The world of financial instruments is more complex. Time to implement change.

Capital markets reform: MiFID II
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Introduction

The revision of the Markets in Financial Instruments Directive (MiFID II*) represents a fundamental change for the European financial markets across a multitude of areas, requiring not only major implementation effort, but also a re-assessment of business models.

MiFID II represents one of the centerpieces of financial markets reform and it is far from an incremental change. As a result of the expanded asset class coverage, structural market reform and its applicability for firms previously exempted, MiFID II will dramatically change almost the entire marketplace as we know it today, with far-reaching impacts on everyone engaged in the dealing and the processing of financial instruments. We expect no business or operating model – especially in the over-the-counter (OTC) space – to remain untouched. In particular, MiFID II will not only completely change the way almost all OTC products are priced, traded and reported, but it will also bring further changes to the exchange-traded equity market. This will lead to a raft of implications for investment banks, private banks, asset managers, retail banks, insurance firms, market infrastructure providers and non-financial firms such as energy providers. The impact of MiFID II will be felt globally as well as within Europe due to the many cross-border implications.

Most importantly, MiFID II is not just a compliance exercise. There are major strategic implications that could bring market opportunities and competitive advantage for those who start to plan in advance, or potential revenue loss for those who fail to react.

MiFID II must be aligned to a number of other regulations that are being implemented at a global, European and local (domestic) level. Therefore, many firms are responding by considering multiple related regulations, e.g., aligning Dodd Frank, Basel III/Capital Requirements Directive (CRD) IV, European Market Infrastructure Regulation (EMIR), Market Abuse Directive (MAD) II and MiFID II under one regulatory change program with thematic workstreams across regulations. This move will provide a much more controlled, consistent and efficient implementation, avoiding duplication of work in overlapping areas. Firms need to understand the impact, both on their organization as well as on the market overall, to influence the legislation as the European Securities and Markets Authority (ESMA) finalizes the Level 2 regulatory technical standards (RTS), assess the specific compliance requirements on their organization and determine potential commercial opportunities. The most obvious commercial opportunity is around the newly created trading venue category of organized trading facility (OTF).

With this complexity and broad scope, firms will need to start assessing the impact of MiFID II early to determine budgets, timelines and ensure that their strategy and organization is aligned for compliance by January 2017.

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*MiFID II consists of a revised Directive and Regulation (MiFIR) and any reference to MiFID II in this document refers to both unless stated otherwise.
Key MiFID II provisions

- **Organized trading facilities (OTF):** in line with G20 objectives, OTC derivative trading is obliged to move to trading venues—regulated markets (RM), multilateral trading facilities (MTF) and OTF—to reduce bilateral risk. OTF is a new category for non-equities allowing some discretion by operator over execution, but with restrictions on the use of own capital.

- **Systematic Internalisers (SIs):** SIs have seen an increase in their obligations and regulatory oversight. Notably the increased scope to include non-equity instruments, the requirement to publish firm quotes and the increased minimum order sizes to attain standard market size (SMS) and size specific to instrument (SSTI) thresholds.

- **Transaction reporting:** asset classes that have previously been exempt from any reporting obligations are now included into the MiFID II reporting scope. The reporting requirements now also apply to a greater range of investment firms that were previously exempt from MiFID I. Additionally, the transaction reports and all orders will need to be retained at the disposal of the competent authority for five years. Given there is a significant increase in the number and nature of data attributes this is likely to have a material impact on organisations with regards to complex planning and implementation of the collation, interpretation and reporting of data. Further, there is an explicit requirement for firms to establish an adequate ongoing control framework to ensure that their reporting is complete and accurate by testing their full reporting process and conducting end-to-end reconciliations of reports and data. Firms should not underestimate the challenges and lead time to ensure compliance.

- **Pre and post-trade transparency:** some of the biggest concerns in MiFID II have been expressed around the expanded pre and post-trade transparency measures and the potential impact on certain markets, such as fixed income, depending on the waivers and liquidity thresholds.

- **Dark pools:** double volume caps are introduced at a trading venue (4%) and on a global basis (8%) to restrict dark pool trading for equity instruments, and to increase transparency with significant impacts for broker crossing networks (BCN).

