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The MiFID and MAD reviews: a focus on some of the key changes and themes

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Summary of talk

- The threats to OTC trading and requirement to trade standardised derivatives on-exchange
- Organised Trading Facilities – what are they & why are they important?
- Transparency requirements
- The attack on high frequency and algorithmic trading
- Complex and non-complex UCITS
- Third country firms
- Regulators' powers: position limits and product bans
- MAD: reason to be more cautious?

Background to MiFID

- In force since November 2007
- Governs:
  - provision of investment services in financial instruments (brokerage/ advice/ dealing/ portfolio management/underwriting) by banks & investment firms
  - operation of stock exchanges & alternative trading venues (multilateral trading facilities – “MTF”)
- Scheduled review after 3 years – somewhat delayed by financial crisis

Key points for MiFID Review

- Commission objective: “improve the competitiveness of EU financial markets by creating a single market for investment services and activities, and ensuring a high degree of harmonised protection for investors in financial instruments, such as shares, bonds, derivatives and various structured products.”
- MiFID I brought more competitive and integrated EU financial market
- But weaknesses highlighted during financial crisis
- New trading platforms and activities currently outside MiFID I scope – not regulated
- Close loopholes to improve investor confidence
- More robust regulatory framework

MiFID II: a Regulation and a Directive

- Regulation covers:
  - Public transparency requirements
  - Private transaction reporting (to national regulators)
  - Derivatives – mandatory move to organised venues
  - Third country provisions – firms operating without an E.U. branch

- No transposition at national level → harmonised regulator framework across E.U.

- Directive covers
  - Authorisation and organisational requirements on investment service providers
  - Investor protection rules
  - Trading venues and reporting services
  - E.U. regulators' powers

- Requires implementation: flexibility at national level over method & form

MiFID II: expected timetable

- Proposals with European Parliament and Council for review and adoption
- Agreement Q4 2012 at earliest
- Implementation period for the directive: currently unknown but likely to be at least 18 months.
- Likelihood of implementation of directive in Member States no earlier than Q1 2015
- Regulation to come into force in Member States simultaneously with Directive

The Threat to OTC Trading

- What is the Commission’s objective?
  - G20 commitment to increase transparency in derivatives market
  - Only ad hoc derivatives to be traded OTC

The Threat to OTC Trading

- Mandatory trading of certain derivatives on organised venues (MiFIR A.24-27)

- Organised venues:
  - Regulated Markets (“RM”)
  - Multilateral Trading Facilities (“MTF”)
  - Organised Trading Facilities (“OTF”)
  - Third country trading venues determined by Commission to be subject to equivalent requirements

- Exchanges to admit derivatives which are subject to trading obligations on a non-exclusive & non-discriminatory basis

- Clear by a CCP (N.B. separate test for application of clearing obligation under EMIR)

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Who does mandatory on-exchange trading apply to?

Derivatives transactions where both parties are either:

- Financial counterparties
  - MiFID Investment firms
  - CRD Credit institutions
  - Insurance undertakings (First Non-Life Directive)
  - Assurance undertakings (Life Directive)
  - Reinsurance undertakings (Reinsurance Directive)
  - UCITS and UCITS managers (UCITS IV)
  - IORPs (OPFD)
  - AIF/AIFM (AIFMD); or
- Non-financial counterparties subject to EMIR clearing obligation
  - Undertaking est. in the EU other than an FCP
  - Subject to *de minimis* threshold and hedging exemption in EMIR; or
- Equivalent third country entities

Which derivatives will be covered?

- ESMA to determine which derivatives subject to trading obligation and when (ESMA technical standards to follow)
- Only those subject to clearing obligation under EMIR
- Sufficiently standardised (EMIR)
- Availability of fair, reliable and generally accepted pricing information (EMIR)
- Sufficiently liquid (EMIR/MiFID)
  - Average size & frequency of trades
  - Number & type of active market participants

Is it a threat to OTC trading?

