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#1 MiFID Briefing Series

The MiFID II Review

A detailed analysis for banks and investment firms

Introduction

In 2007 MiFID was a major step in the creation of the architecture to deliver a harmonised regime for the conduct of securities business throughout the EU. It built upon previous directives, but also made some significant changes in direction – not least attempting to use maximum harmonisation measures to create a single rule book, and giving predominance to home state rules when conducting cross border business. Inevitably, a project as high profile and ambitious as MiFID failed to achieve all of its objectives. Indeed, it was clear from the political compromises that were necessary to agree the original draft that more work would be needed in order to try to complete the project. MiFID II was therefore conceived before MiFID had been born. MiFID II has proved just as technically challenging, just as controversial, and just as time consuming as MiFID did first time round. The level one measures are an attempt to take the MiFID project into new areas: non-equity market transparency; regulatory product intervention powers; and high frequency trading controls being some of the more important. But just like MiFID, MiFID II contains its own idiosyncrasies, and firms will need to figure out which aspects affect their particular business as they may not be identical to the impact upon their competitors.

This guide considers 5 main aspects of MiFID. First, it considers the impacts on markets – how they are structured, and how they are to be regulated. Second, it looks at the impact upon consumers, in particular consumer protection rules and the powers of regulators to enforce them. Third, it looks at products – which products will be caught by MiFID for the first time and how MiFID will distinguish between products that are available for a mass market and those that should have a more specialist audience. Regulators powers of product intervention are also considered. Fourth, it looks at the impact on regulators themselves. What new obligations will fall on them, and how does MiFID contemplate that they will behave? Fifth, it looks upon the impact of MiFID on the internal workings of firms – how they are set up, how they are structured, and what governance arrangements they need.

Finally, conclusions are drawn as to what we think firms will need to consider doing and when these things should be done. If you have any questions or would like to discuss this briefing in more detail please contact a member of the regulatory team, listed below, or your usual Ashurst contact.

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1. Markets

1.1. OTFs

An OTF is defined as a "multilateral system in which multiple third-party buying and selling interests interact" (article 2(7) MiFIR). Importantly, the definition does not apply to equities. This definition is very broad – it is difficult for many banks to say that they operate without a system. And any system that brings together potentially multiple buyers and sellers is caught by the definition. But it is essentially aimed at dark pools of liquidity and broker crossing networks (MiFIR recital 5(A)). It must be hoped that the interpretation of this definition is sensible to avoid other structures being caught.

OTFs are not permitted to undertake any proprietary interaction (except for sovereign debt instruments for which there is not a liquid market) – the counterparties for every client transaction must be another third party (MiFID article 20). This could be an entity within the same corporate group as the investment firm or market operator of the OTF. At the moment, many dark pools will also include an element of proprietary trading, often in order to ensure that unmatched lots are transacted, with the firm taking on the risk and then, at a later date, offsetting it. Equally, an OTF cannot also be a Systematic Internaliser, and trades between those market types cannot interact. Therefore, there will be a clear distinction between OTFs and Systematic Internalisers, and it is likely that the key distinction will be (given the otherwise similar definition) the ability of proprietary trading to be undertaken by a Systematic Internaliser. Indeed, it is possible that some dark pools will attempt to limit the impact of the "no proprietary trading" rule by migrating to Systematic Internaliser status instead of becoming an OTF.

Investment firms and market operators which operate OTFs are subject to organisational requirements (MiFID Article 16) and trading process requirements (MiFID Article 18). However, MiFID Article 20 also sets out a number of specific OTF requirements. In particular, an OTF is required to execute orders on a discretionary basis, but only (a) when deciding to place or retract an order on the OTF it operates and (b) when deciding not to match a specific client order with other orders available in the system at a given time (providing to do so is in line with client's instructions and with the OTF's best execution obligations under MiFID Article 27). The OTF is permitted to operate on a matched principal basis in relation to trading in bonds, structured finance products, emission allowances and certain derivatives where the client has consented. However, the OTF is not permitted to use matched principal trading in relation to derivatives that are subject to the EMIR clearing obligation The competent authority can request a detailed explanation of why the OTF is not a regulated market, MTF or systematic internaliser, how discretion will be exercised, and the OTF's use of matched principal trading.

