MiFID II

- a look into the crystal ball

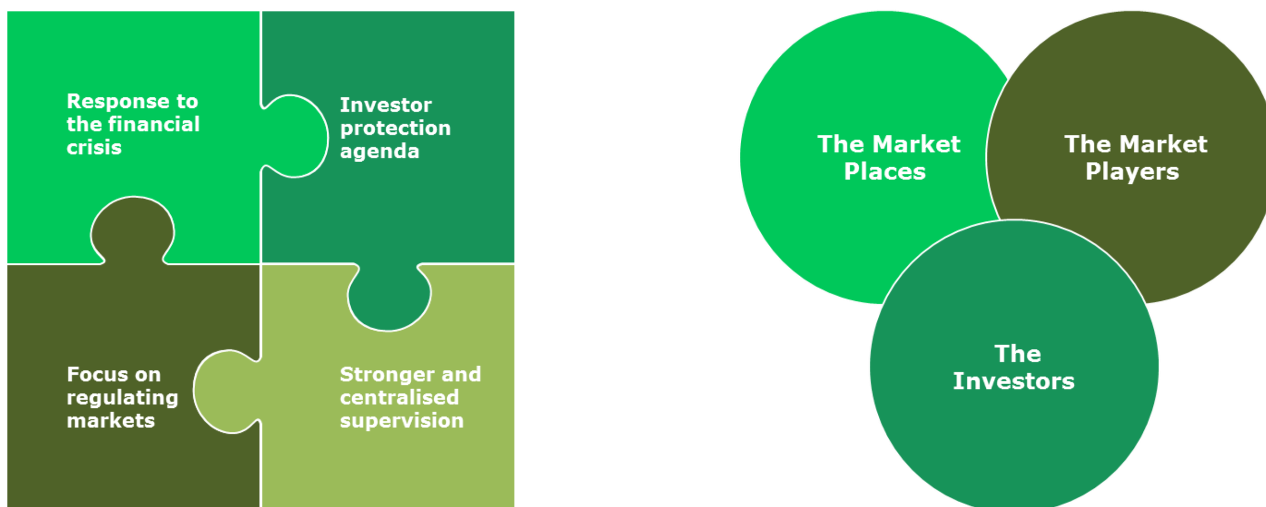
About a year has passed since the EU Commission on 20 October 2011 published its proposal for changes to the MiFID directive (MiFID II), which constitutes a cornerstone in the harmonization of the European capital markets and for the market players. Since then, the proposal has been discussed intensely at EU level, and a number of Presidency compromises have been aired - the latest on 22 October 2012. In this newsletter, we focus on a number of the changes anticipated in MiFID II and the expected implications of the changes for the market players.

The Background for MiFID II

MiFID II is based on the experiences made since the coming into force of MiFID I in November 2007, particularly the ones resulting from the global financial crisis and the obligations assumed by the EU countries under the G20 cooperation.

With the MiFID II proposal, the EU Commission wishes to address a number of the issues which have emerged during the financial crisis, among other things by increasing investor protection and meeting the goal of the G20 countries to increase transparency and degree of regulation of less transparent markets, for example the derivatives market. The underlying political themes as well as the primary target groups have been illustrated in figure 1.

Figure 1. Political themes and target groups



MiFID II's new Regulation Model

The MiFID II proposal contains a significantly larger harmonisation than what we know today, and it is the goal of the EU Commission for MiFID II to constitute an important step on the way to creating a common set of rules across the member countries (A Single Rulebook for EU Financial Markets).

Among other things, this is manifested in larger parts of the level 1 regulation being moved from the directive (MiFID) to the regulation (MiFIR) in order to ensure a total harmonisation between the member states. By doing so, the EU breaks with the regulation model which was used since the adoption of the Investment Services Directive (ISD) in 1993 and MiFID I in 2007 where the upper legislative echelon (level 1) was a directive and where the use of regulations was only at level 2. This development is illustrated in figure 2 (next page).

Figure 2. The development since the Investment Services Directive

The advantage to using regulations instead of directives may particularly be that they remove regulatory and cost-related trade barriers for a common market, but conversely, the players may experience less room for recognition of national differences as well as flexibility.

