Time to take action: MiFID II

Breakfast Briefing

29 July 2014

Building a better
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Agenda

Welcome and introduction

Brian Binchy

Central Bank Presentation on timeline for implementation and key considerations

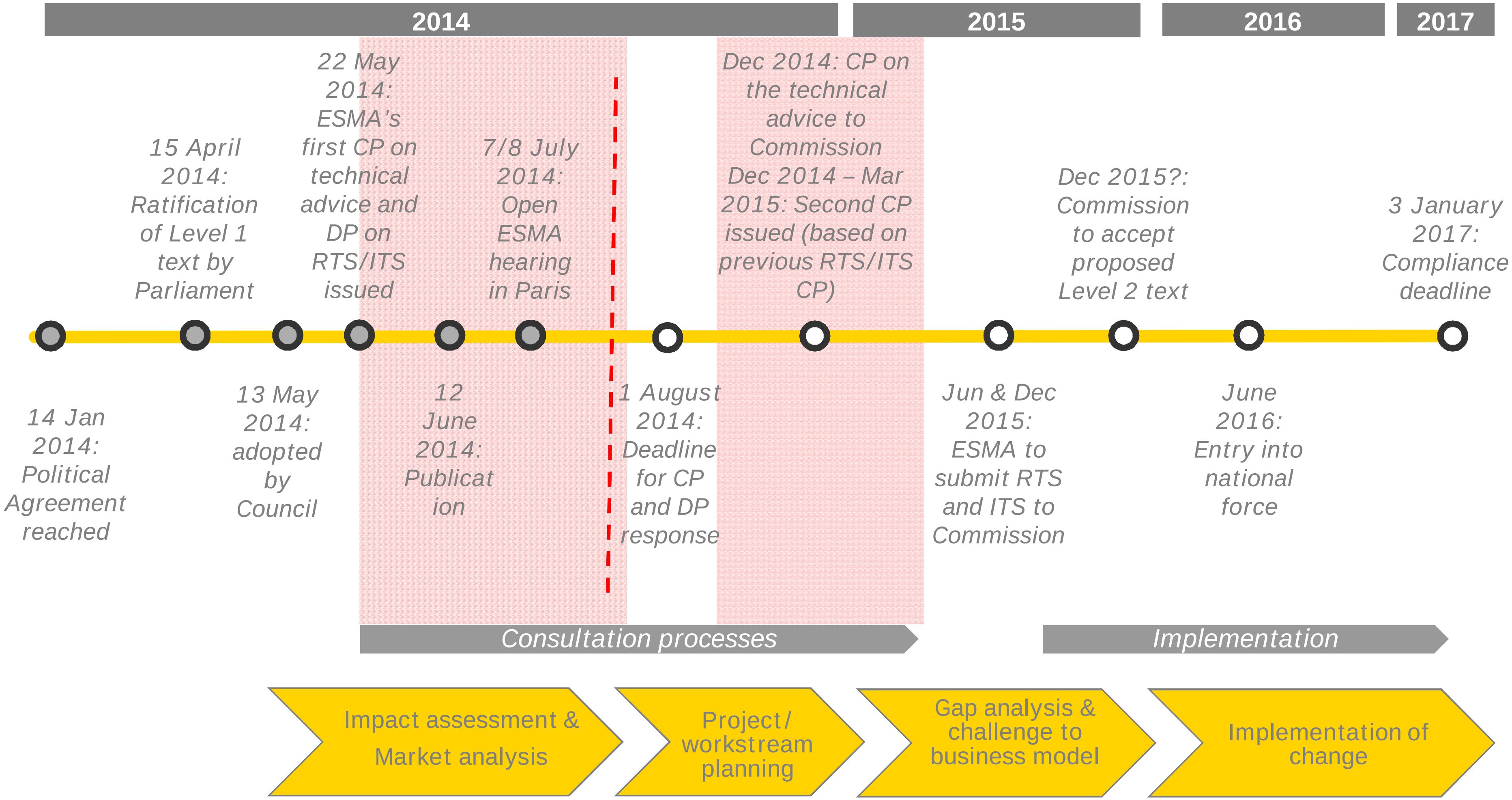
David Owens & Bryan Friel, CBI Markets Policy Division

