Client Alert

June 2012

In This Issue:

Why the need for reform - MiFID and its shortcomings

MiFID II

MiFID II

On 20 October 2011, the European Commission published legislative proposals to reform the Markets in Financial Instruments Directive ("**MiFID**"). These proposals represent a comprehensive and profound set of reforms which, if implemented, would lead to a reshaping across the EU of the financial markets, the products and services that banks and investment firms provide and the relationship between those firms and their customers. The proposals remain subject to negotiation and consideration by the EU Parliament and Council, and are scheduled for implementation at the end of 2015.

In this newsletter lawyers from Baker & McKenzie's European Financial Services Group examine the reasons for MiFID's reform and what it will mean for markets and market participants.

1. Why the need for reform - MiFID and its shortcomings

1.1 Introduction

The Market in Financial Instruments Directive ("**MiFID**"), replaced the Investment Services Directive when it came into force in November 2007. MiFID's central objective was "*to improve the competiveness of EU financial markets by creating a genuine single market for investment services and activities and to ensure a high degree of harmonised protection for investors in financial instruments*". MiFID was intended to contribute to deeper, more integrated and liquid markets, to drive down issuers' costs, to deliver better and cheaper services for investors and to contribute to economic growth and job creation in Europe.

Despite the fact that MiFID only came into force only a little over four years ago, much has happened in the intervening period. Firstly, financial markets have changed enormously: new market participants, new trading venues and products have entered the market and technological developments, such as high frequency trading, have altered the landscape. Secondly, Europe remains in the throes of the severe financial crisis that began in 2007. These developments have revealed weaknesses in some of MiFID's underlying principles and have highlighted areas needing revision or reinforcement in order to strengthen investor confidence and achieve all of MiFID's original objectives. The financial crisis in particular has revealed weaknesses within the European regulatory framework which may not have become obvious under more normal market conditions; the revision of MiFID is an essential part of ongoing structural reforms in the aftermath of the crisis.

1.2 Technological and Other Developments

For several reasons, MiFID has failed to create a level playing field between markets and market participants. For instance, multilateral trading facilities ("**MTFs**") are in practice subject to a less stringent regulatory and supervisory regime when compared to regulated markets. Besides, new trading venues and market structures which carry out similar activities to MTFs or systemic internalizers ("**SIs**"), have emerged without being subject to the same MiFID requirements regarding investor protection and supervision.

Furthermore, MiFID had to be revised in order to deal with rapid technological changes, such as the growth of automated trading, high frequency trading and OTC trading on equities. These changes raised concerns about possible new risks to the orderly functioning of markets.

And third, the growth of OTC trading on equities raised concerns about the quality of price formation on exchanges and whether the price represented the real value.

1.3 Difficulties for SMEs to access financial markets

MiFID had to be revised to make access for small and medium-sized enterprises ("**SMEs**") to financial markets easier, given the important role these enterprises play today. SMEs faced, for instance, greater difficulties and costs to raise capital from equity markets than larger issues due to the lack of visibility of SME markets, the lack of market liquidity for SME shares and the high costs of an initial public offering.

1.4 Lack of transparency for market participants

MiFID has failed to create sufficient transparency for market participants – see, for instance the fact that MiFID was not able to deal with dark pools and that its transparency requirements were not applicable for non-equity markets, which are only regulated at national level. Other issues, such as the quality and format of market information, the cost charged for information and the difficulty in consolidating information, could undermine the overarching objectives of MiFID as regards transparency, competition between financial services providers and investor protection.

1.5 Lack of transparency for regulators and insufficient supervisory powers in key areas

Existing transaction reporting requirements failed to provide regulators with a full view of the market because their scope was too limited and because they were too divergent. Furthermore in relation to derivatives, especially commodity derivatives, there was no regulatory oversight of positions and their management. The financial crisis has also brought into focus the lack of powers available to regulators to ban or restrict the trading or distribution of specific products and services in case of adverse developments or limitations. More generally, some regulators have lacked sufficient investigatory tools and the ability to impose effective sanctions.

1.6 Insufficient investor protection

A number of provisions in MiFID resulted in investors not benefiting from sufficient or appropriate levels of protection (*e.g.*, when the investors enter into execution-only sales). Furthermore, there is insufficient clarity around the existing application of MiFID to certain products such as structured deposits. There is also uncertainty about a number of services, such as the required quality of investment advice and the scope of execution-only services. MiFID also failed to provide sufficiently clear rules concerning disclosure to investors of inducements / incentives that a firm received from third parties.