- **High-frequency trading (HFT):** HFT firms will be subject to a range of restrictions and controls, which include testing of algorithms by the participants, built in circuit breakers, the introduction of minimum tick sizes across trading venues and allowing venues to adjust fees for cancelled orders.

- **Open access:** it aims to increase competition and limit vertical siloes by allowing firms to select their own clearing house, rather than being restricted to the clearing house of the trading venue.

- **Restrictions for commodity derivatives:** a harmonized system for setting position limits for commodity derivatives is introduced with ESMA to define the calculation methodology and checks with the competent authority to set the specific parameters for these limits.

- **Investor protections:** a ban of inducements for firms offering independent advice, enhanced provisions around suitability and appropriateness, particularly around complex products, and the introduction of regulatory powers to ban and suspend trading for specific products.

- **Consolidated tape:** it provides a post-trade transparency regime initially for equities and equity-like products only, but allowing deferred publication or volume masking, which will require further clarity from ESMA on waivers and deferred publication requirements.

- **Third-country access:** MiFID II introduces a harmonized regime for the access of investment firms and market operators of third-countries, who wish to service professional and eligible counterparties in the EU. However, the EU Commission will have to assess the equivalence of the regulatory environment before third country firms can leverage the passporting regime.

- **Synchronization of clocks:** trading venues and their members are required to synchronize their business clocks that are used to record the time of any reportable event.
MiFID II summary

What is driving MiFID II?

Since its implementation in November 2007, MiFID has been the cornerstone of capital markets regulation in Europe. However, since its inception, not all benefits have been fed down to the end investor as envisaged. MiFID II is aiming to address the shortcomings of the original MiFID release and has been amended with measures as a result of the lessons learned from the financial crisis. The diagram below highlights the key objectives and core measure of MiFID II.

Figure 1
MiFID II objectives and core measures

“...The European banking and regulatory reform program is fast becoming a reality that will transform the investment industry. Alongside EMIR, CRD IV, structural change and Solvency II, MiFID II is one of the key regulatory initiatives that will change market structure and business models. Firms that manage the regulatory agenda as part of their strategic evolution and maintain flexibility will capture market opportunities in contrast to those that view implementation merely as a compliance task.”

John Liver,
Partner, Head of Global Regulatory Reform, EY
Scope and impact of MiFID II

MiFID II will command significant changes in business and operating models, systems, data, people and processes. As a result, a fundamental transformation will emerge. The biggest impact will be experienced by banks, broker dealers and trading venues. Additionally, investment managers, insurance firms, independent financial advisors (IFAs), custodian banks and other asset servicing entities will also need to undertake a substantial effort.

The level of impact of MiFID II differs in most areas for investment banks, investment managers, insurance, private banking and retail banking:

**Figure 2**
Preliminary heat map of MiFID II impacts

<table>
<thead>
<tr>
<th>Market structure</th>
<th>Market transparency</th>
<th>Investor protection</th>
<th>External controls/reporting</th>
<th>Internal controls/governance</th>
</tr>
</thead>
<tbody>
<tr>
<td>New market structures</td>
<td>Transparency equity and equity-like</td>
<td>Provision of investment services and protection of client interests</td>
<td>Reg. supervision</td>
<td>Systems and control/record keeping</td>
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<tr>
<td>MTF/OTF/SI changes</td>
<td>Transparency equity and non-equity</td>
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<td>HFT provisions</td>
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<td>Dark pools/SD/MD platforms</td>
<td>Order handling</td>
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<td>Transaction reporting</td>
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<tr>
<td>Open access</td>
<td>Post-trade disclosure</td>
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<td>Systems/records</td>
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<tr>
<td>Derivative trading obligation</td>
<td>Equity-like</td>
<td></td>
<td>Governance/compliance controls</td>
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<tr>
<td>European consolidated tape</td>
<td>Non-equity incl. OTC</td>
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<td>Outsourcing</td>
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<td>Pre-trade transp.</td>
<td>Reverse burden of proof/liabilities?</td>
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<td>Client classification</td>
<td>Client information</td>
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<td>TCF/COI management</td>
<td>Appropriateness</td>
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<td>Client assets/money</td>
<td>Inducements</td>
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<td>Client reporting</td>
<td>Inter-regulatory cooperation</td>
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<td>Circuit breakers, min. tick size, cancellation fees</td>
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<td>Reciprocal third-country access</td>
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<td>Bans/restrictions/limits</td>
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Key:
- High
- Medium
- Low

Implementation timeline

MiFID II will take the form of a regulation called MiFIR, backed by a directive. The EC introduced MiFIR to ensure that a “maximum harmonization” framework was implemented centrally from Brussels with limited scope for national discretions or interpretations. ESMA will now play a central role in coordinating and specifying implementation details of MiFID II. In particular, ESMA will draw much of the monitoring and supervisory support from the national regulatory authorities.

