



FIA AND FIA EUROPE SPECIAL REPORT SERIES: ESMA PUBLISHES TECHNICAL ADVICE AND LAUNCHES CONSULTATION ON MiFID II

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MiFID II comprises a Directive and a Regulation: the Markets in Financial Instruments Directive II (2014/65/EU) and the Markets in Financial Instruments Regulation (Regulation 600/2014) ("MiFIR"). Together, they are referred to as MiFID II and will repeal and recast the Markets in Financial Instruments Directive ("MiFID") (2004/39/EC). MiFID II (as used in this Report to cover MiFID II and MiFIR) will apply on 3rd January 2017. Together, the new regulations will form the legislative framework governing the requirements applicable to investment firms, trading venues, data reporting service providers and third-country firms providing investment services or activities in the European Union ("EU").

On 19 December 2014, the European Securities and Markets Authority ("ESMA") published final Technical Advice to the European Commission (ESMA/2014/1569) (available [here](#)), together with a Consultation Paper on MiFID II (ESMA/2014/1570) (available [here](#)). The Consultation Paper includes draft Regulatory Technical Standards ("RTS") and Implementing Technical Standards ("ITS") (available [here](#)), which ESMA is required to produce under MiFID II.

ESMA is seeking the views of stakeholders on the draft RTS and ITS. The ITS form a part of the draft RTS and cover the common standard forms, procedures and standard templates for the submission of information required when investment firms and credit institutions wish to provide investment services and perform activities in another Member State.

The final Technical Advice and draft RTS (including the ITS) translate the MiFID II requirements into what ESMA describes as "practically applicable rules" for market participants and national supervisors. The new framework is intended to ensure that secondary markets are fair, transparent and safe and that the interests of investors are protected, when investors are sold investment products. Steven Maijoor, the Chairman of ESMA, commented that MiFID II will "bring greater transparency and improve the overall functioning of markets, thus strengthening investors' trust in the financial sector".

The Consultation Paper takes account of feedback from stakeholders to its Discussion Paper published on 22 May, 2014 (the "May DP").

The final Technical Advice will assist the European Commission in drawing up its own implementing rules, which are known as Delegated Acts. The final Technical Advice follows the same structure as the Consultation Paper published by ESMA on 22 May, 2014 (the "May CP"); and the Consultation Paper follows the format of the May DP. Like the May DP and the May CP, the final Technical Advice and the Consultation Paper cover many of the same topics, albeit with a markedly different focus.

Like the May DP, the Consultation Paper contains sections covering an introduction, investor protection, transparency, micro-structural issues, data publication, requirements applying on and to trading venues, commodity derivatives, market data reporting and post-trading issues. Similarly, the final Technical Advice follows the same structure as the May CP: introduction, investor protection, transparency, data publication, micro-structural issues, requirements applying on and to trading venues, commodity derivatives and portfolio compression.

This series of FIA Special Reports will cover the aspects of the Consultation Paper and draft RTS and the final Technical Advice which apply to derivatives.

KEY PROPOSALS

MiFID II introduces changes to the functioning of secondary markets, including transparency requirements for a broad range of asset classes; the obligation to trade derivatives on trading venues; requirements for algorithmic and high-frequency trading ("HFT") and new supervisory tools for commodity derivatives. The legislation also aims to bring in tougher rules on investor protection, (including rules on client assets), manage systemic risks and improve transparency and competition. The final Technical Advice and the draft RTS included in the Consultation Paper include coverage of the issues set forth below.

The Trading Obligation

In line with G20 requirements, MiFIR requires for the first time certain derivatives contracts (those which are both cleared through a central counterparty ("CCP") and deemed sufficiently liquid) to trade on a "trading venue": that is, Regulated Markets ("RMs"), Multilateral Trading Facilities ("MTFs"), Organised Trading Facilities ("OTFs") (broadly akin to a U.S. swap execution facility), or a third country trading venue deemed equivalent by the European Commission (the "MiFIR trading venues"). The Trading Obligation is probably the area where some of the most important interdependencies between MiFID and the European Markets Infrastructure Regulation ("EMIR") may be found, as the MiFIR Trading Obligation applies to certain transactions in clearing eligible and sufficiently liquid contracts, when traded by counterparties subject to the clearing obligation under EMIR. The Trading Obligation is broadly similar to the "trading mandate" for swaps under Title VII of the Dodd-Frank Act.

As set out in EMIR, the main purpose of the MiFIR Trading Obligation is to determine which of those derivatives subject to the EMIR clearing obligation should be required to be traded on the MiFIR trading venues. However, the provisions of MiFIR are vague on the details of the new obligation, placing the responsibility on ESMA to come up with draft regulatory technical standards.