1.7 Weakness in firms' systems and controls

This problem presents two major dimensions. Firstly, in relation to the launch of new products and services in particular there has been insufficient involvement of firms' directors / senior management, as well as failures in firms' organisational arrangements and weaknesses in internal control functions. Secondly, there was a lack of specific organisational requirements in MiFID for the services of portfolio management, underwriting and placing of securities.

1.8 Obstacles to competition in clearing infrastructures

Finally, an important problem with MiFID has been the fact that developments in how EU trading venues connect with providers of clearing services have resulted in a series of obstacles that have hindered pan-EU competition at the level of trading platforms opened up by MiFID.

2. MiFID II

The proposed revision of MiFID consists of two pieces of draft EU-level legislation: a draft Directive and a draft Regulation.

2.1. Extension of scope

The scope of MiFID will be expanded, both in terms of the types of firms that will be subject to MiFID's requirements (such as commodity traders, high frequency traders and custodians), and the types of financial instruments that are within scope (new instruments within scope include structured products and structured deposits, commodity and exotic derivatives, and emission allowances). This will lead to two main outcomes:

- firstly a range of businesses not currently subject to MiFID will in future fall within its requirements (unless they can fall within one of MiFID's exemptions), which will include requiring authorisation from national regulators, or changes to the scope of existing regulatory authorisation, as well as compliance with MiFID's organisational and conduct of business requirements;

- secondly, firms that are currently subject to MiFID in relation to some activities will need to consider how the extension of MiFID will impact on their other activities that are not currently within scope. Under the proposals these activities will include firms issuing of their own shares as well as activities in relation to financial instruments being brought within MiFID's scope.

2.2. More robust and efficient market structures

A range of changes are proposed in order to create more robust and efficient market structures. The Commission proposes several measures to reach this objective.

Firstly, the Commission wants all forms of organised trading to take place on platforms that are subject to regulation and supervision. To this end, MiFID II will apply to a new category of organized trading facilities ("**OTF**"). An OTF will be any facility or system (other than a regulated market or MTF) that is operated by an investment firm or operator and which matches buy and sell side interests (including, for example, broker-crossing systems). OTFs will be regulated and required to play by the same rules as regulated markets and MTFs (e.g. transparency and reporting requirements, conduct of business rules, best execution requirements and client order handling obligations). Purely OTC transactions will, however, remain outside the scope of the OTF definition. However, since many (private) banks have already outsourced their order execution capability, the introduction of an OTF will not be of great concern to them. Furthermore, the Federation of European Securities Exchanges believes that the creation of a fourth category of trading facility - further to RMs, MTFs, SIs - may perpetuate an uneven playing field and increase the opportunity of regulatory arbitrage between execution service providers.

Secondly, MiFID II provides several tools to foster efficient competition and integration of EU markets and infrastructures, such as access and fee provisions, requirements which prohibit the use of discriminatory prices or the imposition of unnecessary requirements. These tools are designed to ensure full price transparency at each level of the post-trading chain and that new providers can compete for the provision of trading or central clearing services.

Thirdly, MiFID II introduces the creation of a specific label for “SME growth markets” to facilitate SMEs’ access to the capital markets. This measure will make the SME markets more attractive to small companies and investors than the existing categories.

2.3. Taking account of technological innovations

MiFID II introduces new safeguards for algorithmic and high frequency trading activities which have drastically increased the speed of trading and pose possible systemic risks. High frequency traders will no longer be able to rely on a particular interpretation of the MiFID exemption for firms which only trade on their own account. These safeguards will impact on both market participants and trading venues and will include, amongst others, the requirement for all algorithmic traders to become properly regulated and provide appropriate liquidity, as well as rules to prevent them from adding to volatility by moving in and out of markets.

Trading venues will have the power to halt trading in circumstances where significant price movements occur in a harmonised fashion. This is an important new requirement since it will prevent high frequency trading from exacerbating bubbles or crashes in prices. Consequently, conditions for competition in essential post-trade services, such as clearing, will be improved. Firms using algorithmic trading strategies will be required to post firm quotes at competitive prices on a continuous basis during the trading hours of the relevant trading venue providing liquidity on a regular and ongoing basis at all times, irrespective of the prevailing market conditions.

2.4. Increased transparency

The Commission has proposed several measures to increase transparency in recent times. The transparency rules are being revamped and moved to MiFID II, so as to become applicable throughout Europe.