The timing of MiFID II is set to coincide with the issue of adjacent regulations, such as the revised Market Abuse Directive (MAD II/MAR), the revised Insurance Mediation Directive (IMD II) and the impending Packaged Retail Investment & Insurance Products Regulation (PRIIPs). MiFID II was published in the Official Journal of the European Union on 12 June 2014 and came into force on 2 July 2014. The compliance deadline is set for January 2017.
Key provisions of MiFID II

**Market structure:**
- **RM/MTF/OTF/SI:** the new rules include a new category of trading venues called OTFs alongside RMs, MTFs, and the amended scope of SIs. In contrast to RMs and MTFs, the OTF category applies only to non-equity instruments (equities being mandatorily traded on either RMs, MTFs or SIs) and allows operators to have discretion over order execution. OTFs have been specifically established for bonds, derivatives, structured products and emission allowances. Furthermore, the OTF category restricts the use of own capital. However, this does not apply for trading in sovereign bonds. Matched principal trading is seen as a riskless market for trading in sovereign bonds. Matched principal trading is seen as a riskless market for trading in sovereign bonds.
- **Derivative trading obligation:** in order to meet G20 obligations, all liquid derivatives are mandated to trade on a regulated trading venue. Level 2 measures have proposed the definition of what “sufficiently liquid” derivatives are, according to specific criteria such as size, trade frequency and number of market participants.
- **Open access:** aims to increase competition and limit vertical siloes by allowing firms to select their own clearing house, rather than being restricted to the clearing house of the trading venue. New CCPs that have been set up within a 3-year period prior to MiFID II entering into force may request an exemption from the non-discriminatory provisions from their respective national competent authority for a period of 2.5 years with respect to transferable securities and money market instruments. Smaller trading venues with close links to CCPs, that deal in exchange traded derivatives (ETDs) and lack the technological capability, may also request an exemption for themselves (and their CCPs) for a 3-year period from non-discretionary access with the possibility of subsequent renewals. ESMA is now tasked with outlining the specific conditions under which an access request may be denied by a CCP.
- **Dark pools and BCNs:** they will face restrictions on how much trading can be conducted in the dark. The policymakers have confirmed a double volume cap for equity and equity-like products traded in the dark. Transparency reporting waivers will now be unavailable when dark trading exceeds 4% per product and trading venue and 8% on a global basis across all trading venues. The volume cap will thereby be based on the trading volume over the past 12 months. Again, ESMA is challenged to define the specifics and operability of the caps across the market. It remains to be seen how the market reacts to the introduction of such thresholds, as these have been set without a detailed assessment of dark pool trading levels across the market.

**Market transparency:**
- **Pre-trade transparency:** the transparency regime is extended to cover non-equity instruments. All trading venues (RMs, MTFs and OTFs) are required to publish bid-ask spreads and show the depth by specifying the size of outstanding unmatched orders.
- **Firm quoting obligation:** The SI rules have received further refinement requiring firm quotes as a response to client request for quotes (RFQ) with the obligation to publish and share that quote with other investors as long as it is below a certain volume threshold and the instrument is sufficiently liquid. This is very similar to the market-maker obligations for exchange-traded equities. However, SIs will be allowed to withdraw quotes and establish “commercial policy” protections, allowing them to consider counterparty credit and settlement risk and thereby giving them greater control over who they are trading with.
- **Waivers:** pre-trade transparency exemptions are available for large orders (in relation to normal order/market size), request for quote and voice trading as well as the deferred publication or volume masking. This is a result of dealer concerns over adverse market price impact, especially when information is publicized too soon after execution. However, a back door is still being left open, allowing the European Commission (EC) to adjust reporting requirements two years after enforcement. Initially, the large-scale waivers will remain the same as under MiFID I.