EY Presentation on implications of new requirements

Sheila Nicoll

Questions and answers

MiFID II Timelines



Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

MiFID II / MiFIR

David Owens & Bryan Friel - Markets Policy Division

29 July 2014

MiFID timeline

MiFID/ MiFIR

- 12 June 2014 - Adopted in Official Journal
- 3 January 2017 - Comes into force

Level 2 (Delegated Acts)

- ESMA to provide advice to EC in its preparation of Delegated Acts
- 8 months from entry in Official Journal to do so
- One consultation (Consultation Paper currently open)

Level 2 (Technical Standards)

- ESMA to draft Regulatory Technical Standards
- Submission of draft RTS within 12 months of entry in Official Journal
- Two consultations (Discussion Paper currently open and Consultation Paper in early 2015)

MiFID II/MiFIR

- MiFID II – 147 pages – 97 Articles – 4 Annexes
- MiFIR – 64 pages – 55 Articles
- MiFID/MiFIR ESMA Consultation Paper – 311 pages
- MiFID/MiFIR ESMA Discussion Paper – 533 pages

MiFID II/MiFIR – Key Objectives

Increased Transparency

- New trade transparency regime for non-equities markets (i.e. bonds, structured finance products and derivatives);
- Extension of existing equity market transparency regime to include “equity-like” transactions;
- Improved data quality, facilitating data consolidation so that investors will have an overview of all trading activities in the EU, helping them make a more informed choice

Reinforced Supervisory Powers and a Stricter Framework for Commodity Derivatives Markets

- Financial regulators to monitor and intervene at any stage in trading activity in all commodity derivatives, including in the shape of position limits if there are concerns about disorderly markets;
- Reinforced role and powers of regulators, in coordination with the European Securities and Markets Authority (ESMA)

Stronger Investor Protection

- Stricter requirements for portfolio management, investment advice, inducements and the offer of complex financial products such as structured products, in order to prevent potential conflict of interest;
- Rules on corporate governance and managers' responsibility are enhanced for all investment firms

MiFID II/MiFIR – Key Objectives (continued)

More Robust and Efficient Market Structures

- More trading on organised venues in order, *inter alia*, to control Over-The-Counter (OTC) and dark trading;
- OTC is to be channelled through a new trading venue called Organized Trading Facility (OTF);
- Small- and medium-sized enterprises, SMEs, should have better access to capital markets; MiFID II creates a specific label for their market;
- Harmonised regime for access of third country firms to EU markets

Accounting for Technological Innovations

- Algorithmic and high frequency trading being more closely regulated in order to prevent systemic risk and to increase market integrity (position limits, effective controls, liquidity provision by market makers);
- Improved conditions for competition in essential post-trade services, such as clearing, by improving access possibilities by trading venues into clearing houses and allow clearing houses to serve more markets

Pre-Trade Transparency – Equities

- Use of a waiver from pre-trade transparency still possible:
  - Reference Price
  - Negotiated Trade
  - Large-in-Scale
  - Order Management
- Conditions for use have been amended:
  - Trades executed via a Reference Price waiver, or in a liquid instrument subject to the Negotiated Trade waiver will be capped at 4% of total trading in all trading venues on a given trading venue, with an overall 8% cap across all venues;
  - ESMA are reviewing the threshold for a liquid instrument and large-in-scale;
  - Final thresholds not decided until next consultation phase, but ESMA/EC view to increase transparency and reduce scope of use

Trading Obligation

- New obligation on investment firms to execute certain trades in shares and centrally cleared derivatives on a trading venue;
- Excludes trades that investment firms conduct if they are non-systematic, ad-hoc, irregular and infrequent, or do not contribute to the price discovery process. Also excludes derivatives not centrally cleared under EMIR;
- ESMA tasked with quantifying the above conditions, as well as determining the class of financial instruments that are subject to the clearing obligation under EMIR should be subject to the trading obligation

