

Tuesday 1 December 2015

## Preparing for MiFID II: Practical Implications

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# AGENDA

- Overview of MiFID II's key provisions
- Organisational and conduct of business requirements
- Product approval, product intervention and suitability
- Practical issues for commodity trading advisers and other commodity firms
- High frequency and algorithmic trading provisions
- Expansion of transaction reporting and transparency obligations



# Overview of MiFID II

Sean Donovan-Smith



## WHY MIFID II?

- MiFID I replaced and extended ISD to create a level playing field, increase competition and ensure investor protection.
- Article 65 MiFID required EC to undertake a review of MiFID after 3 years.
- Key principles for MiFID II:

Greater  
transparency

More  
responsible  
financial players

Increased rules  
to ensure fair  
competition

Restoration of  
trust

## WHAT IS MIFID II?

- MiFID II can be broadly broken down into six key areas:

Market transparency

Market infrastructure

Transaction reporting

Investor protection

OTC derivatives and commodities

Third country access

## HOW IS IT BEING IMPLEMENTED?

- Level 1 legislation:
  - Recast MiFID directive; and
  - Markets in Financial Instruments Regulations (“**MiFIR**”)
- Level 2 measures:
  - Delegated acts which are drafted by the EC with advice from ESMA; and
  - Regulatory Technical Standards (“**RTS**”) drafted by ESMA and approved by the EC
- National implementing measures

## WHAT ARE THE TIMINGS?

- Draft Level 1 legislation originally published on 20 October 2011:
  - Recast MiFID directive; and
  - Markets in Financial Instruments Regulations (“**MiFIR**”).
- Political agreement reached on 14 January 2014
- EP approved MiFID II Level 1 texts on 15 April 2014
- EC formally adopted MiFID II on 13 May 2014
- Original target implementation of 3 January 2017



