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Reforming the Financial Markets in Germany—Update on the Implementation of MiFID2[1]

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The Ministry of Finance in Germany has just concluded a consultation for a 379-page draft bill for the Second Financial Markets Reform Act (*Zweites Finanzmarktnovellierungsgesetz*) (the "**Act**") that aims to transpose, amongst others, the European Markets Infrastructure in Financial Instruments Directive, known as "MiFID2" in Germany. Together with the recent transposition of, amongst others, the Market Abuse Regulation and the PRIIPs Regulation earlier this year, the Act marks the second pillar in reforming the existing regulation of the financial markets in Germany and harmonizing it further with the rest of the European Union. The provisions transposing MiFID2 will come into effect by January 3, 2018.

It will, on the one hand, facilitate access of third-country firms to the European Union without having to apply for authorizations or to rely on reverse solicitation, but will, on the other hand, bring about a much stricter regulation of the financial markets with new authorization requirements for market participants and business conduct rules.

Status of Legislative Process

In contrast to other recent legislation such as the Alternative Investment Fund Managers Directive, Germany aims at transposing MiFID2 1:1 into national laws without further gold-plating. This may have been one of the reasons for limiting the consultation period to only one month, which was heavily criticized because of the complexity of the Act. Still, it can be expected that there will be a smooth legislative process given the upcoming parliamentary elections in Germany in the third quarter of 2017.

Key Changes

The transposition will entail amendments to a number of laws currently regulating the financial markets in Germany. Primarily, the new regime will be implemented in the Securities Trading Act (*Wertpapierhandelsgesetz*). Due to the scope and complexity of the amendments, the Ministry of Finance decided for a complete renumbering of the Securities Trading Act which has been in place for over 20 years now. Further amendments are necessary as regards additional authorization requirements for proprietary trading or data reporting services providers in the Banking Act (*Kreditwesengesetz*), the Stock Exchange Act (*Börsengesetz*) and the Capital Investment Act (*Kapitalanlagegesetz*) which regulates fund managers and funds and their activities comprehensively in Germany.

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[1] Alerts covering specific items of the Act and their impact on the business activities of clients in Germany or with residents of Germany will follow shortly.

The key elements of the Act comprise:

- the regulation of so-called organized trading facilities, i.e. multilateral trading venues which are currently not regulated markets, by imposing authorization requirements and business organization and conduct obligations;
- additional disclosure obligations for financial instruments and the regulation of data reporting services providers;
- stricter supervision of commodity derivatives by imposing position limits and controls;
- regulation of algorithmic trading and in particular high-frequency trading;
- stricter rules for business organization and conduct for investment firms, including conflict of interest rules, inducements, suitability statements for investment advice, requirements as to knowledge and experience when providing discretionary investment advisory services, increased supervision and enforcement powers by the Federal Financial Supervisory Authority ("BaFin");
- tightened sanctions for violations of the applicable obligations. In line with the recent approach within the European Union to ensure that sanctions are sufficiently deterrent by linking pecuniary sanctions to the annual turn-over of a group and making sanctions public (naming and shaming).

Application to Firms Domiciled Outside Germany

The Act will apply to firms that are either domiciled in Germany (themselves or their subsidiaries) or maintain a branch (either authorized or passported) in Germany.

By contrast, firms authorized in another member state of the European Union or the European Economic Area that provide regulated services only by way of cross border service into Germany will not be regulated under the Act, but will be bound to comply with these obligations as a matter of the law of their home member states where MiFID2 must be equally transposed.

For firms originating from third-countries, MiFID2 and MiFIR provide for a harmonized regime for market access into the European Union. Broadly, this regime for market access allows third-country firms to access the markets and provide services in the European Union without having to obtain additional authorizations in any of the member states provided that the European Commission has determined their home jurisdiction as being equivalent to that of the European Union and that they have registered with the European Securities and Markets Association. However, in the course of the equivalence decisions that are currently prepared for the passport for third-country Alternative Investment Fund Managers, it has become obvious that equivalence decisions are likely to take a couple of years of preparation before being adopted. Obviously, this will be an important factor to consider for firms domiciled in the United Kingdom in the case of Brexit. In the meantime, the national regimes of each member state continue to apply to third-country firms.

As regards Germany, there are currently three options available for third-country firms that have clients domiciled or resident in Germany:

- either to establish a subsidiary or a branch each of which would require an authorization in Germany,
- to apply for an exemption with BaFin, or
- to rely on reverse solicitation.

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Where an exemption is granted to a third-country firm from the authorization requirement, it will also be possible to be exempted from a number of the business conduct rules applicable in Germany. To this end, investment advisors managing segregated accounts will have to observe applicable rules on inducements when accepting soft commissions or even research. In case of reverse solicitation, proposed amendments to the Securities Trading Act raise hopes that business conduct rules might no longer apply to third-country firms.

Securities Financing Transactions and Use of Benchmarks

Apart from MiFID2, the Act will also implement the competency and sanctions regimes of two further regulations:

- the Regulation on the Transparency of Securities Financing Transactions and Reuse ("SFT Regulation"), and
- the Regulation on Indices used for Benchmarks in Financial Instruments and Financial Contracts ("Benchmark Regulation").

The SFT Regulation provides a regulatory framework for so-called securities financing transactions such as repurchase transactions, securities or commodities lending or borrowing, buy/sell-back or sell/buy-back transactions or margin lending transactions. It provides for reporting and information obligations and may apply to third-country firms as well.

The Benchmark Regulation provides a very broad regulatory framework for the provision and the use of benchmarks in the European Union with a view to accuracy and integrity such as interest rates or other indices, particularly indices used to measure the performance of investment funds for the purpose of return tracking or of determining the asset allocation of a portfolio or of computing the performance fees.

While the Regulations themselves are directly applicable in each member state, it remains with each member state to determine the competent authority, to assign the necessary powers to it and to implement the sanctions for failure to comply under domestic laws. BaFin will be appointed the competent authority and assigned the necessary supervisory powers to ensure compliance with the obligations in Germany.

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