Indication of interests are also exempted from pre-trade transparency requirements when exceeding a certain size threshold – defined as part of Level 2 measures.
- **Consolidated tape:** MiFID II requires trading venues to make pre- and post-trade equity and equity-like data available on a reasonable commercial basis by establishing a consolidated tape mechanism.

Once sufficient experience is gained by CTPs, the provisions will be extended to cover non-equity instruments. This is a response to the concerns that consolidated tape requirements for these instruments are much more complex.
Synchronization of business clocks: all trading venues and their members will need to synchronize their business clocks that are used to timestamp reportable events. This will support the competent authorities to better monitor the trading activity for market abuse, which is the main driver for the enhanced reporting requirements of MiFID II. Level 2 measures specify accuracy according to international standards.

Investor protection
Regulators are increasingly focusing on investor protection issues and taking disciplinary action including fines, to improve outcomes for investors and prevent mis-selling.

Ban of inducements: the widely debated ban of inducements will be implemented for all 28 EU Member States and apply for firms that choose to offer independent advice to their clients. In advance of any investment advice, firms will have to inform their (potential) clients whether the advice is independent or dependent, which will have different consequences on their operational processes. Member States will have the discretion to go beyond the minimum standard of MiFID II. UK and the Netherlands have adopted their own inducement regime with other countries, such as Denmark and Italy, potentially following. Should the firm classify themselves as providing independent advice, any received commissions will have to be passed on to the retail investor.

Product and client coverage: MiFID II extends the conduct of business rules to new asset classes, and limits the “execution-only” regime to “non-complex” products, albeit within the existing client categorization rules. With the exception of foreign exchange (FX) spot, largely all asset classes are covered as part of MiFID II. This includes FX derivatives, OTC index instruments, interest rates, emissions and physically settled forwards.

However, physically settled oil and coal derivatives that are traded on OTFs have been exempted from the MiFID II scope for a three and a half year period, after which the policy makers will compile a report to decide on extended exemption or their inclusion into the MiFID II scope. Furthermore, physically settled power and gas contracts are fully out of scope of MiFID II as they are covered by earlier EU regulation such as the Regulation on Wholesale Energy Market Integrity and Transparency (REMIT) that came into force at the end of 2011.

ESMA will specify the specific REMIT carve-out requirements in the Level 2 implementation measures. More stringent, up-front and regular disclosure requirements (e.g., detailing any financial inducements received from third-parties as a result of products sold to retail clients) have also received backing. Firms must regularly inform clients about (and produce upon request an itemized breakdown of) total aggregated costs and charges, including for “ancillary” services and the cost of the advice.

Member States are given powers to ban or restrict products where there are threats to investor protection, integrity of the market or financial stability. A formal banning power is likely to be used very sparingly, but regulators are likely to become more interventionist around product development, governance and oversight around the marketing and distribution of products. Lastly, the provisions relating to suitability and appropriateness of investments, especially to retail investors, are strengthened. Lessons from MiFID I are feeding into the level 2 measures to ensure that risks are transparent and understood by the retail investor.

One area of controversy has been the extent to which the MiFID conduct rules and investor protection provisions should apply to insurance-based investment products. Attempts to extend effectively MiFID II to these products appear to have been blocked, but with a commitment to set out detailed requirements in the review of the IMD and an understanding that ESMA and EIOPA should work together to achieve as much consistency as possible.

Investment advice: when providing investment advice, the investment firm needs to detail how the advice meets the client’s objectives, and indicate whether the advice is provided on the basis of a restricted, or otherwise, range of financial products.

External controls/reporting:
Transaction reporting requirements: The new reporting requirements have been significantly expanded from MiFID I. Not only have new asset classes been moved into the MiFID II scope, but also a range of new investment firms that have previously been exempt from any reporting obligation are now captured.

MiFID II will see an increased range of exchange traded derivatives come into scope for reporting, with commodities and interest rate products having a particularly big impact. The reporting of OTC derivatives traded on a MTF
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or OTF (as well as where the ultimate underlying is admitted to trading on a venue) will also increase complexity and volume, particularly for FX derivatives, commodities and rates.

