

## **Markets in Financial Instruments Directive (MiFID): Frequently Asked Questions**

### **1. What is MiFID?**

MiFID is the Markets in Financial Instruments Directive – or Directive 2004/39/EC<sup>1</sup>. It replaces the Investment Services Directive (ISD) which was adopted in 1993. It was agreed unanimously by the Member States and by a strong Parliamentary majority, and is a cornerstone of the EU's regulation of financial markets. It seeks to improve the competitiveness of EU financial markets by creating a genuine single market for investment services and activities, and to ensure a high degree of harmonised protection for investors in financial instruments, such as shares, bonds, derivatives and various structured products. Greater competition across Europe in the provision of services to investors and between trading venues is intended to contribute to deeper, more integrated and liquid financial markets. It also has the potential of driving down costs for issuers, delivering better and cheaper services for investors, and contributing to economic growth and job creation in Europe.

### **2. Why is MiFID being reviewed only three years after entry into force?**

In keeping with its intended objective, MiFID has contributed to a more competitive and integrated EU financial market. However, recent events and market developments have demonstrated weaknesses in some of the underlying principles of MiFID, as well as highlighted areas needing reinforcement or revision. Such measures are necessary in order to bolster investor confidence and achieve all of MiFID's original objectives. Ensuring a more robust framework of regulation will also serve to address the more complex market reality we are now faced with, a reality which is characterised by increasing diversity in financial instruments and methods of trading. Similar discussions are taking place elsewhere in the world.

### **3. Did MiFID contribute to the crisis?**

The financial crisis was caused by multiple factors. The original objectives of MiFID were to improve the resilience of EU financial markets through free competition and high levels of market transparency and investor protection. To some extent these have been achieved. However, the full effects of MiFID are yet to play out. While it is true that the Directive has not entirely delivered on its objectives, it is mistaken to assign all developments, such as the growth of trading in newer trading functionalities (for example high frequency trading) and dark environments (for example all dark pools – see question 6) to MiFID. These have more to do with technological developments.

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<sup>1</sup> The MiFID regulatory framework consists of a framework Directive (Directive 2004/39/EC), an Implementing Directive (Directive 2006/73/EC) and an Implementing Regulation (Regulation No 1287/2006)

#### **4. What are the main objectives of the review?**

Revising MiFID is an essential part of ongoing structural reforms in the aftermath of the financial crisis. These are aimed at establishing a safer, sounder, more transparent, and more responsible financial system that works for the economy and society as a whole. It has four main objectives.

It seeks to address rapid changes in both market structure and technology that could affect the smooth and efficient functioning of EU financial markets. The emergence of new organised trading facilities within banks and technological innovations, such as automated trading – including high-frequency trading – need to be suitably accounted for in the regulatory framework. Accounting for these requires assessing the risks they may pose for the orderly and efficient functioning of markets, and ensuring a level playing field is maintained between all trading venues and investment firms.

Second, significant extensions to MiFID are required to meet G20<sup>2</sup> consensus targets of tackling under-regulated and opaque aspects of the financial system. Extensions will seek to improve the organisation, transparency and oversight of these market segments, especially in those instruments traded mostly over the counter (OTC). Amendments to MiFID in these areas would be complementary to the new framework on the infrastructures for derivatives markets included in the legislative proposal on OTC derivatives, central counterparties and trade repositories (see [IP/10/1125](#)).

Third, specific measures are foreseen to improve oversight and transparency in commodity derivatives markets. Recent developments have heightened concerns that commodity derivatives markets are not functioning as they should. In line with G20 principles, MiFID will work to ensure these markets function efficiently, particularly for hedging and price discovery purposes.

Fourth, comprehensive rules in MiFID concerning investor protection require targeted improvements in order to strengthen high standards of investor protection throughout the EU. This concerns, for example, requirements for the provision of investment advice to clients or information and protection needs of investors in relation to more complex instruments.

#### **5. How do proposals suggested for MiFID fit with other recent initiatives such as OTC derivatives and short-selling?**

MiFID applies to the provision of investment services or activities by banks and investment firms in relation to financial instruments and to the operation of regulated markets. The targeted measures which are suggested in order to address the challenges listed above will improve the existing framework of regulation, not significantly alter its scope. The objective remains to support the development of a more integrated, competitive and efficient EU market in financial instruments with appropriate rules regarding conditions for authorisation as investment firms, organisational requirements to ensure they are managed appropriately, market transparency and investor protection.

