



L&RS Note

MiFID II – key provisions and implications

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Abstract

This *L&RS Note* examines some of the key provisions and implications of the EU's second Markets in Financial Instruments Directive ('MiFID II'). MiFID II is a package of EU reforms aimed at enhancing transparency in the bloc's financial market system and improving consumer confidence in the industry generally. MiFID II was transposed in part by statutory instrument (SI 375/2017) on 10 August 2017, and came into effect on 3 January 2018. Primary legislation to give further effect to the Directive is forthcoming.

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Glossary

Term ¹	Meaning
Derivative	A financial instrument that derives its value from the value of another underlying asset. Derivatives are commonly used for trade in commodities, such as gold and oil. Futures, options, forwards and swaps are all examples of derivatives.
High frequency trading (HFT)	HFT uses algorithms, financial data and electronic trading tools to trade at high speeds, with high turnover rates and a high order-to-trade ratio.
Shares / equities	A unit of ownership in a firm that is traded as a financial instrument.
Structured deposit	A structured deposit's return may be linked to some index or underlying instrument, so that the amount repaid is dependent on this underlying performance.
Collective investment schemes	A fund representing the pooled contributions of multiple investors that is invested by a fund / portfolio manager.
Position limit	The highest number of derivatives (specifically options or futures contracts) that an investor is permitted to hold over a single underlying asset.
Organised trading facility (OTF)	A multilateral system (that is not a regulated market) allowing the interaction of multiple third-party interests in bonds and structured finance products.
Over-the-counter (OTC) trading	Trade in a financial instrument that does not take place on an exchange, but directly between parties.
Depository receipts	A type of transferable financial instrument that is traded on a local exchange but which represents an instrument issued by a company listed on a foreign exchange.
Exchange-traded funds	An investment fund that is traded on an exchange, and which typically tracks an index, a commodity, bonds, or a basket of assets.
Proprietary trading	When an investment manager invests in financial instruments for its own direct gain instead of earning commission by trading on behalf of its clients.

¹ The European Commission has published a more detailed glossary relating to MiFID II, available [here](#).

Market-making strategies	A strategy that quotes both a buy and a sell price for a financial instrument, with the intention of making a profit by exploiting the difference between the two prices, (known as the bid-offer spread).
Title transfer collateral agreements	Arrangements to secure the performance of a financial obligation whereby a person providing collateral transfers full ownership to the person taking security for the obligation.
Short-sale	A transaction in which an investor sells a number of financial instruments that the investor has borrowed, and is required to return an equal number of those instruments at a future date. The investor will profit if the financial instrument goes down in price.
Matched principal trading	A transaction in which the facilitator interposes itself between buyer and seller in such a way, that it is not exposed to market risk throughout execution of the transaction, with both sides executed simultaneously.
Liquidity	A financial instrument is liquid if it can be easily sold or exchanged without a substantial loss in value.
Approved Reporting Mechanism (ARM)	A platform that reports transactions on behalf of firms.
ESMA	The European Securities and Markets Authority. ESMA is an independent European Union (EU) authority that contributes to safeguarding the EU's financial system by enhancing the protection of investors and promoting stable and orderly financial markets. ²

² For more information, see the ESMA website [here](#).

Background to MiFID II

Responding to the global financial crisis

The first Markets in Financial Instruments Directive (commonly known as ‘MiFID’, but now referred to as ‘MiFID I’) represents the European Union’s (EU) efforts to standardise regulation for investment services across all EU Member States. It aims to improve the transparency of financial markets and standardises the regulatory environment for the trading of financial instruments across the bloc.

The reforms in MiFID II also aim to enhance transparency in the industry, with additional provisions aimed at improving investor protection, and targeting over-the-counter and high frequency trading. MiFID II is largely a response to the 2008 global financial crisis, and marks an effort by the EU to improve consumer confidence in financial markets in the wake of fragilities exposed during the crisis.

Legislative framework

The [Markets in Financial Instruments Directive \(MiFID I\)](#) 2004/39/EC is European Union (EU) legislation that provides the framework for regulation of investment intermediaries (e.g. banks, asset managers) providing services to clients in relation to trade in financial instruments (e.g. financial assets such as stocks and bonds). MiFID I came into effect in Ireland on 1 November 2007 and was transposed via the statutory instrument [European Communities \(Markets in Financial Instruments\) Regulations 2007](#) (SI 60/2007).

