AN OVERVIEW OF MiFID II

Introduction

The first Markets in Financial Instruments Directive ("MiFID I") became effective on 1 November 2007. It introduced a number of items including the MiFID passport, client categorisation requirements, client order handling requirements, pre and post trade transparency requirements and requirements relating to investment firms ensuring that clients receive best execution.

MiFID II will come into effect on 3 January 2018 and is widely regarded as one of the most important regulatory initiatives undertaken by the European Union ("EU") since the onset of the financial crisis in 2008. MiFID II was published together with the Markets in Financial Instruments Regulation ("MiFIR") in 2014.

In general, MiFID II relates to the framework of trading venues/structures in which financial instruments are traded. MiFIR is concerned with regulating the operation of these trading venues and the processes, systems and governance measures adopted by market participants.

The main objectives of MiFID II include the pursuit of harmonised regulation across EU financial markets, increased competition between EU financial markets, ensuring appropriate levels of investor protection, and strengthening of supervisory powers. This paper provides a summary of the key aspects of MiFID II.

In general, MiFID II only applies to investment firms that have a physical presence in Europe that are operating under a MiFID permission and regulated by a European regulator. However, non EU investment firms that manage European mandates or compete for European clients' assets will face competitive pressure as clients come to expect the level of transparency that they are receiving from investment firms in Europe. KB Associates will be drafting a separate paper on the impact of MiFID II on non-EU investment firms as a follow up to this paper.

The Key Aspects of MiFID II

The impact of MiFID II can be summarised across five key areas:

Market Infrastructure/Transparency

MiFID II makes a range of significant changes in relation to market infrastructure. It introduces the concept of an Organised Trading Facility ("OTF") which captures trading in non-equity instruments which previously operated outside the scope of MiFID. The rules around Regulated Markets ("RMs[1]") and Multilateral Trading Facilities ("MTFs[2]") have been aligned, and a range of organisational requirements currently applying to RMs and MTFs have been extended to the newly introduced OTFs. Additionally, obligations for SIs[3] have been increased. There are also new requirements for high frequency and algorithmic trading in relation to pre- and post-trade transparency.

Product Governance

MiFID II introduces significant product governance requirements. Investment firms that create products, so called manufacturers, will be required to identify a target market and take reasonable steps to distribute the product. They will need to put in place a product approval process and review the target market and the performance of the investment products they offer on a periodic basis. They will also need to make sure that the distributors have sufficient understanding of the manufacturers' products and product approval processes to sell to their own identified target market.

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[1] Authorised regulated markets for the purposes of MiFID, e,g. in Ireland the Main Securities Market of the Irish Stock Exchange
[2] Multilateral Trading Facilities are self-regulated trading venues and are an alternative to traditional stock exchanges.
[3] Systematic Internalisers were introduced under MiFID I and are investment firms who execute orders from their clients against their own book or against orders from other clients. They are like mini exchanges and execute orders outside an RM.

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In June 2017, the European Securities and Markets Authority ("ESMA") issued guidelines on MiFID II product governance requirements. The guidelines outline a number of criteria that need to be analysed by manufacturers when assessing a target market. These include:

- What type of clients are the products being targeted to?
- What are the clients' objectives and what is their experience/knowledge of the products in question?
- What is the clients' risk appetite and tolerance to risk?

Transaction Reporting

Transaction reporting was introduced under MiFID I and concerns trade detail reporting which is provided by investment firms to regulators. It allows regulators to monitor market abuse in financial markets. Under the MiFID II framework, the transaction reporting requirements increased considerably. The scope of products which need to be reported has been extended with transaction reporting now being required for all products traded on European RMs, OTFs and MTFs. In addition to an increase in the number of products that qualify for reporting, the number of data fields required for MiFID transaction reporting has also greatly increased. The new data fields include the following:

- Details of the person executing the transaction, e.g. the trader
- Details of the algorithm used to make a decision to trade
- A required field to indicate a short sale
- A required field to indicate illiquid instruments.

Finally, transaction reporting will no longer be an issue only for sell-side firms, such as brokers and dealers, but will also become the responsibility of the counterparty who initiates the transaction, typically buy-side firms.

Rules on Inducements and Unbundling of Research

This has been a contentious area for investment firms. Pursuant to the MiFID II general inducement rule, most inducements, including commissions and rebates for independent advisors will be banned. This will force investment firms to review how their funds are distributed. There may be some exceptions, for example, where the payment or benefit is designed to enhance the quality of service to a client.

MiFID II also seeks to unbundle the purchase of research from execution services. In order to ensure that the bundling together of investment research and execution services does not occur, MiFID II proposes two methods to pay for investment research:

- The P&L method where investment firms fund the research themselves from their own resources
- The Research Payment Account ("RPA") method where the costs of research would be funded by the client.

Investor Protection/Best Execution

MiFID II seeks to enhance the best execution framework which was introduced under MiFID I. Under the MiFID I framework, investment firms are required to take "reasonable steps" to obtain the best possible results for their clients. Under MiFID II, the term "reasonable steps" has been replaced with "all sufficient steps", thus raising the bar.

There are also enhanced publicity requirements. Investment firms will be required to publish data relating to execution quality (i.e. cost, speed, etc.) at least annually without charge. Investment firms will have to publish, on an annual basis, their top five execution venues for the previous year, along with specific data relating to the quality of execution of transactions on that venue.

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Timeline for Implementation

The final level one texts of the MiFID II Directive and MiFIR were published in the Official Journal of the EU on 12 June 2014. They entered into force on 2 July 2014 and had been due to enter into effect thirty months later on 3 January 2017. This was subsequently delayed by twelve months to 3 January 2018. Under the revised timeline, EU member states are required to transpose the provisions of MiFID II into their national legislation by 3 July 2017.

How Should Investment Firms be Preparing for MiFID II Now?

The enhanced obligations pose a significant challenge to investment firms, particularly in the absence of a grace period after 3 January 2018. Investment firms should be assessing the impact of MiFID II and asking themselves a number of questions including:

- Does the investment firm know its target markets and client types?
- Will the investment firm submit reporting directly to the regulator or will it use an approved reporting mechanism?
- Has the investment firm updated its IT infrastructure and software to deal with the new additional reporting requirements?
- Has the investment firm improved its archiving systems and back-ups?
- Has the investment firm considered any required changes to its conduct of business in areas such as product governance, best execution and product distribution?

KB Associates' Services

KB Associates offers a range of services to investment funds including:

- The provision of UCITS/AIF management company services.
- The provision of designated persons to perform UCITS business plan and AIFMD programme of activity managerial functions.
- The provision of UCITS/AIF operational support.

If you would like to discuss any issues raised in this article or related to KB Associates' services in general, please feel free to contact Mike Kirby (+353 1 667 1980), Peter Northcott (+44 203 170 8813) or Mike Parton (+1 345 946 4224).