THE MIFID REVIEW

What will be the impacts of MIFID II Implementation for the various market participants? *Petra De Deyne* outlines the key areas of change and considers their direct application in the Corporate environment.
MiFID (the Markets in Financial Instruments Directive) was first implemented in 2007. Designed to achieve a harmonized legal framework for wholesale and retail markets in Europe, it introduced extensive requirements for banks, notably in terms of conduct of business and internal organization.

While MiFID was quite an ambitious piece of legislation, the financial crisis revealed its weaknesses. MiFID had wanted to break the monopoly of the exchanges and foster market liquidity, but after the crisis, equity markets turned out to be a very fragmented place, with the bulk of the activity taking place under the radar, leaving both market participants as well as regulators in the dark as to what was traded where and at what price.

Next to that, MiFID had sought to protect investors, but it appeared that the rules had not always been applied in a consistent way. Also, financial markets had evolved dramatically in the years pre and post crisis, leaving MiFID very quickly outdated and inefficient as a tool for regulators to supervise market activity and to appreciate risks in the financial system.

As a consequence, regulators called for review of MiFID in 2010, barely 3 years after its implementation. This resulted in 2 new pieces of legislation: MiFID II, being the reviewed Directive, and MiFIR, an extra Regulation. These texts became law in the summer of 2014 and will now be implemented as of January 2017.

Like all legislation that has been put in place after the crisis, the new MiFID package aims at stability in financial markets.

**Key areas of change in Markets**

When the crisis hit, it turned out that the existing market structure and the opacity in certain markets had prevented regulators from detecting risks in the system and from responding adequately. MiFID II tackles this concern in the following way:

**It reorganizes markets infrastructure**

As far as multilateral trading is concerned, MiFID II introduces the Organized Trading Facility (OTF), next to existing exchanges and Multilateral Trading Facilities (MTFs). This is a new type of trading venue that will allow for discretionary trading in non-equity instruments (such as bonds, structured products) as well as derivatives. When it comes to bilateral trading, the concept of Systematic Internalizers (SIs) comes to the fore. MiFID I had already introduced this regime for equity, where a firm executed client orders against its own book. MiFID II now broadens the scope of the SI to capture OTC trading in fixed income instruments as well. It means that if a firm that trades a financial instrument outside of a venue on a frequent, organized and substantial basis, it will have to “officialize” this OTC trading, in that it will have to follow specific rules related to pricing and transparency. Today most banks already offer electronic trading to their clients; but under the SI regime, they will have to adjust their platforms to make sure that all clients can see what volumes are being traded at what price.

**It introduces a trading obligation for derivatives and equity**

All equity trading will have to move away from “dark pools” into the light, i.e. on to exchanges, MTFs or SIs. Next to that, OTC derivatives will have to be traded either on exchanges, MTFs or OTCs. Here, MiFID liaises with EMIR: the trading obligation captures OTC derivatives that have to be mandatorily cleared under EMIR, and that are, on top of that, liquid enough to be traded on a venue. As a consequence, counterparties that are subject to the clearing obligation under EMIR (financial counterparties and non-financial counterparties with non-hedging derivatives activity over certain thresholds) will have to trade these derivatives on multilateral venues (exchanges, MTFs and OTCs), they will not be allowed to trade OTC. Non-financial parties that do not need to clear, can continue to trade their derivatives either OTC or via SIs.

**It enhances transparency**

This element is really at the heart of MiFID II. The idea is that regulators as well as market participants have as much transparency as possible on all market activity. Existing transparency in equity markets will be increased and new transparency requirements for fixed income instruments and derivatives will be introduced. Vis-à-vis the market, venues and firms will need to publish pre- and post-trade the details of their transactions. Pre-trade transparency means that prices and volumes will be published ahead of a trade that takes place on a trading venue or on an SI,
and will do so by strengthening the banks’ conduct of business rules. The main changes relate to the following:

**It imposes strict product governance**

Where a firm manufactures an investment product, it will need to have in place an internal product approval process and it will also need to identify a “target market” for its products, so that the product fits the investor. At the same time, it must liaise with its distributors so that they have all the necessary information on the product and on the intended target market. In this way miss-selling should be completely excluded going forward. Banks will ensure that clients understand the products they buy and that these products will indeed match their clients’ investment needs.

**It expands business rules that manage any conflict of interests**

MiFID II introduces panoply of requirements that should avoid conflicts of interests. The focus in this area lies on inducements and remuneration structures that should not incentivize sales persons to offer products that are not the best fit for the client. Also, whenever a client buys an investment product, all costs and charges related to it—will be disclosed so that a client can fully understand the overall cost and its impact on the return of his investment.

