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Reform of the Markets in Financial Instruments Directive: European Commission Consultation

On December 8, 2010, the European Commission published a public consultation (the "**Consultation**")[1] on the review of the Markets in Financial Instruments Directive ("**MiFID**").[2] The Consultation follows technical advice published in July 2010 and October 2010[3] by the Committee of European Securities Regulators ("**CESR**") relating to a number of potential MiFID reforms.

MiFID came into force in the European Economic Area ("**EEA**") in November 2007 and sought to establish a single market for investment services and activities, harmonize conduct of business rules and provide to authorized firms a right to "passport" a branch or services, cross border, into other EEA Member States. MiFID also sets out parallel regimes for regulated markets, multilateral trading facilities ("**MTF**"), and "systematic internalizers."[4]

The Consultation will be open until February 2, 2011. The Commission expects to issue formal legislative proposals in Spring 2011, but the Consultation already indicates the direction these proposals are likely to take. The Consultation proposes numerous reforms that would significantly change the operation of the EU securities and derivatives markets, including a new regime for access by third-country firms to EU markets, increased regulation of derivatives and regulation of currently exempt organized trading venues such as broker crossing systems.

This memorandum summarizes key aspects of the Consultation.

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1 EC Consultation Paper on MiFID: http://tinyurl.com/MIFID-CONSULTATION

2 MiFID consists of a framework Directive (Directive 2004/39/EC), an Implementing Directive (Directive 2006/73/EC) and an Implementing Regulation (Regulation No 1287/2006)

3 CESR technical advice, July 2010 (http://www.cesr.eu/popup2.php?id=7008), and October 2010 (http://www.cesr.eu/popup2.php?id=7283)

4 i.e. an investment firm which, on an organized, frequent and systematic basis, deals on own account by executing client orders outside a regulated market or an MTF.

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This memorandum was prepared as a service to clients and other friends of Cleary Gottlieb to report on recent developments that may be of interest to them. The information in it is therefore general, and should not be considered or relied on as legal advice.

I. ACCESS OF THIRD-COUNTRY FIRMS TO EU MARKETS

Under MiFID, access by non-EU firms to EU markets is currently left to Member State discretion, provided that national provisions do not treat non-EU firms more favorably than EU firms. MiFID allows the Commission to limit or suspend authorization of third-country firms where the third-country regime does not extend the same treatment to European firms as to domestic investment firms, but this power has not been exercised.

The Consultation indicates that the Commission intends to create a new regime to harmonize access by non-EU firms to EU markets, creating a level playing field for all non-EU financial services firms operating in the EU. The Commission is considering introducing a principle of "exemptive relief" for investment firms and market operators based in jurisdictions with equivalent regulatory regimes applicable to markets in financial instruments, including MiFID, the Market Abuse Directive ("**MAD**"),[5] the Prospectus Directive and the Transparency Directive.

The Commission proposes to define the criteria for determining the equivalence of a given third-country regime in implementing rules. Relevant factors could include requirements for the licensing of investment firms, organizational and conduct-of-business requirements, powers of competent authorities, and a regime to address market abuse, including issuer disclosure requirements. Initially, the access mechanism would only apply to professional investors. The Consultation Paper also envisages that Memoranda of Understanding will be signed between the Commission and third-country regulators. ESMA[6] would take the lead role in assessing equivalence under the proposed regime.

II. DERIVATIVES

The Consultation reflects the Commission's general policy objective to tighten the regulation of derivatives markets.

A. Commodity Derivatives

The Commission proposes to introduce a position reporting obligation by certain types of traders for contracts on all EU trading venues that admit commodity derivatives to trading. These obligations would arise in relation to trading on regulated markets, MTFs and the new category of "organised trading venue" (see below). Currently, commodity firms may be exempt from MiFID where they deal on their own account in financial instruments or provide investment services in commodity derivatives on an ancillary basis

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5 Directive 2003/6/EC

6 "ESMA" is an abbreviation for "European Securities and Markets Authority", the new EU securities regulator which, under the new EU Supervisory Framework, begins operating on January 1, 2011. See our Alert Memo for more details: http://tinyurl.com/CGSH-EUSF

and when they are not subsidiaries of financial groups. In relation to these exemptions, the Commission proposes:

- Amending the exemption to exclude dealing on a firm's own account with clients of its main business;
- Narrowing the "ancillary basis" exemption; and
- Removing the exemption for commodity firms that are not subsidiaries of a financial group.

B. OTC Derivatives

The Consultation proposes a series of reforms mirroring the "European Market Infrastructure Regulation" ("**EMIR**")[7], the proposed regulation on OTC derivatives, trade repositories and central counterparty clearing houses. These proposals would require that all trading in derivatives eligible for clearing and sufficiently liquid move to a regulated market, an MTF or an organized trading facility. Where an organized trading facility intends to facilitate trading in OTC derivatives, the Commission suggests that, in addition to the general requirements, the trading venue must:

- Provide non-discriminatory multilateral access to its facility;
- Support the application of pre- and post- trade transparency;
- Report transaction data to trade repositories; and
- Have dedicated systems or facilities in place for the execution of trades.

