

## MiFID 2: The European Commission's Consultation on the MiFID Review

### Introduction

The implementation costs of the European Union's Market in Financial Instruments Directive (2004/39/EC) ("MiFID") have been estimated to have run into several hundred of millions of £s in the UK alone. Now, the European Commission has published a consultation on 8 December 2010 on its proposals to review MiFID three years after its original entry into force with a view to bolstering investor confidence and achieving in practice MiFID's original objectives. Indeed, the Commission has made it clear that it regards the revision of MiFID as a major part of the continuing structural reforms it considers are needed following the global financial crisis. Since MiFID came into force, the financial markets have also altered substantially with technological developments, new types of trading venues and innovative products which have highlighted deficiencies in the consistent application of the original directive across the European Union. The review of MiFID is therefore aimed at establishing a safer, more sound, transparent and responsible financial system. In preparing the MiFID Review and the legislative proposals which are expected in the first half of 2011, the Commission requested evidence and advice from CESR on some of the main elements under Review. In July 2010 CESR published technical advice on equity markets, transaction reporting, investor protection and intermediaries and non-equities markets. Earlier in the preparatory phase, CESR had issued advice to the Commission MiFID provisions relating to commodities derivatives, a report on the impact of MiFID on equity secondary markets functioning and a report on the transparency of the corporate bond, structured finance products and credit derivatives markets. The European Parliament's ECON Committee also adopted an

own-initiative report on the MiFID Review in November 2010. This *DechertOnPoint* considers the principal features of the Commission's consultation.

### Objectives of the Review

First, it is worth noting some of the objectives behind the review of the MiFID:

- **Developments in market structures and practices:** financial markets are now increasingly complex and more trading venues, participants and products are now available than when the original directive was drafted. The EU regulatory framework has to keep pace with such changes in order to remain effective. The Commission asks the general question as to how MiFID should now be updated in order to provide a robust regulatory framework that covers all investment services and activities in an appropriate manner and avoid risks associated with activities not at present covered by MiFID. The definitions of admitted to trading, organised trading facilities, automated trading, systematic internalisers, market surveillance and markets for small and medium sized enterprises are also considered. The Commission proposes to create a new regulatory framework for all trading taking place outside regulated markets, multilateral trading facilities and systematic internalisers.
- **Transparency of the markets:** transparency of market data (including pre- and post-trade data) is considered to be crucial in order that all market participants have equal access to information on trading opportunities. Such transparency also facilitates price formation and promotes liquidity in the

market. Currently, MiFID transparency rules only cover shares. The Commission's consultation considers how to limit derogations from the current framework (for example, in relation to "dark pools") and asks whether other financial products such as bonds and over-the-counter ("OTC") derivatives should also be made subject to similar rules in line with G20 commitments. Any amendments to MiFID in this respect will also complement the Commission's current legislative proposal on OTC derivatives, central counterparties ("CCPs") and trade repositories (also known as the European Market Infrastructure Regulation (or "EMIR" for short)). Measures to improve the availability, quality and consolidation of trading data are also proposed by the Commission, including the proposed introduction of a mandatory EU consolidated tape across all financial instruments in an effort to improve transparency.

- **Commodity derivative markets:** the Commission asks what measures could be taken to address concerns relating to the functioning of commodity derivative markets and their impact on commodity price volatility. It also asks how to improve information flows, what reporting requirements might be needed and whether position limits should be considered in this context. The MiFID review is also designed to complement other current Commission initiatives, including the review of the Market Abuse Directive.
- **Transaction reporting:** clarifications and extensions to the MiFID transaction reporting regime are proposed.
- **Investor protection and provision of investment services:** the Commission also consults on measures needed to strengthen investor protection, in order that investment firms treat all investors appropriately in the light of their specific needs and requirements. There are also a number of changes being proposed to the conduct of business obligations. These include the fact that not all UCITS will be automatically classified as non-complex products in future as the Commission seeks to impose a tighter definition of what constitutes "non-complex products" in the execution only system. In respect to firms providing investment advice, firms will be required to inform clients of the underlying reasons for advice and to keep clients informed of the ongoing suitability of the instruments held throughout the investment period.

- **Supervision:** finally, the Commission asks where changes to the supervision of the various activities and participants may be needed, and in particular the role for the European Securities and Markets Authority ("ESMA") to ensure better supervision of these markets. (The Paris based ESMA begins its operations on 1 January 2011 although its budget has still to be approved by the European Council).