The OTF definition does not apply to equities, and OTFs are not permitted to undertake any proprietary trading.

1.2. Tick Size Regime

Regulated markets will be required to introduce tick size regimes in accordance with further guidance to be issued by ESMA (MiFID article 51(A)). The regime will apply to shares, depository receipts, exchange-traded funds, certificates and other similar financial instruments for which regulatory technical standards are developed. ESMA is to develop such standards to set out what the minimum tick sizes should be. The aim is, presumably, to discourage higher volumes of marginal trading by ensuring that only transactions with more than highly marginal pricing differentials is undertaken.

1.3. High Frequency Trading

MiFID II requires anyone undertaking high frequency trading to be regulated. They cannot, as would be the case at the moment in the UK, undertake this business on the basis of an exemption that they are not holding themselves out as a dealer in the relevant instruments (MiFID article 2(d)(iia)). Two definitions are used: (i) algorithmic trading, which involves a computer algorithm determining when orders are to be sent, and (ii) high frequency algorithmic trading, which is algorithmic trading characterised by an attempt to minimise latency (i.e. speed) (MiFID article 4(30)(30a)). Algorithmic traders must notify the fact that they are trading in this way to both the Home Member State and the state in which the relevant trading venue(s) is/are located. This notification must include a description of the strategy. This will appear a most unusual development for those currently engaged in high frequency trading, where the proprietary rights around the algorithm are considered paramount.

If the nature of the trading involves high frequency buying and selling in similar time periods of the same instrument there is a requirement that it actually be carried out as a market maker and subject to a formal agreement to do so with the relevant exchange. The key part of the definition that produces this requirement is that the simultaneous quoting of comparable sizes and competitive prices "results [in] providing liquidity on a regular and frequent basis to the overall market". It may be that high frequency trading techniques will need to evolve in order to minimise the chances of this requirement being triggered.

Investment firms that allow high frequency traders to access exchanges using their facilities are also required to notify both the Home Member State and the Member State in which the relevant market is based. Regulated markets, MTFs and OTFs must monitor for orders that might be withdrawn (which is sometimes seen as a characteristic of high frequency trading) (MiFID article 31(1)) and can choose to levy higher charges on businesses that subsequently prove to have a relatively high degree of order withdrawal (MiFID Article 51(5)).

1.4. Co-location

MiFID required co-location facilities (i.e. allowing closely proximate access to markets by allowing investment firms to hire space to store facilities to improve the speed with which orders are handled) to be undertaken on a non-discriminatory, fair, and transparent basis (MiFID Recital 46). The risks that are described in this Recital (overloading the system due to large volumes of orders, potentially duplicative or malfunctioning orders) do not actually appear to be relevant to the requirement for non-discriminatory, fair and transparent access, which appears much more to be a commercial factor. It appears that regulators believe that some businesses are unduly advantaged because of their buying power by being able to obtain preferential location. However, it is difficult to see that as anything other than a result of the way that capitalism works – those who can afford better facilities are likely to get more client business. Also, requiring regulated markets to provide co-location facilities in a particular way might only increase the possibility that other businesses located next door to regulated markets would do so if the regulated markets do not. There is, potentially, a "doughnut effect" at play: those surrounding the regulated market might be in a position to extract the unusual rents available for co-location facilities.

1.5. Market Data Services

MiFID introduces 3 new types of regulated activity related to market data. These are defined in Annex 1, Section D.

First, Approved Publication Arrangements (**APA**s), the means by which firms make information public.

Second, Approved Reporting Mechanisms (**ARM**s), the means by which trades are reported.

