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MiFID 2.0 Unveiled

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The drafts of MiFID 2.0, published on October 20th, follow largely what had been proposed by the Committee of European Securities Regulators (CESR) and the European Commission in their consultative paper. But the documents took observers by surprise in both their approach and length. MiFID is now split up into two different legal instruments, a Directive and a Regulation, in which price transparency and open access provisions to clearing facilities are regrouped under the latter piece of legislation, thereby effectively amending the (not yet adopted) European Market Infrastructure Regulation (EMIR). The draft Directive, on the other hand, basically covers organisational and conduct-of-business rules for trading platforms, brokers and data vendors, but it also introduces a few novel provisions, such as one that enables alternative markets for small stocks.

The hallmark provisions of MiFID 1 were:

- the opening-up of competition between trading venues,
- the definition of three sets of trading venues – regulated markets, multilateral trading facilities (MTFs) and systemic internalisers,
- important waivers for the execution of trades outside the regular venues and the scope of pre-trade transparency and
- the introduction of a broad set of conduct-of-business rules for investment firms, most notably the best execution rules.

MiFID has indeed led to a greater fragmentation of trades over different venues, which has reduced trading costs while not damaging liquidity. Nevertheless, the effective application of the conduct-of-business rules leaves much to be desired.

Together, the two new drafts run about 260 pages and are accompanied by a 390-page impact assessment. The Directive is a recast of MiFID 1, and regroups elements that will have to be implemented nationally. The Regulation, on the other hand, will be directly applicable upon adoption. This already raises questions about the consistency of the whole package.

As was expected, the new proposal aims to level the playing field by addressing some loopholes in MiFID 1, and providing a narrower closer definition of the permissible waivers. A third multilateral trading facility is proposed in the form of Organised Trading Facilities (OTFs), which will cover broker crossing networks. OTFs are defined as any system or facility that is not a regulated market or MTF and is operated by an investment firm or a market operator, in which multiple third-party buying and selling interests in financial instruments interact. An OTF will not be allowed to execute client orders against the proprietary capital of the investment firm or market operator operating the OTF. The latter is reserved for systemic internalisers (SIs). The draft also has a new article on algorithmic trading facilities, requiring investment firms to have the basic risk control and procedures in place to meet the requirements of the Directive. The exemption of commodity derivatives from MiFID 1 is removed and national authorities can impose position limits.

Another expected element of the proposal is the licensing of trade data monitors, which have been subdivided into three groups: automated publication arrangements (APAs), consolidated tape providers (CTPs) and approved reporting mechanisms (ARMs). These provisions address one of the central criticisms of MiFID, namely the fragmentation of data, although one wonders why three different regimes are necessary, rather then just one. Data consolidators must meet the organisational requirements to be able to operate such a scheme.

On the conduct-of-business issues, the most important change is the tighter set of rules for investment advice in order to better protect investors

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in the sale of complex financial products. Clients must be told how 'independent' is the financial advice they are receiving and the fees must be unbundled. The broad definition of MiFID's best execution rules have not been changed, but investment firms have to make public the top five venues and the quality of execution on an annual basis.

A new article deals with SME growth markets (Art. 35), but it is difficult to see how this provision differs from what already exists among EU regulated markets. Most large EU exchanges run alternative markets for SMEs, which are registered as MTFs under MiFID.

As with other post-crisis EU legislation, such as the rating agents Regulation and the hedge funds Directive, rules on access for third countries become much stricter, accompanied by a cumbersome procedure for checking the equivalence of rules. Firms from non-EU countries will need to set up a branch in order to operate within the EU, except if they deal with eligible counterparties.

Another draft Regulation – MiFIR – covers pre- and post-trading transparency for equity, equity-like instruments, structured products, bonds, emission allowances and derivatives. Waivers from pre-trade transparency obligations are more closely defined and will be supervised by ESMA, to monitor whether they are effectively large in size. Eligible derivatives will be traded on regulated markets, MTFs or OTFs. These rules are also applicable to SIs, which have to publish quotes in bonds and derivatives. Regulated markets, MTFs or OTFs will have to make post-trade information available free of charge 15 minutes after the execution of the transaction.

MiFID 2.0 and MiFIR foresee a huge task for ESMA in drafting technical and regulatory standards. The task of authorising trade data monitors, however, will not be assigned to ESMA, but will remain with the national authorities, contrary to CESR's earlier proposal.

The new MiFID drafts were published in combination with the amendments to the 2003 market abuse Directive, extending the scope of this latter legislation to all trading venues and products, whereas it had previously been limited to equity and regulated markets. These amendments also reinforce the sanctioning powers of supervisors. The draft amendments are subdivided into a Regulation, covering the definitions of insider trading and market abuse and the venues, and a Directive covering the criminal sanctions.

All in all, these new pieces of draft legislation largely follow what had been previously announced, but they contain definite surprises both in their scope and approach. They introduce a higher degree of protection of the regulated trading space, but also add a new licence for the data vending business. The fact that they come together with several other pieces of recently proposed or announced financial regulation portends a very heavy workload for the European Parliament and the EU Council in the coming year.

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