The scope of MiFID II

The proposal expands MiFID I's scope with regards to the types of companies covered (for example data providers such as Approved Reporting Mechanisms and High Frequency Traders with direct access to trading systems) as well as instruments (for example structured deposits and CO_2 quotas).

This will lead to an increased regulatory control and additional obligations for the types of companies covered. For example, data providers will only be allowed to deliver the particular data services, for which they have applied for permission, and any expansion of their activities will require additional official approval.

The MiFID II proposal also contains specific requirements with regard to control for the companies employed with algorithmic trade and for the companies who provide their customers with direct electronic access to trading systems with a view to order completion.

The Transparency Requirement is expanded to cover more Instruments

With a view to ensuring uniform rules, the new reporting and transparency requirements are contained in the MiFIR regulation. It is suggested to expand the requirements for pre and post trading transparency to additional types of instruments, such as for example bonds, structured products, derivatives and CO_2 quotas which are not currently covered by the transparency rules of MiFID I.

New Types of Markets

Today, MiFID I contains regulation of two types of markets - regulated markets and multilateral trading facilities (MTF). The MiFID II proposal introduces a third market category - organised trading facilities (OTF).

In the proposal, the organised trading facilities are broadly defined in order to ensure that the definition will be able to cover future technological development. The proposal entails that companies who today operate what would correspond to an OTF in the future will need a separate license, and that they will be precluded from carrying out trading against their own accounts in order to protect investors against conflicts of interest.

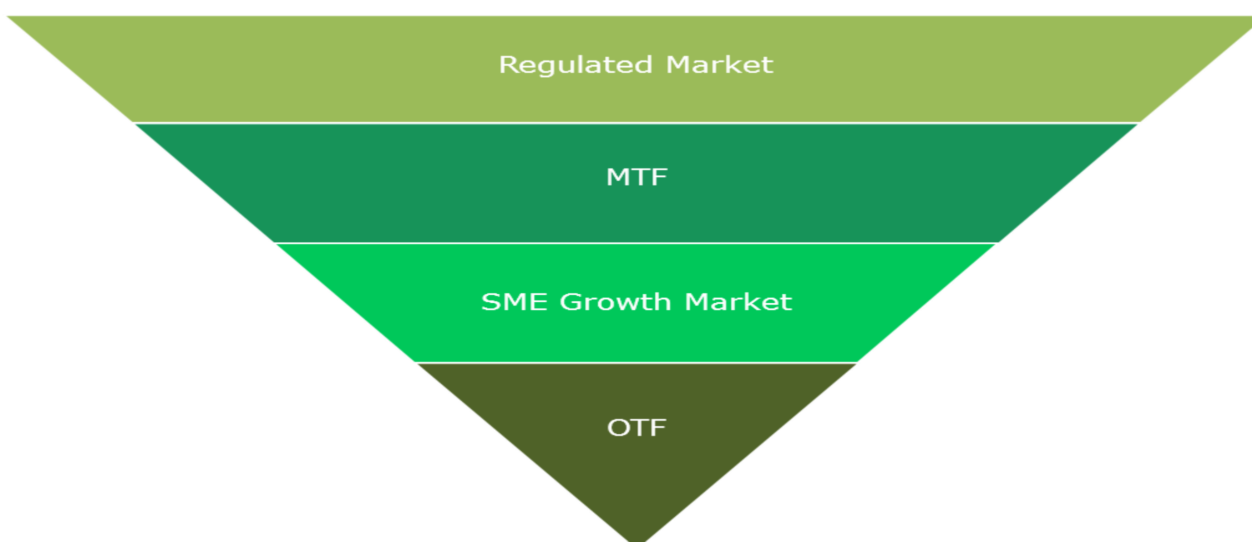
With the organised trading facilities, the EU is seeking to move organised trade, which today is not covered by MiFID I, to fall under regulation, for example broker crossing systems and inter-dealer broker systems. As all markets are covered by the same pre and post trading transparency requirements, MiFID II will entail a light being thrown on trading which today takes place ”in the dark”, for example trading with standardised derivative contracts.