Third, a Consolidated Tape Provider (**CTP**), a party that provides streamed data enabling market participants to follow trading as it gets reported. Whilst APAs and ARMs already exist, CTPs are new. Intriguingly, the Directive says that they will appear either through a commercial or, if the industry fails to respond, a public procurement method (see Recital 78 MiFID). The emphasis is on a version for the equity market first, with non-equity markets to follow at a later date.

MiFID seemingly takes tentative steps to re-introduce a concentration rule, with a vague exemption for certain professional trading.

1.6. Concentration Rule

One of the most significant impacts, in some jurisdictions, of MiFID was the abolition of the concentration rule. That meant that trading did not have to occur on a monopoly national market. MiFID seemingly makes tentative steps to re-introduce a type of concentration rule, presumably against the backdrop of concerns that data relating to trading is fragmented when numerous markets and trading possibilities exist. Recital 9(A) and Article 20(C) of MiFIR contain this provision, which states that trading by investment firms should be undertaken on a market (RM, MTF, OTF) where possible, although there is an exemption for "professional trading that does not contribute to price discovery". This is a surprising position, and it is tempting to assume that one has misread it. Surely the intention cannot be to reintroduce a concentration rule for all retail business, nor can it be to narrowly define categories of professional trading that must be undertaken on a national market. That is, however, what the provision says and firms will wait anxiously to see what, in fact, this provision is taken as meaning.

1.7. Pre- and Post-trade Transparency

One of the most important aspects of the initial conception of the MiFID II project was to extend the MiFIR pre- and post-trade transparency requirements in equity markets to non-equity markets. MiFIR takes this project forwards. It extends these requirements for equity-like instruments (e.g. depository receipts), bonds, derivatives, structured finance products and emissions allowances (Recital 10, Articles 3, 5, 7, 9 and 20, MiFIR). These changes are likely to have fundamental impacts on markets that do not currently operate in a transparent environment, and firms, along with industry associations, will need to evolve an approach to meet these important new obligations.

1.8. Volume Caps for Transparency Waivers

MiFID currently contains an important exemption from the obligation that falls on firms and markets to provide pre-trade transparency. Two examples are the reference price waiver (where no transparency is required if the price is taken from another market, such as a mid-point price) and negotiated trades (where it is thought that direct negotiations between parties leading to a bilateral transaction do not need to be subject to pre-trade transparency). Many MTFs operate in a dark environment on the basis of these exemptions. There was a disagreement between the various parties putting together the MiFID II project as to whether or not maintaining these waivers was a good or bad idea. The outcome is a classic compromise. The waivers remain, but with limits. (MiFIR, Recital 14(A), Article 4(A)(3)). These limits are: 4 per cent for any one firm; and 8 per cent within an overall market. ESMA is to give further guidance on how to calculate and operate these limits. However, there is already an intriguing "game theory" possibility for lessor market participants. Let us assume that a market currently has 3 dominant providers who all use a reference price waiver. They amount to 2.5 per cent of the trading volume each. One other minor market participant amounts to 0.1 per cent of the overall trading. The market is therefore operating below the firm and overall market limits. However, if the fourth market participant can increase their share of the overall market so that the 8 per cent limit is breached, then the ability of its key competitors to rely upon the exemption is automatically suspended, as is everyone else's. Equally, the dominant market players have a vested interest in keeping the overall amount of the market which is served by reference price waivers (for example) below 8 per cent. It is very unusual that an ability to suspend an exemption is based upon the behaviour of participants in the market rather than the views of regulators.

1.9. Systematic Internalisers

The Systematic Internaliser definition was, in some markets (including the UK), one of the most controversial parts of the original MiFID project. Put simply, if a firm traded equities in an organised, frequent and systematic way above a defined standard market size then it was required to provide pre-trade transparency – in other words, to operate as a quasi-market maker. The UK, in particular, interpreted this requirement narrowly and said that it only applied to firms who committed capital to transactions that fell below standard market size. This would not necessarily be common, as those transactions could usually be done risk free if firms wanted to avoid the pre-trade transparency obligation.

