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MiFID II: The new market structure paradigm

Overview

On 14 January 2014, after months of negotiations, EU legislators reached political agreement on reforms to the Markets in Financial Instruments Directive ("**MiFID**") that will overhaul financial services regulation in the European Union. The changes, which were first proposed by the European Commission in October 2011, consist of a new Directive ("**MiFID II**") and Regulation ("**MiFIR**"). The new legislation must now be formally adopted by the European Parliament and the Council of the European Union, and will not be implemented until late 2016 at the earliest.

Among other things, the legislation will introduce a new type of trading venue, the organised trading facility ("**OTF**"), to capture multilateral trading in non-equity instruments that does not currently take place on regulated markets ("**RMs**") or multilateral trading facilities ("**MTFs**"). Requirements for MTFs have been aligned with those of RMs in order to create a more level playing field. The legislation also includes new trading rules for equity and derivative instruments, new pre- and post-trade transparency obligations for equity-like and non-equity instruments, and a regulatory framework for consolidated trade data to be made available. Investment firms that deal on own account by executing client orders outside a trading venue – known as "systematic internalisers" ("**SIs**") – will be subject to enhanced firm quote obligations.

Background

MiFID, which entered into force in November 2007, established a harmonised regulatory framework for the provision of investment services and the operation of regulated markets across the European Union[1]. Its overarching goal was to make EU financial markets more integrated, competitive and efficient. Among other things, it introduced EU-wide competition between traditional exchanges (RMs) and alternative venues (MTFs) for trading financial instruments.

The Commission's proposals arose out of a review in which the Commission had identified a number of issues with the existing regime. While the introduction of MTFs had brought about increased competition between

[1] MiFID comprises three main pieces of legislation: the Level 1 Directive 2004/39/EC, the level 2 Directive 2006/73/EC and Regulation 1287/2006.

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trading venues, it had also resulted in market fragmentation, which complicated the collection of trade data. A significant amount of bonds and derivative instruments were traded outside organised venues, hindering price discovery and allowing risk to build up beyond the purview of regulators – a problem made manifest by the financial crisis. The Commission concluded that changes were needed to increase transparency and create a more level playing field.

Changes to market structure

The new legislation seeks to address these issues in a number of ways. All organised trading will now take place either on regulated trading venues or by systematic internalisation. In order to accomplish this, a new type of trading venue, the OTF, has been introduced to capture broker crossing systems and other organised trading in non-equity instruments that currently takes place outside RMs, MTFs and SIs. Derivative contracts that are eligible for clearing under the European Market Infrastructure Regulation ("**EMIR**") and have been declared subject to the trading obligation by the European Securities and Markets Authority ("**ESMA**") will be required to be traded on an RM, MTF, or OTF.

Any investment firm that operates an internal matching system which executes client orders in shares and other equity instruments on a multilateral basis will need to be authorised as an MTF. Transactions in shares admitted to trading on an RM or traded on a trading venue will be required to take place on an RM, MTF or SI, or an equivalent third country trading venue, unless they are (a) non-systematic, ad-hoc, irregular and infrequent, or (b) carried out between eligible and/or professional counterparties and do not contribute to the price discovery process.

RMs, MTFs, and OTFs will be subject to substantially identical pre- and post-trade transparency requirements. The current requirements under MiFID, which are limited to shares traded on RMs, will be extended to cover other equity-like instruments such as depositary receipts and exchange-traded funds, as well as non-equity instruments including bonds, structured finance products, emission allowances, and derivatives, in each case including actionable indications of interest. Firm quote requirements for SIs and post-trade disclosure requirements for investment firms, including SIs, which are also currently limited to shares admitted to trading on an RM, have been similarly extended to include non-equity and equity-like instruments and instruments traded on an MTF or OTF.

The three types of trading venues

Under the new legislation, any "**multilateral system**" – defined as a system or facility in which multiple third-party buying and selling trading interests in financial instruments are able to interact in the system – must now operate as one of three types of "**trading venues**": an RM, MTF, or OTF. Each category of trading venue will have the same transparency requirements, calibrated for different types of instruments, and similar organisational and market surveillance provisions. All trading venues are also subject to new requirements for systems resilience, circuit breakers, electronic trading and tick size regimes, which are intended to address risks posed from algorithmic trading and direct electronic access.

A “**regulated market**” is defined as a multilateral system operated by and/or managed by a market operator, which brings together or facilitates the bringing together of multiple third-party buying and selling interests in financial instruments – in the system and in accordance with its non-discretionary rules – in a way that results in a contract, in respect of the financial instruments admitted to trading under its rules and/or systems, and which is authorised and functions regularly and in accordance with the provisions of Title III of MiFID II.

