MiFID II/MiFIR most remarkable change related to market infrastructures. July 2014.

The new Directive on Markets in Financial Instruments (hereinafter MiFID II) and the Regulation on Markets in Financial Instruments and amending Regulation 648/2012 (hereinafter MiFIR) have been published in the Official Journal of the European Union on the 12 of June. Over three and a half years after the publication of the first draft (October 2011), a political agreement was reached on a compromise text that was approved in the European Parliament on the 15 of April. Member States shall adopt and publish within two years the laws, regulations and administrative provisions necessary to comply with MiFID II/MiFIR that, in general, will be applied from January 2017 while some provisions will be applied immediately after their entry into force and others from January 2019. ESMA has published, on the 22 of May, a public consultation on the technical advice to be provided to the European Commission (hereinafter EC), according to the formal request of the 23 of April, on the possible content of the delegated acts that the EC should adopt on several aspects of the new provisions; the advice does not determine the final EC legislative option. ESMA has published on the same date a discussion paper on innovative or technically complex issues included in MiFID II/MiFIR for drafting the different regulatory and implementing technical standards that will be submitted to public consultations later on. (A summary of both consultation papers is available in the appropriate sections of this Bulletin and in the website of the CNMV).

The most relevant aspects of the new provisions on market structures are:

1. New market structures framework with the aim of promoting competition between trading venues.

2. Increased transparency requirements for a broader range of asset classes and the investment firms´s trading obligation for shares and derivatives.

3**. First time regulation of the high frequency algorithmic trading technique and of the direct electronic access**, together with the specification of the requirements for operating in the market using these techniques.

4. Publication of data and access: description of the requirements of Consolidated Tape Provider (CTP), Approved Publication Arrangement (APA) and Approved Reporting Mechanism (ARM).

5. Access to Central Counterparties, trading venues and benchmarks.

6. More organizational requirements for trading venues.

7. New supervisory tools on commodities derivatives, including position limits.

These aspects of the new MiFID II/MiFIR are developed with a bit more detail below:

1. New market structures framework.

MiFID II/MiFIR introduce a new type of trading venue called Organised Trading Facility (OTF). It is defined as a multilateral system, which is not a regulated market or a Multilateral Trading Facility (MTF) and in which multiple third-party buying and selling interest in bonds, structure finance products, allowances (CO2) or derivatives are able to interact in the system in a way that results in a contract. OTFs aim to capture non-equity instruments trading that is currently taking place OTC.

MiFID II/MiFIR regulate SME growth markets. Managers of an MTF may apply to have the MTF registered as an SME growth market if at least 50% of issuers whose financial instruments are admitted to trading on the MTF are SMEs at the registration date and after. ESMA proposes for the SME growth markets a more flexible application of legislation on prospectuses, market abuse and transparency that, at the same time, enables a degree of regulation that ensures an European quality label for this market.

Systematic internalisers regime is also strengthened in order to increase its trading volume and are subject to transparency rules for equities and equity-like instruments and non-equity instruments similar to those applicable to trading venues. The new systematic internaliser definition includes quantitative criteria for assessing when the dealings on own account executing client orders outside trading venues is done on an organised, frequent, systematic and substantial basis.

2. Increased transparency requirements for a broader range of asset classes and the investment firms´s trading obligation for shares and derivatives.

.- Pre and post trade transparency requirements for equities and instruments similar to equities.

The new dispositions extend pre transparency requirements to instruments similar to equities, understood as depositary receipts, ETFs, certificates and other similar financial instruments so as to actionable indication of interests.

The changes are not substantial although some exemptions are modified. The exemption on transactions which are large in scale compared with normal market size, according to ESMA, will continue to be based on the average daily turnover (ADT), the number of ADT types will be extended from 5 to 8 and the threshold will be modified. A rise in the threshold would reduce the number of operations that can benefit from the waiver and viceversa. Other exemptions will be subject to two cumulative limits (double volume cap): i. a trading carried out under those waivers on a single trading venue is limited to 4% of the total volume of trading on all trading venues across the EU over the previous 12 months, and ii. overall EU trading in a financial instrument carried out under those waivers shall be limited to 8% of the total volume of trading an all trading venues across the EU in the same period of time.

Regarding post-trade transparency requirements, ESMA raises key issues to be taken into consideration in the developing of MiFID II/MiFIR: what should be the information to be published, if that information could include flags indicating to the market that the trade published was executed under any pre trade waiver, and some new proposals for the deferral publication for Large In Scale transactions.