- Yes
- Harder to develop tailored, derivatives–based solutions (source: PwC)
- Restricting trading only to regulated venues will limit choice/ access – may affect liquidity/ability of firms to manage risk
- Limited co-ordination with the US
  - costs for traders in both jurisdictions
  - risk of regulatory arbitrage between US/EU
- Transaction reporting requirements may squeeze trading margins
- Enhanced collateral requirements in EMIR also a threat

Organised Trading Facilities

What are they?

- "Any system or facility, which is not a RM 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 in accordance with [MiFID II]" (MiFIR A.2)

- Includes "crossing networks"

  - Broker dealing systems/ inter-broker dealing systems

How will a OTF differ from an MTF or Systematic Internaliser?

- MTF "means a multilateral system, operated by an investment firm or a market operator, which brings together multiple third-party buying and selling interests in financial instruments – in the system and <u>in accordance with non-discretionary rules</u> – in a way that results in a contract in accordance with [MiFID II]"

- A systematic internaliser can execute client transactions against its own proprietary capital – systematically executes client orders outside RM/MTF/OTF

  (MiFIR A.2)

Why are OTF important?

- Fills gap in MiFID coverage
- Pre-trade transparency requirements – avoid “dark pool” trading and enhance level playing field across venues
- Significant to determine what is not within the OTF definition, as much as what is – defines borderline of regulated universe

How are OTF regulated?

- Discretion over how orders are executed – therefore investor protection, conduct of business (e.g. client order handling) and best execution requirements under MiFID II (MiFID II A.20)

- Treated like other markets under MiFID II – therefore needs systems resilience/circuit breakers etc to handle algorithmic trading if it allows such trading

- Similar to the current position, written client consent needed to execute orders other than on RM/MTF/OTF

Transparency Requirements Under MiFID II

	Regulated Market	MTF	OTF	Systematic Internaliser	OTC
	Platform trading ("multilateral")			*OTC trading ("bilateral")*	
Pre-trade transparency	Y	Y	Y	Y	N
Post-trade transparency	Y	Y	Y	Y	Y
Non-discretionary execution	Y	Y	N	Y	N
Transparent access rules	Y	Y	Y	Y	N
Market surveillance	Y	Y	Y	N	N
Conduct of business	N	N	Y	Y	Y

Transparency Requirements: Pre- and Post-Trade

Scope

- MiFID I: shares trading on RM

- MiFID II:
  - Equity instruments (shares/depositary receipts/ ETFs/ certificates)
  - Non-equity instruments (bonds/structured finance products/emission allowances/derivatives)

- Applicable to RM and firms operating MTF/ OTF

- Basic pre-trade obligation on venues to make public prices and depth of trading interest at those prices for orders or quotes advertised through the relevant venue

- Should assist price discovery process

(MiFIR A.3-12)

Transparency Requirements: Post-trade

- Obligation on markets and investment firms to ensure that RMs, MTF and OTF post-trade data is available within 15 minutes, free of charge and on a reasonable commercial basis (the meaning of which is to be determined by the Commission)
- Investment firms required to publish trade reports through Approved Publication Arrangements (APAs) (MiFIR A.19/20)
- Consolidated Tape Providers (CTPs)
  - Consolidate post-trade reports from RM/ MTF/ OTF/ APA
  - Create continuous electronic live stream providing real time price and volume data per financial instrument
  - Commercial providers left to provide this service so no guarantee it will happen
- APAs and CTPs are required to be authorised by competent authorities and subject to organisational requirements
- Possibility of deferred reporting if authorised by competent authorities (e.g. for large transactions) – subject to definition under delegated acts by Commission)

(MiFID II A.61-68)