## Current Regulatory Issues

Current regulatory issues addressed in the Commission's consultation include:

- **Dark Pools:** a "dark pool" is a trading system where the price and volume of orders or quotes are not displayed before a transaction is executed, after the trade is executed, or any information about the trade is made public. Dark pools are subject to most regulatory MiFID requirements at present, except those concerning pre-trade transparency. Dark pools fall into two categories. The first is trading venues such as regulated markets and multilateral trading facilities that use waivers from pre-trade transparency not to display orders or quotes (for example, in the case of large trades). The second is other types of facility operated by brokers, such as crossing systems internally matching orders that are not subject to pre-trade transparency requirements. The Commission proposes a number of measures that are relevant to both types of dark pools. For example, in relation to the first type, the consultation recognises the validity of waivers, but proposes that there should be greater clarity and legal certainty as to how and when waivers apply. It proposes that certain waivers should be subject to further clarification and, in some cases, restrictions. It also proposes that ESMA should play a greater role in monitoring this area and ensuring the consistent use of waivers.
- **High Frequency Trading ("HFT"):** the increased use of automated and high frequency trading has introduced new risks, including those associated with rogue algorithms causing undue impact on prices, algorithms reacting to market events or from the increased pressure on trading systems trying to cope with large numbers of orders. The main Commission proposals in this area would require that:
  - all entities involved in HFT activities should be authorised and supervised under MiFID (currently an exemption in

the directive allows some participants not be authorised);

- ❑ firms involved in all forms of automated trading should have in place robust risk controls to reduce the possibility of potential system errors or rogue algorithms;
  - ❑ firms that allow other automated traders to use their trading systems to gain access to a market (for example, by sponsored access) should have in place adequate risk controls and filters to detect errors or attempts to misuse the facilities; and
  - ❑ trading venues should strengthen their risk controls and arrangements to reduce the risk of crashes or breakdowns in their trading systems, for example, by having in place appropriate “circuit breakers” to halt or pause trading in the event of disorderly trading movements or errors generated by automated trading, and trading venues should be required to stress test their systems to make sure they are resilient.
- **Commodity derivatives:** the Commission has stated that there is a clear need to reinforce the regulation of the commodity derivatives markets beyond the current policy initiatives for other derivatives markets, in line with G20 commitments. It intends to use the review of MiFID as a key pillar of a more comprehensive regulatory overhaul aimed at improving commodity market transparency and oversight. The proposals include measures:
    - ❑ to increase transparency of trading activity on all organised trading venues by introducing a position reporting obligation by categories of traders;
    - ❑ to give harmonised and comprehensive powers to financial regulators to monitor and intervene at any stage in trading activity in all commodity derivatives, including in respect of position limits, where there are concerns in terms of market integrity or orderly functioning of the markets; and
    - ❑ to give commodity firms some exemptions from MiFID when they deal on their own account in financial instruments or provide investment services in commodity derivatives on an ancillary basis as part of their main business and when they are not subsidiaries in financial groups.

## Other Investor Protection Issues

Some other investor protection issues are also addressed in the consultation. Note in particular the new powers proposed to be granted to the EU institutions to ban specific services and investments mentioned below.

The Commission has also already published two other relevant consultations which will rely heavily on the revised MiFID stance on sales practices. Its consultation on legislative next steps on the packaged retail investment products (“PRIIPs”) initiative closes for comments on 31 January 2011. The PRIIPs proposals seek to adopt a horizontal approach so that products with comparable functionality are treated in the same way, irrespective of their legal form. The other consultation is the review of the Insurance Mediation Directive (the “IMD”), which also closes for comments on 31 January 2011.

## Other Issues

Other aspects of the Commission’s consultation that should be considered include the following:

- The depth and breadth of the operating powers proposed to be given to EU bodies, whether the Commission itself or ESMA, under MiFID 2 need to be considered carefully. For example, the Commission has considered it necessary to introduce what is likely to be a very controversial proposal, albeit that in clearly specified conditions and subject to a clear procedure, **it may impose a ban on the provision of investment services and the carrying out of investment activities in certain financial instruments**. This also extends to national regulators who are proposed to be given the power to temporarily ban or restrict the trading or the distribution of a product by one or more investment firms, or the provision of an activity in the event of exceptional adverse developments considered to constitute a serious threat to financial stability or to market confidence either in a member state or in the EU as a whole. The Commission envisages that the exercise of this power could be pre-notified to and coordinated through ESMA. It seems likely that the Commission will target OTC derivatives deemed ineligible for clearing but which no CCP is able or willing to clear. Perhaps even more controversial is the proposal that when the Commission considers a national competent authority has not taken measures to address a threat to the orderly functioning and integrity of its financial markets, or to the stability of the whole or

part of the financial system, arising from the distribution of a product or the provision of an activity, or that the measures it has taken do not sufficiently address the threat, **a mechanism will be established at the EU level to ban temporarily the distribution of the products or the provision of the activities concerned.** This proposed devolution of power from member states to the EU institutions may also raise constitutional issues in some member states.

