EUROPEAN COMMISSION

MEMO

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Markets in Financial Instruments Directive (MiFID II): Frequently Asked Questions

See also STATEMENT/14/129

A. Background, main elements and costs/benefits of the reform

1. What is MiFID and why was it reviewed only four years after its entry into force?

MiFID is the Markets in Financial Instruments Directive (Directive 2004/39/EC[1]). It replaced the Investment Services Directive (ISD) which was adopted in 1993. It has been in force since 2008. It is a cornerstone of the EU's regulation of financial markets. It seeks to 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 has brought greater competition across Europe in the provision of services to investors and between trading venues. This has helped contribute to deeper, more integrated and liquid financial markets. It has also driven down costs for issuers, delivering better and cheaper services for investors, and contributing to economic growth and job creation in Europe.

In keeping with its intended objective, MiFID has contributed to a more competitive and integrated EU financial market. However, past years' events and market developments have demonstrated weaknesses in some of the underlying principles of MiFID, and highlighted areas needing reinforcement or revision, for example it has arguably led to the development of new trading platforms and activities which fall outside its scope and thus outside any regulations. Closing such a gap was necessary in order to bolster investor confidence and achieve all of MiFID's original objectives. Ensuring a more robust regulatory framework will also serve to address the more complex market reality we are now faced with, a reality which is characterised by increasing diversity in financial instruments and new methods of trading. Similar discussions have taken place in the United States and other major global financial centres and have led to a strong regulatory response.

[1] The MiFID regulatory framework consists of a framework Directive (Directive 2004/39/EC), an Implementing Directive (Directive 2006/73/EC) and an Implementing Regulation (Regulation No 1287/2006)

2. What are the main elements of the reform?

MiFID II aims at establishing a safer, sounder, more transparent and more responsible financial system that works for the economy and society as a whole. The main contributions introduced by MiFID II to achieve these objectives are:

(1) MiFID II introduces a **market structure framework** which closes loopholes and ensures that trading, wherever appropriate, takes place on regulated platforms. To this end, it subjects shares and non-equity instruments to a trading obligation. It further ensures that investment firms operating an internal matching system which executes client orders in shares, depositary receipts, exchange-traded funds, certificates and other similar financial instruments on a multilateral basis have to be authorised as a Multilateral trading facility (MTF). It also introduces a new multilateral trading venue, the Organised Trading Facility (OTF), for non-equity instruments to trade on organised multilateral trading platforms.

These rules ensure a level playing field with Regulated Markets (RMs) and MTFs. The neutrality of OTF operators is ensured through restrictions on the use of own capital, including matched principal trading, and discretion in their execution policy. MiFID II introduces a trading obligation for shares as well as a trading obligation for derivatives which are eligible for clearing under the European Markets Infrastructure Regulation (EMIR) (MEMO/12/232) and are sufficiently liquid. This will move trading in these instruments onto multilateral and well regulated platforms in accordance with the G20 commitments.

(2) MIFID II increases **equity market transparency** and for the first time establishes a principle of transparency for non-equity instruments such as bonds and derivatives. For equities a double volume cap mechanism limits the use of reference price waivers and negotiated price waivers (4% per venue cap and 8% global cap) together with a requirement for price improvement at the mid-point for the former. Large-in-scale waivers and order management waivers remain the same as under MiFID I. MiFID II also broadens the pre- and post-trade transparency regime to include non-equity instruments, although in view of the specificities of non-equity instruments, pre-trade transparency waivers are available for large orders, request for quote and voice trading. Post trade transparency is provided for all financial instruments with the possibility of deferred publication or volume masking as appropriate.

Rules have also been established to enhance the effective consolidation and disclosure of trading data through the obligation for trading venues to make pre- and post-trade data available on a reasonable commercial basis and through the establishment of a consolidated tape mechanism for post-trade data. These rules are accompanied by the establishment of approved reporting mechanism (ARM) and authorised publication arrangement (APA) for trade reporting and publication.

(3) To meet the G20 commitments, MiFID II provides for **strengthened supervisory powers** and a harmonised position-limits regime for commodity derivatives to improve transparency, support orderly pricing and prevent market abuse. Under this system competent authorities will impose limits on positions in accordance with a methodology for calculation set by the European Securities and Markets Authority (ESMA). It also introduces a position-reporting obligation by category of trader. This will help regulators and market participants to have better information on the functioning of these markets.

(4) A new framework will improve conditions for **competition in the trading and clearing of financial instruments**. This is essential for the integration of efficient and safe EU capital markets. For this purpose, MiFID II establishes a harmonised EU regime for non-discriminatory access to trading venues and central counterparties (CCPs).Smaller trading venues and newly established CCPs will benefit from optional transition periods. The non-discriminatory access regime will also apply to benchmarks for trading and clearing purposes. Transitional rules will ensure the smooth application of these provisions.