Transaction Reporting by Investment Firms to National Regulators

- MiFID I: financial instruments trading on RM
- MiFID II: all financial instruments trading on MTF/OTF, or whose value depends on, or which is likely to have an effect on, such a traded financial instrument [N.B. drafting in MiFIR is somewhat unclear on this point]
- Standardised derivatives brought on-exchange subject to rule
- Reporting by investment firms that execute transactions
- Reporting includes (*inter alia*) “a designation to identify the persons and the computer algorithms within the investment firm responsible for the decision”
- Authorisation regime for approved reporting mechanisms (ARMs) – reporting system for investment firms
- Reporting by the end of the next business day

(MiFIR A.23)

Pre-trade Transparency Waivers

- Concerns about overuse
- Potential availability of waivers more limited for equity instruments compared with non-equity instruments
  - Equity instruments – size/ type of orders (i.e. orders larger than normal market size); market model
  - Non-equity instruments – also specific characteristics of trading activity in the product; liquidity profile, including the number and type of market participants in a given market
- Delegated legislation of Commission to clarify scope of waivers
- Obligation on EU regulators to notify ESMA of waiver requests
  - At least 6 months before waiver to take effect
- ESMA to publish an opinion assessing the waiver's compatibility with MiFID II within 3 months of notification

(MiFIR A.4, A.8)

Transparency: Co-operation between MTFs, RMs and OTFs

- MTF/ OTF/ RM to give immediate notice to other MTF/OTF/RM in the case of:
  - Disorderly trading conditions
  - Abusive behaviour (MAR)
  - System disruptions

(MiFID II A.34, A.54)

The Attack on High Frequency Trading and Algorithmic Traders

EU Commission's concerns:

- Drastically increased speed of trading
- Possible systemic risks – 2010's U.S. 'flash crash'
- Regulators unclear as to:
  - What strategies are being used
  - Which strategy generates which order
- Members are not checking what strategies are being used on their systems and how the strategies are being controlled

Algorithmic Trading: definition

- Algorithmic trading is trading in financial instruments where a computer algorithm automatically determines individual parameters of orders such as whether to initiate the order, the timing, price or quantity of the order or how to manage the order after its submission, with limited or no human intervention.

- Definition excludes systems used for routing orders to one/more trading venues or for confirmation of orders.

(MiFID II A.4)

Requirements for High Frequency/ Algorithmic Traders

- Investment firm must have in place:
  - Effective systems and controls
    - Resilient trading systems
    - Sufficient capacity for peak order volumes
    - Trading thresholds & limits
    - Prevent erroneous orders/ disorderly functioning
- Annual reporting to national regulator, detailing:
  - Trading strategies
  - Trading parameters/ limits
  - Key compliance & risk controls
  - System testing

(MiFID II A.17)

Requirements for High Frequency/ Algorithmic Traders

- Mandatory continuous trading throughout trading hours of trading venue on which they deal
  - Ensure strategy posts firm quotes at competitive prices
  - Liquidity to be provided on a regular and on-going basis
  - Regardless of market conditions
- Suitability screening by exchange members for direct electronic access
  - Ensure users do not exceed trading thresholds
  - Appropriate risk controls
  - Binding written agreement between firm and user
  - Suitability criteria to be developed

(MiFID II A.17)

Requirements for Markets in Relation to High Frequency/ Algorithmic Traders

- RMs/MTFs/OTFs (where the OTF allows/enables algorithmic trading on its system) to have in place effective systems and controls:
  - Resilient trading systems and sufficient capacity for peak order volumes*
  - Ensure orderly trading in market stress
  - Fully tested re above
  - Effective business continuity arrangements in case of unforeseen failure of trading system
  - Reject clearly erroneous orders and those which exceed pre-determined volume/price thresholds
  - Halt trading if significant price movement in a particular instrument on its or a related market over a short period of time and, in exceptional cases, to cancel/vary/correct transactions*
- *Commission may adopt delegated acts to clarify