# Organisational and Conduct of Business Requirements

Jacob Ghanty

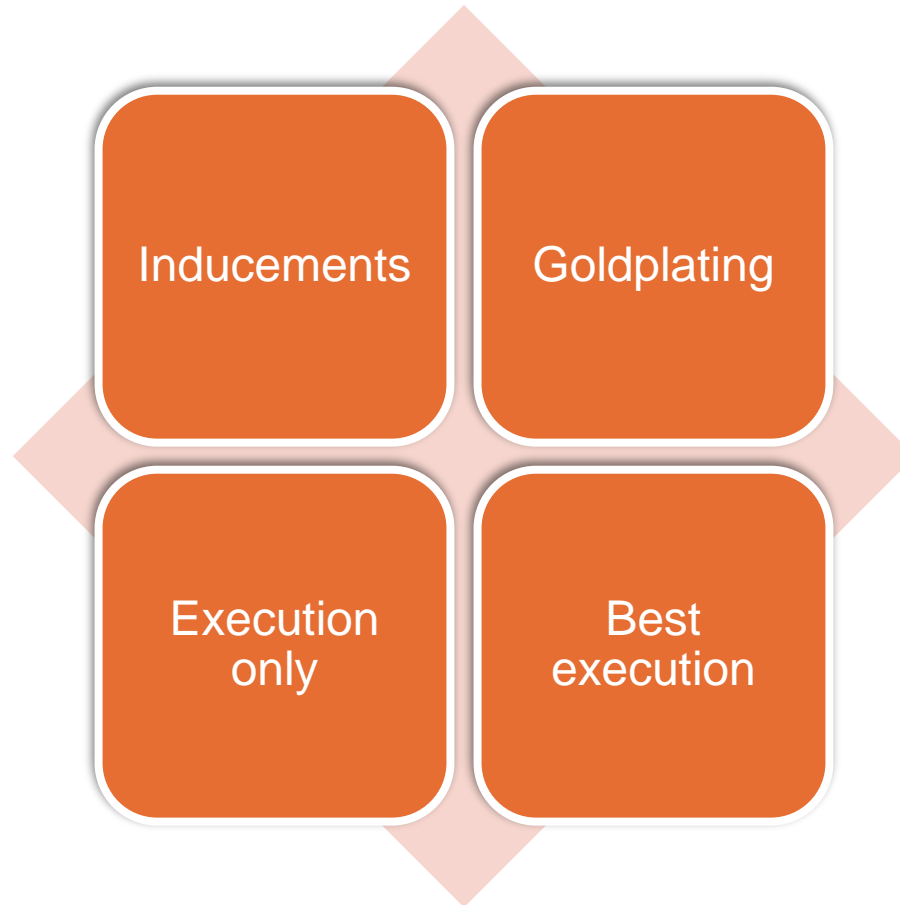




# ORGANISATIONAL REQUIREMENTS



# CONDUCT OF BUSINESS REQUIREMENTS



# COMPARISON OF MIFID VS MIFID II

	MiFID	MiFID II
<b>Management bodies</b>	Sufficient good repute and experience	Extension of CRD IV provisions to investment firms (art. 9)
<b>Product governance</b>	N/A	Explicit arrangements for product governance required (Art. 24)
<b>Sales targets and remuneration</b>	ESMA Guidelines on Remuneration Policies and Practices	Prohibition on incentives based on sales targets (Art. 24)
<b>Title transfer collateral arrangements</b>	Recital and national law	Prohibited for retail clients (Art. 16)
<b>Inducements</b>	Restriction on commissions except in prescribed cases	Ban on payments from third parties (Art. 24)
<b>Execution only</b>	Prescribed list of execution-only products	List narrowed (Art. 25)
<b>Best execution</b>	Contains the basic requirements	Additional requirements (Art. 27)



# Investor Protection: Product Approval, Distribution And Product Intervention

Andrew Massey



### Miscellaneous

Client assets safeguards

Telephone / electronic communications

### Client categorisation

Eligible counterparty enhancements

Public authority default retail client categorisation

Product governance

### Distribution

Distributor due diligence

Suitability / appropriateness

Independent / restricted advice labels

Inducements / commission prohibition

Product intervention powers

### Client best interests

Conflicts of interest

Remuneration

### Investor Protection

### Disclosure

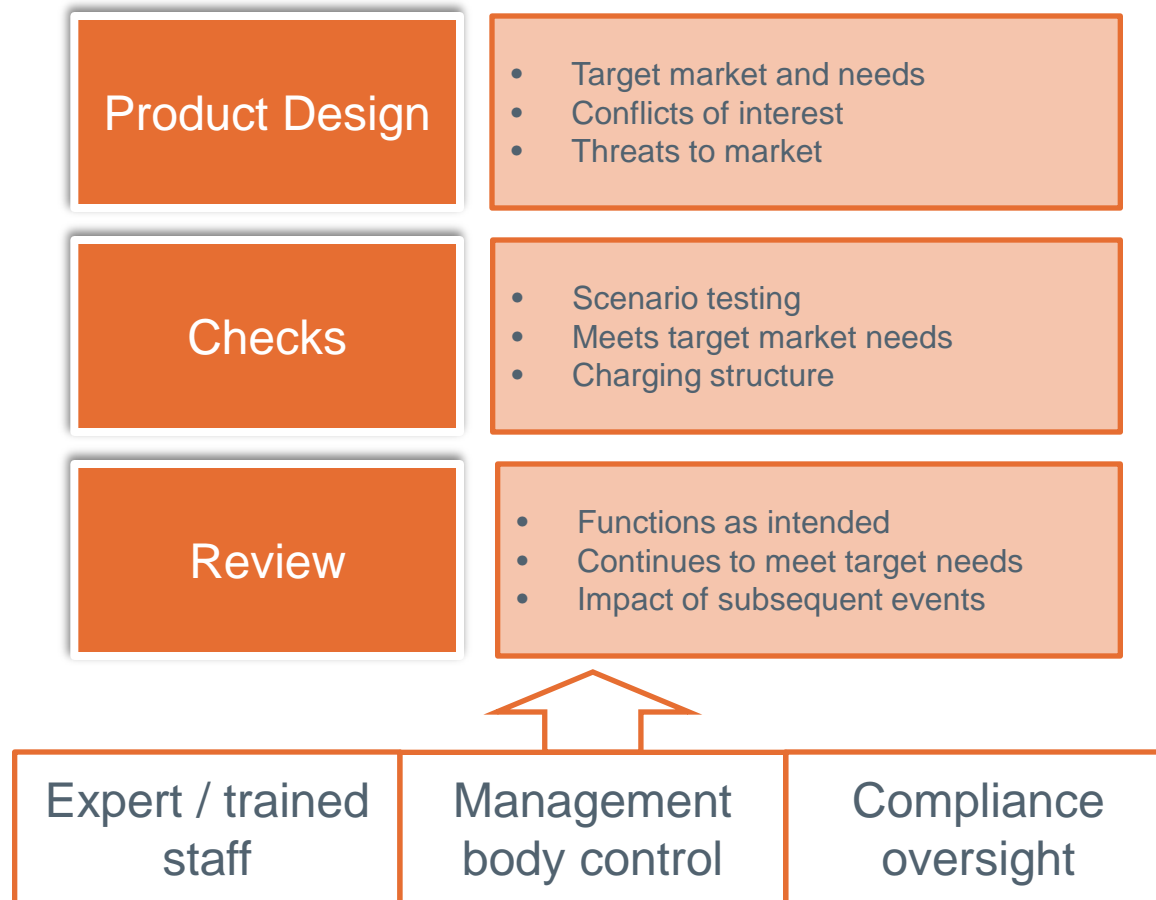
Investment advice / financial instruments information