(5) MiFID II will introduce trading **controls for algorithmic trading activities** which have dramatically increased the speed of trading and can cause systemic risks. These safeguards include the requirement for all algorithmic traders to be properly regulated and to provide liquidity when pursuing a market-making strategy. In addition, investment firms which provide direct electronic access to a trading venue will be required to have in place systems and risk controls to prevent trading that may contribute to a disorderly market or involve market abuse.

(6) **Stronger investor protection** is achieved by introducing better organisational requirements, such as client asset protection or product governance, which also strengthen the role of management bodies. The new regime also provides for strengthened conduct rules such as an extended scope for the appropriateness tests and reinforced information to clients. Independent advice is clearly distinguished from non-independent advice and limitations are imposed on the receipt of commissions (inducements). MiFID II also introduces harmonised powers and conditions for ESMA to prohibit or restrict the marketing and distribution of certain financial instruments in well-defined circumstances and similar powers for the European Banking Authority (EBA) in the case of structured deposits. Concerning Packaged Retail Investment Products (PRIPS), the new framework also covers structured deposits and amends the Insurance Mediation Directive (IMD) to introduce some rules for insurance-based investment products.

(7) The agreement strengthens the existing regime to ensure **effective and harmonised administrative sanctions**. The use of criminal sanctions is framed so as to ensure the cooperation between authorities and the transparency of sanctions. A harmonised system of strengthened cooperation will improve the effective detection of breaches of MIFID.

(8) A harmonised regime for granting access to EU markets for **firms from third countries** is based on an equivalence assessment of third-country jurisdictions by the Commission. The regime applies only to the cross-border provision of investment services and activities provided to professional and eligible counterparties. For a transitional period of three years and pending equivalence decisions by the Commission, national third-country regimes continue to apply.

3. What are the anticipated costs and benefits of MiFID II?

MiFID II is estimated to impose one-off compliance costs of between €512 and €732 million and ongoing costs of between €312 and €586 million per year. This represents an impact for one-off and ongoing costs not exceeding 0.15% of total operating spending in the EU banking sector. This is only a fraction of the costs imposed at the time of the introduction of MiFID. The one-off cost impacts of the introduction of MiFID were estimated to be about 0.6 per cent (retail and savings banks) and 0.7 per cent (investment banks) of total operating spending. Recurring compliance costs were estimated at about 0.1 per cent (retail and savings banks) to about 0.2 per cent (investment banks) of total operating expenditure.

The main benefits of MiFID II will be very tangible, but are not readily quantifiable. The benefits of an improved level playing field, of increased market transparency, of better transparency towards regulators and stronger powers for regulators, of increased investor protection and the implied confidence investors have in financial markets, and reduction of the risk taken and the related impact on the financial stability of EU financial markets are real benefits, on which it is almost impossible to place a number.

B. More robust and efficient market structures

4. How are developments in trading outside of venues categorised in MiFID II being dealt with? How is the trading of standardised OTC derivatives being addressed?

Much of the trading currently being carried out outside of the MiFID venues, on a so-called over-the-counter basis, takes place on broker platforms operating in the market. These are organised, non-regulated platforms where financial instruments are increasingly traded. This hinders effective price formation processes. MiFID II deals with this concern in a number of ways.

With respect to equities, it subjects shares to a **trading obligation**. It further ensures that investment firms operating an internal matching system which executes client orders in shares, depositary receipts, exchange-traded funds, certificates and other similar financial instruments on a multilateral basis have to be authorised as a Multilateral trading facility (MTF). Bilateral transactions will be executed on systematic internalisers.

For non–equities, MiFID II introduces a new category of platform, an **organised trading facility (OTF)**, to properly regulate all kinds of organised trading in these instruments and to level the playing field in the EU. This new venue will be subject to the same core requirements for the operation of a trading venue as other existing platforms. It is defined in a broad way to capture all forms of organised trading in non–equities not matching the existing categories. Proprietary trading on OTF will not be allowed except for illiquid sovereign debt. Matched principal trading will be available where clients consent, except for transactions in derivatives subject to the clearing obligation in accordance with EMIR.

In addition, MiFID II requires all standardised derivatives to be traded on organised and **transparent venues, i.e. on regulated markets, MTFs and OTFs**. As a result, all organised trading, in other words trading which takes place in a system, that currently takes place outside of regulated venues will in the future be conducted on regulated venues.