In addition to the new transparency and other requirements described above, RMs will be subject to enhanced governance requirements similar to those that have been introduced for investment firms, including numerical limits on directorships, diversity obligations, and mandatory nomination committees.

A “**multilateral trading facility**” or “**MTF**” means a multilateral system, operated by an investment firm or a market operator, which brings together multiple third-party buying and selling interests in financial instruments – in the system and in accordance with non-discretionary rules – in a way that results in a contract in accordance with the provisions of Title II of MiFID II.

The requirements for MTFs have been aligned with those of RMs so that investment firms and market operators operating an MTF will be required to have (a) systems and measures in place to manage, identify and mitigate risks, (b) effective arrangements for the efficient and timely finalisation of transactions executed under its systems and (c) sufficient financial resources for its orderly functioning.

An “**organised trading facility**” or “**OTF**” means a multilateral system which is not an RM or an MTF and in which multiple third-party buying and selling interests in bonds, structured finance products, emission allowances or derivatives are able to interact in the system in a way that results in a contract in accordance with the provisions of Title II of MiFID II. Unlike RMs and MTFs, operators of OTFs will have discretion as to how to execute orders, subject to pre-transparency and best execution obligations.

Key differences between trading venues

	Regulated Market	MTF	OTF
Financial instruments	Equity and non-equity	Equity and non-equity	Non-equity only
Execution of transactions	Non-discretionary	Non-discretionary	Discretionary
Proprietary capital	Prohibited	Prohibited	Prohibited, with exceptions
Matched principal trading	Prohibited	Prohibited	Permitted in some cases with client consent
Own account trading	Prohibited	Prohibited	Permitted with respect to illiquid sovereign debt instruments

Execution of transactions

MTFs and RMs are characterised by non-discretionary rules for the execution of orders. The execution of orders on an OTF, on the other hand, must be carried out on a discretionary basis. An OTF operator may only exercise discretion in the following circumstances:

- when deciding to place or retract an order on the OTF; or
- when deciding not to match a specific client order with other orders available in the system,

provided it is in compliance with specific instructions received from a client and with its best execution obligations.

For the system that crosses clients' orders the OTF operator may decide if, when and how much of two or more orders it wants to match within the system. In accordance with other requirements, for a system that arranges transactions in non-equities, the firm may facilitate negotiations between clients in order to bring together two or more potentially compatible trading interests in a transaction.

Because OTFs are discretionary, they are subject to investor protection, conduct of business, and best execution requirements towards clients using the platform.

Access

RMs and operators of MTFs and OTFs must establish and maintain transparent and non-discriminatory rules, based on objective criteria, governing access or membership. While RMs and MTFs continue to be subject to similar requirements regarding whom they may admit as members or participants, OTFs are able to determine and restrict access based on the role and obligations which they have in relation to their clients, among other things. In this regard, trading venues are able to specify parameters governing the system such as minimum latency, provided this is done in an open and transparent manner and does not involve discrimination by the platform operator.

Proprietary capital and matched principal trading

RMs and MTFs are not allowed to execute client orders against proprietary capital, or to engage in matched principal trading. In order to ensure its neutrality and prevent it from profiting at its client's expense, an OTF operator may not execute orders against the proprietary capital of the operator or of any entity that is part of the same corporate group or legal person. However, OTFs are allowed to engage in matched principal trading in bonds, structured finance products, emission allowances, and derivatives that have not been declared subject to the clearing obligation under Article 5 of EMIR, provided the client consents. OTFs may deal on own account other than matched principal trading only with regard to illiquid sovereign debt instruments.

"**Matched principal trading**" is defined as "a transaction where the facilitator interposes between the buyer and seller to the transaction in such a way that it is never exposed to market risk throughout the execution of the transaction, with both sides executed simultaneously and the transaction is concluded at a price where the facilitator makes no profit or loss, other than a previously disclosed commission, fee or charge for the transaction."

The operator of an OTF must provide the relevant competent authority with information explaining its use of matched principal trading. The competent authority will monitor the OTF operator's engagement in matched principle trading to ensure that it complies with the definition and to ensure that it does not give rise to conflicts of interest between the OTF operator and its clients.