Furthermore, some of the firms engaged in algorithmic trading as well as firms engaged in commodity trading fall now under the remit of MiFID II and can no longer rely on exemptions.

► **Third-country access:** as with all EU regulations and directives, the issue of third-country access is one of the more controversial areas. MiFID II introduces a harmonized regime for the access of investment firms and market operators to the EU. The regime only applies to third-country firms that wish to service professional and eligible counterparties in the EU. The EU Commission will have to assess the equivalence of the regulatory environment of the third country.

Firms wanting to service retail clients may be required to establish an EU branch, as well as obtain branch authorization from the local authority where the branch is situated. For firms wanting to provide investment services to professional and eligible counterparties only, no mandatory presence with a branch in an EU state is needed, subject to notification to ESMA. National regimes would continue to apply until the end of a three-year transitional period with firms being able to continue operating with the national regimes, but without passporting until a decision on equivalence has been made.

Since MiFID II has established some principles around third-country access, where dealing with professional and eligible counterparties, it seems likely that these would be read across to Alternative Investment Fund Managers Directive (AIFMD) in due course.

► **Sanctions** can be enforced by local competent authorities and ESMA to firms and trading venues firms that are in breach of the requirements. The administrative sanctions can therefore be applied to both legal and natural persons and range from a fine to the withdrawal of authorization of an investment firm or trading venue.

► **Position limits and trading restrictions:** MiFID II implements trade restrictions and position limits on commodity derivative contracts that any given market member or participant can enter into over a specified period of time. These limits and restrictions, which target excess speculation, will be determined by ESMA and applied on a net position basis. The restrictions will not be imposed on positions built for hedging purposes by non-financial services firms. However, exempted firms could be impacted due to an overall decrease in demand and supply for commodity derivatives as a result of the position limits. The limits will be applied on a firm-by-firm basis and set across the various marketplaces (i.e., RMs, MTFs and OTFs). Given the economic consequences of the restrictions, firms need to start modelling scenarios, assess the impact and, where necessary, reassess their strategies before these trading restrictions are enforced.

► **High-frequency trading (HFT)/Algo trading:** to avoid “flash crashes” and ensure orderly markets, algorithmic and HFT traders will be required to register as an investment firm, disclose their algorithms to the regulator and test them in an approved environment. The algorithms are required to have built in circuit breakers that “exit” once certain market relevant criteria are met. Level 2 measures define these criteria and thresholds. Firms providing direct market access will also have to have measures and controls in place to mitigate the risk of markets becoming disorderly due to HFT algorithms.

Additionally, a minimum standard on tick size will be introduced and placed consistently across trading venues. Standards on cancellation fees are introduced allowing trading venues to tailor the fees as appropriate to their market and calibrate to the length of time for which the order was maintained in relation to the order-cancel ratio. HFT currently plays an important role in providing liquidity especially to the equities market (FX spot, another big HFT market is out of scope of MiFID II) and much of the impact remains to be seen – whether the standardization and the move to regulated and standardized trading venues will open opportunities for algo and HFT traders.

“Surprisingly, the controversial debate of third-country access has been concluded and the results are better than expected. The anticipated mandate to have a branch in each member state, has not happened.”

Christian Röthlin, Partner, Legal & Compliance Financial Services, EY, Switzerland

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Given the impacts, HFT firms will need to start thinking how their business models will need to evolve. In particular, HFT firms need to ensure that they are compliant with the requirements of MAR.

**Internal controls/governance:**

► **Record-keeping**: MiFID II sets the overall requirement to store records of all orders and all transactions for a minimum period of five years. However, national authorities have the capacity to set firmer record-keeping standards. To date for instance, the Belgian and German National Competent Authorities (NCA) have imposed requirements of 7 and 10 years, respectively.

