

MIFID II more market stability?

MIFID II is meant to bring more stability and transparency to the European financial markets



This paper outlines how MIFID II will impact your business and how you can prepare for this new regulation

November 2011

MIFID II is likely to have more consequences than its predecessor integrating lessons learnt from the financial crisis overhauling the trading activity of investment firms and bringing more transparency for all financial instruments. The main changes cover :

- Improved pre and post-trade transparency rules identical on all regulated trading venues ensuring level playing field.
- Creation of a new category of trading platforms, the OTF, covering a number of previously uncovered market segments, such as dark pools and broker crossing networks, aiming to push all organised trading on trading venues.
- Specific rules for algorithmic and high frequency trading of investment firms controlling high risk activities.
- Standardised OTC derivative contracts are forced onto regulated trading venues bringing more transparency to OTC trading activities.
- Specific rules for commodity derivative contracts allowing regulators to intervene at any stage in the trading activity, including position limits, should the orderly functioning and integrity of the financial markets be compromised.

MIFIR, covering pre and post-transparency, competition in post-trade services and the new supervisory powers of ESMA is directly applicable in the Member States and no longer subject to regulatory arbitrage.

In conclusion, MIFID II together with other regulatory changes such as EMIR, Market Abuse Directive (MAD), Bâle III and regulation on its way in the US with the Dodd–Frank Act, will contribute to a more stable and transparent market with more control over high risk activities.

Authors :

Yvette Roozenbeek
Director Eurogroup Consulting

Morgane Leclerc
Consultant Eurogroup Consulting

Tel : +33 1 49 07 52 37

Yvette.roozenbeek@eurogroupconsulting.fr

1. MIFID II, building on MIFID I integrating lessons learnt from the financial crisis



MIFID II level 1 arrived

The legislative proposal for MIFID II was published on October 20th, building on the initial MIFID Directive promoting a single European market and a harmonized high level of customer protection. The proposal has now gone to the European Parliament and the European Council where it will be subject to negotiations. After agreement of both bodies, the common text for MIFID and MIFIR has to be accepted by the trialogue (the Commission, the Council and the Parliament).

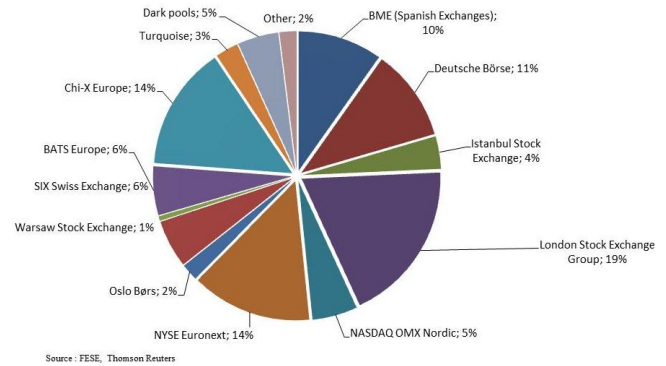
At the same time, details of the technical standards of the level II text are delegated to the Commission and/or ESMA and discussed with the industry. The outcome of these discussions further impact the extent of the MIFID II implications for market participants.

Contrary to the Directive (MIFID), the Regulation (MIFIR) applies directly to investment firms, Multilateral Trading facilities (MTFs), Organized Trading facilities (OTFs) and Regulated Markets (RMs) and does not need further transposition into the national laws. MIFIR covers especially rules concerning transparency of equity and non-equity financial instruments, Systematic Internalisers (SIs), commercialisation of data rules, transaction reporting to competent authorities, OTC derivatives trading, clearing access rules and supervisory measures.

What did MIFID I bring to the market?

MIFID I delivered a certain number of its promises including greater competition between trading venues and between investment firms on execution services decreasing trading costs for investors. New trading venues were created by new market operators like MTFs, dark pools and broker-dealer crossing networks (BCNs). Competition between clearing houses increased and new services in public trade reporting

European Equity Trading Market Share of MTFs and RMs (Jan-sept 2011)
as a % of total turnover



have been offered to the market. Overall, the market has made tremendous investments in innovation and technology for trading and platforms, with high-frequency trading representing more than 50% of daily volume on certain lit books. Investor protection has improved through best execution rules and client classification obligations.

However, MIFID I also had some shortcomings, especially with regard to the objective of harmonising rules across Europe. Full harmonization has not been achieved causing concerns about level playing field and increasing costs for market participants. Certain OTC equity flow is still escaping transparency rules like the BCNs. Today, around 15% in volume is traded inside banks without any pre-trade transparency. Market data has been widespread and the lack of a consolidated tape has kept certain areas still opaque. Market quality in terms of price formation did not improve and overall, the supervision of the new rules and the coordination between countries to reinforce them have not been sufficient. Finally, no revolution was made in terms of investment advice for end clients such as retail.