Other requirements for OTFs

The relevant competent authority may require, either when an investment firm or market operator requests to be authorised for the operation of an OTF or at any other time:

- a detailed explanation why the system does not correspond to and cannot operate as a RM, MTF, or SI, and
- a detailed description as to how discretion will be exercised, in particular when an order to the OTF may be retracted and when and how two or more client orders will be matched within the OTF.

The operation of an OTF and systematic internalisation may not take place within the same legal entity. An OTF may not connect with an SI or another OTF in a way which enables orders or quotes to interact. The operator of an OTF may engage another investment firm to carry out market making on the OTF on an independent basis. Market making will not be deemed to be carried out on an independent basis if the other investment firm has close links with the OTF operator.

Transactions concluded on an OTF are also subject to investor protection provisions of MiFID II, including information, suitability, best execution and client order handling rules.

Suspension and removal of financial instruments from trading

An RM, MTF or OTF may suspend or remove from trading a financial instrument which no longer complies with its rules unless such a step would be likely to cause significant damage to investors' interests or the orderly functioning of the market. This is in addition to the right of competent authorities to demand suspension or removal of a financial instrument from trading. A trading venue that suspends or removes a financial instrument from trading must also suspend or remove derivatives that relate or are referenced to that financial instrument where necessary.

In order to address potential risks arising from the multitude of trading venues that operate across the European Union, when a trading venue suspends a financial instrument or derivative from trading, RMs, MTFs, OTFs and SIs, in the same or in different Member States, that trade the same financial instrument or derivative may also be required to suspend or remove that financial instrument or derivative from trading in some cases.

Cooperation arrangements

In view of the significant impact and market share acquired by various MTFs, adequate cooperation arrangements must be established between the competent authority of the MTF and that of the jurisdiction in which the MTF is providing services. In order to anticipate any similar developments, this will also be extended to OTFs.

Systematic internalisation

Organised trading can also take place by systemic internalisation. A "**systematic internaliser**" is defined to mean an investment firm which, on an organised, frequent systematic and substantial basis, deals on own account by executing client orders outside an RM, MTF or OTF without operating a multilateral system.

The *frequent and systematic basis* prong of this definition is measured by the number of OTC trades in the financial instrument carried out by the investment firm on own account by executing client orders. The *substantial basis* prong is measured either by the size of the OTC trading carried out by the investment firm in relation to the total trading of the investment firm in a specific financial instrument or by the size of the OTC trading carried out by the investment firm in relation to the total trading in the European Union in a specific financial instrument. Both pre-set limits, the one for frequent and systematic basis and the other for substantial basis, must be crossed in order for an investment firm to be defined as an SI. An investment firm may also choose to opt in under the SI regime.

Unlike trading venues, an SI can execute client transactions against its own proprietary capital. However, it may not bring together multiple third party buying and selling interests in functionally the same way as an RM, MTF or OTF, and therefore is not a trading venue.

Not all transactions concluded by members or participants of an RM, MTF or OTF are considered as concluded within the systems of a trading venue. Transactions which members or participants conclude on a bilateral basis and which do not comply with all the obligations established for an RM, MTF or OTF under MiFID II are considered transactions concluded outside a trading venue for the purposes of the definition of systematic internaliser.

Firm quote requirements for SIs have been extended to non-equity and other equity-like instruments traded on a trading venue and for which there is a liquid market, in addition to shares. The minimum quote size for equity instruments must be at least 10% of the standard market size. For structured finance products, emission allowances and derivatives traded on a trading venue for which there is no liquid market, SIs must disclose quotes to clients on request if they agree to provide a quote, subject to pre-trade transparency waivers.

What happens next?

The texts of MiFID II and MiFIR must now be reviewed by jurist-linguists and translated into the different languages of the Member States. The exact dates for implementation will not be known until the final text is formally adopted by the Parliament and Council and published in the Official Journal. Some aspects of the rules will be spelled out in more detail in technical standards and delegated acts to be drafted by ESMA and the Commission. The following provisional schedule is based on the likely dates of approval by the EU legislators and is subject to change.

April 2014	Final text approved by Parliament plenary
May/June 2014	Final text approved by EU Council
June 2014	Publication in Official Journal
July 2014	MiFID II and MiFIR enter into force (20 days after publication in Official Journal)
2014/2015	ESMA consults on technical standards
July 2015 (1 year after entry into force)	ESMA submits draft regulatory technical standards to Commission
January 2016 (18 months after entry into force)	ESMA submits draft implementing technical standards to Commission
July 2016 (2 years after entry into force)	MiFID II must be transposed into national law of Member States
January 2017 (30 months after entry into force)	MiFID II and MiFIR apply within Member states

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