Those financial institutions and investment services companies who carry out trading against their own accounts will in future be classified as systematic internalisers (SI) and consequently be covered by the same pre and post trading transparency requirements as the markets. The detailed changes in the definition of systematic internaliser will be determined by the European Securities and Markets Authority (ESMA).

Another central innovation in MiFID II is the creation of the market type ”SME Growth Market”. It is suggested that an MTF operator should be able to apply to have the MTF approved as an SME Growth Market, provided that certain detailed conditions are fulfilled. The main idea is to create a customised framework covering these markets’ specific characteristics, which at the same time ensures a high degree of investor protection.

Figure 3 contains an illustration of the markets covered in the existing MiFID II proposal.

Figure 3. Overview of the markets



Trading with standardised Derivatives is moved onto Markets

The proposal contains certain requirements for electronic trading, including trading with certain types of derivatives on approved platforms in order to fulfil the obligation with the G20 countries which were assumed in order to ensure an increased transparency in the non-transparent derivatives markets. The derivative types which will be covered will be defined in detail by ESMA. This part of the regulation is inseparably connected to the introduction of the new types of markets described above.

Transaction Reporting for Securities Dealers

For securities dealers, the proposal involves additional requirements to transaction reporting, including an expansion of the reporting requirements to also cover instruments traded on multilateral trading facilities and organised trading facilities.

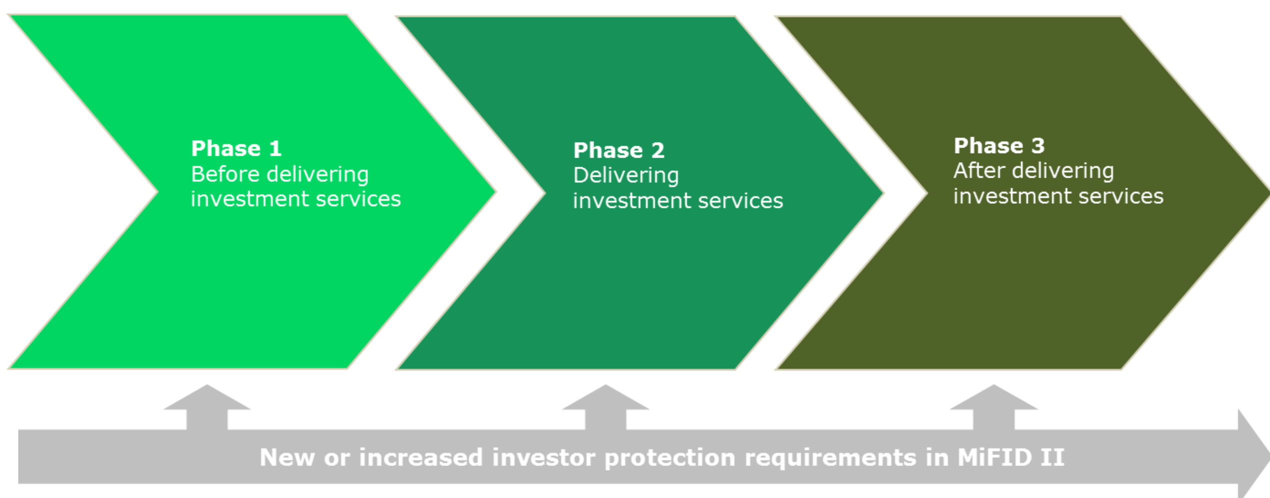
The MiFIR regulation contains a detailed description of the types of information which must be included in the transaction reports, for example identification of the individuals (or computer algorithms, if relevant) who are responsible for making the decision to invest. This is a measure to ensure consistency in relation to format and contents of reports prepared in the EU countries.

Investor Protection Requirements for Securities Dealers

A general feature of the MiFID II proposal is the considerable focus on investor protection, particularly with regards to protection of private customers - retail clients.

For securities dealers, MiFID II will therefore imply new as well as increased requirements to all phases of their interaction with customers. This is illustrated in figure 4.

Figure 4. MiFID II’s effect on client relations



Investment Advice, Portfolio Management and Inducements

One of the more debated proposals in MiFID II is the prohibition against securities dealers who provide portfolio management and offering independent investment advice, respectively, receiving inducements.