ESMA would be empowered to assess the circumstances in which a derivative that is eligible for clearing is sufficiently liquid to be traded exclusively on an organized venue. ESMA would base its decisions on the frequency of trades in a given derivative and the average size of transactions.

C. Supervisory Powers

Furthermore, the Commission proposes stronger oversight of derivatives positions, including commodity derivatives. Proposed amendments include

- Giving regulators power to intervene at any stage during the life of a derivative contract;

[7] See CGSH Alert Memo for more details: http://tinyurl.com/CGSH-EMIR

- Adopting implementing measures setting *ex ante* position limits for derivative contracts traded on exchange and OTC; and
- Defining the circumstances in which the powers to impose position limits may be exercised.

III. REGULATION OF ORGANIZED TRADING FACILITIES

In addition to regulated markets, MTFs and systematic internalizers, the Commission proposes creating an additional category of trading venue: an "organised trading facility." This new category would catch all organized trading currently occurring outside the scope of MiFID, for example, trades through broker crossing systems.

The proposed definition of an organized trading facility would capture "any facility or system operated by an investment firm or a market operator that in an organized basis brings together buying and selling interests or orders relating to financial instruments." This definition would cover "facilities or systems whether bilateral or multilateral and whether discretionary or non-discretionary." The definition would exclude facilities or systems that are already regulated as a regulated market, MTF or systematic internalizer.

"Organised trading facilities" would be subject to various requirements, certain of which mirror those applicable to other trading venues. They include the adoption and publication of clear rules governing access to the system, the putting in place of arrangements to address conflicts of interest and the identification of market abuse, and compliance with the MiFID transparency and reporting obligations.

IV. TRANSACTION REPORTING

A. Basic Requirements

Under the MiFID transaction reporting regime, investment firms must report to their regulator all trades in financial instruments admitted to trading on a regulated market on or off market. Concerns have been raised at the divergence in reporting requirements between different Member States. For example, Member States take differing views on which part of the order process actually constitutes "executing" a transaction. Transaction reporting would be extended to include:

- Instruments traded on an MTF or "organised trading facility" or that relate to the credit risk of a single issuer of such instruments;
- Instruments whose value correlates with the value of an instrument traded on a regulated market, MTF or "organised trading facility";

- Depositary receipts related to an instrument traded on a regulated market, MTF or "organised trading facility"; and
- Commodity derivatives not traded on a regulated market, MTF or "organised trading facility" (see above).

The Commission is also considering amending content requirements for transaction reports to include the identity of the person making the investment decision, as opposed to simply the trader executing the transaction.

B. Pre- and Post-Trade Transparency

The Consultation revisits the MiFID pre- and post-trade transparency regimes. In relation to pre- trade transparency, the Commission observes that the growth of electronic trading has facilitated the emergence of "dark" orders – trades that occur without the preceding bid and offer details being disclosed to the market. Concerns have been raised about the effect of dark orders on the accuracy of the price discovery mechanism on the "lit markets"; that is, markets fully subject to pre-trade transparency obligations.

In this regard, the Commission is considering empowering ESMA to ensure that waivers from pre-trade transparency obligations are applied consistently and coherently in equity markets. The Consultation proposes introducing binding technical standards in relation to the application of the waiver rules, promoting legal certainty in their interpretation alongside monitoring by ESMA of their application.

In relation to post-trade transparency, some market participants have expressed concerns relating to the efficiency of trade detail publication. Currently, trade reports must generally be published in real time, and in any case within three minutes, but for large transactions delays between 60 minutes and four trading days are permitted. Some market participants consider these limits excessive. Accordingly, the Commission proposes to specify that post-trade information be published as close to instantaneously as technically possible, reducing the deadline for reporting in real time from three minutes to one minute. The Consultation includes further proposals regarding transparency for equity-like instruments, in non-equity markets and for shares traded only on MTFs and organized trading facilities.

V. INVESTOR PROTECTION AND PROVISION OF INVESTMENT SERVICES

According to the Commission, several regulators have raised concerns about investor protection, particularly in relation to complex financial products. Consequently, revisions are proposed in relation to the conduct of business obligations and authorization and organizational requirements for investment firms.

A. Execution Only Services

The Consultation includes two potential amendments to the "execution only" regime, under which limited types of "non-complex financial instruments" (*e.g.*, listed shares and debt securities) may be sold to a client without an assessment of the "appropriateness" of the investment. The Commission proposes either reducing the scope of non-complex financial instruments to which the "execution only" regime applies or abolishing the regime in its entirety.