2. Overview of the new Directive and the Regulation



MIFID II drives again fundamental changes in the European securities markets. Other regulatory changes such as central counterparties and trade repositories (EMIR), short-selling and CDS, Bâle III, review of the Market Abuse Directive (MAD) and regulation underway in the United States such as the Dodd-Frank Act will further strengthen this. As MIFID I created a single EU market for equities with more competition, MIFID II will have a wider reach and overhaul trading strategies, cover a much larger scope of financial asset classes and change the way trading flows can interact with reinforced risk controls and supervision.

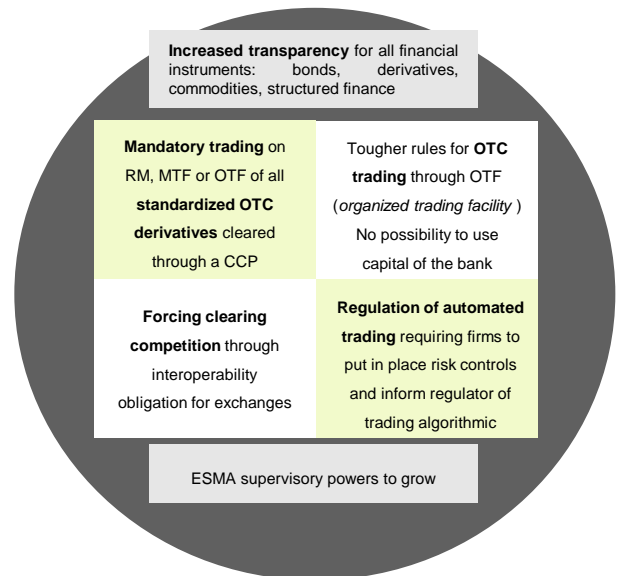
MIFID II impacts the activity of investment banks with regard to their OTC trading activity of financial instruments and their execution model crossing different type of order flows such as agency order flow and proprietary order flow using the capital of the investment firm. Algorithmic and high-frequency trading activity will also be regulated, imposing risk controls and quote requirements. More transparency and supervision are required for positions taken in commodities and the possibility of regulators to limit positions during the life of a derivative contract.

The new regulation also further regulates exchanges, MTFs, SIs and OTFs requiring stricter and more harmonised risk controls and the publication of information regarding quality of execution.

Surprisingly, MIFID II does not further precise best execution rules introduced by MIFID I. The investor protection framework is slightly enhanced in terms of documentation and execution only services and local authorities and municipalities now benefit from heightened protection.

At the same time more power has been given to a central supervisory body, ESMA (European Securities and Markets Authorities), to guarantee a harmonized implementation of the MIFID rules within the UE. Member States should provide the

MIFID II framework (MIFID and MIFIR) :



Source : Eurogroup consulting

possibility to apply administrative sanctions in case of breaches of MIFID by market participants.

In conclusion, MIFID II should bring more transparency to OTC trading, further control different high risk trading strategies, limit systematic risks in commodity derivatives contracts and allow for intervention if needed.

MIFID II will therefore not just be a compliance exercise, it impacts different business areas of market participants and trading models are to be redesigned as well as the impact on current business strategy are to be assessed.

It is now time to start looking at your strategy to overcome the threats of this new regulation and optimise possible benefits.



3. MIFID II will further regulate high risk activity of investment firms

Impact on investment firms' trading models

MIFID II integrates lessons learned from the financial crisis and therefore, besides continuing the extension of MIFID I to other financial products, it deliberately regulates further the trading activity of investment banks and the transparency of OTCs trading activities.

The Regulation now includes a new broadly defined category of organized trading, called Organized Trading Facility (OTF), capturing all types of organised execution and arranging of trading in a system which do not correspond to the functionalities or regulatory specifications of existing venues. OTFs have to comply with the same pre and post-trade transparency requirements as RMs and MTFs.

Broker Crossing Networks (BCNs) and dark pools are covered by this new definition and therefore these platforms will have to be transformed into OTFs, which were not regulated before. The technical standards of level II will have to further specify the thresholds with regard to the minimum required volume. OTFs will, however, keep a degree of discretion over how a transaction will be executed and consequently the operator is subject to investor protection, best execution and conduct of business towards clients using the platform. Under the new regulation BCNs and OTFs are no longer allowed to contain proprietary trading flows and OTFs are not permitted to connect to other OTFs.