Systematic internalisers also make up a portion of trading outside platforms. They are investment firms which deal with their clients in an organised way, in other words any trading which goes beyond *ad hoc* deals. In order to sustain a level playing-field and support market-wide price discovery, MiFID II broadens the specific transparency rules for investment firms acting as a systematic internaliser (SIs) beyond equity instruments other than shares for which SI transparency rules already existed under MIFID I. New transparency rules for SIs are also introduced for non-equities, including bonds, structured finance products, emission allowances and derivatives traded on a trading venue and for which there is a liquid market.

5. How will trading in standardised OTC derivatives be moved onto organised venues in line with G20 commitments?

The G20 commitment states that "all standardised OTC derivatives contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by the end of 2012".

In order to meet this commitment in Europe, all trading of derivatives which are eligible for clearing and which are sufficiently liquid must move on to either regulated markets, Multilateral Trading Facilities or to the new organised trading facilities (OTFs).

The European Securities and Markets Authority (ESMA) shall assess and determine when a derivative which is eligible for clearing is sufficiently liquid to be traded exclusively on such trading venues. Appropriate criteria for such assessment will need to be taken into consideration by ESMA.

This approach should be pragmatic and progressive enough to factor in the trading specificities of each derivative while meeting the G20 commitment.

6. What is proposed on clearing and access to post-trade infrastructures?

The issue at stake is about competition, stability and the integration of EU market infrastructures. Although the vertical integration model of trading and post-trading infrastructures may present advantages in terms of coordination, it may also introduce inefficiencies with respect to competition and price transparency. The introduction of non-discriminatory access requirements in the Regulation on OTC derivatives, central counterparties and trade repositories (known as "EMIR" - European Market Infrastructure Regulation – see MEMO/12/232) is a response to these potential negative effects. While EMIR covers only OTC derivatives, MiFID II will cover all financial instruments.

Trading venues will be required to provide access, including data feeds on a non-discriminatory basis to central counterparties (CCPs) that wish to clear transactions executed on the trading venue and CCPs will be required to clear transactions executed in different trading venues subject to certain well-defined conditions being fulfilled.

These are for example that the access arrangement does not require an interoperability arrangement (the requirement cannot be imposed on the CCPs that they must connect and cross-margin) in the case of exchange traded derivatives, and that it does not threaten the smooth and orderly functioning of the market, in particular due to liquidity fragmentation.

The issue of fungibility will be further clarified: i.e. in which circumstances contracts can be netted or cross margined. These rules are necessary to ensure that CCPs cannot unduly refuse access by reference to absence of fungibility and at the same time provide more clarity on when CCPs should net or cross margin.

To ensure consistency with the access provisions under EMIR, which covers OTC derivatives, it was agreed to align the requirements so that regulatory technical standards for MIFIR and EMIR should be the same.

Transitory arrangements have been introduced with respect to exchange traded derivatives. The Commission should assess six months before the entry into application whether exchange traded derivatives should be excluded from the scope (for a maximum period of 30 months) on the basis of a risk assessment. If it finds that there is no reason to exclude them, CCPs or trading venues may still request with the competent authority not to be subject to the access obligation (again 30 months transition) having regard to systemic risks.

MiFID II also ensures non-discriminatory access to benchmarks upon which some derivatives are built. For new benchmarks, the obligation starts 30 months after its first use.

Together these rules will prevent discriminatory practices and help remove barriers that hinder competition in the clearing of financial instruments. Consequently, existing or new providers will be able to compete for the provision of trading or central clearing services.

To ensure that the burdens of a new regulatory environment is phased in in a proportionate manner, for exchange traded derivatives and trading venues which fall below the relevant thresholds, and for transferable securities, newly established CCPs can avail themselves of a transitional period of 30 months.

7. How is the need to improve SME access to capital markets taken into consideration?

Small- and medium-sized enterprises (SMEs) across Europe make a significant contribution to economic growth, employment, innovation and social integration. Two main sources of funding for such companies are private financing by banks or other institutions and raising finance through capital markets (e.g. the issue of shares). SME markets aim at providing smaller, growing companies with a platform to raise capital both through initial offerings and ongoing fund raisings. However, not all these markets have been successful. In order to facilitate better access to capital markets for SMEs, MiFID II introduces a specific label for SME markets by creating a new, tailor-made market for SMEs, under the framework of an MTF. The registration of these markets should raise their visibility and profile as well as lead to common pan-European regulatory standards that are tailored to take into account the needs of issuers and investors in these markets while maintaining existing high levels of investor protection. This will also provide a quality label for platforms that aim to meet SMEs' needs.