Costs and charges information

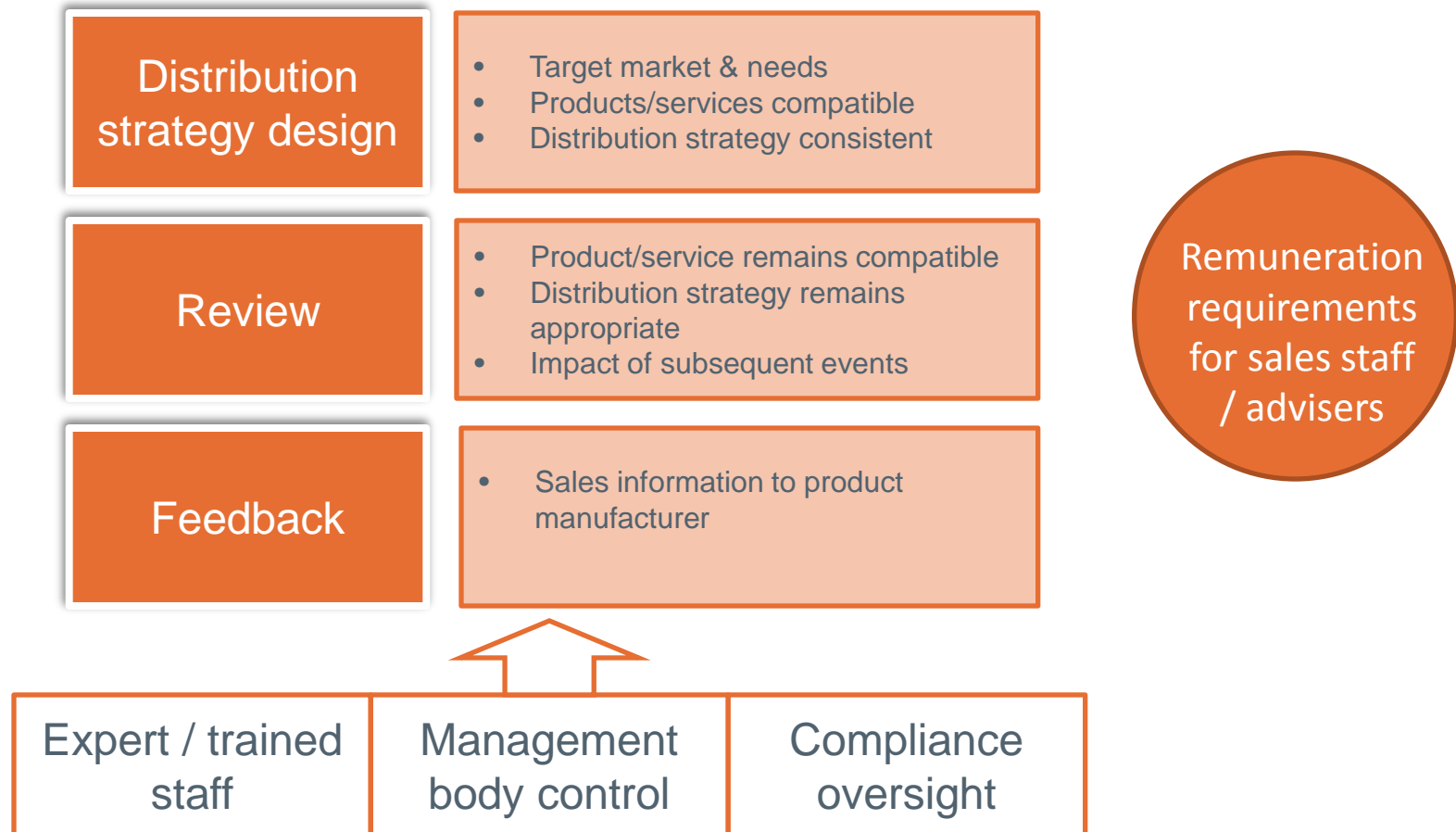
Component costs of bundled services

Best execution

# PRODUCT GOVERNANCE



# DISTRIBUTOR DUE DILIGENCE



# SUITABILITY AND APPROPRIATENESS

## Suitability

- Equivalent financial instruments that meet client's profile / needs
- Every personal recommendation must be suitable
- Check on reliability of information provided by clients

## Appropriateness

- Changes to scope by extending definition of “complex instruments” e.g.:
- Shares unless on regulated market (or 3<sup>rd</sup> country equivalent) or MTF
  - Non-UCITS CIS
  - Structured UCITS
  - Shares and debt instruments that embed a derivative



# "EUROPEAN RDR"

	UK	MiFID II
<b>Advice labels</b>	<u>Independent advice</u> Comprehensive and fair analysis of relevant market	<u>Independent advice</u> Sufficient range of financial instruments available on market with sufficiently diverse type and issuers / product providers
	<u>Restricted advice</u> Not independent	<u>Restricted advice</u> Not independent
<b>Inducements</b>	<u>Scope</u> <ul style="list-style-type: none"> <li>Relevant services / activities: <ul style="list-style-type: none"> <li>Advice</li> <li><b>Platform services</b></li> </ul> </li> <li>Retail investment products</li> <li>Limited to <b>retail clients</b></li> <li>Rebates prohibited (except unit rebates for platform services)</li> </ul>	<u>Scope</u> <ul style="list-style-type: none"> <li>Relevant services / activities: <ul style="list-style-type: none"> <li><b>Independent</b> advice</li> <li><b>Portfolio management</b></li> </ul> </li> <li>MiFID financial instruments</li> <li>Not limited to retail clients</li> <li>Rebates potentially possible</li> </ul>

# PRODUCT INTERVENTION

## Powers

- Restrict marketing, distribution or sale of certain financial instruments or type of financial activity
- May be temporarily or permanent

## Exercisable by

- ESMA
- EBA
- Competent authorities

## Conditions

- Investor protection concern
- Threat to market
- Threat to stability of financial system
- Regulatory requirements do not address threat