Requirements for Markets in Relation to High Frequency/ Algorithmic Traders

- RMs/MTFs/OTFs (where the OTF allows/enables algorithmic trading on its system) to have in place effective systems and controls:
  - Limit ratio of unexecuted orders by a member/ participant
  - Slow the flow of orders if near capacity
  - Limit permissible "tick size"*
- Where direct electronic access is available, RM/MTF/OTF (if applicable)*
  - Members/ participants must be authorised investment firms
  - Market to set appropriate standards re risk controls/thresholds on trading through such access
  - Ability to stop orders/trading if necessary by person using direct electronic access, separately from member/participant

– *Commission may adopt delegated acts to clarify

(MiFID II A.19,20,51)

UCITS: Complex and Non-complex

- MiFID I: if dealing on an execution-only basis, not required to assess appropriateness of transactions in non-complex financial instruments (including UCITS)
- MiFID II: exemption from ‘appropriateness test’ for non-complex UCITS but not for ‘structured’ UCITS
- ‘Structured’ UCITS = “UCITS which provide investors, at certain predetermined dates, with algorithm-based payoffs that are linked to the performance, or to the realisation of price changes or other conditions, of financial assets, indices or reference portfolios or UCITS with similar features” (UCITS IV)

(MiFID II A.25)

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Access for Third Country Firms

- Third country firm → eligible counterparties
  - Eligible counterparties includes for this purpose: investment firms, credit institutions, UCITS and their management companies, pension funds etc (i.e. some within current ‘professional client’ category)
  - Register with ESMA
  - Equivalency of third country ‘legal and supervisory framework’
  - Authorised in third country for those services
  - Co-operation agreements in place
- Third country firm → retail investors/ probably also professional investors except those referred to above
  - Establish E.U. authorised branch
  - Passporting available

(MiFIR A.36-39)

Third Country Provisions

- Commission to determine equivalency:
  - Legal and supervisory arrangements ensure third country firms comply with legally binding requirements that have equivalent effect to MiFID II, MiFIR and CAD
  - Third country must have reciprocal recognition for E.U. firms
- For equivalency, firms providing investment services and activities in the third country must be subject to:
  - Authorisation & effective supervision and enforcement on an on-going basis
  - Sufficient capital requirements (N.B. US?)
  - Appropriate requirements on shareholders and management body members
  - Adequate organisational requirements concerning internal control functions
  - Market rules which ensure transparency and integrity to prevent market abuse, insider dealing and market manipulation

Third Countries: Criteria for Establishing a Branch

- Commission confirmed equivalency re legal and supervisory arrangements of third country
- Proposed services also subject to regulation in third country
- Authorised in third country
- Co-operation arrangements between third country authority and host E.U. regulator (including exchange of information to preserve integrity of market/ investor protection)
- Sufficient initial capital at disposal of branch
- One or more managers appointed meeting MiFID requirements re skills/ experience
- Third country signed tax agreement with host MS (art 26 OECD Model Tax Convention on Income and Capital)
- Firm has requested membership of authorised EU investor compensation scheme

(MiFID II A.41)

Third Countries: Passporting

- Available to third country firms with authorised E.U. branch
- Notify branch's home E.U. authority:
  - Where intend to passport
  - Programme of operations (investment services and activities, ancillary services)
- Branch E.U. authority must notify relevant MS authorities within 1 month
- Third country firm can then begin business in host country

(MiFID II A.44)

Position Limits: Regulators’ Powers

- Competent authorities able to:
  - Demand information/ documentation from any person re: size/ purpose of any derivative position or exposure and any assets/ liabilities in the underlying market
  - Request reduction in the size of such positions/ exposure or (in relation to commodity derivatives) impose limits based on size of positions or number of positions over a specified period of time
- ESMA to be informed of such requests with > 24 hrs’ notice
- ESMA role to ensure consistency between competent authorities
- Able to step in itself where stability of E.U. financial system is threatened

(MiFID A.34,59,60,72)