C. Taking account of technological innovation

8. How have issues raised by algorithmic and high frequency trading been addressed?

Algorithmic trading is a form of trading where a computer algorithm automatically decides to place an order with minimal or no human intervention. An important form of algorithmic trading is high frequency trading, where a trading system analyses the market at high speed and then sends large numbers of orders very quickly.

MiFID II introduces a series of safeguards both on market participants who use algorithms as part of their trading strategies as well as on trading venues where algorithmic and high-frequency trading takes place:

(1) **Information requirements by regulators** on the strategies of various algorithmic traders will be enhanced, and stricter checks will be imposed on arrangements whereby members of trading venues allow other firms employing algorithms to access public markets through their systems (direct electronic access). Currently, regulators do not know which kinds of strategies are being used, by which strategy an order is generated, and members may not check what sort of strategies the persons using their systems are using and how those persons control their strategies.

(2) Algorithmic traders must be **registered as an investment firm** and have in place effective systems and risk controls in place. When engaged in a market making strategy they are required to post quotes at competitive prices to provide liquidity on a regular basis which will contribute to more orderly trading.

(3) Trading venues will also be required to have **robust controls** against problems such as disorderly trading, erratic price movements, and capacity overload. To mitigate the latter, restrictions on how far venues may compete in attracting order flow will be imposed for example by reducing the size by which prices may rise or fall ("tick size") or through the design of their fee structures.

(4) Finally, MiFID II will require venues to be able to halt trading in case of significant price movements ("circuit breakers") in a harmonised fashion.

D. Increased transparency

9. What are the proposals for enhancing equity market transparency, including the issue of "dark pools"?

In all markets, buyers need to know what sellers are asking and vice versa. However, wholesale transactions are frequently carried out at non-public prices. The same applies to financial instruments. Therefore, "dark pools", or platforms where trading interests interact without full pre-trade disclosure to other users or the public, are a common feature of financial markets. MiFID II continues to allow waivers from pre-trade transparency, but only as long as they do not cause competitive distortions and reduce the overall efficiency of the price discovery process. Financial regulators can grant waivers from transparency obligations for:

(i) transactions which are large in scale compared with normal market size (large in size waivers)

(ii) systems where the price is determined by reference to a price generated by another system (reference price waivers)

(iii) systems that formalise negotiated transactions, provided that they meet certain criteria (negotiated price waivers)

(iv) orders held in an order management facility of the trading venue pending disclosure (order management waivers).

In order to avoid any negative impact on the price formation process and to ensure that trade in equities takes place on transparent regulated venues to the maximum extent possible, the use of waivers is subject to certain restrictions.

MiFID II introduces a **"double" volume cap mechanism** which limits the use of reference price waivers and negotiated price waivers (4% per venue cap and 8% global cap). In addition, the use of reference price waiver is subject to a price improvement mechanism, i.e. the orders must be matched at the midpoint within the current bid and offer prices of the trading venue. When the midpoint price is not available, the orders can be matched at the open or closing price of the relevant trading session.

These restrictions do not apply to waivers for large-in-scale transactions as they protect investors selling large quantities of shares (nor do they apply with regard to order management facilities). Having to disclose large order would move the market down, which would mean they would sell at worse prices. The specific conditions, under which waivers may operate will, as for shares today, be defined in implementing measures.

Finally, MiFID II extends the transparency regime to actionable indication of interests, equity instruments other than shares, including depositary receipts, exchange–traded funds and certificates. The existing transparency rules for systematic internalisers will continue to apply to shares, while new provisions are introduced for equity-like instruments (such as depositary receipts, ETFs (exchange traded funds), certificates).

10. Is the introduction of a mandatory consolidated tape for trade data being considered?

The reporting, publication and consolidation of trade data needs to be addressed due to problems with its formatting, cost, quality and reliability. Trade data helps investors to find the right price when looking to buy or sell, and to check whether they got the best price by comparing the price that they got with other market prices. MiFID II improves the situation by introducing measures to ensure data quality and consistency as well as measures to reduce the costs of data. A mandatory consolidated tape providing a consistent and reliable record of executed trades will be established by data providers authorised to do so under harmonised standards set out in MiFID. Based on this trading data for the whole EU, investors will be able to make a more informed choice.

11. How will pre- and post-trade transparency requirements be extended beyond shares and why?

Currently, MiFID imposes harmonised pre-and post-trade transparency requirements only on shares admitted to trading on regulated markets. MiFID II introduces such requirements for other instruments as well, i.e. for equity instruments other than shares admitted to trading on regulated markets (depositary receipts, exchange traded funds, certificates etc.) and non–equities (bonds, structured finance products, emission allowances and derivatives traded on a trading venue).