MiFID I has been revised to improve the functioning of financial markets in light of the global financial crisis. The revised regulatory framework is referred to as MiFID II. The reforms in MiFID II reflect concerns regarding market transparency, investor protection, rapid changes in technology and the complexity of modern financial products in general.

MiFID II comprises two linked pieces of legislation, the Directive: [Markets in Financial Instruments \(MiFID II\) Directive](#) 2014/65/EU and the Regulation [Markets in Financial Instruments Regulation \(MiFIR\) Regulation](#) 600/2014/EU. Text Box 1, overleaf, clarifies the difference between EU Directives and EU Regulations. MiFID II was transposed into Irish law by statutory instrument as the [European Union \(Markets in Financial Instruments\) Regulations 2017](#) (SI 375/2017) on 10 August 2017, which took effect on 3 January 2018.

According to the Central Bank of Ireland, the effect of MiFID II on the asset management industry:

“cannot be understated. Firms should fully understand the effect this legislation will have both on their businesses and on the industry as a whole”.³

The Government’s [legislative programme for Spring / Summer 2018](#) includes the *Markets in Financial Instruments Bill* (the ‘Bill’), which further transposes MiFID II into Irish law. The [Markets in Financial Instruments and Miscellaneous Provisions Act 2007](#) allows criminal sanctions to be imposed for serious offences under MiFID I rules. The purpose of the Bill is to provide for the continuation of the same regime of criminal sanctions for serious offences under MiFID II rules.

The Heads of the Bill were approved by the Government on 26 July 2017. On 31 October 2017, the Cabinet also approved proposals to amend the [Credit Reporting Act 2013](#) (the ‘2013 Act’) and the [Financial Services and Pensions Ombudsman Act 2017](#) (the ‘2017 Act’)⁴. In November 2017, the Joint Committee on Finance, Public Expenditure and Reform, and Taoiseach elected not to undertake pre-legislative scrutiny of the General Scheme. The Bill is awaiting publication as of February 14th 2018.

Text Box 1. EU Directives and EU Regulations

A **Directive** is a legal instrument of the EU that requires Member States to achieve a specific result within their domestic legal framework. Directives typically give Member States some leeway regarding the specifics of the rules to be adopted.

A **Regulation** is a legal instrument of the EU that has been adopted by the European Council, the European Parliament, or the European Commission. A regulation has direct effect in Member States simultaneously, and is directly applicable, meaning that it does not require any implementing legislation.

³ [MiFID II Keynote Speech](#), PwC breakfast Briefing, Denis Murray, Head of Asset Management: Authorisation and Inspection Division, 28 June 2017.

⁴ Correspondence between the Minister for Finance and the Chairman to the Joint Committee on Finance, Public Expenditure and Reform and Taoiseach.

Timeline of MiFID II and the preparedness of industry

MiFID II timeline

The initial deadline for the transposition of MiFID II by Member States was 3 January 2017. However, given the scope of the legislation and the uncertainty surrounding some of the provisions, there were concerns that industry would be unable to adapt in time. In fact, 50 per cent of firms indicated in a 2015 Bloomberg survey that they would not be prepared by the January 2017 implementation deadline.⁵

