

MiFID 2: Reforming the Regulation of EU Securities and Derivatives Markets

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The European Union has begun a wide-ranging and radical reform of its securities and derivatives markets through MiFID 2,1 which is scheduled to be implemented across the EU by January 3, 2017. Implementation is dependent on a large amount of EU-level secondary legislation, drafts of which recently have been published for consultation. MiFID 2 implementation will present significant strategic challenges and operational issues for both EU and many non-EU investment firms to consider in the coming year.

At a high level, MiFID 2 will:

- Tighten the regulation of algorithmic and high-frequency trading;
- Force more trading in shares and derivatives onto regulated venues, and reduce over-the-counter (OTC) trading in those instruments;
- Increase trading transparency across a broader range of securities and derivatives, and restrict the use of waivers from transparency requirements that allow dark-pool trading;
- Bring more commodity derivatives trading within EU regulatory scope and implement commodity derivative position limits and reporting requirements;
- Tackle vertical silos in trading, clearing and settlement;
- Begin harmonizing rules allowing non-EU investment firms to access EU securities and derivatives markets; and
- Give the European Securities and Markets Authority (ESMA) an expanded supervisory role.

MiFID 2 will:

- Enhance investor protection
- Tighten regulation of algorithmic and high-frequency trading
- Reduce OTC trading in shares and derivatives, increase on regulated venues
- Increase trading transparency across a broader range of securities and derivatives
- Bring more commodity derivatives trading within EU regulatory scope
- Tackle vertical silos in trading, clearing and settlement
- Begin harmonizing rules for non-EU investment firms
- Give ESMA an expanded supervisory role

MiFID 2 will apply to EU-established investment firms and regulated exchanges, as is the case under MiFID 1. However, its scope will expand in several ways:

- Algorithmic trading conduct-of-business rules will be extended to entities that currently fall outside MiFID's scope, such as EU-established management entities of the Undertakings for Collective Investment in Transferable Securities (UCITS) and alternative investment funds, pensions funds and insurance companies;
- The obligation to trade all "clearing-eligible" liquid derivatives on a regulated execution venue (the "trading obligation") will effectively be extended to European Market Infrastructure Regulation (EMIR) financial counterparties (such as UCITS managers), authorized alternative investment fund managers and insurance companies, irrespective of whether they are EU-established. Further, the trading obligation will be extended to

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nonfinancial entities whose nonhedging derivatives trading exceeds specific thresholds;

- Commodity derivatives position limits will apply to persons, not just financial entities. Although investment firms will bear the brunt of commodity derivatives position reporting, they will have to obtain position information from their financial and nonfinancial clients so as to be able to comply; and
- Non-EU firms that provide investment services to EU retail clients and less sophisticated professional clients may need to establish an EU presence if a local regulator so demands. An ESMA registration requirement may eventually apply to non-EU firms that wish to conduct cross-border business with more sophisticated EU institutional investors.

In addition to scope extension and extra compliance obligations, MiFID 2 presents a number of strategic issues that regulated entities must consider and address, including:

- Internationally active groups, especially those headquartered in the United States, will need to adapt policies and procedures to comply with international regulatory requirements, which are similar in thrust but different in detail, making implementation of global standards difficult (See "[Reconciling Regulatory Requirements in Cross-Border Derivatives Takes Center Stage](#)");
- Financial services groups with a sell-side focus will need to make a number of strategic decisions regarding whether they wish to become multilateral trading facilities, organized trading facilities (OTFs) or systematic internalizers. A number of restrictions and compliance obligations come with each execution model, and the potential level of market demand for the new OTF and expanded systematic internalizer categories is unknown;
- It remains to be seen whether the push to move more securities and derivatives trading to "lit" regulated execution venues will result in less buy-side trading and, therefore, less liquidity — particularly in fixed-income markets potentially affecting a wide variety of market users, liquidity providers and, ultimately, issuers; and
- MiFID 2 provisions regarding both non-EU firms' access to EU markets and EU entities' ability to trade "trading-eligible" derivatives on non-EU exchanges depend on the EU making equivalence assessments on non-EU countries' regulatory regimes and the non-EU countries giving reciprocal access rights. Thus far, mutual recognition in the derivatives clearing space has been very slow. Although the effects of some of the MiFID 2 mutual recognition requirements will be mitigated by transitional arrangements, the pace of global regulatory convergence will need to quicken in order to avoid EMIR, MiFID 2, Dodd-Frank and derivatives laws from other countries reversing the trend toward more globalized financial markets.

¹ MiFID 2 will comprise the Markets in Financial Instruments Directive (2014/65/EC) and the Markets in Financial Instruments Regulation (Regulation (EU) No 600/2014) and will be supplemented by delegated acts from the European Commission, as well as technical standards and guidelines by the European Securities and Markets Authority.

² EU investment firms are EU-established and -licensed firms and banks that act as brokers, investment advisers, discretionary managers, underwriters, placement agents and multilateral trading venues with respect to securities and derivatives.