**It extends the “Best execution” regime**

“Best execution” is the obligation of the investment firm to obtain the best possible result when executing orders, in terms of price, cost, speed and likelihood of settlement. The new rules require that trading venues as well as Systematic Internalisers now publicly disclose information on the quality of execution that they provide. Next to that, an investment firm must also disclose information on which are the top 5 trading venues by

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post-trade transparency means real-time publication of the execution of a trade. That means that anyone involved in financial markets (banks as well as their clients) will be able to follow what is going on. However, where pre- and post-trade transparency would not be beneficial for market liquidity or would put market makers at risk, these rules will be calibrated accordingly in that certain carve-outs and/or delays will be foreseen. Vis-à-vis their authorities, banks will now be subject to a full transaction reporting on all financial instruments that they have traded.

**It sets out position limits and position reporting requirements for commodities**

New requirements for commodities specifically are being introduced. Authorities will impose position limits the net positions that a person can hold and operators of trading venues must report on positions both to the market and to the authorities. Whereas these requirements of course look to improve transparency in commodities markets, they also address two other concerns that regulators have on their minds: they are meant to support orderly pricing and avoid excessive price volatility and even more importantly, to prevent market abuse. The goal that regulators want to achieve here is to limit speculation in things such as food prices, oil prices etc. as this directly affects households.

**Key areas of change in Investor Protection**

The financial crisis had also brought to the light a number of cases of miss-selling, as MiFID rules that were intended to provide investors with an adequate level of protection had not always been interpreted in a correct way, and had in some instances apparently even been neglected. MiFID II is committed to achieve significant improvements in investor protection.
While clients will feel the impact only indirectly, a number of trends will emerge that will definitely also have an impact on their daily business.

**Volume in respect of a particular type of instrument used by that firm. It must also be able to demonstrate that orders have been executed in accordance with its order execution policy. This type of information that the client will receive from its bank will show that the client’s best interests are really taken to heart.**

**It enhances supervision**
National regulators, as well as the European Supervisory Authorities now have extra supervisory powers to ban products, certain types of financial activity or services that would pose a threat to investor protection, to financial stability or to the orderly functioning of markets.

**Impact**
It is clear that MiFID II will bring about major changes in the way that investment firms will pursue their activities in financial markets going forward. While clients will feel the impact only indirectly, a number of trends will emerge that will definitely also have an impact on their daily business:

**More electronic trading**
This trend has already been in place and will now be reinforced because of the obligation to trade derivatives on multilateral platforms and that fact that market makers will set-up SIs or convert their existing systems into SIs for bilateral trading. It implies that clients will need to plug into the banks’ electronic platforms. Even for products for which there is no trading obligation but which are liquid, like certain bonds for example, we will probably see an increase in automated trading going forward.

**Less OTC trading**
OTC trading will not go away in instruments that are not very liquid (such as bonds for example) or tailormade hedges. However, on the back of increased electronic trading, we will most probably see a reduction in pure OTC trading (i.e. outside of platforms or SIs) and a push towards more standardized and hence more liquid products, possibly leading to innovations in hedging solutions for clients.

**Bifurcation in terms of liquidity**
Market transparency is a two-edged sword. A clear view on what is traded where at what price can be quite beneficial: it increases secondary market liquidity, reduces bid/offer spreads, reduces the cost of funding in primary markets and enables customers to make well-informed decisions. One big caveat: this is true as long as we are talking about liquid products. At the time of writing, we do not yet know how regulators will define what is liquid or not, and hence, what level of transparency pre- and post-trade will have to be applied. Correct calibration will be key. If too much transparency is applied to what is illiquid, it could very well become even more illiquid.

**Market concentration**
For banks, MiFID comes with a number of challenges as far as operational matters are concerned. We can expect that not all market players are willing or able to make the necessary investments and provide liquidity in the way that MiFID II requires. As a consequence, the number of market makers may decline. However, this does not need to be a concern for clients as those banks that will set up a Systematic Internaliser, will show a clear commitment towards their customers, engage in giving support and provide secondary markets in a consistent way.

**Client-centered approach**
Whether it comes to providing prices, giving investment advice or offering other types of services, the client will get the spotlight. We are talking about the clients’ best interests, not the banks’ preferences. Investor protection is really the heart of the matter in MiFID II and MiFID II requires banks to prove it to their clients.

**Conclusion**
MiFID II is a game changer for all market participants, for banks as well as for their clients. It will definitely change the ways that they will pursue their activities in financial markets going forward. Market transparency and Investor Protection are the two pillars that will contribute to financial stability and consumer confidence.