- For UK firms, there are also implications for the FSA's Retail Distribution Review ("RDR") as it is clear that there is going to be significant regulatory overlap as a result of the two reviews. When MiFID was originally implemented, the Financial Services Authority retained some leeway on both the content of the detailed rules and its own supervisory approach. However, that leeway is likely to be severely curtailed under MiFID 2, as the Commission considers minimum harmonisation to have failed to deliver strong consistent investor protection in the EU and is now seeking much greater consistency of both rulebooks and the supervisory approach. Through ESMA's oversight of national regulators and development of detailed MiFID technical standards, this is likely to become the reality in future.
- A horizontal approach to financial services policy in the EU now appears to have been enshrined by the approach taken by the Commission in the MiFID review and in its review of the IMD and the PRIPs initiative. This represents a fundamental shift from regulating products and services based on their legal form. Regulation is likely to be based on the functionality of a product or service rather than either its legal form or the source from which it is provided or marketed.
- The Commission's consultation also contains specific proposals on the compliance function. Under the original MiFID directive, firms were given a general framework for the establishment and the operation of internal control functions. The compliance function was required to monitor that a firm implemented and maintained policies and procedures to detect and minimise the risk of non-compliance with its obligations under MiFID and to assess the adequacy and effectiveness of such policies and procedures in the light of their application.

The Commission has now also put forward proposals, which include:

- the three internal control functions of compliance, risk and internal audit should report directly to the board of directors;
- the removal of officers responsible for the internal control functions should be subject to prior approval by the board of directors and should be notified to the regulator
- the specific involvement of the compliance function in the procedures established by the firm to handle complaints received from any clients should take place, and in particular:
  - the periodic report from the compliance function should specifically summarise complaints received from clients and their treatment; and
  - based on the assessment of the functioning of internal policies and procedures, including the assessment of the behaviour of personnel in complying with obligations under the Directive, the periodic report of the compliance function should also include proposals to address any deficiencies which may have emerged.
- the introduction of position limits and position management for derivatives. According to the Commission, currently the manner in which national authorities monitor and supervise positions in derivatives on trading venues and OTC varies between Member States, with some jurisdictions having hard position limits and/or ad hoc position management approaches. Because of the growth in the derivatives, and specifically commodity derivatives, greater oversight is required in this area in the Commission's view. This means that authorities will be given the power to intervene at any stage during the life of a derivative contract. In addition ESMA will be called upon to set technical standards to "ex-ante position limits" for both exchange-traded and OTC derivatives.

## Next Steps

Comments are requested by the Commission in response its consultation by 2 February 2011 on the 148 specific questions raised, and on the Commission's general approach to rewriting the rules for European investment business.

The Commission states that the feedback received from the consultation will be used to develop formal legislative proposals likely to be released in mid-May 2011.

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This update was authored by Martin Day  
(+44 20 7184 7565; martin.day@dechert.com).

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## Practice group contacts

For more information, please contact the author, one of the attorneys listed, or any Dechert attorney with whom you regularly work. Visit us at [www.dechert.com/financialservices](http://www.dechert.com/financialservices).

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**Karen L. Anderberg**

London  
+44 20 7184 7313  
karen.anderberg@dechert.com

**Andrew Hougie**

London  
+44 20 7184 7373  
andrew.hougie@dechert.com

**Achim Pütz**

Munich  
+49 89 21 21 63 34  
achim.puetz@dechert.com

**Peter D. Astleford**

London  
+44 20 7184 7860  
peter.astleford@dechert.com

**Angelo Lercara**

Munich  
+49 89 21 21 63 22  
angelo.lercara@dechert.com

**Keith T. Robinson**

Hong Kong  
+852 3518 4705  
keith.robinson@dechert.com

**Gus Black**

London  
+44 20 7184 7380  
gus.black@dechert.com

**Angelyn Lim**

Hong Kong  
+852 3518 4718  
angelyn.lim@dechert.com

**Marc Seimetz**

Luxembourg  
+352 45 62 62 23  
marc.seimetz@dechert.com

**Peter Draper**

London  
+44 20 7184 7614  
peter.draper@dechert.com

**Stuart Martin**

London  
+44 20 7184 7542  
stuart.martin@dechert.com

**Hans Stamm**

Munich  
+49 89 21 21 63 42  
hans.stamm@dechert.com

**Olivier Dumas**

Paris  
+33 1 57 57 80 09  
olivier.dumas@dechert.com

**Michelle Moran**

Dublin  
+353 1 436 8511  
michelle.moran@dechert.com

**James M. Waddington**

London  
+44 20 7184 7645  
james.waddington@dechert.com

**Richard Frase**

London  
+44 20 7184 7692  
richard.frase@dechert.com

**Antonios Nezeritis**

Luxembourg  
+352 45 62 62 27  
antonios.nezeritis@dechert.com

**Jennifer Wood**

London  
+44 20 7184 7403  
jennifer.wood@dechert.com

**John Gordon**

London  
+44 20 7184 7524  
john.gordon@dechert.com

**Declan O'Sullivan**

Dublin  
+353 1 436 8510  
declan.osullivan@dechert.com

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