The definition has been somewhat changed. Trading now also has to be undertaken on a "substantial" basis – whatever difference that might make. Presumably, it would give a firm who undertakes the trading frequently but insubstantially the chance to say it had fell outside the definition, although we cannot see that this would be common. ESMA has also been asked to give more guidance on what "frequent", "systematic", and "substantial" mean in the context of the Systematic Internaliser definition.

Systematic Internalisers are now going to be required to bid in a minimum quote size. Previously, they could bid for one share if they wanted to, which made a mockery of the Systematic Internaliser system. In addition, they now need to place both bid and offer prices, and the previous ability to offer one-way prices again made something of a mockery of the original system (MiFIR Article 13).

Finally, the products subject to the Systematic Internaliser regime have been extended to bonds, derivatives, structure finance products and emissions allowances, and therefore these markets are likely to undergo the agonizing that occurred in the equity markets prior to the introduction of the Systematic Internaliser definition in MiFID I.

The reference price and negotiated trade waivers survive, but with caps for both firms and the market that are susceptible to gaming.

2. Consumers

2.1. Client Definitions

One minor breakthrough achieved by MiFID was to harmonise the definitions applying to different categories of client throughout the EU. MiFID II makes some changes to the definitions.

First, all local authorities (presumably including, for example, their pension funds) are to be considered as Retail Clients (see MiFID Recital 67). This is quite a transformation from their current Eligible Counterparty status. It reflects both a general view that local authorities may not be as sophisticated as the Eligible Counterparty definition would suggest, and a political view in some Member States that they require the highest degree of protection given some local scandals involving municipalities.

MiFID now makes clear that Eligible Counterparties are clients. There had been some differences of view as to how two market participants who transacted on a Regulated Market should treat each other. Are they, in fact, not dealing with a "customer" at all, and therefore there is no need to classify anyone? Or does another regulated firm amount to a client of some description, albeit Eligible Counterparty? This Recital (66) does not make it entirely clear, but may re-open debate on the correct treatment of business between counterparties who are trading on a market.

MiFID contains a definition of "independent" for advisers to use, and a ban on payments from product producers to advisers.

Finally, firms are told they must have contracts in place with clients. At the moment, the only formal requirement to do so is with Retail Clients. In practice, Professional Client relationships are also documented in order to meet certain other disclosure requirements, and because it makes sense legally to do so. However, if Eligible Counterparties are clients, and firms must have contracts in place with clients, then it would certainly be new, and highly problematic, to expect Eligible Counterparties to put terms of business in place with each other. That is certainly not the basis upon which they currently undertake business, where the rules are normally governed by underwritten standard market practice.

2.2. The Distribution of Retail Products (in the UK, RDR)

MiFID adopts a measure similar to that in the UK which is known as the Retail Distribution Review (and there are other well-known local examples in different jurisdictions in the EU). In short, the MiFID rules (Recital 52, Article 24(4)) contain the following requirements. First, for an adviser to call themselves independent, they must advise on a "sufficiently diverse range" of products. That appears to be a more generous or definition than that currently used in the UK, where an independent adviser must, in effect, be able to advise on the whole range of financial products, excepting only those riskiest products that may not be suitable for the type of customer with whom the adviser contemplates dealing. Second, payments by product providers to advisers are banned. That suggests that customers should pay for the advice that they receive. These measures have some similarities, but are probably not identical, to any of the existing European regimes. As such, gold-plating is permitted explicitly (Article 24(4)(a)). This will help national regulators to maintain existing regimes where they are necessary. Therefore, where an existing RDR-like regime already is in place (such as the UK), these measures are unlikely to make much difference on the ground, but they will have the effect of introducing similar regimes (albeit seemly on a more principle-led basis than on the extreme guidance approach taken in the UK) in other Member States.

