MIFID II/MIFIR DELEGATED ACTS

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The European Commission has published three Delegated Regulations on MiFIR and MiFID II. This article explores the European Commission's latest Delegated Regulations on MIFIR and MiFID II, examining what these developments will mean for the UK.

What are the key provisions contained in the Delegated Acts that would have the biggest impact on the way UK financial institutions organise their business?

Three Delegated Acts have been published: a draft **MiFID II Delegated Regulation**; a draft **MiFID II Delegated Directive**; and a draft **MiFIR Delegated Regulation**.

The Delegated Acts are only a part of the overall rule-making jigsaw and many of the requirements set out in them, while very significant changes in member states other than the UK, will essentially codify UK Financial Conduct Authority (FCA) requirements as EU-wide requirements. Good examples of this are the safeguarding of client financial instruments requirements (**Chapter II**) and the product governance requirements (**Chapter III**) of the **MiFID II Delegated Directive** which closely mirror FCA client assets rules and new product/product governance requirements.

However, some of the Delegated Acts' requirements will mean significant changes. In particular, the inducements rules are becoming even tighter than under the current rules and the detail of these is set out in the **MiFID Delegated Directive**. **Article 11** requires Member states to pass laws requiring investment firms (including UCITS managers and AIFMs) who pay, or are paid, any "fee or commission" or are provided with "any non-monetary benefit" connected with the provision of MiFID investment or ancillary services to meet restrictive requirements in relation to such fees or benefits.

Generally, such fees or benefits will only be permitted where they "enhance the quality of the relevant service" and **Article 11 (2)** sets out quite a narrow interpretation of the sorts of benefits which provide such an enhancement. There must be an ongoing benefit to the relevant client where fees or benefits are ongoing.

There are specific provisions for certain arrangements to be permitted but usually associated with significant record keeping and organisational requirements. For example, it will be permissible to pay for research but **Article 13** only permits this where the investment firm either pays this direct from its own resources or from a separately created research payment account ("RPA") which it controls.

Among the obligations when running an RPA are obligations to fund this through a specific research charge to the client, to regularly assess the quality of the research provided and to set a research budget and regularly assess this. The total of any research charged to clients annually cannot exceed the budget for the RPA and a range of disclosures about the research must be made to investors and/or clients. Most fund managers see these requirements as so deeply unappealing that it is thought that RPAs will become unattractive.

These provisions may well prove to be another nail in the coffin for research analysts at investment banks. They also have significant effects on the business models of fund managers and the research departments of the sell side.

Other key requirements have a bigger impact on trading. The **MiFIR Delegated Regulation** is particularly relevant here, and it is worth highlighting key provisions in three areas.

Firstly, **Articles 1 to 5** set the definitions of "a liquid market" for equity and equity-like instruments. For equities, this is where the free float of the share is not less than EUR 100 million where traded on a regulated market and EUR 200 million where traded only on an MTF plus average daily transactions of less than EUR 250 million and average daily turnover of not less than EUR 1 million shares.

Secondly, in **Articles 12 to 16**, obligations for systematic internalisers are fleshed out including their data publication obligations, what amounts to exceptional market conditions, when they can suspend quotes and what constitutes "orders considerably exceeding the norm".

Finally, **Articles 19 to 21** set out the criteria to be taken into consideration by ESMA, EBA and competent authorities when exercising the MiFIR product intervention powers. The criteria are so broad as to give the authorities a very wide discretion to intervene.

Most investment firms will have to reorganise parts of their business in the light of the major changes to how firms will interact in financial markets, particularly through MTFs and the new concept of the OTF. Larger firms in particular may find that they are a systematic internaliser in certain financial instruments and will have to ensure, for example, that they separate any systematic internaliser business from any business run as an OTF.

What changes are made to the way firms provide investment services to clients, including any changes to suitability and appropriateness requirements?

The **MiFID II Delegated Regulation** (**Articles 54** to **58**) sets out the requirements relating to suitability and appropriateness requirements and suitable client agreements. While these requirements are significantly greater than set out in the current MiFID they broadly mirror the current expectations of the FCA which essentially goes further than MiFID in COBS. UK firms should not find them difficult to comply with.

The most significant change in this context is the definition of "non-complex instruments" in **Article 57**, which puts into EU law formally the definition previously devised by ESMA some time ago, and which means that many instruments which in the UK might have been considered as non-complex will have to be considered as complex in the future.

How do the Delegated Acts propose to address derivative contracts?

There are a range of provisions which address derivatives contracts. In particular, **Articles 5** to **8** of the **MiFID II Delegated Regulation** contain more detailed definitions of a variety of physically settled or derivatives contracts which previously were only briefly described in Annex I of current MiFID. These provisions should considerably assist in analysing whether a particular derivative contract falls within MiFID or outside of its scope. Where the derivative is energy-related it should also assist in relation to the legal interface with REMIT.

In addition, **Article 15** includes a definition of who will be a systematic internaliser with regard to derivatives contracts of a specific class. The SI will have to carry out on its own account 2.5% or more of the total number of transactions in the relevant class of derivatives executed in the EU on any trading venue or OTC during the prescribed period for calculation. The OTC transactions it undertakes will have to take place on average once a week.

The **MiFIR Delegated Regulation** also sets out more detailed requirements on portfolio compression to supplement **Article 31** of **MiFIR** including the information which must be made public for each portfolio compression cycle (**Articles 17** and **18**).

What practical steps should firms be taking to implement the Delegated Acts into their policies, procedures and systems?

At this stage the legislation has not been finalised - although it is not expected to change much. The general expectation is that it will be finalised by the end of this year. Firms should already be analysing the Delegated Acts for their impact on their business model and how they interact with the RTSs and the primary MiFID II and MiFIR laws.

It is easier to start work on some requirements than others. The market structure requirements are often dependent on what is put in place by third parties (such as exchanges and MTFs), or by the regulators themselves e.g. regarding calculating your percentage share in the EU market in a particular financial instrument. Some areas which are more focused on internal policies and on information to be provided to clients are more within the control of the individual firms and where it is clearer what is required these are issues where work could be begun.

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