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# Practical Issues for Commodity Trading Advisers and Other Commodity Firms

Philip Morgan

# INTRODUCTION

What is a “commodity derivative”?

How is the regulatory perimeter for MiFID licensing changing?

What are the new rules on position limits and position reporting?

# WHAT IS A COMMODITY DERIVATIVE?

- ESMA technical advice (December 2014); Delegated Regulation awaited from Commission with possible delivery December 2015

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## Some key points:

New inclusion in “financial instrument” definition – commodity derivatives (incl. forwards) that can be physically settled that are traded on an OTF (ie. organised trading facility) [C6]

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Quite wide definition of “can be physically settled” – see ESMA/2015/675 6 May 2015 on C6 & C7 derivatives

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# WHAT IS A COMMODITY DERIVATIVE?

- New exclusion – wholesale energy products [derivatives with electricity or natural gas as the underlying that are within REMIT] traded on an OTF that must be physically settled
- Commodity derivatives that can be physically settled, are not traded on a market, and are not for commercial purposes; on this ESMA advice is (i) to keep current spot contract definition [delivery in 2 trading days or (if longer) the standard delivery period in the relevant market], but (ii) not to require clearing or payment of margin [C7]

# WHAT IS A COMMODITY DERIVATIVE?

## Consequences

- Transaction reporting
- Position limits/position reporting
- Application of MAR different
- EMIR
- REMIT

# HOW IS THE REGULATORY PERIMETER CHANGING?

- Only remaining exemption for commodity derivative traders is the “commercial end user” exemption (new Article 2(1)(j))
- Even if exempted under Article 2(1)(j) or 2(1)(d) (only dealing on own account), some of MiFID II applies – esp. position limits and reporting and, for traders exempt under A.2(1)(j) but also a member of a regulated market or MTF, organisational requirements for algorithmic trading