2.3. Suitability

Under MiFID, when a firm provides advice or discretionary management services it needs to get sufficient information from its customer to be able to demonstrate the suitability of the advice it is providing. MiFID II makes some minor changes to this regime. It appears to contemplate particular types of information that might need to be obtained in order to show the client's risk appetite as well as their ability to bear loss (see Article 25). New client information forms may need to be amended with this in mind.

2.4. Best Execution

MiFID introduced a comprehensive best execution regime. MiFID II builds upon it. First, it requires markets to publish information on the quality of the execution provided by their market. Second, firms that use markets are going to be required to publish annually information on the top five venues that they used, to compare it with the information which is made available by different execution markets generally. In other words, why did the firm choose the five markets that it chose? Is it going to continue with those markets in the future?

2.5. Telephone Records

MiFID does not change the regime that applies to decide when telephone records must be kept. However, it does require firms to make those records available to the clients for the first time. At the moment, clients can request information under data protection legislation, but this rarely permits them access to all of the information that will be contained on tapes. Firms will need to consider the impact this might have on their ability to manage consumer complaints or Ombudsman processes in the future. (MiFID, Recital 42 and Article 16(7)).

3. Products

3.1. Structured deposits and complex products

Structured deposits will be caught by MiFID (Article 4(34) contains the definition). A structured deposit must (i) be a deposit and(ii) involve the payment of interest according to a formula. Examples are given of a formula that relates to an index, a commodity, or foreign exchange rates. This means that structured products will not only be caught by the capital requirements that apply to banking products but also the financial promotion and suitability requirements of MiFID.

MiFID contains a curious comment on balance sheet issuance (MiFID, Recital 30, Article 4(2)(4)). Balance sheet issuance is said to count as execution of orders on behalf of clients. That means that whenever a firm issues a product from its own balance sheet it cannot treat the client as an execution-only client (at least not in the commonly understood sense of this phrase). When firms execute orders on behalf of clients, they owe obligations to those clients, such as best execution. Quite how best execution can apply to a product issued from the balance sheet of a bank to investors who have, presumably, decided that they want the product at that price is not clear. More thought will need to go into the precise implications of this proposal before they can be fully assessed.

MiFID maintains the important distinction between complex and non-complex products. Complex products can only be sold on an advised or discretionary basis, or following an appropriateness assessment. MiFID makes certain structured deposits complex for this purpose, meaning that they can no longer be sold on an execution only basis. A structured deposit will be complex if it is "difficult for clients to understand the risk of return or the costs of exiting" (MiFID Article 25(3)(a)(v)). In addition, structured UCITS, and all non-UCITS funds will, by definition, be complex (MiFID Article 25 (3)(a)(v)).

Structured products will be caught, and they may be treated as complex if it is difficult for clients to understand the risks or costs.

3.2. Product Governance

MiFID introduces a new Europe-wide product governance regime for the manufacturers of products (MiFID, Recital 51(a), Articles 16(3) and (24)(1)). This regime will look (possibly painfully) familiar to UK-regulated firms. It contains the following key elements:

- Firms must have a process for approving products based upon the identified needs of the specified target audience. This may often be more complex than it at first glance appears. If the firm manufacturing a product does not itself have a distribution arm it can be difficult to assess the needs of clients; only those who interact with clients are likely to have a clear view on this. Identifying a specific target market requires an understanding of what clients actually need, rather than what they will buy, which has often been seen as the true test of whether or not there is demand for a product.
- The relevant risks of a product must be assessed, and the distribution strategy used by the manufacturer must be consistent with those risks and the identified target market. In other words, what sort of clients should, and should not, be buying this product? What is the outlook on life of an investor who wants to buy a complex structured product which will kick him out if markets rise too quickly, and put his capital at risk if they fall too quickly? Firms will need to "join the dots" between the type of product that they want to sell, the type of investor who they think might buy it, the needs and wants of those investors, and the risks inherent in the product before deciding upon the best route to market.
- Manufacturers will be required to provide distributors with sufficient information, including on the manufacturers' view of the target market, to enable the distributor to carry out their role of successfully distributing the product in

accordance with (presumably) the relevant MiFID suitability and appropriateness criteria.