Due to the different structure of markets in non-equity instruments compared with those in equities, the exact transparency regime is calibrated for different types of instruments and trading models. Waivers will be available for large–in–scale orders, orders held in an order management facility, derivatives that are not subject to the trading obligation and for non–equity instruments for which there is not a liquid market. Waiver can also be granted for indications of interest in request-for-quote and voice trading system that are above a size specific to the instrument, which would expose liquidity providers to undue risk. In this case, the trading venue makes public at least indicative pre–trade bid and offer prices. Pre–trade transparency requirements are to be further specified in implementing measures.

Post-trade requirements, to be specified in detail in implementing legislation, will be applicable for all bonds and structured finance products as well as all derivatives traded on a trading venue. Publication of the details of transactions can be deferred in prescribed circumstances.

Pre-trade requirements, also to be further detailed in implementing legislation, are imposed for equity like instruments and non–equity instruments when offered by investment firms acting as systematic internalisers in over-the-counter trading. The reason for the introduction of pre- and post-trade transparency requirements for these instruments is that the absence of harmonised transparency requirements in these markets has been perceived by many, including EU securities regulators, to lead to inefficient and unfair price formation and higher risks than would otherwise be the case.

12. Does MIFID II constitute the start of price regulation in the area of market data?

Market participants need data on trading activity, prices and volumes in order to make decisions about how and when to invest. The data should be available on an equal and easily accessible basis. At present, various incentives exist for data providers and vendors to sell their data at rates or in a way which do not correspond to the "reasonable commercial basis" or to the straightforward "consolidation of data with similar data from other sources" which MiFID envisioned. MiFID II delivers on these objectives. Implementing legislation will further define what constitutes a "reasonable commercial basis" to make the regime effective.

E. Reinforced supervisory powers and a stricter framework for commodity derivative markets

13. How will MIFID II regulate commodity derivatives?

First, emission allowances have been brought within the scope of MIFID (see question 14 below) and the definition of a financial instrument has been broadened to include commodity contracts which can be physically settled which are traded on MIFID trading venues, including the newly established OTF. Certain exemptions apply however regarding energy contracts (see question 15 below)

Second, fewer commodity firms will be exempt from MiFID II 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 of financial groups. New regulation narrows down existing exemptions in the interests of greater regulatory oversight and transparency taking into account the need for continued exemptions for commercial firms and the risks posed by these players.

Third, MiFID II provides for reinforced supervisory powers and a harmonised position limits regime for commodity derivative markets to support orderly pricing and prevent market abuse. This will help regulators and market participants to have better information on the functioning of these markets.

Harmonised and comprehensive powers are granted to financial regulators to monitor and intervene at any stage in trading activity in all commodity derivatives, including in the shape of position limits set in accordance with ESMA methodology for calculation if there are concerns in terms of market integrity or orderly functioning of markets. Venues offering trading in commodity derivatives will also be required to adopt suitable transparent and non-discriminatory position management controls on their platforms, to monitor positions and, where necessary, request holders to reduce or terminate positions or to provide liquidity back into the market. Details of these controls must be communicated to ESMA.

MIFIF II increases transparency of trading activity on all organised trading venues by introducing a position reporting obligation by category of trader. This harmonised and more disaggregated information will help regulators and market participants to better assess the role of financial flows in these markets.

In addition, pre- and post-trade transparency requirements are extended to derivatives traded on trading venues, including commodity derivatives. Also, mandatory trading on organised venues will apply to commodity derivatives.

14. Why are emission allowances now included in the scope of MiFID and the Market Abuse Directive?

Trading in allowance derivatives already falls under the scope of MiFID and the Market Abuse Directive (IP/14/424). By now bringing emission allowances under the same framework, the regulation on emission allowances trading (EUA), the spot market will be aligned with what is applicable to the EUA derivatives market. Together, MiFID and the rules on market abuse provide a comprehensive framework for trading in financial instruments and the integrity of the market. The extension to EUAs will introduce greater security for traders of EUAs but without interfering with the purpose of the market, which remains emissions reduction.

15. What energy contracts are covered by MiFID II, which are excluded and why?

The Commission proposal was to include as financial instruments all commodity contracts traded on any type of trading venue and that can be physical settled to be within the scope of MiFID II. This is because these instruments are economically equivalent to financial instruments and can be used like financial instruments and pose similar risks.

However the final text excludes wholesale energy contracts covered under the Regulation on the integrity and transparency of the market wholesale energy (REMIT) because these contracts are subject to a certain level of regulation and supervision comparable with financial markets legislation and so their exclusion is justified as a proportional amendment to avoid unnecessary dual regulation.

Oil and coal physically settled contracts are not however subject to similar legislation and so will be included as financial instruments for the purposes of MiFID II and therefore subject, amongst other things, to position limits and transparency requirements.

