-border business. Business may only be carried out without a branch in respect of transactions with eligible counterparties. There is a four year grandfathering period for existing arrangements.

## Cost

As with most of the current raft of regulatory change, the new MiFID will involve cost. The Commission estimates that there will be one-off compliance costs of between €512 million and €732 million and ongoing costs of between €312 million and €586 million.

**In conclusion, market impacts could be substantial and actual implementation costs may be higher. The new powers of intervention granted to Esma, including to ban products and the delegated acts provisions for the Commission all indicate that the result may severely limit the discretionary powers of Member State regulators.**