The adoption of this regime in the UK (and similar regimes in some other member states) in recent years has proved highly problematic, particularly in relation to stress testing products, target market identification and analysing investor's wants and needs. These issues will now be shared throughout the EU.

3.3. Commodity derivatives

MiFID introduces group-wide position limits for commodity derivatives (MiFID Article 59). The stated aim of these limits is to achieve "convergence between prices of derivatives in the delivery month and spot prices". The actual limits are to be agreed between the member state where the largest volume of that commodity derivative is traded, and other member states with "significant volumes". In practice, that is likely to lead to some interesting discussions. Some member states, such as the UK, appear to think that position limits for commodity derivatives are unnecessary, where others, such as France, have pushed them as a crucial part of the post-crisis regulatory change agenda. An ESMA dispute resolution mechanism will apply, see 5.1 below.

3.4. Benchmarks

MiFIR contains new requirements for benchmarks, which are defined as "any rate, index or figure, made available to the public or published that is periodically or regularly determined by the application of a formula to, or on the basis of the value of one or more underlying assets or prices… and by reference to which the amount payable under a financial instrument or the value of a financial instrument is determined" (MiFIR Article 2(24) and Article 30). In other words, benchmark is broadly defined. It is possible that many products will fall within this definition. Benchmarks are required to provide clearing houses and trading venues with relevant price and data feeds, information on the composition, methodology and pricing of the benchmark, and a licence to use it, on a fair, reasonable and non-discriminatory basis within three months of any request to do so by clearing house or trading venues.

As MiFID is often used as the dictionary by other directives, it is possible that this definition will now solidify into that used across a variety of European directives including, potentially, the Benchmarks Directive itself, which contains wide-ranging obligations on those who input into, administer, or use benchmarks.

3.5. Product Intervention

MiFIR gives national regulators extensive powers to intervene in relation to the sale of particular products (MiFIR, Recital 24, Articles 31, 31(a) and 32). These powers will, again, appear familiar to UK-regulated firms. In reality, many European regulators already have equivalent powers and this aspect may add little new. However, ESMA is also being given the power to override the views of national regulators, and is to be required to publish detailed criteria on when it might exercise these rights. Granting ESMA such sweeping powers to act over the heads of national regulators is likely to lead to criticism and, potentially, legal challenge – for example, from the UK, which has previously challenged similar power delegations in relation to short selling.

4. Regulators

We have noted elsewhere in this paper areas where regulators are being given particular powers to intervene in product and commodity markets (see above). We focus here on direct powers being given to regulators to take, or co-ordinate, actions.

4.1. Dispute Mechanism

ESMA has been given amended dispute resolution powers to help it with the specific aspects of MiFID and MiFIR that might prove most controversial. For example, Article 59 of MiFID sets out a dispute mechanism to be used in relation to commodity derivatives. Article 59(2)(d) gives ESMA the power to "settle any dispute arising from a disagreement between competent authorities", i.e. the competent authority where the largest volume of trades takes place and the other competent authorities affected.

Article 59(2)(d) gives ESMA the power to "settle any dispute arising from a disagreement between competent authorities"

4.2. Fines

Regulators are being given increased powers to fine both individuals and firms.

For individuals, the new requirement is that each member state has, at least, a minimum fine of €5m for breaches of the MiFID requirement by individuals. We have started to refer to this as the "minimum maximum"!

The position is the same for firms, but they can also be fined up to 10 per cent of their turnover. For many substantial players in the EU this could be a very significant amount indeed and could dwarf their annual profits. The good news is that in the past, whilst sizeable fines have been levered using the percentage of turnover calculator, they have also generally reflected the conduct involved. Given the size of some of the recent LIBOR fines, this probably does not add much to the powers of regulators in some jurisdictions at the moment.