However, many of these contracts are not currently cleared and so to ensure a smooth transition, the application of EMIR provisions to these physically settled oil and coal contracts traded on an OTF are deferred. The EMIR provisions will not apply for six years after the entry into force of MiFID II. This transition period can be extended once by two years and once by one year. Before taking any decision on the extension or non-extension of this initial transition period by two years, the Commission will have to assess the potential impact on the energy prices as well as the benefits in terms of reducing counterparty and systemic risks and if necessary propose legislative solutions.

F. Reinforced supervisory powers and a stricter framework for commodity derivative markets

16. What role will ESMA play in relation to the revised MiFID?

ESMA already plays an important role in advising the Commission on possible regulatory changes and in ensuring convergent application of the rules across Member States. Many of the proposed changes in MiFID II stem from advice received from ESMA, and it is foreseen that it will play a major part in developing most of the technical implementing measures necessary to ensure the full functioning of the regulatory framework. In terms of specific supervisory tasks, ESMA has an increased role in, for example, determining the conformity with MiFID II of individual cases where venues propose to waive pre-trade transparency ("dark pools"). In accordance with the mandate defined in the ESMA regulation and in line with ESMA powers conferred in the Regulation of 14 March 2012 on short selling and certain aspects of credit default swaps (MEMO/11/713), it will also take any steps necessary to coordinate actions by national competent authorities with regard to waivers from pre–trade transparency, products considered risky from the point of view of investor protection or financial stability as well as positions in commodity derivatives by specific market participants deemed excessively large.

17. What purpose does transaction reporting serve and what measures are being proposed?

Investment firms have to report all their trades to competent authorities (in all financial instruments that are admitted to trading on a regulated market or MTF as well as those traded on an MTF or OTF). This obligation also applies to financial instruments where the underlying is a financial instrument traded on a trading venue, an index or a basket composed of financial instruments traded on a trading venue. This means that the reporting obligation applies regardless of where the trade takes place. This system of transaction reporting enables supervisors to monitor the activities of investment firms, which helps them to ensure compliance with MiFID II, and to monitor for abuses under the Market Abuse Regulation.

Because transaction reporting mainly serves the purposes of supervision, the requirements under MiFID II mirror the scope of the Market Abuse Regulation. To this end, MiFID II extends the scope of transaction reporting to all financial instruments, with the exception of instruments which are not susceptible to or could not be used for market abuse.

Second, reporting requirements today diverge between Member States, which adds costs for firms and limits the use of trade reports for competent authorities. By including the reporting requirements in MiFIR, the requirements are further harmonised, notably the information that identifies who is trading and for whom a trade is being executed. Also, ESMA is empowered to propose technical standards on a common European transaction reporting format and content.

Finally, for cost and efficiency purposes, double reporting of trades under MiFID II and the reporting requirements to trade repositories should be avoided. MiFID II proposes that a trade already reported to a repository will not need to be reported again under MiFID II, provided all the necessary information is thereby available to competent authorities.

G. Stronger investor protection

18. How will MiFID II better protect investors?

MiFID includes a number of measures aimed at protecting investors in the context of the provision of investment services. Those rules take into account the type of services (for instance, investment advice or execution of orders) and the classification of clients, with higher protection granted to retail clients. The MiFID rules include both conduct of business requirements (for instance, collecting sufficient information to ensure that the products provided are suitable or appropriate for the client) and organisational requirements (for instance, requirements to identify and manage any conflicts of interest).

However, modifications and improvements are introduced to strengthen the framework for the provision of services.

First, the scope of the Directive is broadened in order to cover financial products outside the scope of MiFID I but which satisfy similar investor needs and raise comparable investor protection challenges. In the future, the sale of structured deposits will have to comply with several MiFID requirements, and in particular with conduct of business and conflicts of interest rules. MiFID II will also extend some of the information to clients and conflict of interest requirements to insurance-based investment products by amending the Insurance Mediation Directive 2002/92/EC.

Second, conduct of business requirements are modified in order to grant additional protection to investors. The rules for investment advice are improved both when advice is provided on an independent basis and in the long term. Advisers declaring themselves as independent will need to match the client's profile and interests against a broad array of products available in the market and say whether they will provide the client with a periodic assessment of the suitability of advised products. Independent investment advisers and portfolio managers will be required to transfer all fees, commissions or any monetary benefits paid or provided by a third party to the client who should be accurately informed about all such commissions. The conditions for services where investors receive less protection from firms are more limited. In particular, the Directive clarifies the conditions and situations in which investors are able to transact freely in certain non-complex instruments with minimal protection afforded by investment firms.