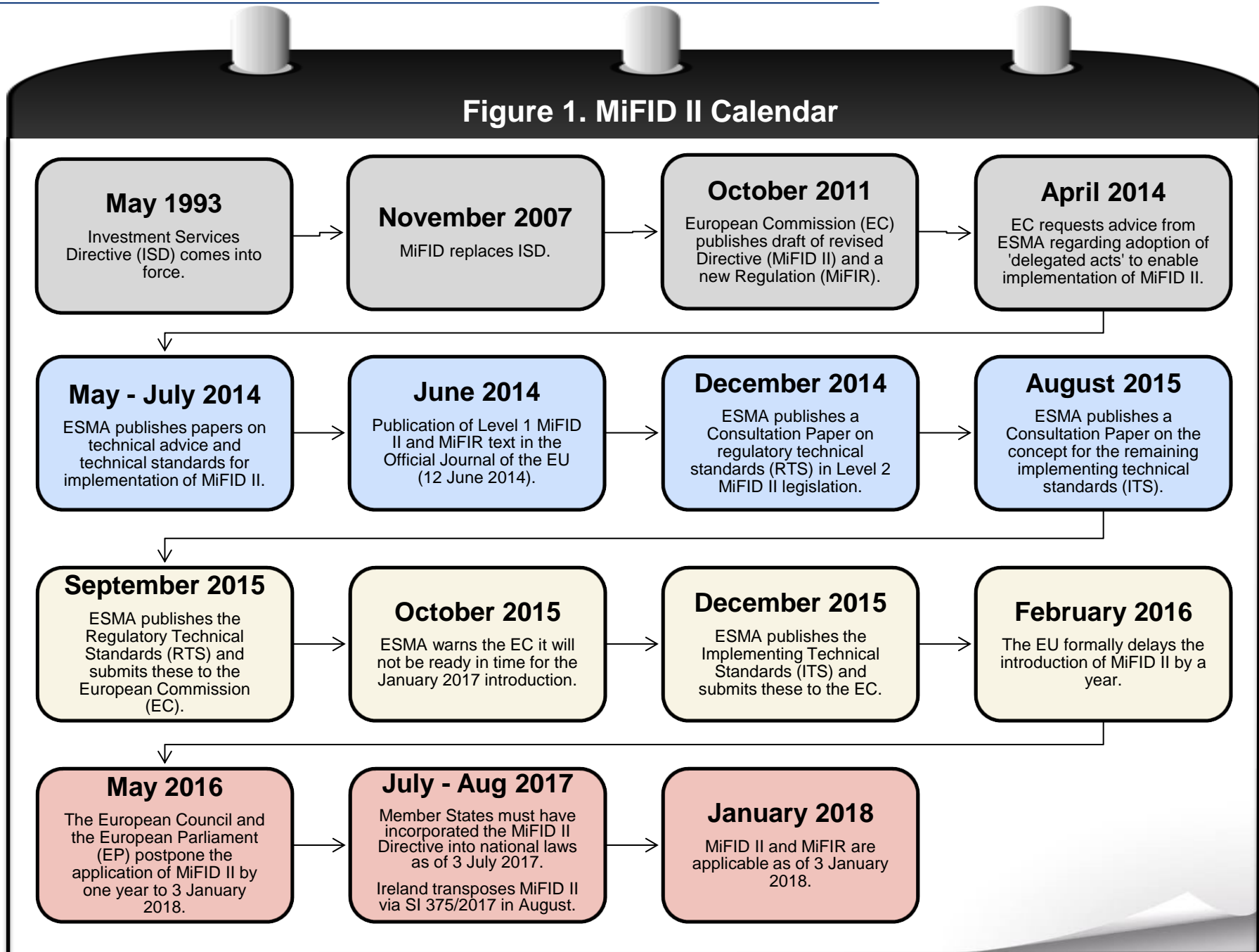
[Speaking](#) to the European Parliament's economic affairs committee in November 2015, European Securities and Markets Authority (ESMA) chairman Steven Maijoor described the January 2017 timetable as 'unfeasible', given the scope of the necessary changes under MiFID II.⁶

Ultimately, in February 2016, the deadline for transposition of MiFID II was delayed by one year until 3 January 2018. Figure 1 overleaf shows the timeline of the MiFID II legislation (compiled by L&RS).

⁵ [Firms tackle MiFID II challenges at Bloomberg event in London](#), *Bloomberg*, 21 October 2015.

⁶ [EU poised to delay securities reform by a year](#), *Reuters*, 10 November 2015.

Figure 1. MiFID II Calendar



Preparedness of industry

Some of the issues identified in the Bloomberg survey in relation to the preparedness of firms for MiFID II include:

- **a shortage of talent:** high demand and a tight supply of legal, compliance and technical talent are slowing the efforts of many firms to adequately prepare for MiFID II;
- **technology rollout and adoption:** particularly in regard to the changes in pre-trade transparency requirements;
- **time-clock synchronization:** firms with global operations may have difficulty with the requirements for clock synchronization in markets;
- **data volume:** the amount of records generated is resulting in many firms struggling to process and retain adequate records as required under MiFID II;
- **engagement with regulators:** firms report that they encountered pushback from officials when asked for greater clarity on elements of MiFID II; and,
- **resolving conflict laws:** global firms will have to reconcile differences between financial regulation and local laws in Europe, particularly in relation to privacy laws.