SIs are also under stricter rules, obliging firms to put firm two-sided quotes on a continued basis with a minimum quote size of at least the equivalent of 10% of the standard market size of a share regardless of the prevailing market conditions. Agency flow cannot match against each other in the SI where only the Investment Firm can be counterparty of the transaction. This agency flow should be matched in the newly defined OTF.

Investment firms that engage in algorithmic trading/ automated trading and provide DMA access to their clients will have a number of new obligations; Firstly, algorithms have to post competitive prices continually during trading hours, providing liquidity on a

regular basis, regardless the prevailing market conditions, secondly put in place certain risk controls and lastly provide a description of the nature of their trading strategies, trading parameters or limits to their home competent authority on an annual basis .

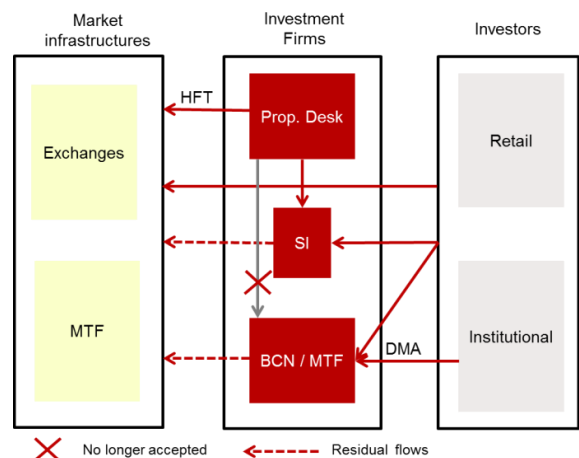
Investment firms are required to make public 5 execution venues they use for client orders on annual basis.

Investment firms are further constraint by extended pre-and post trade transparency rules that are now also covering derivatives, bonds, commodities and structured finance products.

All trading in standardized OTC derivatives have to move to regulated trading venues (the thresholds, as to which derivatives are sufficiently liquid, still are to be defined by the technical standards of the ESMA and the Commission). EMIR obliges all these derivatives to be cleared by a central counterparty (CCP).

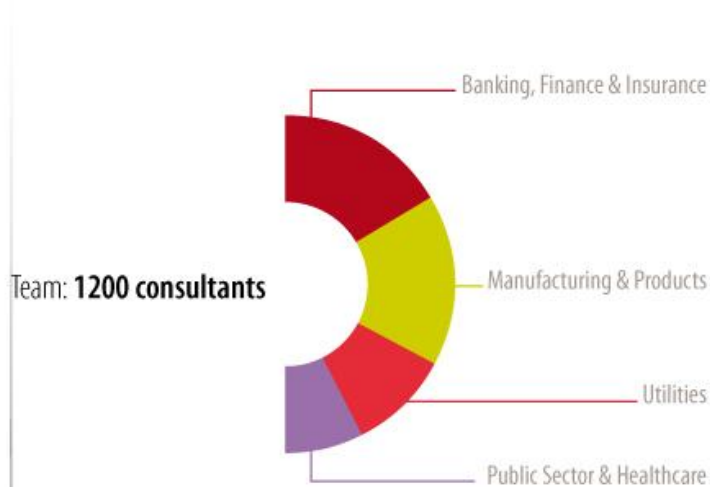
The regulation also provides for regulator's intervention to limit positions in commodities and therefore members of RMs, MTFs or OTFs need to report in real-time their positions to the trading venue who will in turn report the aggregated positions to the local authority.

Main trading flows impacted by MIFID II



Source : Eurogroup consulting

EUROGROUP CONSULTING
the **European** management
consulting group



Locations (Group Members and Affiliates): **26 offices in 20 countries**

Austria, Belgium, Canada, France, Germany, Ireland, Italy, Luxembourg,
Morocco, Poland, Portugal, Romania, Spain, Sweden, Switzerland,
The Netherlands, Turkey, UK, United Arab Emirates, USA

Group website: www.eurogroupconsulting.com

EUROGROUP CONSULTING has helped many banks, brokers, asset managers and market infrastructures in more than 12 countries to get ready for the implementation of MIFID I. We have helped our clients to identify new business opportunities, perform functional impact analysis and market studies and manage their implementation projects. We are engaged to help our clients again to get ready for this new regulation.

EUROGROUP CONSULTING FRANCE

Tour Vista

52/54 Quai De Dion Bouton

92806 Puteaux Cedex

Tel. + 33 (0)1 49 07 57 00

Fax + 33 (0)1 49 07 57 57

E-mail info@eurogroupconsulting.fr

www.eurogroupconsulting.fr