In the Consultation Paper and draft RTS, ESMA sets out draft RTS and the reasoning behind them to determine which of the class or classes of derivatives declared subject to the EMIR clearing obligation must be traded on the MiFIR trading venues; and the date (or dates) from which the Trading Obligation takes effect, including a phase-in period and the categories of counterparties to which the obligation applies. ESMA asks for comments from stakeholders on its proposed approach.

Transparency

The Consultation Paper and accompanying RTS cover a variety of matters related to transparency, including ESMA's proposals on the criteria for a definition of "liquid market" for non-equity financial instruments. MiFIR introduces transparency requirements for bonds, structured finance products, emission allowances and derivatives.

National regulators have the power to waive the obligation for market operators and investment firms operating a trading venue to make public pre-trade information for certain non-equity instruments for which there is not a liquid market. On the post-trade side, they may also authorise market operators and investment firms to provide for deferred publication in respect of transactions that are related to non-equity instruments, for which there is not a liquid market.

ESMA's proposal, set out in its Consultation Paper, advocates using the "classes of financial instrument approach" ("COFIA") as the basis for the determination of the liquidity of all the various non-equity financial instruments. The COFIA approach provides for the segmentation of non-equity financial instruments into specific classes and sub-classes, defined on the basis of a set of criteria (such as maturity, currency, or underlying instrument) which varies from one asset class to another. ESMA sets out the segmentation of the classes and sub-classes it has arrived at and which constitute the framework for the transparency regime. ESMA also describes the analysis carried out across different asset classes, for the purpose of segmenting non-equity financial instruments, in order to define the sub-set of liquid classes.

Post-Trading Issues

The Consultation Paper contains ESMA's proposals in relation to the obligation to clear derivatives traded on a regulated market and the timing of acceptance for clearing (the latter is referred to in the U.S. as "straight through processing" or "STP"). MiFIR extends the scope of the clearing obligation to all derivative transactions concluded on a regulated market and requires clearing members to ensure that derivatives are submitted for clearing as quickly as practicable. ESMA provides draft RTS specifying the minimum requirements for systems, procedures and arrangements, taking into account the need to ensure proper management of operational or other risks. The draft RTS apply to CCPs, trading venues and investment firms acting as clearing members and when finalised, will apply to all derivatives to be cleared, both over-the-counter ("OTC") and Exchange-traded derivatives and will apply to them whether or not they are subject to the clearing obligation.

Indirect Clearing

MiFIR provides for indirect clearing arrangements in respect of Exchange-traded derivatives. These are permissible under MiFIR, provided that the arrangements do not increase counterparty risk and provided that they ensure that the assets and

positions of the counterparty benefit from suitable protection. ESMA's draft RTS specify the types of indirect clearing service arrangements, where established, that meet these conditions.

Algorithmic and High Frequency Trading

In the final Technical Advice, ESMA clarifies the definition of HFT and algorithmic trading. New rules are introduced governing HFT and algorithmic trading. These new rules impose a strict set of organisational requirements on investment firms and trading venues. Given that algorithmic trading and HFT have been the subject of increased global regulatory attention in recent years, this area should be of particular interest to FIA and FIA Europe members.

Open Access by a CCP or Trading Venue

The draft RTS attached to the Consultation Paper set out provisions regulating access to CCPs, trading venues and benchmarks. In particular, ESMA sets out the conditions under which an access request may be denied by a CCP, including the anticipated volume of transactions; arrangements for managing operational risk and complexity; or other factors creating significant undue risks. Similarly, the RTS set out conditions under which an access request may be denied by a trading venue, including conditions based on operational risk and complexities; or other factors creating significant undue risks.

The RTS also contains provisions relating to non-discriminatory and transparent fees charged by CCPs and trading venues; the conditions for the non-discriminatory treatment of contracts (including how to determine whether two contracts are economically equivalent); the conditions under which access must be permitted; transitional arrangements for CCPs and trading venues; non-discriminatory access to and licencing of benchmarks; and the standards guiding how a benchmark may be proven to be new.

Stakeholders' views are sought on the new provisions, which are designed to increase competition in the EU.