5. Firms

5.1. Governance

MiFID introduces standard governance criteria for all MiFID firms. In some ways, it is a similar approach to that undertaken in the UK by the PRA and FCA with their recent focus on the responsibilities of boards to run businesses, committees to help them, and elevated priority for risk functions, along with an emphasis on conflicts management.

MiFID Recital 38 contains interesting wording on diversity. Boards of MiFID firms are recommended to be "sufficiently diverse as regards age, gender, geographic provenance and educational and professional background to prevent a variety of views and experiences. Employee representation in management bodies could also, by adding a key perspective and genuine knowledge of the internal workings of firms/institutions, be seen as a positive way of enhancing diversity… [firms should be] encouraged to select candidates from shortlists including both genders".

MiFID contains board diversity measures that say firms should be "encouraged to select candidates from shortlists including both genders".

Management bodies must define, oversee and be accountable for the governance arrangements of a firm, and its prudent (an important word when used by a regulator) management, including the prevention of conflicts of interest. MiFID also adopts the CRD IV limits on directorships so that directors can now only hold a limited number of directorships.

5.2. Payment for order flow banned

MiFID retains a detailed best execution obligation. The revisions to MiFID now add a requirement that firms shall not "receive any remuneration, discount or non-monetary benefit for routing client orders to a particular trading venue or execution venue", and reference is made to the conflicts and inducement rules. This appears to back up the recent approach in the UK of specifically banning payments for order flow between brokers and market makers (MiFID, Article 27(1)(a)).

5.3. Third country branches

The third country regime preserves national discretions and potentially establishes a useful EU-wide relaxation in some areas, but there are also some significant errors in the drafting of the third country measures.

MiFID and MiFIR both contain detailed new rules on the ability of non-EU firms to access EU markets. (They are variously contained in MiFIR Recitals 34 and 36(a) and Articles 36 to 39, and MiFID Articles 41 and 44(a)).

Non EU-firms can provide investment services to eligible counterparties and professional clients without establishing a branch. National private placement regimes continue to apply. However, there is a potential step forward that could standardise and, in many countries, liberalise the approach to conducting business with non-EU firms. MiFIR Article 37 contains an equivalence decision process that would enable third countries to gain better access. Equivalence of the overseas regime is assessed on the following basis:

- Is there an authorisation, supervision and enforcement regime?
- Are firms subject to sufficient capital requirements?
- Are firms subject to internal organisational requirements?
- Are firms subject to appropriate conduct of business rules?
- Are firms subject to anti-market abuse and insider dealing rules?
- Does the relevant third country provide reciprocal access for EU firms?

For many G20 countries, the first five tests should not be problematic – but the last one probably will be. Only if reciprocal access is offered is the equivalence key able to unlock the third country access. And equivalence can mean many different things. The wording of the Directive makes it sound as though an equivalent registration regime is required (as ESMA will keep a register of firms in third countries who have been deemed equivalent and who wish to use this permission). That would be a very narrow reading. Hopefully, a more pragmatic approach will be taken whereby a regime that merely permits third country business to be undertaken without any local registration requirement and on the basis of open access rules, would also be deemed reciprocal.

If a firm is in a country that meets these requirements, it must register with ESMA (and this does not appear to involve any detailed assessment of the merits of the application – merely the provision of information) and, at that point, the third country firm can provide services and conduct business with EU parties with only the following conditions applying:

- The firm must make it clear that it is not based in the EU.
- The firm must submit to the jurisdiction of an EU Court. This might sound problematic for some businesses, but in our view, submission to the jurisdiction of the English Courts would suffice. However we do not think that an English Court would agree, unless there was a very good reason to do so, to hear a case relating to a New York law governed contract entered into with a New York-based bank.

Where the business that is to be undertaken is with retail clients, member states have an option. They can either permit the business to be undertaken on a cross-border basis subject to whatever local requirements might apply, or the country can choose to allow the firm to "opt-in" to the national licensing regime and to establish a branch.