At 1.7 million paragraphs, the legislation has been described by industry as ‘onerous’ and ‘hugely time consuming’ with ‘big hidden costs’ and a ‘giant headache’. In addition, industry professionals have remarked on the overall lack of clarity regarding the practical application of MiFID II rules and the implications of the rules once enacted. The Chairman of the European Securities and Markets Authority (ESMA), Steven Maijoor, has suggested that the complexity of MiFID II means that there is the risk of ‘potential glitches’ in the early implementation of the rules.⁷

Indeed, on January 9th 2018, just six days post-enactment, ESMA delayed new transparency rules relating to equity-trading for a minimum of three months. The rules sought to limit the number of transactions taking place in so-called ‘dark pools’. That is, trading that is transacted in private venues with prices being disclosed only after a trade has been completed. ESMA indicates that a large proportion of trading venues had yet to provide complete data and that, while it had received files from three-quarters of trading venues, they contained complete data from only 650 instruments, or about 2 per cent of the expected total.⁸

Research providers have raised additional concerns in relation to the implementation of MiFID II. The legislation targets potential conflicts of interest arising from how investment managers compensate brokers for research services. Under MiFID II, investment firms will have to make explicit payments for research, rather than packaging research services with commissions that are paid for trading). Specifically, there are fears among analysts in the industry that investment managers will cut back on research from brokers and banks. A survey by Greenwich Associates

⁷ [Europe begins countdown to MiFID II](#), *Financial Times*, 1 January 2018.

⁸ [ESMA Press Release](#), January 9th 2018.

found that European fund managers had cut their 2018 equity research budgets by 20 per cent compared to the previous year, shrinking the overall annual equity research budget by an estimated €300 billion.⁹

The Central Bank has engaged with firms based in Ireland to examine preparedness for MiFID II. Some of the central themes that have emerged from this exercise include:¹⁰

- firms noted that, despite having significant MiFID II budgets, they face time pressures to ensure that all systems and processes are fully compliant by the implementation deadline;
- firms that are part of international groups have broader group-wide MiFID II projects and have the additional challenge of ensuring that their Irish firms take appropriate steps to implement and own MiFID II initiatives at a local level; and,
- other challenges include uncertainty as to whether brokers will report transactions on their behalf, or whether they will need an Approved Reporting Mechanism (ARM).

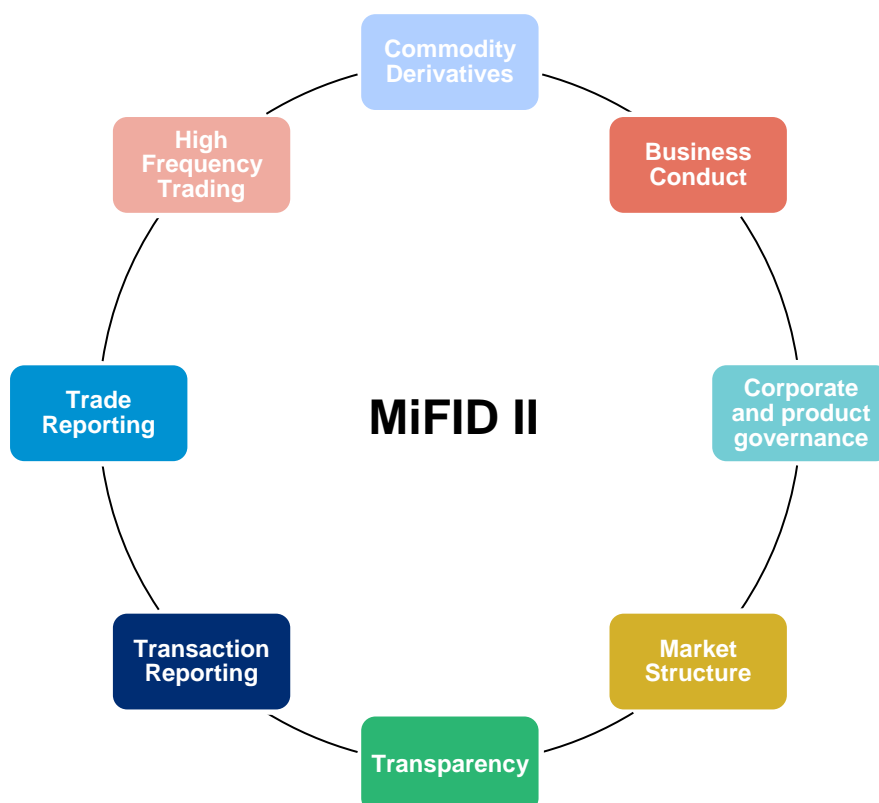
⁹ [MiFID II – Cost of Research](#), Greenwich Associates, 2 November 2017.