Transaction Reporting

The Consultation Paper and draft RTS cover various aspects of transaction reporting, including data standards and formats; and clarification on the obligation to report transactions. The MiFIR Transaction Reporting and Reference data regime provides for a number of reporting requirements in relation to the disclosure of transaction data and reference data on financial instruments falling within the scope of MiFID II. ESMA is currently assessing and evaluating the key elements of existing technical formats for transaction reporting and financial instruments reference data and this is mentioned in the Consultation Paper. In doing so, it is carrying out a thorough analysis and examination of the current regime, in order to evaluate the suitability of the current formats for the MiFIR regime. This examination will assist ESMA in selecting the most appropriate format for transaction reporting and reference data to be used along with their respective standard schema. The outcome of this analysis is planned for March 2015. ESMA's analysis here is similar the review the CFTC is undertaking related to issues with formats for reporting to swap data repositories.

In the Consultation Paper, ESMA also looks at the obligation to report transactions. Respondents to the May DP requested further clarification on what the concept of “transaction” actually covers and what it does not. Respondents also requested that certain specific activities should be excluded in order to restrict activity that was reportable to the extent that this was practicable. There was also a request that transaction reporting under MiFIR should be aligned with reporting under EMIR. ESMA provides its thoughts on these areas in the Consultation paper. ESMA provides draft RTS on reporting obligations; the obligation to supply financial instrument reference data; the obligation to maintain records of orders; the requirement to maintain records of orders for firms engaging in high-frequency algorithmic trading techniques; and technical standards on clock synchronisation.

Commodity Derivatives

The final Technical Advice introduces position limits and reporting requirements with regard to commodity derivatives. ESMA also provides technical advice on specifying the derivative contracts that have the characteristics of wholesale energy products that must be physically settled. ESMA advises that a contract must be physically settled if: it contains provisions which ensure that parties to the contract have proportionate arrangements in place to be able to make or take delivery of the underlying commodity; it establishes unconditional, unrestricted and enforceable obligations of the parties to the contract to deliver and to take delivery of the underlying commodity; it is not possible for either party to replace physical delivery with cash settlement; and the obligations under the contract cannot be offset against other obligations.

Data Publication and Access

MiFID II deals with three new types of entities, which are described as “data reporting services providers (”DRSPs”): approved publication arrangements (”APAs”); consolidated tape providers (”CTPs”) and approved reporting mechanisms (”ARMs”).

In the Consultation Paper and draft RTS, ESMA sets out its proposals in relation to the authorisation and organisational requirements for DRSPs; the publication of transactions by APAs and CTPs; and data disaggregation. The proposals include general authorisation and organisational requirements for data reporting services; issues related to the publication chain of post-trade transparency information from investment firms and trading venues to the CTP through an APA; as well as the content of the published information.

The Safeguarding of Client Assets

The final Technical Advice contains ESMA’s advice to the European Commission on various aspects of the safeguarding of client assets. These include: the governance and organisation arrangements concerning the safeguarding of client assets and the prevention of the unintended use of client financial instruments; measures to ensure an appropriate use of Title Transfer Collateral Arrangements (”TTCA”) when dealing with non-retail clients; arrangements to be adopted with respect to securities financing transactions; strengthening the due diligence requirements, including diversification, for firms depositing client funds; recording and disclosure requirements with respect to inappropriate custody liens or similar rights, to the

extent possible, over client assets; and measures aiming to increase the effectiveness of segregation requirements.

NEXT STEPS

The final Technical Advice has now gone to the European Commission and will assist the European Commission in drawing up its own implementing rules. However, the Consultation on the RTS and ITS is currently open and will close on 2 March 2015. ESMA has also announced that it will hold an open hearing on the consultation on 19 February 2015. Additional information on the open hearing is available [here](#).

UPCOMING SPECIAL REPORTS

In the coming days, FIA and FIA Europe will issue eight special reports on the topics addressed in the Consultation Paper:

1. Derivatives - Part 1 (including trading obligation and other topics);
2. Derivatives - Part 2 (including post-trading issues, indirect clearing and other topics);
3. Algorithmic and High Frequency Trading (HFT);
4. Open Access;
5. Transactions Reporting;
6. Commodity Derivatives (including ancillary activities);
7. Definitions and Exemptions; and
8. Safeguarding of Client Assets.

For more information about these reports contact Will Acworth at FIA (wacworth@fia.org) or Emma Davey at FIA Europe (edavey@fia-europe.org)

Additional MiFID II/MiFIR documents are available [here](#).

Disclaimer: This report was drafted by the London office of [Covington & Burling LLP](#) on behalf of FIA and FIA Europe. The report is part of a series of reports intended to provide factual summaries of MiFID/MiFIR on certain topics of interest to the members of FIA and FIA Europe. The reports are provided for general informational purposes only. They do not constitute legal or regulatory advice and should not be relied upon for this purpose.

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