Third, organisational requirements for the provision of services to investors are strengthened. For instance, the involvement of senior management in the design of the firm's policies as to how products and services may be sold or provided to their clients and the adoption of adequate internal controls is consolidated. Also, MiFID II introduces harmonised powers and conditions for national competent authorities, the European Securities and Markets Authority (ESMA) and the European Banking Authority (EBA) to prohibit or restrict the marketing and distribution of certain financial instruments and structured deposits, financial activities or practices in case of threats to investor protection, financial stability or the orderly functioning of markets.

19. Will UCITS be included under MiFID as a result of the MiFID review? Will the classification of some UCITS as complex instruments change their status under the UCITS directive?

Shares or units in UCITS (Undertakings for Collective Investments in Transferable Securities) are financial instruments and therefore investment services relating to them are already fully covered under MiFID. The issue which is addressed in the MiFID review concerns their classification as complex or non-complex instruments.

The distinction is relevant in order to establish the application of the "execution-only" regime, under which investment firms or banks selling certain instruments are subject to less stringent rules for the protection of retail investors. In particular they are not obliged to assess whether the client has the knowledge and experience to understand the financial instrument – the so-called appropriateness test. The execution only regime only applies to non-complex financial instruments. So far, all UCITS have been classified as non-complex instruments. In the meantime, however, certain UCITS have become more complex and the UCITS legislation itself reflected the separate and distinct characteristics of such "structured UCITS" which, on account of their pay-off formula raise additional challenges for investors to understand how they operate.

For this reason - for the mere purpose of the execution only regime - MiFID II maintains the general classification of UCITS as non-complex instruments but it introduces the exception of "structured UCITS" which will now be treated as complex instruments for the purposes of the execution-only regime. The objective is to ensure that investment firms will be obliged to request information on their clients' knowledge and experience, in order to assess the appropriateness of these instruments for them.

H. MIFID II and relation with other pieces of financial regulation, choice of legal instruments

20. How does the revision of MiFID fit with other European legislation, such as the Market Abuse Directive, Over-the-Counter derivatives, short-selling, and Packaged Retail Investment Products (PRIPs)?

The revision of the Market Abuse Directive (MAD) and MiFID has been considered at the same time because together they guarantee the competitiveness, efficiency and integrity of EU financial markets. In order to ensure that they are fully coherent and support each other's objectives and principles, they needed to be updated in tandem. Moreover, the pan-EU competition facilitated by MiFID has given rise to new challenges in terms of cross-border supervision, and maximum harmonisation of the rules and competent authorities' powers in relation to offences are a necessary step.

MiFID applies to the provision of investment services or activities by banks and investment firms in relation to financial instruments and to the operation of regulated markets. The objective is to support the development of a more integrated, competitive and efficient EU market in financial instruments with appropriate rules regarding conditions for authorisation as investment firms, organisational requirements to ensure they are managed appropriately, market transparency and investor protection.

The Regulation on OTC derivatives, central counterparties and trade repositories (EMIR) on the one hand, and the Regulation on short-selling and credit default swaps on the other, have different objectives and therefore complement MiFID. The former aims to minimise counterparty credit risk and operational risk, while the latter increases harmonisation and transparency, and mitigates risks associated with short selling and the use of credit default swaps.

Packaged retail investment products (PRIPs) are common products in the retail investment market, with broadly comparable functions for investors while taking a variety of legal forms. While offering benefits for investors, PRIPs are often complicated and opaque. In line with the Regulation to improve the quality of information that is provided to consumers (MEMO/14/299), MiFID II addresses some of the problems identified in the PRIPs market by creating a robust and coherent framework in the areas of information about the product to clients and the rules governing the sales process for those PRIPs that are financial instruments or structured deposits, such as the conduct of business and the conflicts of interest requirements for intermediaries distributing these products. At the same time, the measures on product disclosure proposed in the PRIPs context complement the investor protection measures on investment advice and sales services regulated under MiFID.

21. Why are some elements of MiFID placed in a directive and others in a regulation? Which parts will be in which instrument?

As in other pieces of EU financial services regulation, the split reflects the need to achieve a uniform set of rules in some areas, while allowing for national specificities in others. The De Larosière report highlighted that one of the problems leading to the crisis was an inconsistent implementation of financial services rules leading to a fragmented internal market.

As a result, a Regulation (MiFIR) sets out requirements on:

- the disclosure of data on trading activity to the public and transaction data to regulators and supervisors;
- the mandatory trading of derivatives on organised venues;
- removing barriers between trading venues and providers of clearing services to ensure more competition, and
- specific supervisory actions regarding financial instruments and positions in derivatives.