¹⁰ [MiFID II Keynote Speech](#), PwC breakfast Briefing, Denis Murray, Head of Asset Management: Authorisation and Inspection Division, 28 June 2017.

Focus of MiFID II

MiFID II is a sizeable piece of EU legislation, comprising approximately 1.7 million paragraphs. Figure 2 below highlights seven key areas on which the legislation focuses. Figure 2 is followed by a more detailed discussion of each of these themes, with reference to the provisions of the legislation.

Figure 2. Key areas of focus for MiFID II



Source. L&RS 2018, based on themes identified and analysis carried out by [London Stock Exchange Group](#)

Market structure

MiFID II contains efforts to revise market structures to allow for the fair, efficient and safe regulation of secondary trading.

Organised Trading Facilities (OTFs): MiFID II introduces OTFs as a new category of venues, alongside the existing categories of regulated markets (RMs) and multilateral trading facilities (MTFs). OTFs will be limited to trade in non-equity financial instruments. They are capable of exercising discretion in order execution, such as playing a role in the negotiations between market participants.

Systematic internalisers (SIs): firms dealing outside a trading venue in liquid equities on an organised, frequent, systematic and substantial basis are currently subject to pre-trade transparency requirements. MiFID II introduces a similar pre-trade transparency regime for SIs in other liquid financial instruments.

Derivatives trading obligation: in line with G20 commitments, transactions in derivatives subject to the clearing obligation under the [European Market Infrastructure Regulation \(EMIR\)](#) will be required to take place on an RM, MTF or OTF where the instrument is sufficiently liquid.

Trading obligation in shares: where a share is admitted to trading on a venue, it will (with some exceptions) be required to be traded on a RM, MTF or SI.

Transparency

Pre- and post-trade transparency provided for under MiFID I applies only to equities admitted to trading on a RM. Under MiFID II a similar regime will be applied to financial instruments other than equities where they are traded on MTFs or OTFs.

Scope of regime for equities: under MiFID II depositary receipts, exchange-traded funds (ETFs), certificates and other similar financial instruments traded on a RM or MTF, will be covered by the pre- and post-trade transparency regime previously limited to equities under MiFID I.

Non-equity pre-trade transparency: trading venues must (subject to some exceptions) make public information about trading concerning securities other than equities.

Non-equity post-trade transparency: details of transactions in non-equity financial instruments conducted in trading venues conducted on trading venues will need to be made publically available as close as possible to real time, with deferred publication allowed for some exceptions. For sovereign debt instruments, the volume of transactions can be published on an aggregated basis (rather than at the individual transaction level) after the deferral period.

High Frequency Trading (HFT)

MiFID II introduces provisions designed specifically to ensure that HFT does not have an adverse effect on the quality or integrity of financial markets.

Authorisation: MiFID II will require HFT firms engaging in proprietary trading to be authorised in much the same way as investment firms.

Market making: HFT firms that use market-making strategies on trading venues will be required to enter into market-making agreements with these venues, to ensure they provide liquidity on a consistent basis. This is in addition to systems and controls requirements on the use of algorithms.

Order-to-trade ratios: MiFID II requires trading venues to impose limits on the total number of order messages that a participant can send relative to the number of transactions they undertake.

Tick sizes: MiFID II implements measures that set minimum tick sizes. That is, minimum increments by which prices can change in shares and other financial instruments.

Corporate and product governance

MiFID II introduces expanded requirements in respect of the management of firms. This includes explicit organisational and conduct requirements relating to product governance.

Management bodies: provisions imposed on banks under the [Capital Requirements Directive](#) (2013/36/EU) are being extended to investment firms. These provisions impose limits on the number of appointments that members of management bodies may take on. They also require members of those bodies to act with honesty and integrity. It further requires larger firms to have nomination committees to propose suitable candidates for management functions. In addition, the management body is responsible for ensuring the firm has governance arrangements that allow for effective, prudential management.