Algorithmic Trading

- Specific rules on algorithmic traders in 3 areas:
  - Widened scope – MiFID exempts entities from authorisation if only dealing on own account provided they are not a market maker. MiFID II narrows this exemption so that members of trading venues, DEA clients, or using a "high frequency algorithmic trading technique" require authorisation
  - Specific controls on algo trading – any algorithmic trading entity must
    - Have systems and controls to ensure resiliency;
    - Have effective business continuity arrangements;
    - Notify relevant competent authorities that it is engaged in algo trading;
    - Provide written descriptions of algo strategies
    - If conducting a "market making strategy", enter into a written market making agreement with trading venues using a "high frequency algorithmic trading technique" require authorisation
  - Specific controls on trading venues permitting algo trading – in line with *ESMA Guidelines on systems and controls in an automated trading environment*
- ESMA tasked with quantifying many market microstructural issues relating to algorithmic trading, detailed proposals in the Discussion and Consultation Papers

Reasonable Commercial Basis

- Trading venues must make post-trade information available free of charge 15 minutes after the execution of the transaction, must offer pre- and post-trade data separately and ESMA must advise the Commission (EC) on how trading data can be provided on a "reasonable commercial basis".
- 3 options
  - Prepare a set of principles that outline the elements the EC should consider;
  - "Long-Run Incremental Cost plus method (LRIC+)", which tries to find a middle ground by having a more granular approach and allowing increases to the fees charged by providers (based on any costs directly incurred) to supply this data;
  - A granular, detailed approach imposed on data providers so as to prevent them charging exorbitant prices
- Any approach that is not principles-based will be a significant task. All options for consultation, with combination of principles and LRIC+ another alternative.

Other Topics included in the ESMA consultation

- SME growth markets
- Management body
- Definitions of High-Frequency Trading and Direct Electronic Access (DEA)
- Monitoring of DEA users
- Order-to-trade ratios
- Clearing and access provisions
- Harmonised tick sizes
- Synchronisation of business clocks

MiFID II: Time to take action

Sheila Nicoll

Dublin, 29 July 2014

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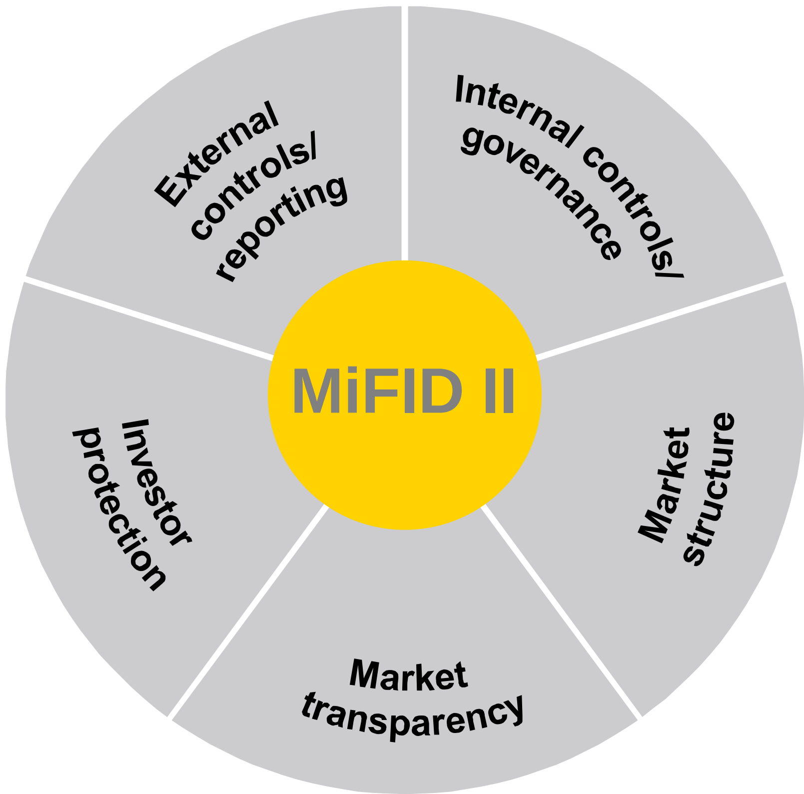
MiFID II – Introduction and objectives

MiFID seeks to provide a response to the financial crisis, increase transparency and formalisation of capital markets and introduce much more stringent investor protection provisions.