First, the introduction of the OTF category will improve the pre-trading transparency of trading activities in equity markets, including ‘dark pools’ since these platforms will now be subject to the same transparency conditions as other venues. The existing pre-trade transparency waivers, which have led to the increasing use of dark pools for professional markets, will be removed and trading venues will only be allowed to operate dark pools by applying to national authorities for a waiver. The exemptions will only be allowed under precisely prescribed circumstances, which will be defined in implementing measures once the draft Regulation is approved. However, in each case where national regulators wish to grant waivers, approval from the European Securities Markets Authority (“**ESMA**”) must be sought. However there are fears that these changes would undermine the role played by dark venues in the efficient functioning of markets and the provision of liquidity.

Secondly, MiFID II introduces a new trade transparency regime for non-equity instruments, including bonds and derivatives. The exact transparency regime will be tailored to the instrument in question and the pre- and post-trade requirements will be specified in further implementing legislation. Many industry participants and market associations argued in responses to the Commission's Consultation on MiFID II that the transparency requirements are not suited to the non-equity market. They fear brokers in professional markets will have a lesser role should price become more transparent and that forcing price transparency will reduce liquidity. Some argue that, in recognition of these concerns, national authorities should be given discretion to waive the pre-trade transparency requirements for non-equity instruments based on local market models, the specific characteristics of trading activity in a particular product, and liquidity.

Thirdly, the Commission proposes the introduction of requirements to gather all market data in one place. This will provide investors with an overview of all trading activities in the EU, which would help them to make a more informed choice. MiFID II also contains measures to ensure data quality and consistency as well as measures to reduce the costs of data.

The Commission also proposes the introduction of pre- and post-trade transparency requirements for instruments other than shares. The exact transparency regime will be tailored to the instrument in question. The pre- and post-trade requirements will be specified in further implementing legislation.

Theses changes to the transparency rules will significantly reduce the scope to circumvent them.

2.5. Reinforced supervisory powers and stricter framework for commodity derivatives markets

Several proposed changes will reinforce regulators' / authorities' powers and make the framework for commodity derivative markets stricter. As mentioned above, a wide range of commodity derivatives are to be brought within the scope of MiFID through the tightening and/or removal of existing exemptions for proprietary commodity derivatives trading. The current "commodity traders" exemption will be removed and the "ancillary business" exemption under MiFID will be restricted. Many utilities, oil companies, metals traders, energy and commodity businesses and others that are active in commodity derivatives or emissions trading may be captured by MiFID, unless they can benefit from the remaining exemptions.

Firstly, MiFID II will provide regulators with new powers in the commodity derivatives area. National regulators will, for instance, have the explicit power to demand information from any person regarding the size or purpose of a position in commodity derivatives contracts and to require a reduction of the position. Regulators will even get the power to ban specific products, services or practices in case of threats to investor protection. This power will, however, only be exercisable in coordination with ESMA and, even then, only under specified circumstances. In this respect, MiFID II ties in with amendments to the Market Abuse Directive.

Secondly, the supervision of commodity derivative markets will be strengthened by inter alia the introduction of a position reporting obligation on each category of trader. In addition, regulators will be empowered to monitor and intervene at any stage in trading activity in relation to all commodity derivatives.

Thirdly, the Commission has proposed several measures in relation to transaction reporting, including the extension of the scope of transaction reporting to all financial instruments, except those which are not vulnerable to or cannot be used for market abuse. Venues where commodity derivatives are traded will be required under MiFID II to publish an aggregated weekly breakdown of positions held by different types of market participants, including clients of those not trading on their own behalf. They have to make this breakdown available to the relevant national authority upon request. The reporting requirements will be introduced in MiFID II, increasing harmonisation. The Commission also dealt with double reporting of trades under MiFID by stating that a trade which has already reported to a repository need not be reported again under MiFID, provided all the necessary information is available to the authorities.

2.6. Stronger investor protection

MiFID II contains several measures designed to strengthen investor protection and therefore increase investor confidence. A wide range of conduct of business rules will be modified and strengthened.

Requirements for "Independent" Advisors to do a fair market analysis

Firstly, MiFID II provides that financial advisors describing themselves as "independent" should match the client's profile and interests against a broad range of products that are available in the market. Advisors will be required to consider a diverse range of: (a) types of financial instruments and (b) issuers as part of this analysis, and the analysis should not be limited to financial instruments issued or provided by entities having close links with the investment firm.

Inducements

Secondly, in relation to inducements MiFID II will introduce a specific, non-conditional, activity-based prohibition on firms receiving inducements. In particular, investment firms and credit institutions will no longer be allowed to accept or receive fees, commissions or any monetary benefits paid or provided by any third party or a person acting on behalf of a third party when providing portfolio management or when providing advice that is described as "independent."

