

E-ALERT | Financial Services and Regulation

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EU INSTITUTIONS AGREE MiFID 2 AND MiFIR PROPOSALS

On 14 January 2014, representatives of the European Parliament and the Greek Presidency of the EU Council reached a broad political agreement on two legislative proposals to overhaul the EU's financial markets regulatory regime. The proposed Markets in Financial Instruments Directive (MiFID 2) and the Markets in Financial Instruments Regulation (MiFIR) are intended to expand the scope of regulated activity, enhance conduct of business rules, and fulfil the EU's outstanding G20 commitments on over-the-counter (OTC) derivative markets reforms. The proposals also seek to address popular concerns regarding speculation in commodity derivatives and the growth of high-frequency trading, as well as to promote greater competition in derivatives trading in Europe.

The negotiations did not address the majority of MiFID 2 and MiFIR provisions, which have already been agreed through political and technical trialogues¹ undertaken since July 2013. Instead, negotiations focused exclusively on questions related to MiFID 2 scope, position limits for commodity derivatives, the provision of services by third country firms, and the MiFIR open access provisions.

There is as yet no combined or definitive text recording the political agreement. However, based on reports by the European Commission and European Parliament and the [statement](#) of Commissioner Barnier, the highest Commission official responsible for the MiFID reforms, the key elements of the agreement appear to be as follows:

I. SCOPE: COMMODITY DERIVATIVES AND INSURANCE

The Greek Presidency and the European Parliament agreed the extension of the highly contentious definition for commodity derivatives. It expressly excludes gas and power contracts which fall within the EU Regulation on Energy Market Integrity and Transparency (REMIT). The EU legislators have further agreed an extended derogation from clearing and margin requirements for coal and oil derivative contracts. In addition, they have agreed that investments that involve contracts of insurance will be regulated by the proposed Insurance Mediation Directive (IMD 2), rather than MiFID 2.

II. THIRD COUNTRY REGIME

The agreement confirmed the result of the previous dialogue, according to which MiFID 2 will harmonise the regime for granting access to EU markets for firms from third countries, based on an equivalence assessment of third country jurisdictions by the European Commission, that is, without the need to establish a branch in the Member State in which they operate. For a transitional period of three years, and then pending the equivalence decision by the Commission, national third country regimes will continue to apply.

That harmonised regime will apply only to the cross-border provision of investment services and activities provided to professional and eligible counterparties. Retail investors will be excluded from

¹ Under the EU's co-decision process for introducing new legislation, the European Parliament and the EU Council need to agree on a common regulatory text, with the European Commission acting as a mediator. This process is known as "trialogue".

the harmonised regime. As a result, each Member State will have discretion as to whether a third country firm must open a branch before offering retail banking services in that Member State.

III. POSITION LIMITS

The agreement on position limits is based on the proposal drafted by the Greek Presidency. In short, position limits would be set by national competent authorities on the basis of a methodology defined by the European Securities and Markets Authority (ESMA). Limits would be applied to net positions in commodity derivatives (a) traded on a trading venue and (b) “economically equivalent OTC contracts”. Limits would not apply to hedge positions of or held on behalf of non-financial counterparties.

IV. OPEN ACCESS

The new legislation will establish a harmonised EU regime for non-discriminatory access to trading venues, central counterparties (CCPs), and benchmarks for trading and clearing purposes, subject to certain transitional rules. Smaller trading venues and newly-established CCPs will be able to take advantage of optional transition periods.

Subject to further confirmation, EU legislators agreed an overall “transitional period” of 30 months for the application of the open access provisions. As a result, the open access provisions would only apply 30 months after the application of MiFIR.

V. OTHER ELEMENTS OF THE NEW LEGISLATION

Other aspects of the new legislation, which were agreed prior to the dialogue include:

A. Market structure

The new legislation will introduce a market structure framework which ensures that trading, wherever appropriate, takes place on regulated platforms. To this end, it will subject shares and derivatives which are eligible for clearing under the European Markets Infrastructure Regulation (EMIR) and are sufficiently liquid to a trading obligation. This will move trading in these instruments onto multilateral and well regulated platforms, in accordance with the EU’s G-20 commitments.

The legislation will also ensure that investment firms operating an internal matching system which executes client orders in shares, depositary receipts, exchange-traded funds, certificates and other similar financial instruments on a multilateral basis are authorised as a Multilateral Trading Facilities (MTF). Finally, it will introduce a new multilateral trading venue, the Organised Trading Facility (OTF), for non-equity instruments to trade on organised multilateral trading platforms.

B. Market transparency

The new legislation will increase equity market transparency and establish a principle of transparency for non-equity instruments such as bonds and derivatives.

With respect to equities, the new legislation will establish a double volume cap mechanism - to limit the use of reference price waivers and negotiated price waivers (4% per venue cap and 8% global cap), together with a requirement for price improvement at the mid-point for the former. Large in scale waivers and order management waivers will remain the same as under MiFID I. The new legislation will also extend the pre- and post-trade transparency regime to non-equity instruments. However, pre-trade transparency waivers will be available for large orders, request for quote and voice trading. Post-trade transparency will apply to all financial instruments with the possibility of deferred publication or volume masking, as appropriate.

The new legislation will oblige trading venues to make pre- and post-trade data available on a reasonable commercial basis and to establish a consolidated tape mechanism for post-trade data.

These rules will be accompanied by the establishment of an approved reporting mechanism (ARM) and authorised publication arrangement (APA) for trade reporting and publication.

C. Controls for algorithmic trading activities

MiFID 2 will include new trading controls for algorithmic trading activities (including high-frequency trading), such as the requirement for all algorithmic traders to be properly regulated and to provide liquidity when pursuing a market-making strategy. In addition, investment firms which give direct electronic access to a trading venue will need to have in place systems and risk controls to prevent trading that may contribute to a disorderly market or involve market abuse.

D. Stronger investor protection

The new legislation will introduce better organisational requirements for investment firms, such as client asset protection and product governance. The new regime will also provide for strengthened conduct rules, such as an extended scope for the appropriateness tests and reinforced information to be provided to clients. It will also allow ESMA and the European Banking Authority (EBA) to restrict the marketing and distribution of certain financial instruments in certain well-defined circumstances.

With regard to Packaged Retail Investment Products (PRIIPS), the new framework will extend to structured deposits and amend the Insurance Mediation Directive (IMD) to introduce certain rules for insurance-based investment products (as indicated above).

E. Sanctions

The new legislation will establish a harmonised system of strengthened cooperation between the EU and national authorities, aimed to improve the effective detection of breaches of MiFID 2 and MiFIR.

The EU institutions will hold a technical triologue meeting on 28 January, during which they will iron out the technical details of the agreement. Legislators representing the European Parliament hope to schedule a plenary vote on the final legislative proposals in March. However, that timing will depend on how many issues are reopened by Member State governments in the course of technical negotiations and how quickly a final text can be agreed.

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