B. The Provision of Investment Advice

The Consultation proposes that MiFID "intermediaries" providing investment advice be required to inform the client, prior to provision of advice, about the basis on which the advice is given. In the case of advice based on a fair analysis of the market, the advisor would be obliged to consider a sufficiently large number of financial instruments from different providers.

C. Inducements

The Commission is considering abolishing the possibility of disclosing inducements to the client in summary form, particularly in cases where *ex ante* disclosures have been limited to bands or formulae for calculating inducements, and replacing it with a requirement to make detailed and specific *ex post* disclosures.

D. Eligible Counterparties

The Consultation suggests that eligible counterparties should be subject to a high-level principle to act honestly, fairly and professionally. In addition, it is proposed that the obligation to be fair, clear and not misleading when communicating with clients should be extended to eligible counterparties. The Commission is also considering certain limitations to the scope of the eligible counterparty regime to exclude non-financial undertakings and certain financial institutions and to exclude transactions in complex products, such as asset backed securities and non-standard OTC derivatives. In addition, the list of *per se* eligible counterparties and professional clients may be amended to exclude local public authorities and municipalities.

E. Fit and Proper Criteria

The Commission is considering extending the requirement that those who direct a firm's business be "fit and proper" to all board members, both executive and non-executive. This proposal reflects a similar proposal set out in the Commission's Green Paper on

corporate governance.[8] It is also proposed that the criteria should be enhanced to include an assessment of a time commitment, particularly for non-executive board members. All board members are to be of sufficiently good repute and sufficiently experienced to carry out their respective roles and functions.

F. Segregation of Client Assets

The Commission notes recent instances of ownership disputes resulting from "poor rules or practices" relating to client asset segregation. It therefore proposes prohibiting "title transfer collateral arrangements" involving retail clients' assets and permitting Member States to extend that prohibition to arrangements with eligible counterparties and professional clients. In addition, in the case of securities financing transactions involving retail client financial instruments, arrangements are to be adopted ensuring that the borrower of such financial instruments provides appropriate collateral and that the firm continues to monitor the appropriateness of the collateral posted.

VI. REINFORCEMENT OF SUPERVISORY POWERS

The Commission is considering harmonizing regulators' powers in relation to sanctions. Currently, Member States must ensure that regulators can impose "effective, proportionate and dissuasive" sanctions. The Commission now proposes to specify particular sanctions that national regulators must be able to deploy, including injunctions against infringements, the temporary prohibition of an activity, the suspension or replacement of management body/supervisory body person, the publication of a censure, and administrative fines.

The Commission considers it necessary to introduce the possibility for the Commission to ban the provision of investment services and the carrying out of investment activities in certain financial instruments, for example were there are significant investor protection concerns or a product or activity threatens the orderly function and integrity of financial markets or stability of the financial system.

In addition, the Commission proposes giving national regulators new investigatory powers, such as the power to ask a court for authorization to enter private premises and to seize documents relevant for enforcement action. The Commission is also considering the creation of whistle-blowing mechanisms to create incentives to report infringements to the relevant authorities and provision for national criminal sanctions for serious breaches of MiFID.

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8 European Commission: "Green Paper on corporate governance in financial institutions and remuneration policies", June 6, 2010: http://tinyurl.com/EU-COMM-GPCG. See CGSH Alert Memo for more details: http://tinyurl.com/CGSH-EUGPCG

VII. OTHER PROPOSALS

In addition to the proposals outlined above, the Consultation raises a number of other issues, including the following.

A. Telephone and Electronic Recording

MiFID currently leaves to Member State discretion the decision on whether and how to require firms to record telephone and electronic communications involving client orders. The Commission notes that this wide discretion has led to different approaches, ranging from "lack of any obligations" to "very detailed rules." The Commission proposes to create a harmonized and mandatory regime governing telephone and electronic recording. The Commission envisages a minimum retention period of three years, with Member States having the right to extend this period.

B. SME Markets

Small and medium enterprises ("**SMEs**") often face a higher cost of capital than larger enterprises. SME markets therefore aim to provide smaller, growing companies with a platform to raise capital both through initial offering and ongoing fundraising. Currently, a good proportion of specialist SME markets are organized as MTFs.

The Commission is considering the creation of a new market solely for SMEs within the existing framework of regulated markets and MTFs, subject to a regulatory approach that is proportionate and appropriate to the nature of the industry sector. The Commission is considering defining an "SME market" by reference to the Prospectus Directive definition of an SME, or some other similar threshold-based test. The Commission is also considering a market capitalization test. For example, a SME market could be limited to companies with the market capitalization that is less than 35% of the average market capitalization on the trading venues of the Home Member State of the issuer.

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If you have any questions, please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under the 'Practices' section of our website at http://www.clearygottlieb.com.

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