► **Corporate governance**: MiFID II establishes a strengthened corporate governance regime, encompassing rules on time commitments and fit and proper criteria for governing bodies. It also strengthens the role of the compliance officer. Although MiFID II does not require complete independence of the compliance function, it does require a recording of where senior management deviates from the compliance officer’s assessment and recommendations, and an explanation as to the remedial action the investment firm intends to take. Some firms have begun to acknowledge the increased regulatory scrutiny and are responding by strengthening their control functions; e.g., creating a new function such as Chief Control Officer and/or strengthening the role of the Chief Compliance Officer.
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Many valuable lessons have been taken from MiFID I. These inevitably will help reduce costs in relation to the upcoming implementation of MiFID II. However, the cost will be substantial given product scope, impact on business models, degree of European harmonization and the need to align with other parallel regulatory developments.

**Figure 3**
MiFID I and MiFID II comparisons

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<thead>
<tr>
<th>MiFID I</th>
<th>MiFID II</th>
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<tr>
<td><strong>Equities</strong></td>
<td><strong>Non-equities</strong></td>
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<tr>
<td>Market structure</td>
<td>Addition of OTFs (including crossing networks)</td>
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<td></td>
<td>Treatment of SDPs/MDPs/Dark pools (including crossing networks, dark pools)</td>
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<tr>
<td>Transparency – pre- and post-trade</td>
<td>Extends to other asset classes</td>
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<td>Extends regulatory transparency requirement tailored to asset classes</td>
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<td>Waivers to large-scale trade reporting</td>
<td>Conditions for waivers will be revised</td>
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<td>European consolidated tape (initially only for equities and equity-like products)</td>
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<td>Best execution</td>
<td>Extends to other asset classes</td>
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<td>Reporting to clients</td>
<td>Extends to other asset classes</td>
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<td>Complex products (could include product bans in future)</td>
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<td>Treatment of inducements</td>
<td>Extends to other asset classes (revision of independent advice)</td>
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<td>Required on marketing and sales material</td>
<td>Extends to other asset classes</td>
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<td>Suitability and appropriateness tests</td>
<td>Extends to other asset classes</td>
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<td>Governance/strengthening internal compliance functions</td>
<td>Algorithmic trading provisions (HFTs)</td>
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<td>Third-country access</td>
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<td>Position limits for products</td>
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<td>Extends to other asset classes and new services</td>
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<td>Extends to other asset classes with expanded reporting requirements</td>
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**Business model:**

- **Revenue impact:** the migration of trading to RMs, MTFs or OTFs, coupled with increased transparency requirements, should in principle increase competition and reduce spreads. In other words, the long-term direction will be toward a transparent, higher volume, lower margin, more commoditized and standardized market. As experienced in the equity market with MiFID I, fragmentation of liquidity across multiple venues could, at least in the short term, lead to mixed results – greater competition, equally greater fragmentation and increased market impact costs (particularly for the buy side). In addition, a drive toward greater transparency may deter some investment banks from making firm quotes. This will drive valuable liquidity away from the market and concentrate the business on a smaller number of price-makers, which would not be so beneficial for the buy-side. The impact remains to be seen.

There are significant opportunities for banks, trading venues and market infrastructure providers to capture market share, particularly for those that invest in scalable platforms and are able to reduce operational complexity for their client base.
Cost impact: despite the opportunities to capture market share, there are also significant cost impacts of MiFID II. In 2011, the EC estimated initial MiFID II implementation costs to be between €512m and €732m, with ongoing compliance costs in the region of €312m to €586m. This is significantly lower than the overall €2b implementation cost of MiFID I. The expanded scope and the far reaching impact of MiFID II could very well lead to costs exceeding expectations.

Given the cost of the investment required to meet regulatory demands, coupled with increased capital and liquidity requirements due to Basel III and CRD IV, some businesses will no longer be profitable. The return on capital employed (ROCE) figures may struggle to reach double digits. This may apply to mid-tier firms that do not have capital available to invest. Firms wishing to design, approve and service products with different, or complex, financial characteristics for retail classified clients in different countries, may find the cross-border challenges a step too far. There could be a migration of the business toward more streamlined client take-on structures accompanied by products that are simpler to disclose, fungible and above all, liquid.

Outsourcing: MiFID II could present a shift in the industry toward more outsourcing providers. The move to execution on trading venues is likely to result in higher volumes of smaller value transactions in quote-driven markets, just as those that occurred with equity trades across Europe from 2007-12. Enhancing the scalability of OTC derivative trading, trade confirmation, as well as novation and netting systems will be imperative. Many asset managers and other intermediaries who lack the scale to invest in systems, may look toward new outsourcing service providers as a way to provide support services and facilitation at the appropriate price points. Parties who outsource will still need to perform the necessary regulatory due diligence and manage operational complexities in the front, middle and back offices. There is a likely increase in industry utilities (e.g., data) as firms look to share costs and leverage regulatory investment.