The introduction of an actual ”independence concept” is an innovation relative to MiFID I. The concept implies that the securities dealer must ensure his independence by, on the one hand, advising on an appropriate amount of securities (both in relation to type and issuer) and, on the other hand, by the securities dealer being prohibited from receiving inducements from third parties. However, the same company may provide independent and non-independent advice. The prohibition against inducements covers ”fees, commissions or any monetary benefit”.

The rationale behind the prohibition against inducements can, with a wording from the English Retail Distribution Review, be expressed in the way that ”charges should reflect the service being provided rather than the particular provider or product being recommended.”

However, the introduction of the prohibition against premiums will have a varying effect in the individual EU countries, where there are large difference as to how the markets look today. For example, the prohibition will fit in nicely in the present English market where independent investment advisors constitute approximately 60% of the market.

In contrast, other EU countries (for example France and Denmark) do not have a correspondingly large market for independent investment advisors, and for securities dealers in these countries, the new rules necessitate a consideration with regards to their future business areas and models. In that connection, a number of questions are lurking: Will there be more products developed in-house? Will this mean the end of open-architecture? Will small product developers without their own distribution channels be hit the hardest? How may the product developer incentivise distribution? How may the current costs be split up, in order that the PM fee will appear?

MiFID II also contains a proposal suggesting that clients in connection with the investment advise must be informed on whether the advise is independent and whether the company will carry out an on-going assessment of whether the products delivered are suitable for the customer.

In figure 5, some of the changes for investment advice, portfolio management and premiums following from the MiFID II proposal are illustrated (next page).

Figure 5. Overview over parts of the MiFID II's investor protection rules

Investment services	Protection rules	Information in advance of service	Inducements
Portfolio Management	Suitability test (no changes)	No changes	**Prohibited**
Independent investment advice	Suitability test (no changes)	**Inform that advice is independent** **Inform if continued assessment of suitability is made**	**Prohibited**
"Restricted" (limited) investment advice	Suitability test (no changes)	**Inform that advice is not independent** **Inform if continued assessment of suitability is made**	No changes
Execution, reception and transmission of orders	**Structured UCITS will be "complex" under the execution only-regime**	No changes	No changes

Additionally, further requirements to ensure best execution are laid down in the proposed investor protection rules, for example that companies must disclose their top five trading systems for each financial instrument at least once a year.

Changes to the Execution only Regime

The MiFID II proposal implies that structured UCITS will no longer be considered "non-complex instruments", with the consequence that they may no longer be sold/offered to customers under the execution only rules.

This will among other things imply that it will become more difficult to sell certain structured UCITS via internet banks etc., as this will either require that an investment profile be prepared and that a suitability test be carried or that the customers be informed that above is lacking. All things equal, this measure will make it more difficult to sell/trade with structured UCITS.

Strengthening of the Corporate Governance of Securities Dealers

In line with the other national and international initiatives after the financial crisis, MiFID II also contains a strengthening of the requirements on managements in securities dealer firms, including in relation to the following areas:

- Limitation on the number of directorships. A person may as a maximum accept either one executive management position and two directorships or four directorships (several intragroup positions are viewed as a single position). It is only possible to exceed the maximum if the Financial

Supervisory Authority approves this.

- Competence and training. The collective board of directors must have the necessary knowledge, skills and experience to handle its tasks, and the necessary resources must be earmarked to training of board members. ESMA will prepare detailed standards in this area.
- Diversity policy. A policy which promotes diversity in the composition of the board of directors based on gender, age, geography, education and competence must be prepared.
- Requirement for nominating committees. Such committees must assess the composition of the board of directors. However, the requirement is dependent upon the size and complexity of the company.

Strengthening of Supervision

With MiFID II, the national supervisory authorities will be authorised to issue permanent product bans, and it will be possible for ESMA to issue temporary product bans. This is an attempt to increase investor protection and to improve market stability, and additional detailed regulation regarding product bans will be prepared.

The proposal on product bans also includes the introduction of position limits for commodity derivatives and CO^2 Quotas (including on spots and derivatives). This requires that the trading systems introduce position limits and inform their local supervisory authority hereof.

National supervisory authorities and ESMA will be authorised to force through a reduction of positions and will be able to impose position limits under certain conditions (for example with a view to ensuring market stability).