Product governance: firms are expected to have explicit arrangements for product governance. These arrangements apply to firms that manufacture investment products as well as those that sell them. This is to ensure that firms understand the nature of products they are involved in manufacturing or selling, and that these products are sold to suitable clients.

Sales targets and remuneration: MiFID II builds on the ESMA's [Guidelines on Remuneration Policies and Practices](#) under MiFID I and aims to ensure that staff incentives do not cause a conflict of interest or cut across the obligation of the firm to act in the best interests of its clients.

Title transfer collateral arrangements: the existing prohibition on title transfer collateral arrangements in relation to retail clients' dealings in foreign exchange derivatives, is extended under MiFID II to all retail clients' dealings in financial instruments.

Commodity derivatives

MiFID II provides for regulators to impose mandatory restrictions on the size of commercial trading in respect of position limits in commodity derivatives. Specifically, MiFID II provides for a new regime of position limits and position reporting.

Exemptions: MiFID II narrows exemptions under MiFID I for commercial firms that trade in commodity derivatives. Exemptions will apply only if the activity is ancillary to a firm's primary business, and only if the primary business is not the provision of financial services.

Financial instruments: emission allowances (that is, trading in financial instruments derived from carbon allowances under environmental policy) will be classified as financial instruments under MiFID II.

Organised Trading Facilities: MiFID II introduces Organised Trading Facilities (more detail on OTFs is provided under 'Market structure'). Physically settled contracts traded on Organised Trading Facilities will be considered as financial instruments (with the exception of electricity and gas contracts).

Position limits: contracts traded on trading venues (and economically equivalent contracts) will be subject to position limits. Exemptions apply to non-financial firms in respect of positions that are measurable as reducing risks directly related to commercial activity (hedging).

Position reporting: details of positions will need to be reported to trading venues daily. This information will then be sent by the trading venues to the ESMA weekly, which will publish aggregated reports that distinguish between positions held by commercial and financial firms.

Trade reporting

Changes under MiFID II on trade reporting are designed to resolve problems experienced under MiFID I concerning data quality and issues relating to the availability of data

Consolidated tape: MiFID II envisages that there should be a consolidated tape of trade reports for shares, depositary receipts, ETFs, certificates and other similar financial instruments, and eventually for non-equity instruments. This consolidated tape will be available without charge, 15 minutes post-publication. The consolidated tape will be produced by firms that are to be granted authorisation as consolidated tape providers.

Approved publication arrangements (APAs): under MiFID I, trade reports are published through trading venues, a third party or proprietary arrangements. MiFID II implements a similar regime, which requires third parties publishing data to meet organisational requirements and to seek authorisation as APAs.

Business conduct

MiFID II aims to enhance the levels of protection granted to different categories of client. Further, countries will be able, in limited circumstances, to impose requirements that go beyond those in MiFID I.

Inducements: MiFID I restricts payments that firms providing services to clients can receive or make in relation to the provision of these services. MiFID II goes beyond these restrictions by

prohibiting firms that provide independent advice or portfolio management from receiving and retaining payments from third parties.

Execution-only: under MiFID I, firms can allow clients to buy and sell only a certain range of products on an execution-only basis. MiFID II narrows this list of execution-only products. In particular, structured UCITS (Undertakings for Collective Investment in Transferable Securities) may no longer be sold on an execution-only basis. Structured deposits (which are being introduced with MiFID II) will also be affected.

Best execution: MiFID I requires firms to take “all reasonable steps” to obtain best execution of their clients’ orders. MiFID II strengthens this, requiring “sufficient steps” for best execution. Firms must report annually, showing the top five venues (in terms of trading volume) where they execute orders.

Transaction reporting

Relative to MiFID I, MiFID II extends the scope of the transaction reporting obligation. The scope of reports is also enhanced and an EU-wide system of Approved Reporting Mechanisms (ARMs) is being introduced.

Scope: MiFID II extends the scope of transaction reporting obligations, beyond instruments admitted to trading on regulated markets. It now includes instruments trading on MTFs and OTFs.

Flags: MiFID II requires additional information to be included in transaction reports, including whether a transaction in shares or sovereign bonds is a short-sale and whether a transaction took place under an applicable waiver.