Identifying topical themes across regulations

	MiFID II	UCITS	AIFMD	EMIR	CRD	AML	PRIPs/ IMD II	FTT	FATCA
Legal Entity/Business Model	▲	▲	▲	▲			▲	▲	
Business Conduct	▲	▲	▲	▲		▲	▲		▲
Distribution/Advice	▲	▲				▲	▲	▲	
Trade Execution	▲			▲		▲		▲	
Clearing & Settlement	▲			▲				▲	
Regulatory Reporting	▲	▲	▲	▲	▲	▲		▲	▲
Reference Data & Identifiers	▲	▲	▲	▲	▲	▲	▲	▲	▲
Collateral and Margin		▲	▲	▲	▲			▲	
Risk Management	▲	▲	▲	▲	▲	▲			
Capital	▲	▲	▲	▲	▲				
Pricing and Valuations		▲	▲	▲	▲				
Product Control and Accounting	▲	▲	▲	▲	▲		▲	▲	
Tax								▲	▲

Scope

- Extension to cover banking structured products
- Conflicts of interest rules applied to insurance distribution activities
- A consistent regulatory approach to be applied by IMD for insurance based investments

There are a lot of specific investor protection issues in MiFID II

- Product intervention
- Inducements
- Suitability/appropriateness
- Governance/remuneration
- Client disclosure, particularly re cost

Product intervention

A formal banning power is likely to be used very sparingly, but regulators are focused on product development, governance and oversight:

- Governance
- Product integrity
- Investor focus – target market
- Responsibilities of product providers and distributors (‘know your distributor’)

Inducements

Ban on inducements for independent advisers and discretionary portfolio managers

- Implications for cross-border operators
- Controversy around non-independent advisers and 'service enhancement' – implications for vertically integrated business?
- Independent v. non-independent – closed or open architecture?
- Controversy around dealing commission and research

Suitability/appropriateness/complex products

"Not non-complex" products not able to be offered execution-only

- With embedded derivatives
- "Structure making it difficult for the client to understand the risk"
- Incorporating a clause, condition or trigger which would fundamentally alter the nature of the investment or pay-out profile.

Suitability

- On going?
- Suitability letter
- A cheaper or less complex alternative?
- Different test from "target market"

Disclosure

Total cost – with itemisation on request

- Separation out of price of advice, even for non-independents
- Dealing costs?
- Inter-action with UCITS, PRIIPs?

Changes to businesses of wealth and asset managers

Profitability

- Margins are likely to be put under pressure: the combination of the requirements will bring about change to products, how they are distributed, operating models across the business and pricing and cost structures

Products

- Fewer products are likely to be offered
- Greater focus on alignment of product and customer profiles
- Model portfolios expected to be a greater feature

Changes to businesses of wealth and asset managers

Distribution

- More scrutiny needed by providers as to how, and by whom their products are distributed and how they communicate with distributors and end investors
- Reduction in the number of distributors expected
- Likely to see a further growth in platforms
- Independents may find distribution more challenging
- Technology will open up new distribution and advice models

Changes to businesses of wealth and asset managers

Operating Models

- Market infrastructure changes will force operating model changes in the impacted business models
- Inducement and distribution requirements combined with technology changes will require operational change and force new distribution models

Pricing and Costs

- Greater awareness of cost base and product profitability will be required
- The changes themselves will have implications for pricing and costs

EY insights: six “know yours….”

- Know your business
- Know your client
- Know your product
- Know your distributor
- Know your vendor
- Know your technology

Thank you

EY

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ED none.