# HOW IS THE REGULATORY PERIMETER CHANGING?

- Article 2(1)(j) covers:
  - dealing on own account in commodity derivatives (except when executing customer orders)
  - providing other investment services in commodity derivatives to customers or suppliers of their main business
- But only if:
  - individually and on an aggregate basis this is ancillary activity to their main non-investment business when considered on a group basis
  - the person does not apply high frequency algorithmic trading techniques
  - an annual notification is made to the relevant regulator

# HOW IS THE REGULATORY PERIMETER CHANGING?

## Ancillary activity test:



- Political intent to extend the scope of financial regulation
- One of the most contentious parts of MiFID
- It is clear that no licensing required if no speculative activity

## HOW IS THE REGULATORY PERIMETER CHANGING?

- Key tests per ESMA are (i) size of EU speculative trading activity (by gross notional value) versus overall market trading activity for that asset class (ESMA proposes threshold at 3% for oil and gas rising to 20% for emissions allowances) and (ii) the amount of speculative trading versus the amount of overall trading (incl. hedging) (ESMA proposes exemption if  $< 10\%$  and reduced thresholds for test (i) above that)

Must pass both tests to be exempt

# HOW IS THE REGULATORY PERIMETER CHANGING?

Consequences of falling outside the ancillary activities test:



- CRD IV capital requirements
- become a financial counterparty under EMIR
- hedging exemption re position limits lost

# POSITION LIMITS

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Position limits apply to all commodity derivatives traded on Regulated Market, MTF or OTF

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Applied at an entity level and, on an aggregate basis, at a group level (top hold-co)

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Netting of long and short positions (NB delta – adjusted for options)

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OTC contract may be deemed economically equivalent to a contract traded on a venue if it has a highly correlated economic outcome (but we understand that no published list of these is proposed)

# POSITION LIMITS

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Regulators set and enforce limits – new work for them and is a considerable burden as the range of contracts is considerable

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Hedging transactions excluded but only where held by non-financial entity

# POSITION LIMITS

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Separate limits for “spot month” (i.e. the contracts next to expire) and ‘other months’ (i.e. everything else)

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In each case the “baseline” percentage is 25% except that the “other months” limit is 2500 lots where the open interest is less than 10,000 lots (a special regime for “new and illiquid contracts” so as not to stifle innovation)

## POSITION LIMITS

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Spot months – limits based on deliverable supply of the underlying commodity (between 5% and 35%; set by regulator)

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Other months (and spot months where no deliverable supply) – limits based on total open interest (between 5% and 35%, again set by regulator)

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Regulators to exercise their discretion based on factors in MiFID II Article 57(3) – e.g. maturity, deliverable supply, volatility and liquidity



# POSITION REPORTING

- Mostly fixed in the Directive
- Reporting obligation on members or participants of regulated markets, MTFs and OTFs but data needed down to the ultimate client; onus then on venues to report to the FCA
- FCA has highlighted potential data privacy issues

## POSITION REPORTING

- Reports will need to identify (i) position holder; (ii) ultimate parent (for purposes of application of position limits on group basis); and (iii) whether position is hedging or speculative
- Technical standards on this expected to be delivered to the EU Commission by ESMA by 3 January 2016
- A big task to get this working!



# HFT and Algorithmic Trading

Sean Donovan-Smith



# ARTICLES 17 AND 48 MIFID II: ALGORITHMIC AND HFT TRADING

- Requirements include:
- Extension of licensing regime to investment firms:
  - Members of RMs or MTFs;
  - Direct Electronic Access to trading venues; or
  - Apply high-frequency algorithmic trading strategies
- Regulatory disclosure of algorithmic strategies
- Restrictions on Direct Electronic Access
- Appropriate systems and controls
- Introduction of a liquidity obligation
- Trading venues to implement circuit breakers and robust controls

# OVERVIEW OF ARTICLES 17 AND 48 MIFID II

## Trading Venue

### Art. 48, 49 MiFID II

Systems Resilience and Capacity

Systems and Controls to reject orders:

- exceeding pre-determined volume or price thresholds; or
- being clearly erroneous

Circuit Breakers

Order-to-Transaction Ratios

Rules on DEA

Minimum Tick-Sizes

Algo-Flagging Rules

Rules on Co-Location

Fee Structures

## Firms providing DEA

### Art. 17 para. 5 MiFID II

effective systems and controls which ensure:

- a proper assessment and review of the suitability of clients using the service
- that clients using the service are prevented from exceeding appropriate pre-set trading and credit thresholds;
- that trading by clients using the service is properly monitored
- that appropriate risk controls prevent trading that may create risks to the investment firm itself or that could create or contribute to a disorderly market or could be contrary to Regulation (EU) No .../2014(87) or the rules of the trading venue.

responsible for ensuring that clients using that service comply with the requirements of this Directive and the rules of the trading venue

monitor the transactions in order to identify infringements of those rules, disorderly trading conditions or conduct that may involve market abuse and that is to be reported to the competent authority

binding written agreement between the investment firm and the client regarding the essential rights and obligations arising from the provision of the service and that under the agreement the investment firm retains responsibility under this Directive

notify the competent authorities of its home Member State and of the trading venue at which the investment firm provides direct electronic access

provide, on a regular or ad-hoc basis, a description of the systems and controls

records to be kept in relation to the matters referred to in this paragraph and shall ensure that those records be sufficient to enable its competent authority to monitor compliance with the requirements of this Directive

## (In-)direct Trading Participant

### Art. 17 para. 1, 2 MiFID II

effective systems and risk controls suitable to the business it operates to ensure that its trading systems are:

- resilient and have sufficient capacity
- are subject to appropriate trading thresholds and limits
- prevent the sending of erroneous orders or the systems otherwise functioning in a way that may create or contribute to a disorderly market
- cannot be used for any purpose that is contrary to Regulation (EU) No 596/2014
- cannot be used for any purpose contrary to the rules of the trading venue to which it is connected

notification of competent authority and trading venue

record keeping requirements

**In addition for HFT:**

authorisation required

store in an approved form accurate and time sequenced records of all its placed orders, including cancellations of orders, executed orders and quotations on trading venues and shall make them available to the competent authority upon request

# RTS THAT SUPPORT ARTICLES 17 AND 48 MIFID II

RTS 6 (organisational requirements for investment firms)

RTS 7 (organisational requirements for trading venues)

RTS 8 (market making)

RTS 9 (Order-to-Trade Ratios (“**OTRs**”))

RTS 10 (fee structures and co-location)

RTS 11 (tick sizes)

RTS 12 (material markets in terms of liquidity)

# RTS 6 AND 7: ORGANISATIONAL REQUIREMENTS

- Formalises and expands 2012 ESMA Guidelines
- Investment Firms and Trading Venues:
  - Mandatory prior testing of algorithms and separation of testing environment and production environment
  - Continuous self-assessment and stress testing
- Investment Firms:
  - Order recording formats
  - Systems and controls requirement for Direct Electronic Access providers (with input from Trading Venues)
- Trading Venues
  - Infrastructure must be able to handle 2x historical peak message volume over past 5 years
  - Implement measures to prevent disorderly trading

## RTS 8: MARKET MAKING

- Applicable only to members and participants of the Trading Venues
- Market making agreement to be signed when posting firm, simultaneous two-way quotes of comparable size and competitive prices and dealing on own account in at least one financial instrument on one Trading Venue
- Agreement required if firm is present in the market for at least 50% of the daily trading hours for 50% of the trading days over a one month period
- Trading Venues to have a market making scheme for equities and equity-related instruments that are traded on an automated, continuous auction order book system
- Access to market making schemes must be on a fair and non-discriminatory basis



## RTS 9-12

### OTRs

- Consistent across all EU Trading Venues

### Fee structures and co-location

- Fair and Transparent access

### Tick sizes

- Scaled by price and volume

### Material markets

- Article 48(5) MiFID II and trading halts



# Transaction Reporting and Transparency

Rodney Smyth



## WHY?

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**Pre-trade quotes and post-trade reports:** to increase the efficiency of the “price formation process”, through greater transparency

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**Transaction reports:** to detect market abuse (cp. **EMIR** transaction reports – to reduce systemic risk)