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<sup>2</sup> See Leaders' statement of Pittsburgh Summit 24-25 September 2009, <http://www.pittsburghsummit.gov/mediacenter/129639.htm>

The two proposals adopted on 15 September 2010 on OTC derivatives, central counterparties and trade repositories on the one hand, and on short-selling and credit default swaps on the other, have different objectives (see [IP/10/1125](#) and [IP/10/1126](#) respectively). The first aims to minimise counterparty credit risk and operational risk, while the second works to increase harmonisation and transparency, and mitigate risks associated with short selling and the use of credit default swaps.

## **6. What are the proposals for enhancing equity market transparency, including the issue of "dark pools"?**

A "dark pool" is a trading system where the price and volumes of orders or quotes are not displayed before a transaction is executed on the system (i.e. they are dark in the sense that there is no pre-trade transparency). But after the trade is executed, information about the trade is then displayed. Dark pools are subject to most regulatory requirements except concerning pre-trade transparency.

Dark pools fall under two categories:

- 1) trading venues such as regulated markets and multilateral trading facilities (MTFs) that use waivers from pre-trade transparency not to display orders or quotes (e.g. for large trades)
- 2) other types of facilities operated by brokers such as crossing systems internally matching orders that are not subject to pre-trade transparency requirements (see next question).

The consultation proposes a number of measures that are relevant to the two types of dark pools. Regarding the first type, the consultation recognises the validity of waivers, but proposes that there be greater clarity and legal certainty as to how and when waivers apply. It proposes that certain waivers be subject to further clarification and in some cases restrictions, and proposes that ESMA play a greater role in monitoring this area and ensuring the consistent use of waivers.

## **7. How are developments in trading outside of venues categorised in MiFID being dealt with? How are crossing networks and the trading of standardised OTC derivatives being addressed?**

The current MiFID framework captures three different types of trading venues – namely regulated markets, multilateral trading facilities and systematic internalisers – and lists requirements for their authorisation, organisation and level of transparency when equities are traded on these venues. The reality to the implementation of MiFID, however, saw the arrival of new types of platforms conducting trading on an organised basis which were not covered by the existing MiFID categories, largely due to greater automation and the inherent incentives for various market participants to avoid disclosing their trading intentions. In the MiFID Review, the Commission services propose to address these new types of platforms operating in the market, to adequately regulate all kinds of organised trading and to level the playing field in the EU. More specifically, the Commission services suggest introducing a new MiFID category of an organised trading facility subject to certain core requirements for the operation of a trading venue.

So-called crossing networks (systems operated by investment firms which mainly internally match client orders) would be one of the venues captured under this new category which would be subject to the core requirements and to additional rules specifically calibrated to their business model. This would ensure that the facilities are appropriately regulated while recognising that such facilities may be diverse and different in a number of respects compared to traditional markets. Operation of such facilities will be subject to separate and proportionate new requirements to take into account the specific nature of this activity. For example, operating such a facility would require specific authorisation and operators would have to provide increased transparency about how the facility works. Details concerning conditions of access and the trades executed in the facility would also be required.

Trading of standardised derivatives could also occur on an organised trading facility operating under a slightly different business model, provided requirements on pre-trade transparency are upheld (see question 10).

When their business model accords with that of another venue, for example an MTF or a systematic internaliser, they could no longer operate as an organised trading facility. The proposal also states that if they exceed a certain size they will be required to convert to MTFs. As a result of these and other proposed changes, the proportion of trading taking place OTC should become more transparent and be subject to appropriate regulation.

## **8. What proposals are being suggested to deal with issues raised by algorithmic and high frequency trading? For example, the potential risk that increased use of automated trading could contribute to a crash such as the one that occurred in the US?**

The consultation involves a number of proposals aimed at the potential new risks that increased use of automated and high frequency trading could pose to EU markets. Those risks might be caused by rogue algorithms causing undue impacts on prices, algorithms reacting to market events or from the increased pressure on trading systems trying to cope with large numbers of orders. Other issues are related to ensuring the efficiency of markets.