Such a harmonised approach will help avoid confusion in the daily functioning of markets, and minimise opportunities for harmful regulatory arbitrage between Member States.

The Directive (MiFID) amends existing provisions on authorisation and organisational requirements for providers of investment services, and all rules regarding investor protection, including for firms located in third countries but actively engaged in EU markets. Also, the Directive specifies requirements in relation to the authorisation and organisational rules applicable to different types of trading venues, providers of market data and other reporting services, as well as the complete powers to be granted by Member States to national competent authorities, including the framework of sanctions for breaches of the rules. These provisions are best situated in a Directive to account for differences in national markets and legal structures as well as the profile of local investors.

I. MIFID and international issues

22. How is the treatment of firms and market operators from outside the EU being considered?

The access of third country firms to the EU markets was not harmonised under MiFID I. Each Member State could introduce its own third country regime, subject to the general principles of the EU Treaties and provided that national provisions did not result in treatment more favourable than that given to the EU firms. In order to overcome the existing fragmentation and to ensure a level playing field in the EU for third country firms, MiFID II introduces a harmonised third country equivalence regime for the access of third country investment firms to the EU when providing services to professional clients *per se* and eligible counterparties. The access will be preceded by an equivalence decision taken by the Commission. Third country firms for which a decision is adopted will be able to request to provide services in the EU, without having to establish a branch in a Member State. For three years after the equivalence decision is made, Member States are allowed to apply national rules for provision of services and activities by third country investment firms. Likewise, as long as an equivalence decision is not taken, third–country firms will continue to operate in Member States according to national regimes but will not benefit from the EU passport (they will not be able to provide services to professional and eligible counterparties in the entire EU).

The equivalence process for a specific third country is initiated by the Commission but Member States can indicate their interest that a specific jurisdiction(s) is subject to the equivalence assessment. The equivalence assessment is outcome based (not line-by-line) and it means that the Commission will be looking into whether the third-country regulatory (prudential and business conduct requirements) and supervisory framework achieves the same objectives as the EU legislation. The third-country framework needs to provide for an effective equivalent system for the recognition of investment firms authorised under third-country legal regimes.

Once the Commission has adopted an equivalence decision with respect to a specific third-country and that ESMA has established cooperation arrangements with the competent authorities of that third-country, the operators from that third-country will simply have to submit an application with ESMA and once registered with ESMA they will freely provide services to professional clients *per se* and eligible counterparties.

With respect to provision of services by third country firms to retail clients, Member States will continue to apply national rules. The Commission regrets that there is not a fully EU harmonised third-country regime for retail clients but understands that the specificities and the increased level of protection for retail clients may also justify why Member States wished to maintain their national regimes. However, where Member States have chosen to require that third-country firms intending to provide investment services to retail clients establish a branch in their territory, the Directive harmonises the requirements (core organisational and conduct of business rules) with which the branch of a third-country firm will have to comply in order to be authorised by the competent authority of a Member State, but that branch will not have the right to provide services to retail clients in other Member States. In this sense, by third-country firms should see this as a positive step forward as it reduces divergences across EU Member States and therefore the legal and regulatory costs for third-country operators.

In addition, MiFID II will not apply when investment services are provided at the exclusive initiative of EU clients. This exemption will apply only to the service or activity initiated by the client. An initiative by the client shall not entitle the third–country firms to market new categories of investment products or services to that client and still benefit from the above exemption.

23. How does MiFID II compare to what other jurisdictions in the world are doing, in particular the United States?

MIFID II is the legislation through which the EU has implemented a number measures to meet our G20 commitments, in particular in relation to derivatives and is in line with the principles of regulation established by the International Organisation of Securities Commissions (IOSCO). This helps ensure convergence with other jurisdictions, including the US, Australia, Asia, and South America. Other jurisdictions are at different stages in the process of implementation, with some further advanced than others.

Many provisions of MiFID II reflect core precepts in the regulation of securities markets globally. However, different jurisdictions have rules specific to their own markets. Assessments of comparability, as is the case under equivalence assessments for third-country recognition, should not be made on a line-by-line basis but rather look at the totality of the relevant legislation in terms of achieving the relevant objectives.

As regards the US, MiFID II covers areas addressed by various pieces of US financial markets regulation such as the Securities Exchange Act and the Commodity Exchange Act. Like the Dodd-Frank Act, which amends these texts, the review of MiFID both amends provisions already in force and adds measures in light of the financial crisis and other market developments.

The US and EU approaches and legislation are very much aligned in terms of achieving the same objectives. For example, the revised MiFID complements the regulation on OTC derivatives, central counterparties and trade repositories (EMIR).

For more information:

http://ec.europa.eu/internal_market/securities/isd/mifid/index_en.htm