## WHO?

- **Pre-trade quotes and post-trade reports:** RMs, MTFs, OTFs & (new) (pre-trade only) SIs - with **waivers** available for pre-trade quotes (but note, for certain quotes in liquid equities, annual “double volume cap”: MiFIR,5)
- **Transaction reports:** “MiFID” firms (including a non-EEA (i.e., non-“MiFID”) branch of a “MiFID” firm):
  - whether on buy-side or sell-side of a transaction;
  - **provided** 1) there has been a “transaction” and 2) the firm is “deemed to have executed” it: RTS 22, 2 and 3 (note that, e.g., “securities financing transactions” (stocklending/repos) are **not** “transactions”);
  - **no** waivers available;
  - **but:** note “transmission-of-orders” **exemption** – e.g., for fund managers using EEA brokers: MiFIR, 26.4 – subject to the conditions in RTS 22, 4

# WHAT “FINANCIAL INSTRUMENTS”?

## Pre-trade quotes and post-trade reports:

- Equities
- Depositary receipts (new)
- Bonds (new)
- “Structured finance products” (new)
- Emission allowances (new)
- Derivatives (new): MiFIR, 3.1, 6.1, 8.1 and 10.1

## TRANSACTION REPORTS:

All the “financial instruments” listed above, **provided:**

- admitted to trading/traded on an RM, MTF or OTF **or**
- underlying traded on an RM, MTF or OTF **or**
- underlying is an index/basket traded on an RM, MTF or OTF:  
MiFIR, 26.2
- **irrespective** of whether transaction **actually** carried out on an RM, MTF or OTF

Transactions in “>100,000” EEA “financial instruments” will therefore become reportable – vs. in only c.6,000 EEA equities, currently

## WHEN?

- **“Post-trade reports** of transactions carried out on an RM, MTF or OTF during “daily trading hours”: must be “made public” in T + 1 minute – equities, depositary receipts and ETFs: RTS 1, 14: and in T + (initially) 15 minutes – bonds, “structured finance products”, emission allowances and derivatives: RTS 2, 4
  - unless they qualify for **“deferred publication”**: RTS 1, 15 and 2, 8
- **Availability to the public free of charge of the post-trade reports**: time made public + 15 minutes: MiFIR, 13.1
- **Transaction reports**: T + 1: MiFIR, 26.1

## TO?

- **Pre-trade quotes:** the “public”: MiFIR, 3.1 and 8.1
- **Post-trade reports:** the “public”: MiFIR, 6.1 and 10.1
- **Transaction reports:** the “competent authority” (i.e., in the UK, the FCA): MiFIR, 26.1

## HOW?

- **Post-trade reports:** via an (authorised) APA (new) (e.g., the LSE’s TDM service): MiFIR, 20.1 and 21.1
- **Transaction reports:** in practice, in the UK, via an (authorised) ARM (e.g., the LSE’s UnaVista) or directly: MiFIR, 26.7

APA = Approved Publication Arrangement

ARM = Approved Reporting Mechanism



## WHAT DATA?

- **Post-trade reports:** 9 fields (RTS 1, annex 1, table 3) – in summary: volume; price; time
- **Transaction reports:** 65 fields (RTS 22, annex 1, table 2) (cp. 24 currently, in the UK (FCA SUP 17, Annex 1); and 85, under EMIR) – e.g.:

identity of buyer and seller – and (new) date of birth, if an individual

identity of decision-maker (e.g., individual fund manager or algorithm), if different from buyer/seller (new)

identity of trader (i.e., individual or algorithm who/which actually executed the transaction) (new)

## WHAT NEXT?

- **Dec. 2015/Jan. 2016:** draft FCA “**Level 3 Guidelines**”
- **CTPs** (consolidated tape providers)? A CTP = a person authorised under MiFID II to “provide the service of collecting trade reports [submitted under MiFIR] ... and consolidating them into a **continuous electronic live data stream** providing price and volume data per financial instrument”: MiFID II, 4.1(53). A CTP must “make the information available to the public as close to real time as is technically possible on a reasonable commercial basis”: MiFIR, 65.1
- The EU authorities want CTPs
- But will they happen?
- If so, only gradually? – e.g., starting with just equities?
- Will they be useful? Who needs them?



Expected timings

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## WHERE ARE WE NOW?

- ESMA provided advice to the EC on the delegated acts to at the end of 2014
- ESMA delivered draft RTSs on 28 September 2015 and will deliver drafts of remaining RTSs early 2016
- EC has not yet endorsed the RTSs or adopted delegated acts
- They are subject to further scrutiny by EP and Council before they enter into force
- Currently EU Member States have until 3 July 2016 to introduce national implementing measures



# Questions

# CONTACT DETAILS



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