Systems, processes and controls:

Front-to-back infrastructure impact: the implementation of MiFID II, MAD II and EMIR may usher in significant market microstructure changes by introducing auction systems competing with dealer pricing, as “former OTC products” become more “equity like.” A whole array of system and process changes would be required to cater for the auction models impacting both the sell-side and buy-side. However, early movers on the sell-side will be able to achieve a competitive advantage and attract market share. Specifically in areas such as collateralization and the “futurization” of formerly traded OTC instruments. Also, firms with the capabilities for efficiently processing market and reference data will enjoy a distinct advantage when executing effective trading strategies or reporting to clients, regulators and senior management.

Trading impacts: MiFID II and Dodd Frank will stimulate a high degree of trading process changes over the next five years. This includes multiple competing trading venues with the potential for a) order-driven models (both continuous-auction and batch-auction systems in the secondary OTC market) and b) quote-driven models (the evolution of OTC dealers to full market makers or a more hybrid system).

About 60%-70% of all trade volumes (measured in number of transactions across exchange and OTC traded instruments) occurs in equities, with HFT traders responsible for approximately 30% to 35% of all equity volume. Due to the introduction of circuit breakers and minimum tick sizes across venues, some HFT trading might be discouraged and lead to a reduction of equity volume. On the other hand, should OTFs/MTFs be a suitable trading venue for HFTs in other asset classes, trading volumes could increase in these products as a result of substitution effects.

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1 MiFID II data European Commission MiFID II draft of 20 October 2012; MiFID I costs EY estimates

2 EY Analysis 2013
The world of financial instruments is more complex. Time to implement change. Capital markets reform: MiFID II

Data and reporting:
MiFID II will require major changes in both operational and reference data for all financial services firms.

► Reporting: Those firms (e.g., commodity firms or certain algorithmic trading organizations) that were previously exempt could face significant challenges in meeting the reporting requirements, since these firms cannot leverage experience and infrastructure from MiFID I. For other firms, the efforts could still be significant due to the complexity of the increased asset class scope as well as increased volumes. Given the recent scrutiny by regulators of existing transaction reporting processes, firms will not only need to enhance their infrastructure but ensure the ongoing effectiveness of their controls.

The accuracy and efficiency of client/counterparty, instrument and other reference data provision will be of increasing importance, not only for reporting but to support trading in the new market structure and to help manage investor protection requirements. New industry standards such as legal entity identifiers (LEI) may help to some degree but will themselves require significant changes to data infrastructure.

MiFID II and EMIR reporting solutions will need to be aligned. Given the increased range of reporting requirements, and need for accuracy, driven by these and other global regulations, many leading firms are considering strategic solutions for enhanced operational data stores and reporting engines. Firms are also increasingly looking at greater use of market utilities for data and reporting. Those firms that have already invested in enhancing their data architecture across multiple asset classes will be best placed, while others will need to investigate this as an immediate priority.

► Record-keeping and documentation: most firms have already implemented their transaction reporting capabilities to comply with MiFID I, resulting in robust arrangements in which to store their records for five years. However, because there were several high-profile cases in recent years where firms were fined for misdemeanors, audit trails will need to be more robust and also need to keep all orders at the disposal of the competent authority. They should now include on-demand documentary retrieval for more complex instruments, such as OTC derivatives, to evidence best execution with regard to the broader OTC-traded markets. In addition, some EU Member States, such as the UK, will remove the exemption for mobile phone conversations for reasons of market abuse prevention. As a result, MiFID II will strengthen the treatment of client assets and money, which will necessitate further investments in data management.

► Venue reporting: market operators and investment firms that operate a trading venue such as a MTF or OTF will need to publicize transactional data as close to real time as possible and SIs will need to publish firm quotes. Exemptions for deferred publication will be available and specified by ESMA (including the specific data requirements).