Execution-Only Services

Thirdly, the MiFID II Proposal retains the principle of execution-only services, but it will no longer be possible to provide these services when the ancillary service of granting of credit or loans to the client (to allow the client to carry out the transaction) is also provided. The suitability and appropriateness test, on the other hand, will not be changed.

MiFID II provisions will however restrict further the types of instruments that would be regarded as "non-complex" (and in relation to which, therefore, "execution only" services can be offered). MiFID II addresses, for instance, the classification of UCITS as "non-complex". Currently, all UCITS are classified as "non-complex" instruments but MiFID II will introduce an exception for "structured UCITS"which will now be classified as "complex" instruments for which investment firms have to apply the appropriateness test. "Structured UCITS" are defined as "*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*." This element o f the proposal is likely to reduce the scope for firms to offer execution-only investment services to their clients without the need to assess "appropriateness" of a product.

Reporting Obligations

Furthermore, the Proposal introduces two additional reporting requirements. Firstly, if investment firms or credit institutions provide investment advice to their clients, they must specify how the advice given meets the personal characteristics of the client. Secondly, periodically firms must send communications to clients confirming that the product still meets the client's objectives, taking into account the type and the complexity of the financial instrument involved and the nature of the service provided to the client.

Conflicts of Interest

Unlike the conduct of business rules, the conflict of interest rules remain largely unchanged, except that investment firms and credit institutions have to take <u>all appropriate steps</u>, rather than all reasonable steps to identify conflicts of interest.

Senior Management Responsibility

MiFID II requires senior management involvement in a firm's policies on how products and services may be sold or provided to their clients. This shows a strengthening of organisational requirements for the provision of services to investors.

Additional rules on corporate governance and managers' responsibilities will be introduced for all investment firms.

Client Classification

The Commission also proposed various minor modifications to client classification which may be far-reaching and costly to implement. It is, for instance, proposed that the scope of the more liberal rules that apply to eligible counterparties will be tightened by increasing information and reporting requirements for transactions and imposing a high-level standard of fair conduct on dealings. Additionally, municipalities and local public authorities will no longer be treated as "per se professional clients" or "eligible counterparties" (although they will be able to "opt up" to professional status under the rules on elective changes to classification).

Conclusions on Investor Protection

Put briefly, MiFID II will not be a milestone in terms of investor protection. Most changes consist of clarifications and only some additional restrictions are included. MiFID remains, however, of major importance in relation to investor protection, but more work is required. In particular:

- Structured deposits will fall within the scope of MiFID II, but insurance (structured) products are still not covered.
- MiFID II still lacks appropriate rules with regard to the level and content of information, as well as remuneration rules.

www.bakermckenzie.com

For further information please contact

Arun Srivastava
+44-(0)20-7919-1285
arun.srivastava@bakermckenzie.com

Manuel Lorenz
+49 (0) 69 29 908 606
manuel.lorenz@bakermckenzie.com

Pieter Berger
+32 3 213 40 40
pieter.berger@bakermckenzie.com

María Gracia Rubio
+34 (91) 230 45 33
mariagracia.rubio@bakermckenzie.com

- The financial crisis demonstrated that consumers, and especially those younger and less educated, lack a basic knowledge and understanding of financial products and concepts. MiFID II does not address the need for these consumers to be protected or educated.

- It is not enough to introduce new rules; they must also be effectively enforced. MiFID II does not particularly focus on the importance of compliance and of complaints handling procedures.

2.7. Treatment of firms and market operators from outside the EU

Currently firms and market operators from outside the EU do not fall within the scope of MiFID. This leads to fragmentation. In order to overcome this problem and to ensure a level playing field in the EU for non-EU country players, the Commission proposes that a firm authorised in a non-EU country will be able to provide services directly to professional investors, provided that the country where it is based is deemed by the Commission to have equivalent rules and supervision. However, in order to be allowed to provide services to retail investors, a branch must be established within the EU.

These provisions, if implemented, are likely to have far-reaching consequences and some fear that they may materially restrict cross-border business since, despite a proposed four-year transitional period, severe disruption is likely in the short-term.

2.8. Next step

The MiFID II Proposals have now passed to the European Parliament and the Council for negotiation and adoption. Once adopted, the Regulation, the Directive, and the necessary technical rules implementing these will apply together as of the same date. The implementation is scheduled for the end of 2015.