Approved Reporting Mechanisms (ARMs): MiFID II introduces an ARMs regime under which investment firms can make transaction reports through firms authorised as ARMs and subject to organisational requirements to ensure that they are organised to discharge their responsibilities.

Trading venues: operators of trading venues are required to report transactions executed through their systems by firms not subject to [Markets in Financial Instruments Regulation \(MiFIR\) Regulation 600/2014/EU](#).

Optional exemptions under MiFID II

Article 3

Under Article 3 of MiFID II, Member States may exercise the option to exempt some firms from authorisation as MiFID investment firms. The definition of an investment firm as set out in SI 375/2017 is detailed in Text Box 2 below.

Text Box 2. Definition of investment firm

The statutory instrument transposing MiFID II into Irish law ([European Union \(Markets in Financial Instruments\) Regulations 2017; SI 375/2017](#)) defines an **investment firm** as:

‘any person whose regular occupation or business is the provision of one or more investment services to third parties or the performance of one or more investment activities on a professional basis or both but does not include a natural person unless:

- (a) his or her legal status ensures a level of protection for third parties’ interests equivalent to that afforded by legal persons,
- (b) he or she is subject to equivalent prudential supervision appropriate to his or her legal status, and
- (c) if paragraph (2) is applicable, he or she ensures that the conditions set out in that paragraph are fulfilled’.

The firms that may be exempted are those that:

- provide only limited investment services as set out in regulation 4(3)(b);
- do not hold clients’ funds or financial instruments;
- provide investment services to their parent or subsidiary;
- branches of third-party firms established in Ireland;
- Firms that deal on their own account in financial instruments (other than commodity derivatives or emission allowances and do not perform any investment activities in financial instruments other than commodity derivatives or emission allowances).

This optional exemption under Article 3 of MiFID II has been transposed into Irish law under regulation 4(3) of SI 375/2017. An exempt firm will be subject to regulation under the [Investment Intermediaries Act 1995](#) and its activities will be limited. The investor protection regime outlined in MiFID II will not apply to exempt firms, and these firms will be subject only to investor protection requirements under the [Central Bank’s Consumer Protection Code 2012](#) (the ‘CPC’) and the [Investment Intermediaries Act 1995](#) (the ‘1995 Act’)¹¹. Firms designated as exempt under Article 3

¹¹ [Irish MiFID II Regulations Transposing MiFID II Have Now Been Published](#), Matheson, 29 August 2017.

of MiFID II are still subject to authorisations and conduct of business and organisational requirements, but not the full range of regulations that will apply to MiFID II investment firms.

In June 2016, the Department of Finance consulted on the Member State discretion under MiFID II, including that under Article 3. The Department published its [Feedback Statement](#) in relation to its public consultation on 14 July 2017.

The Feedback Statement sets out a 'gap list', detailing what changes will be required to comply with the obligation under MiFID II that exempt firms are sufficiently regulated. The Central Bank has since published an [addendum to the CPC](#) addressing these.

Safe Harbour regime

In their [Feedback Statement](#), the Department of Finance stated that it had decided to substantially maintain the national Safe Harbour regime in place for non-EEA investment firms (third country firms) that do not provide investment services to retail clients in Ireland.

The Safe Harbour regime has been retained under SI 375/2017. The Safe Harbour exemption means that a third country firm can provide investment services in Ireland to professional clients and eligible counterparties without obtaining authorisation from the Central Bank¹².

In line with SI 375/2017, third country firms will not be allowed rely on the Safe Harbour exemption unless the following requirements are met:

- the firm is subject to authorisation and supervision in the country in which it is established and the competent authority of the third country does not appear on the FATF list of non-cooperative jurisdictions; and
- co-operation agreements are in place between the Central Bank and the national competent authority of the third country, including provisions regulating the exchange of information.

Under SI 375/2017 any third country firm looking to provide investment services to retail clients or elect-up professionals will have to establish an authorised branch in Ireland to provide those investment services.

In the event that a third country firm has its registration withdrawn from ESMA, the Central Bank may issue a direction stating that the firm is unable to continue performing investment activities in Ireland. Under MiFID II, the Central Bank can further implement rules that obligate third country firms to inform it of any relevant information necessary to ensure that the firm complies with applicable Safe Harbour exemption conditions.

¹² Ibid.



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