Position Limits: Obligations on Trading Venues

- RM/ MTF/ OTF which admit commodity derivatives to trading to set cap on number of contracts a given participant can enter into over specified period
- Or alternative arrangements, such as position management with automatic review thresholds
- Aims to support liquidity and orderly pricing and settlement conditions and prevent market abuse
- Limits/arrangements reported to competent authorities and ESMA

Position Limits: Reporting by Trading Venues

- Members and participants in RM/ MTF/ OTF trading commodity derivatives/emission allowances or derivatives of same to report positions real time to venue
- Trading venue then obliged to:
  - Publish a weekly report (subject to *de minimis* re number of traders/open positions):
    - Aggregate positions in commodities derivatives etc held by categories of traders
      - Number of long and short positions by each category
      - Changes since last report
      - % of total open interest represented by each category
      - Number of traders in each category
    - Applicable only when both number of traders & their open positions exceeds minimum thresholds
  - Send national regulator a complete breakdown of positions in commodity derivatives etc of market members/participants

Position Limits: Regulators' Powers

- E.U. Commission given power to adopt delegated acts to (amongst other things):
  - Determine the limits or alternative arrangements to be put in place by venues on the number of contracts which any person can enter into over a specified period
- National regulator given power to bring in more restrictive rules only in "exceptional cases" if objectively justified and proportionate taking into account the liquidity of the specific market and the orderly functioning of the market
  - Notify ESMA
  - Initially valid for 6 months from publication on website
  - Renewable for further 6 months

(MiFID II A.59)

Product Bans: Regulators' powers

- Very broad powers
- In coordination with ESMA, under defined circumstances, competent authority may ban specific products/ services/ practices if investor protection concerns/ threat to financial stability/ orderly functioning of markets
- ESMA is able to impose E.U.-wide bans if financial stability of E.U. is threatened and competent authorities have not acted

(MiFIR A.31-35)

MAD: Why Review Now?

- Gaps in regulation of:
  - New markets, platforms and OTC trading
  - Commodities and commodity derivatives
- Ineffective national level enforcement
- Lack of legal certainty – undermines effectiveness
- Administrative burdens (SMEs)

MAD II: Objectives

- Update, strengthen and harmonise the existing MAD framework:
  - Ensure market integrity and investor protection provided by MAD
  - Keep pace with market developments
  - Strengthen the fight against market abuse across commodity and related derivative markets
  - Reinforce the investigative and administrative sanctioning powers of regulators
  - Reduce administrative burdens on SMEs
- Definitely more reasons to be cautious

MAD II: Directive on Criminal Sanctions

- Mandatory criminal sanctions if insider dealing or market manipulation is committed with intent
- Inciting/ aiding/ abetting/ attempting all to be criminalised too
- Liability extended to legal persons
- Criminal sanctions must be "effective, proportionate and persuasive". No minimum standards at present but will be reviewed within four years of Directive's entry into force

MAD II: Regulation

- Extended to cover financial instruments only traded on new platforms (MTF/OTF); Also market manipulation offence extended to cross market manipulation between spot and derivative commodity markets
- Inside information definition re commodity derivatives conformed – and now includes, in relation to commodity derivatives, price sensitive information relevant to the related spot commodity contracts
- Gives examples of algorithmic trading strategies which amount to market manipulation eg. submitting orders without intending to trade but rather to disrupt trading system ("quote stuffing")

MAD II: Regulation

- New attempting offences re insider dealing and market manipulation
- Persons executing transactions in financial instruments to have systems to detect and report market abuse.

MAD II: Regulation

- Regulators given power to obtain telephone and data traffic records from telecoms operators & to access private docs or premises where a reasonable suspicion of insider dealing/ market manipulation
- Fines not less than profit stemming from market abuse (where quantifiable)
- Max fine not less than 2x such profit, €5m (for natural persons) and 10% of amount turnover (legal persons)

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