Firms should also take advantage of leveraging new public trade information. Specifically, the consolidated tape for equities and equity like instruments, in combination with the pre-trade price publication requirements of trading venues, will provide a significant opportunity for firms to research trading behaviour and trends across the entire market.

3 Five years constitutes the minimum record-keeping duration with the option to impose more stringent requirements at a national level by local regulators.
Where to next?

Aligning MiFID II with other regulations

Depending on the type of financial services offered by an organization and the geographic scope, a number of other regulations need to be considered in conjunction with MiFID II.

Figure 4
Cross-regulation impact assessment

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<th>MiFIR/ MiFIDII</th>
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<th>AIFMD</th>
<th>PRIIPs</th>
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Source: EY 2014 analysis

Common global programs are essential for organizations impacted by multiple measures. However, the differences in the timing of implementation and emergence of detailed rules will prove challenging, as will the evaluation of potential extra-territorial impacts. Organizations must consider the overall business strategy impact of global programs due to operating models and program efficiencies that could be realized, while managing in-built challenges. For example, those aiming to establish one platform covering swap execution, under Dodd-Frank, and OTF trading will have to manage the different requirements of each jurisdiction and ensure that their platform is flexible enough to cater for each set of requirements.

Regulatory reporting, as illustrated in figure 4, requires a consistent approach to avoid duplication and ensure cost efficient implementation. In terms of EMIR, the overlaps are significant and should at the very least be aligned.

Firms should also consider aligning the MiFIR reporting requirements with MAD II to minimize regulatory, operational and reputational risk by analyzing what their organization is sending to regulators and preempt any transactional queries that competent authorities are likely to have.

Many face the prospect of being impacted by the proposed financial transaction tax (FTT), but this is particularly pertinent for HFT traders. Given their central role and equity market share, potential changes in liquidity could have significant impacts on the rest of the market participants, and not only for HFT in the 11 EU countries where FTT is being introduced. The combined impact of FTT and MiFID II will be one for the entire industry to observe.

In addition, non-banking organizations, such as insurance firms, will need to start aligning any MiFID II analysis with PRIIPs and IMD II, especially in relation to investor protection measures and commission prohibitions, as these could significantly change business models by reducing the choice of products for policyholders.

National regulations will come into play earlier and potentially interact with MiFID II. In the UK, for instance, the Retail Distribution Review (RDR) has taken effect and complements the originally published MiFID II requirements on the ban of inducements.
Overall priority actions

Given the size and scope of MiFID II and the current regulatory landscape across financial markets, organizations have begun to plan how they will respond to competing regulatory challenges. Furthermore, the strategic impact of this landscape should be considered, to allow the analysis of commercial opportunities. Some of the key priorities are shown below:

► If not already started, conduct an impact assessment for MiFID II to determine the key focus priorities requiring detailed analysis; this should include timelines, high-level budget and the major impact areas with compliance lead times
► Where priority areas with sufficient regulatory clarity have been identified; undertake detailed gap and scenario analysis as appropriate
► Align with the cross-regulatory reform agenda and ensure that MiFID II analysis is joined up with other regulatory projects
► Conduct overall market impact analysis to identify suitable opportunities
► Review validity of current business models (e.g., single dealer platforms (SDP), OTF, revenue structure)
► Assess MiFID II impact on legal entity structures arising from changes in requirements to third-country access
► Assess improvements to investor protections, arising from changes to fees and commissions, treatment of independent vs. dependent advice, and thirdly treatment of advised vs. non-advised sales
► Ensure MiFID II program governance is defined, appropriate and mobilized
► Ensure compliance management tracking and monitoring is in place with the ability to incorporate further

“Organizations will need a plan that spans across individual regulations. Managing them one-by-one will incur significant costs and duplications and will simply stretch even large organizations beyond their capabilities.”

Natasha Bonner-Fomes,
Senior Manager, Financial Services Advisory, EY
The world of financial instruments is more complex. Time to implement change. Capital markets reform: MiFID II

How EY can help

EY has extensive experience in helping organizations navigate through regulatory initiatives. Our global regulatory reform team is a dedicated, cross-functional team with years of relevant industry experience advising clients in derivatives risk management, regulatory matters and process or systems changes. The team is composed of core members, as well as those drawn from across the broader global regulatory team.

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