

MiFID II: THE LONG AND WINDING ROAD

The multiverse or meta-universe is the hypothetical set of infinite or finite possible universes that together comprise everything that exists and can exist. That thought crossed my mind the other day, when considering the parallel universe of working on our many TISA projects and planning interactions with UK regulation and that which is perhaps less publicised from the European Union.

In many of our working groups, councils and public presentations, the “European” position is often overlooked.

One piece of legislation which has been with us for some time, but so far unheeded, is the coming impact of MiFID II. This provides a wide ranging package of important reforms covering both retail and wholesale investment markets, with new obligations for a range of firms providing investment services. I am not sure yet that within the wide TISA community and across UK financial services, the potential impacts are fully appreciated.

These new rules will largely come straight from the EU via ESMA technical standards and guidance, rather than from the FCA. It is important that everyone understands what they will need to do to meet the obligations of MiFID II in 2017. That may seem a long way off but with around 95 technical standards to look at, in the next two years covering 800+ pages of consultation and discussion papers by ESMA/ time and planning will be of the essence.

Once these policy discussions are held and decisions are made, the task falls to the FCA to incorporate MiFID II obligations into our regulatory regime and for firms to implement the requirements. I am pretty certain that right now, very few firms understand what they will need to do.

When firms have understood what is expected of them and recognise the scale of the challenge, they must then make changes within their businesses and implement MiFID II. The FCA has already stated failing to prepare will not be considered acceptable.

TISA expects ESMA to publish its second Consultative Paper at the end of this year, and its recommendations to the European Commission, Parliament and Council in mid-2015. Publication of technical standards will follow in late in 2015 or early 2016. Only then will the FCA consult on changes to its own rules. The FCA also has to make changes to systems, consider how to handle new responsibilities and resource themselves to supervise new markets.

MiFID – so what?

Transparency in wholesale markets

One of the goals of MiFID II when being proposed was to consider if and how the reforms that MiFID I created for the equity markets could be exported to the non-equity markets. The desirability of greater transparency is obvious – greater information, improving price discovery and liquidity in the markets. MiFID II will extend transparency into two large new markets - bond trading and derivative trading, at both the pre- and post-trade stages of a transaction. There is also provision for specified derivative contracts, that hitherto have been privately negotiated with very little visibility to the market, to be mandated to trade on exchanges or similar venues, such as new Organised Trading



Facilities created by this legislation. The equity transparency regime will be extended from shares to other equity-like instruments, such as certificates, GDRs and ETFs.

There will be a cap on so-called dark trading for equities, set at 8% of total trading in the EU and 4% of total trading per venue in any one stock. We know this is likely to result in a change in the trading of both large and small cap stocks. Important questions remain about how this is done and in particular how to increase transparency without reducing liquidity – the granularity of application of the rules, the calibration of thresholds for large in scale, and publication delays and the definition of ‘liquid’ instruments are key components of the thinking that must now be done.

Commodity markets

In commodity derivatives, MiFID II brings a whole new regulatory regime, including pre- and post-trade transparency and commodity position reporting requirements, and a system of position limits – the details of which are all to be worked out. All of these are important to help underpin efficient pricing and market integrity. They will help ensure underlying fundamentals of supply and demand in physical commodity markets set the prices there, and are not distorted by financial speculations.

The methodology that ESMA chooses to set position limits will be one of the greatest challenges in this space, but the FCA are confident that both physical and financial markets can continue to operate effectively within the new regime.

HFT and micro-structural issues

Computerised trading, both widely used algorithmic trading and more specialist high-frequency trading (HFT), will be given enhanced scrutiny by European regulators. New rules will tackle a range of concerns about market integrity, protection of ordinary investors and prevention of market abuse, what has been referred to by the European Commission as the toughest package of messages in the world to address HFT. Key components of the regime to regulate this space include direct regulation of HFT firms, subjecting market making strategies to market making obligations, testing of algorithms before their execution and formalisation of the ESMA automated trading guidelines.

Some market structural changes will also make markets safer and fairer, such as requirements for market circuit breakers, standards on ‘tick sizes’ and synchronisation of exchange clocks to allow better monitoring, detection and prosecution of abuse. While the framework is set by level 1, we have to now develop a balanced regime that doesn’t throw our markets back into the technological dark-ages, but ensures they are fair and safe for all users in the future.

Wholesale conduct

Wholesale conduct is also a major focus of MiFID II. These proposals advance best execution obligations, and restrictions around the use of dealing commissions to purchase investment research are two significant areas.

Best execution

For achieving best execution, the Commission has made a number of provisions designed to help improve firms’ best execution policies, enhance disclosure of order routing behaviour, and enable better client scrutiny of execution quality through the provision of more standardised data. Some significant challenges remain at level 2 on developing metrics for execution quality which are appropriate for a very diverse range of financial instruments and market models in the absence of a consolidated tape.

The FCA will welcome a debate about the detail of the new rules and how firms might implement this in practice.



Dealing Commission

MiFID II takes steps to remove the incentives on asset managers that could influence their decisions to trade, against the interest of their clients, when purchasing research from pots of money generated by that trading. This is currently a hot-button topic for some in our industry.

ESMA's proposal, as it stands, would lead to a market in which all valuable research (for example, that which is not generic and widely distributed) must be paid for by fund managers themselves, rather than paid unseen by their clients within transaction fees. ESMA is aware of the challenge of removing such incentives which work against investors' interests in a way which avoids unintended consequences.

The FCA believes, in line with the results of their recent thematic work, that a more effective market for research and more efficient asset management sector will develop if dealing commissions are not used to fund these goods and services. Therefore, the FCA has been supportive of ESMA's proposal.

Retail investor protection

MiFID II contains a number of provisions that learn the lessons from MiFID I and the rules implemented in different EU Member States to enhance retail investor protection. This includes revised conduct of business rules (particularly addressing inducements and suitability requirements), new requirements around product governance and disclosure of costs and charges to investors when purchasing financial instruments and services, and a number of organisational requirements (telephone taping, remuneration of staff and conflicts management).

So where to now?

There are obviously a range of issues that still need resolving in MiFID II and now is the time for the industry collectively to put our heads together to find answers. This proposal is a massive project both for regulators and industry and implementation will be a major exercise with the challenge posed.

The first hurdle by passing the primary legislation has happened but there is a lot more of the race to go and complacency about the finishing line looks to be still in the distance, 2017 will come round quickly and there is plenty of hard work to be done before we all dip at the finishing flag.

The FCA recently held a conference solely on this subject and gave the following warnings:

- . It is important that stakeholders remain engaged in the policy-making process, especially given that we can expect a second large consultation from ESMA at the end of the year.
- Second, firms cannot hold back on developing their implementation plans until all the details are available. Efforts are required now, and firms must make sure they understand our expectations and are planning towards January 2017.
- And third, the FCA recognises the challenges for industry and will be on hand to help. They will do their best to explain the new requirements, what is required of the industry and set out expectations clearly.

TISA will look to work closely in its Policy Councils with members, regulators and the industry to resolve issues and help firms cross the finish line in good health!

Peter Smith, Head of Distribution Engagement