The proposals try to deal with the potential new risks posed by automated trading while recognising that there is a widespread trend towards greater use of automated trading that can benefit markets and investors.

The main proposals in this area would require:

- all entities involved in high frequency trading to be authorised and supervised under MiFID (currently an exemption in the Directive may allow some participants not to be authorised)
- firms involved in all forms of automated trading to put in place robust risk controls to reduce the possibility of potential system errors or rogue algorithms
- firms who allow other automated traders to use their trading systems to gain access to a market (e.g. sponsored access) to put in place proper risk controls and filters to detect errors or attempts to misuse the facilities
- trading venues to strengthen their risk controls and arrangements to reduce the risk of crashes or breakdowns on their trading systems. For example, by requiring trading venues to have in place appropriate "circuit breakers" to halt or pause trading in the event of disorderly trading movements or errors generated by automated trading, and requiring trading venues to stress test their systems to make sure they are resilient and can deal with increased numbers of automated trades.

To deal with more general market efficiency risks the consultation also proposes that:

- trading venues make sure co-location facilities for market participants are offered to users on a fair and equal basis
- if a high frequency trader provides significant liquidity on a market it must continue to do so on an ongoing basis subject to similar conditions as market makers with obligations to provide quotes and liquidity
- orders could be required to rest on the order book for a minimum period before being cancelled or that the ratio of orders to transactions be capped – to reduce excessive volumes of orders.

Further, in many areas the proposal contemplates that the newly created European Securities Market Authority would be given powers to prescribe technical standards relating to algorithmic and high frequency trading.

### **9. Is the introduction of a mandatory consolidated tape for trade data being considered?**

The Commission services believe that the reporting, publication and consolidation of trade data needs to be addressed due to problems with its formatting, cost, quality and reliability. The Commission therefore submits a number of proposals for consultation designed to improve the situation, among them various measures to ensure data quality and consistency as well as measures to reduce the costs of data. The Commission services also consider how the introduction of a mandatory consolidated tape providing a consistent and reliable record of trades could best be brought about and consults on three different options as to how such a tape could be established and organised. These range from a single provider operating under public mandate to one or several operating under harmonised standards set out in MiFID.

### **10. What suggestions are made for extending pre- and post-trade transparency requirements beyond shares and why?**

Currently MiFID imposes harmonised pre-and post-trade transparency requirements only to shares admitted to trading on regulated markets. The absence of harmonised transparency requirements in non-equity markets (e.g. bonds, structured products, derivatives) has been perceived by many, including EU securities regulators, to lead to lower market efficiency and higher risks than would otherwise be the case. Due to the different structure of markets in non-equity instruments compared with those in equities, it is proposed to tailor the exact transparency regime according to the instrument in question. Post-trade requirements, to be specified in further detail in implementing legislation, are suggested for all bonds and structured finance products with a prospectus as well as all derivatives eligible for central clearing and those submitted to trade repositories regardless of where the trades take place. Pre-trade requirements, likewise to be further detailed, are suggested for the same instruments both when traded on organised venues as well as when offered by investment firms in over-the-counter trading, but with slight differences reflecting the current market structure.

## **11. What steps are being considered for moving trading in standardised OTC derivatives onto organised venues in line with G20 commitments?**

The G20 commitment states that "all standardised OTC derivatives contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end 2012".

In order to appropriately meet this commitment in Europe, it is suggested that all trading of derivatives which are eligible for clearing and sufficiently liquid move to either regulated markets, Multilateral Trading Facilities, which are already existing in the current MiFID framework, or to a new specific sub-regime of organised trading facilities to be defined in the revised text.

Once the main features of this new sub-regime are defined, the proposal is that ESMA could assess and decide when a derivative which is eligible for clearing is sufficiently liquid to be traded exclusively on the various organised venues i.e. regulated markets, MTFs or organised trading facilities. Appropriate criteria for such assessment will need to be taken into consideration by ESMA.

This approach should be pragmatic and progressive enough to factor in the trading specificities of each derivative while meeting the commitment of the G20.

## **12. What proposals are being considered for trading in commodity derivatives and why?**

In light of recent developments and concerns expressed over the functioning of commodity derivatives markets, there is a clear need to reinforce the regulation of commodity derivatives markets beyond the current policy initiatives for other derivatives markets in line with G20 commitments<sup>3</sup>. Efficient and well functioning physical and derivatives commodity markets are crucial for the EU economy.