.- Pre-and post-trade transparency requirements for non-equity instruments

MiFID II/MIFIR introduce a very substantial change by requiring the application of a minimum level of transparency requirements to non-equity instruments, understood as bonds structured finance products, emission allowances and derivatives. ESMA understands that it is important to define when an instrument is liquid or not when deciding what transparency regime should be applied and, to this effect, ESMA proposes definitions of liquid instruments and liquid markets, and describes various options to define the transparency regime applicable depending on types of assets or on a more detailed instrument by instrument basis.

.- Trading obligation for shares and derivatives

As it has already been said, MiFID II/MIFIR aim to reduce the volume of OTC trading. For this, MiFIR establishes the trading obligation for shares already admitted to trading on a regulated market shall take place on a regulated market, MTF or systematic internalisers. MiFIR establishes the same obligation to trade derivatives on regulated markets, MTFs or OTFs for the class of derivatives that has been declared subject to the trading obligation according with the procedures set out in MiFIR. ESMA asks what would be the appropriate exceptions to this obligation and methods for identifying the categories of derivatives that should be subject to the trading obligation.

3. First time regulation of the high frequency algorithmic trading technique and of the direct electronic access.

Algorithmic trading means trading in financial instruments where a computer algorithm automatically determines individual parameters of orders (such as whether to initiate the order, the timing, price or quantity of the order or how to manage the order after its submission), with limited or no human intervention. The high-frequency algorithmic trading technique is an algorithmic trading technique characterised by: a) infrastructure intended to minimize network latencies and other types of latencies, including at least one of the following facilities for algorithmic order entry: co-location, proximity hosting or high-speed direct electronic access; b) system-determination or order initiation, generation, routing or execution without human intervention; c) high message intraday rates which constitute orders, quotes or cancellations. To concrete these characteristics ESMA proposes two possible options:

1. requires the following requirements to be met: (i) there is an infrastructure intended to minimize network and other types of latencies when the server providing messages with algorithms is directly proximate to the trading venue´s machine engine, and a high bandwidth is used compared to the standard access offered by the respective trading venue; and (ii) the participant/member has a "high message intraday rates" when at least 2 messages per second are submitted to the trading venue over the trading day.
2. could establish as a proxy to assess the "high frequency nature of the message intraday rate" the daily lifetime of orders (having been modified or cancelled) and, when the median daily lifetime of the orders of the member/participant is shorter than the median daily lifetime of orders in a given trading venues, that member/participant should be considered as High Frequency Trader (HFT).

The direct electronic access (DEA) is an arrangement where a member/participant/client of a trading venue permits a person to use its trading code so the person can electronically transmit orders relating to financial instrument directly to the trading venue. The DEA is different from the electronic market access through a website, a mobile application or a software vendor. ESMA proposes if the DEA is compatible with algorithmic trading techniques.

4. Publication of data and access.

The Consolidated Tape Providers (CTPs) are the persons who collect reports for certain financial instruments from regulated markets, MTFs, OTFs and APAs and consolidate them into a continuous electronic live data stream providing price and volume data per financial instrument. The Approved Publication Arrangements (APAs) sign agreements for the publication of trade reports on behalf of the investment firms. The Approved Reporting Mechanisms (ARMs) offer the service of reporting details of transactions to competent authorities or ESMA on behalf of investment firms. CTPs, APAs and ARMs are subject to authorization that shall be granted if they meet the organisational requirements applicable to each case. MiFID II describes the minimum content of the information to be supplied by PICs, APAs and SIAs respectively. Investment firms could provide those services if the competent authority verifies that they comply with the requirements contained in MiFID II and the given authorisation includes the service.

To determine what is a “reasonable commercial basis” in the context of the data publication services, ESMA proposes three options: a) the supplier sets prices to be fair, reasonable and non-discriminatory published in price lists alongside with other key metrics; b) it may be considered imposing certain high-level limits; c) prices do not recover more than the Long Run Incremental Costs (LRIC). The information shall be made available free of charge 15 minutes after publication. Data should be distributed in a disaggregated form so that final users are allowed to buy only data they need.