In addition, where a branch has been established, in a significant departure from both the current arrangements and from the entire philosophy behind the granting of passports, such a non-EU branch will be able to get a passport to do business throughout the EU with Eligible Counterparties and Professional Clients on the basis of its authorisation and compliance with the EU branch's home state rules. Third country branches will only be permitted to use this regime where they are authorised in a third country, not in a jurisdiction which would be problematic for FATF purposes, where co-operation arrangements are in place between the regulators, sufficient initial capital is at the disposal of the branch, both countries have signed up to the OECD Model Tax Convention, and the firm belongs to an investor compensation scheme. To take London as an example, some existing branches will almost certainly pass these tests, where some existing branches will almost certainly not.

That raises an interesting question for national treasuries about whether to "turn the key" on this option for branches or not. Branches from countries who would pass the tests would presumably want the option to be turned on – they would then get passports. Branches from countries that would not pass the test would presumably not want the option to be turned on – they would be closed if it were. Hopefully, there may be a route between these two paths. MiFID is not entirely clear on the point, but it might be possible for a member state to say that it will turn on the MiFID passporting optionality for branches that are based in third countries, but still permit local business to be undertaken by branches from countries that would not pass these equivalence tests.

There are some significant errors in the drafting of the third country measures. Article 36(1) of MiFIR omits the words "with or without any ancillary services", which might mean that only core services could be provided from outside the EU, not ancillary services. This would be an absurd result, and hopefully will not be the interpretation. Recital 35 of MiFIR says that the provision of services without branches should be limited to Eligible Counterparties and per se Professional Clients, whereas MiFID clearly says the opposite. We hope that the clear wording of MiFID relating to the ability of third country firms to do business with Retail Clients without establishing a branch prevails.

Finally, MiFID and MiFIR contain an attempt to harmonise the reverse solicitation requirements. These generally look helpful but do not specifically attempt to cater for "above the line" marketing : it is still, unfortunately, not clear whether or not the mere presence of a website would prevent a firm from claiming that business that was subsequently undertaken was done on a reverse solicitation basis. We hope that a more sensible interpretation can be taken and that it must be specific products or services that are marketed before reverse solicitation, in relation to such products or services, becomes impossible.

5.4. EMIR Products

MiFID follows the EMIR agenda and repeats the requirement that EMIR-governed products must be traded on a regulated market (MiFIR Article 24) and cleared through a clearing house (MiFIR Article 25).

Timing and Concluding Thoughts

The MiFID project will involve more than merely dusting down the MiFID I gant charts, but there will still be a feeling of déjà vu for some compliance officers and lawyers.

MiFID and MiFIR are now final (subject only to typographical work). In the summer of 2014, ESMA is expected to put out a consultation (rumours suggest it is already 500 pages long, although how accurate that can be given that the rumours seemed to pre-date the finalisation of MiFID is anyone's guess). There is likely to be considerable drafting and lobbying based upon those proposals before they become firm at some point in 2015. The matter would then pass to national governments to spend mid-2015 to mid-2016 getting ready for national implementation. The rules should be finalised in mid-2016 for "go live" on 1 January 2017 (although very few major measures actually seem to come in on 1 January nowadays, the fear of too many people being away might make 1 February 2017 a more likely deadline).

So firms should expect much of 2014 to be spent analysing and lobbying; 2015 to be spent reading rules and running MiFID implementation projects; and 2016 to be driven by systems and governance changes, and client contact to get ready for implementation date.

The MiFID project is wide ranging and, in some areas, contains major changes to the way that firms and markets work. It will take a major co-ordinated effort between firms, markets, regulators, and national governments to ensure that firms can deliver project plans on time and against a stable new rule book. The MiFID project will involve more than merely dusting down the MiFID I gant charts, but there will still be a feeling of déjà vu for some compliance officers and lawyers.

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