The review of MiFID will be a key pillar of a comprehensive and ambitious regulatory overhaul on improving commodity market transparency and oversight.

First, the Commission services propose to increase transparency of trading activity on all organised trading venues by introducing a position reporting obligation by categories of traders. This harmonised and more disaggregated information will help regulators and market participants to better assess the role of speculation in these markets.

Second the Commission services propose to give harmonised and comprehensive powers to financial regulators to monitor and intervene at any stage in trading activity in all commodity derivatives, including in the shape of position limits if there are concerns in terms of market integrity or orderly functioning of markets.

Finally, commodity firms may be exempt from MiFID when they deal on own account in financial instruments or provide investment services in commodity derivatives on an ancillary basis as part of their main business and when they are not subsidiaries of financial groups. These exemptions will be reviewed in the interests of investor protection and greater transparency taking into account the specificities and the risks posed by these players.

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<sup>3</sup> There is agreement within the G20 in favour of improving "the regulation, functioning, and transparency of financial and commodity markets to address excessive commodity price volatility".

### **13. What purpose does transaction reporting serve and what measures are being proposed?**

Investment firms have to report to competent authorities all their trades in all financial instruments that are admitted to trading on a regulated market. This obligation applies regardless of where the trade takes place. This system of transaction reporting enables supervisors to monitor the activities of investment firms, which helps them to ensure compliance with MiFID, and to monitor for abuses under the Market Abuse Directive (MAD). Commission services propose the following changes.

First, because market supervision is the main reason for transaction reporting, the requirements under MiFID need to mirror the scope of the MAD. This is not fully the case at the moment and the ongoing review of the MAD makes further changes necessary. Commission services propose to extend the scope of transaction reporting to all financial instruments that are admitted to trading only on other organised venues, to all financial instruments that are not themselves admitted to trading but that are correlated with financial instruments that are, and to all financial instruments that can be used to influence commodity prices.

Second, reporting requirements today diverge between Member States, which adds costs for firms and limits the use of trade reports for competent authorities. Commission services propose to clarify which transactions should be reported, to harmonise the information that identifies who is trading and for whom a trade is being executed, and to empower ESMA to propose technical standards on a common European transaction reporting format and content.

Finally, for cost and efficiency purposes, double reporting of trades under MiFID and the recently proposed reporting requirements to trade repositories should be avoided. The Commission proposes that a trade already reported to a repository would not need to be reported again under MiFID, provided all the necessary information is thereby available to competent authorities.

### **14. How do proposals in MiFID interact with those in the consultation on packaged retail investment products (PRIPs) published on 26 November?**

PRIPs are common products in the retail investment market, with broadly comparable functions for investors. Although there is no rigid definition of PRIPs, they take a variety of legal forms. While offering benefits for investors, PRIPs are often complicated and opaque. The objective of the Commission is to better address the problems identified in the PRIPs market by creating a robust and coherent framework in two key areas:

- 1) the rules on the form and content of disclosures about the product, and
- 2) the rules governing the sales process for PRIPs, such as the conduct of business and the conflicts of interest requirements for intermediaries distributing the products.

This is achieved by adopting a horizontal approach in the two areas, which builds on the most effective and efficient elements of existing Community legislation. In the case of selling practices, the MiFID has been identified as the clear benchmark as it contains comprehensive rules covering these aspects.

The consultation on PRIPs published on 26 November does not deal with selling practices but only with the scope of the PRIPs initiative (that is, defining the covered products) and the content of a possible regime for product disclosure. It also explains the broad legislative approach to be followed.

Concerning the selling practices, the scope of MiFID will be expanded to cover those PRIPs which are not insurance products and that might currently not be covered (e.g. structured bank deposits) and to ensure that MiFID principles concerning selling practices apply to all sales of PRIPs under MiFID, even in the case of entities which are currently exempted under MiFID. In addition, certain MiFID rules may be strengthened (see question 14), also as a result of the work on PRIPs. The consultation document concerning the MiFID review covers these aspects.