5. Access to Central Counterparties (CCPs), trading venues and benchmarks.

MiFIR establishes: a) all trading venues non-discriminatory access to CCPs so as to ensure that the trading venues have the right to non-discriminatory treatment of contracts traded on them in terms of collateral requirements and netting of economically equivalent contracts and cross-margining with correlated contracts; b) all CCPs non-discriminatory access to a trading venue who shall provide trade feeds on a non-discriminatory and transparent basis, including as regards fees related to access, upon request, to any CCP that wishes to clear transactions in financial instruments that are concluded on that trading venue; c) non-discriminatory access to benchmarks given by a person with proprietary rights on the benchmarks so that it is guaranteed that CCPs and trading venues have access to relevant price and data fees and information on the composition, methodology and pricing of that benchmark for the purposes of trading and clearing.

ESMA proposes to concrete the reasons to deny access to CCPs and trading venues and a risk-based approach is proposed focusing on how grating access would create risks that could not be mitigated. For CCPs, for example, the anticipated volume of transactions and the number and type of users exceeds the capacity of the CCP, the cost of ensuring access would threaten the viability of the CCP or conflicts of law may threaten the ability of CCPs to enforce their rules. Derivatives trading venues may avail themselves of a 30 month period during which they might not be subject to the access provisions provided that the notional amount traded during the preceding year fall below 1 billion euros. ESMA proposes that competent authorities could deny access when CCPs or trading venues are at the risk of not meeting its legal obligations or there is a risk of liquidity fragmentation. ESMA should specify what information must benchmarks provide to CCPs and trading venues on methodology, composition and administration of the index, and if this information is also available to members, participants or users.

6. More organizational requirements for trading venues.

MiFID II requires regulated markets to have in place effective systems, procedures and arrangements to ensure that its trading systems are resilient, have sufficient capacity to deal with peak order and message volumes, are able to ensure orderly trading under conditions of severe market stress and are subject to effective business continuity arrangements to ensure continuity of its services if there is any failure of its trading systems. Regulated markets will adopt tick size regimes in shares and instrument similar to shares. ESMA discusses how to set up the tick size regime adjusted to the liquidity level of shares and other instruments similar to shares that enables a high level of liquidity quality.

Trading venues should adjust their systems and controls to algorithmic trading. ESMA proposes to adopt similar requirements to those described in the Guidelines on systems and controls in an automated trading environment for trading platforms, investment firms and competent authorities (February 2012). ESMA should determine the maximum ratio "order-to-trade", that is, the maximum ratio of unexecuted orders to transactions that may be entered in the system. ESMA proposes that the OTR ratio is x times the average OTR of the market participants and that should be reviewed annually.

7. New supervisory tools on commodities derivatives.

MiFID II/MiFIR include as a financial instrument the commodities derivatives which can be physically settled and are traded on trading venues with the exception of those whose underlying are natural gas or electricity that are subject to their own legislation.

MiFID II gives competent authorities powers to intervene at any stage in trading activity if there is a threat to the integrity or orderly functioning of the market. Trading venues will be required by the authorities to: a) adopt suitable, transparent and non-discriminatory position management controls for a better supervision; b) request, if necessary, holders to reduce or terminate their positions; or c) provide liquidity back to the market. MiFID II appoints that competent authorities shall establish and apply position limits on the size of a net position which a person can hold at all time in commodity derivatives traded on trading venues and economically equivalent OTC contracts. ESMA has the task of developing the methodology for calculating the limits and will be responsible for monitoring their implementation thereof by the competent authorities. In addition to other positions reporting obligations, a complete breakdown of the positions held by members/participants/clients will be provided at least daily by investment firms or the governing bodies of trading venues to the competent authority.

MiFIR assigns ESMA position management powers when there is a threat to the orderly functioning and integrity of financial markets and a competent authority have not taken measures to address the threat or the measures taken do not sufficiently address the threat. ESMA could: a) request from any person all relevant information regarding t the size and purpose of a position or exposure; b) require that person to reduce the size or to eliminate the position or exposure; c) as a last resort, limit the ability of a person from entering into a commodity derivative.

If you want to read the MiFID, please, click on: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:JOL_2014_173_R_0009&from=EN

If you want to read the Spanish version of MiFID, please, click on: http://eur-lex.europa.eu/legal-content/ES/TXT/PDF/?uri=OJ:JOL_2014_173_R_0009&from=EN

If you want to read the MiFIR, please, click on: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:JOL_2014_173_R_0005&from=EN

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If you want to read ESMA consultation paper, please, click on: http://www.esma.europa.eu/system/files/2014-549_-_consultation_paper_mifid_ii_-_mifir.pdf

If you want to read the ESMA discussion paper, please, click on: http://www.esma.europa.eu/system/files/2014-548_discussion_paper_mifid-mifir.pdf

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