The new competencies and instruments can be summarised as follows:

- ESMA may issue temporary bans on (i) marketing, distribution or sale of certain financial instruments or financial instruments with certain characteristics, or (ii) a certain activity or procedure.
- The national Financial Supervisory Authority will, in coordination with the ESMA, be authorised to issue permanent bans or to limit (i) marketing, distribution or sale of certain financial instruments or financial instruments with certain characteristics, or (ii) a certain activity or procedure.
- The use of bans is conditional upon there being a threat against the protection of investors, the market's function or the stability in the financial system or parts thereof.

Companies from Third Countries

The proposal introduces a harmonised European procedure on how companies from third countries wishing to carry out investment services in the EU are to be treated. This procedure contains a requirement that a company from a third country, which delivers services to retail customers, must establish a branch in an EU country. Companies from third countries may use this solution if the financial supervision in their home country is assessed to correspond to the requirements under the MiFID II

(”equivalent supervision”).

ESMA will assess whether ”equivalent supervision” may be applied and will keep a central list of the countries covered. The branch must fulfil specific requirements on, for example, investor protection and rules regarding conflicts of interest.

Companies from third countries may deliver services to approved counterparties as long as they are subject to supervision in their respective home country and as long as they are registered with ESMA. However, it is unclear whether companies subject to supervision in their home country must also be controlled by supervisory authorities in the local market where they wish to conduct business.

At the moment, the regulation of companies from third countries is subject to national rules in each individual EU country. This implies that companies will be affected differently by the new rules. The effect on companies from third countries, including companies delivering services to retail clients and approved counterparties, will be dependent upon which additional requirements are laid down by ES-MA.

Anticipated Implementation Costs

A careful assessment from the EU Commission estimates that the costs for implementing MiFID II in the EU will amount to approximately EUR 512,000,000 - 732,000,000.

Additionally, annual expenses to ensure compliance with MiFID II are expected to amount to between EUR 312,000,000 - 586,000,000.

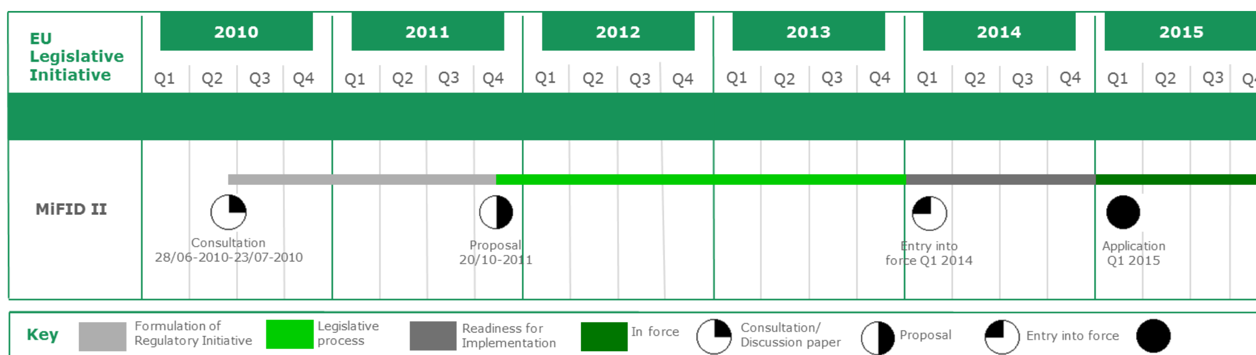
Expected Time Schedule

That MiFID II is a central regulatory initiative at EU level is among other things reflected in the intense discussions that there have been regarding the scope and the detailed contents of MiFID II.

When the fact that the most significant part of the regulation is sought placed in a regulation (which is directly applicable in the member states), it is clear that the political discussions between the member states will be sharper and more thorough than what has previously been the case as the ”battle is fought” already now and not, as previously, in connection with the negotiations on the implementation directives/implementation regulations.

All this put together implies that the time schedule will slip and that MiFID II will probably not be applicable in the member states before 2015. In figure 6, we have tried to illustrate our guess as to a possible time schedule for MiFID II (next page).

Figure 6. Possible time schedule for MiFID II



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