As explained in the consultation document on PRIPs published on 26 November, PRIPs which are insurance products will be covered under the Insurance Mediation Directive (IMD). In the context of the review of the IMD, the Commission will propose rules on sales of insurance PRIPs that are consistent with those in MiFID.

### **15. What other suggestions are made to reinforce investor protection?**

MiFID includes a number of measures aimed at protecting investors in the context of the provision of investment services. Those rules take into account the type of services (for instance, investment advice or execution of orders) and the classification of clients, with higher protection granted to retail clients. The MiFID rules include both conduct of business requirements (for instance, collecting sufficient information to ensure that the products provided are suitable or appropriate for the client) and organisational requirements (for instance, requirements to identify and manage any conflicts of interest).

However, modifications and improvements are clearly needed to strengthen the framework for the provision of services. They should cover the following areas:

- 1) The scope of the directive should be broadened or clarified in order to cover financial products, services and entities which are currently not covered (for instance, structured deposits as mentioned above).
- 2) Conduct of business requirements should be modified in order to grant additional protection to investors. The rules for investment advice can be improved both when advice is provided and in the long term (specific conditions should apply to the provision of independent advice and investors should expect longer term assistance from firms). The conditions for services where investors receive fewer protections from firms should be narrowed. Further, information to different categories of clients should be enhanced, particularly when complex products are involved. Firms should be liable towards clients when they violate rules aimed at protecting them.
- 3) Organisational requirements should be strengthened in relation to the provision of services to investors. For instance, the involvement of senior management in the design of distribution policies and the adoption of adequate internal controls should receive a specific focus in legislation.

The European Securities and Market Authority (ESMA) should help ensure an equal and rigorous application of investor protection requirements across Europe.

**16. How is the treatment of firms and market operators from outside the EU being considered?**

Currently the access of third country firms to the EU markets is not harmonised under the MiFID. Each Member State can introduce its own third country regime, subject to the general principles of the TFEU and provided that national provisions do not result in treatment more favourable than that given to EU firms. In order to overcome the existing fragmentation and to ensure a level playing field in the EU for third country players, the consultation paper suggests the introduction of a harmonised third country equivalence regime in MiFID for the access of third country investment firms and market operators to the EU, at a first stage only for non-retail investors.

**17. How are you taking into consideration the need to improve SME access to capital markets?**

Small and medium sized enterprises (SMEs) across Europe significantly contribute to economic growth, employment, innovation and social integration. Two main sources of funding for such companies are private financing by banks or other institutions or raising finance through capital markets (e.g. the issue of shares). SME markets aim at providing smaller, growing companies with a platform to raise capital both through initial offerings and ongoing fund raisings. However, not all these markets have been successful. In order to make SME markets more attractive to small companies and to investors, the consultation paper suggests the development of a separate proportionate regime specifically designed for SME markets. This specialised regime could promote the creation of a network of markets specialised in SMEs.

**18. Are you considering the encouragement of ethical and social investments?**

Socially responsible investment should be encouraged. One way to do it is by providing potential investors with all the necessary information to help them to invest in sectors such as social housing, social transport, green and ethical consumption, green- and clean-tech, recycling, regeneration, public health, education, etc. In order to raise awareness on ethical and social investments and to allow investors make informed decisions on which products to invest, the consultation paper suggests requiring investment firms to disclose any relevant information concerning ethical or socially oriented investment criteria when providing information about financial instruments.

**19. What are the suggestions for the future role of the European Securities and Markets Authority (ESMA) in the context of MiFID?**

The European Securities and Markets Authority should be empowered to propose in clearly defined cases draft technical standards which will lead to more convergence in the application of MiFID and increase legal certainty for firms and investors. In addition, ESMA will have a role in settling possible disagreements between national competent authorities, for instance when authorities are cooperating in cross border cases. ESMA will also be involved in tasks related to consumer protection. It may for instance analyse potential risks resulting from new financial products or activities and adopt guidelines with a view to promote the safety and soundness of markets and convergence of regulatory practice.

**20. When will the Commission adopt formal proposals amending MiFID?**

A Commission proposal for amending the Level 1 MiFID directive is scheduled for adoption in mid-May 2011.

More information is available at:

[http://ec.europa.eu/internal\\_market/securities/isd/index\\_en.htm](http://ec.europa.eu/internal_market/securities/isd/index_en.htm)