LATHAM & WATKINS

MiFID OVERVIEW

A beginner's guide to MiFID II and the impact of Brexit

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BACKGROUND TO MIFID II

When MiFID came into force in 2007, it was widely perceived within the financial industry as an incomplete project that would require major revision. These revisions led to MiFID II, which came into force in January 2018. The partial nature of the original framework was due to a number of political compromises that left key aspects of the legislation unresolved, but MiFID was also experimental, and so reviewing whether its impact had been beneficial had always been seen as a necessary undertaking.

Amid these revisions, the financial crisis of 2008 prompted regulators to reassess how legislation could better protect investors. This reassessment led to an increasing focus on improving the level of protection available to professional clients in MiFID II, more in line with the approach to protecting retail clients than had been the case in the past. Whilst some aspects of MiFID II remain highly controversial (see the equivalence rules, in light of the IMPACT OF BREXIT), the balance between regulators who wanted more rules, and those who thought more rules were unnecessary, shifted between MiFID and MiFID II, such that regulators generally favoured more rules as part of a broader political response to the financial crisis.

SCOPE, APPLICATION, AND STRUCTURE

MiFID is applicable to EU-based investment firms, but, notably, it is not an EU investor protection measure that applies to firms anywhere in the world that provide services to EU clients (other notable pieces of EU legislation do work this way). MiFID's requirements apply to EU-based firms, no matter where their clients are located and irrespective of where the relevant instrument may be listed or traded. In this respect, MiFID is refreshingly non-extraterritorial and its conduct rule protection measures do not apply even to business conducted by non-EU branches of EU firms. Only on rare occasions does MiFID deliberately alter this position — for instance, MiFID requires non-EU branches of EU investment firms to submit transaction reports to EU regulators.

The MiFID commodity derivatives position limit requirements apply globally. MiFID's product governance regime requires EU firms to impose certain obligations on non-EU distributors, whilst the MiFID research unbundling regime requires EU firms to acquire research from non-EU firms in accordance with MiFID's rules. The mandatory trading obligation also requires EU firms, in some circumstances, to avoid trading on non-EU venues. So, whilst MiFID has an impact in non-EU jurisdictions, this impact is usually realised by placing obligations on EU firms rather than (perhaps with the commodity derivatives position limit reporting regime as an honourable exception) on non-EU entities.

In common with some other pieces of financial services legislation (the UK's Regulated Activities Order, for example), MiFID defines its scope by setting out a series of activities (such as dealing, advising, etc.) and a series of instruments (transferable securities, derivatives, etc.) and requiring firms to obtain authorisation as "investment firms" if they are undertaking any of those activities in relation to any of those instruments. MiFID categorises the activity types as investment services and ancillary services; the latter are only caught by MiFID if they are carried out alongside investment services (the provision of investment research is a good example of an ancillary service). As a result, MiFID creates a regime that captures a variety of different segments of the financial services industry: investment banks, corporate finance houses, advisors, managers, etc.

MiFID investment services and activities	
1.	Reception and transmission of orders in relation to one or more financial instruments
2.	Execution of orders on behalf of clients
3.	Dealing on own account
4.	Portfolio management
5.	Investment advice
6.	Underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis
7.	Placing of financial instruments without a firm commitment basis
8.	Operation of an MTF
9.	Operation of an OTF

MiFID financial instruments	
1.	Transferable securities
2.	Money-market instruments
3.	Units in collective investment undertakings
4.	Options, futures, swaps, forward rate agreements, and any other derivative contracts relating to securities, currencies, interest rates or yields, emission allowances, or other derivatives instruments, financial indices, or financial measures which may be settled physically or in cash
5.	Options, futures, swaps, forwards, and any other derivative contracts relating to commodities that must be settled in cash or may be settled in cash at the option of one of the parties, other than by reason of default or other termination event
6.	Options, futures, swaps, and any other derivative contract relating to commodities that can be physically settled provided that they are traded on a regulated market, a MTF, or an OTF, except for wholesale energy products traded on an OTF that must be physically settled
7.	Options, futures, swaps, forwards, and any other derivative contracts relating to commodities that can be physically settled, not otherwise mentioned in point 6 of this Section and not being for commercial purposes, which have the characteristics of other derivative financial instruments
8.	Derivative instruments for the transfer of credit risk
9.	Financial contracts for differences
10.	Options, futures, swaps, forward rate agreements and any other derivative contracts relating to climatic variables, freight rates, or inflation rates or other official economic statistics that must be settled in cash, or may be settled in cash at the option of one of the parties other than by reason of default or other termination event, as well as any other derivative contracts relating to assets, rights, obligations, indices, and measures not otherwise mentioned in this Section, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are traded on a regulated market, OTF, or an MTF
11.	Emission allowances consisting of any units recognised for compliance with the requirements of Directive 2003/87/EC (Emissions Trading Scheme)

In addition, MiFID also captures within its definitions the market infrastructure providers that supply services in these fields, such as exchanges and alternative exchange facilities (defined in MiFID as Multilateral Trading Facilities and Organised Trading Facilities). So MiFID's application is therefore broad, and it applies detailed and harmonised rules across those broad sections. MiFID's application is not, however, universal. Fund management is not necessarily caught by MiFID (as opposed to carrying out discretionary management activities on behalf of particular investors, which is). M&A activity is not necessarily caught by MiFID, although some services that are provided alongside M&A activities may be. Not all asset classes are caught by MiFID — real estate is an example (as opposed to real estate funds, which would be caught). MiFID changes from time to time, and it is possible in due course that additional alternative securities and cryptoassets will fall within its scope. Finally, even where activities or instruments are not caught by MiFID, they may be caught by individual national regimes, and the UK captures a number of activities that do not fall within MiFID's scope within the border of its own regulatory perimeter.

MiFID's contents are complex, and therefore so is its structure. MiFID II is separated into a Directive (which contains a number of broad structural requirements) and a Regulation (which attempts to set a harmonised rulebook that investment firms must follow). In addition, much of the important legislation is set out in so-called level 2 measures. ESMA has also provided extensive guidance (level 3) on what a number of the key provisions require — for instance, various extensive Q&A on how to implement investor protection measures under MiFID. Further, national regulators occasionally offer their views on the application of MiFID. Therefore, overcoming the challenge of understanding a measure as broad and deep as MiFID requires stakeholders to follow all of the sources of legislation in order to find answers.

IMPACT OF BREXIT

One of the key controversies in drafting MiFID II was what to do about third country business (in other words, to what extent could non-EU firms do business with EU customers without triggering a licencing requirement). In general terms, the controversy centred around a disagreement between the UK and French authorities on how legislation such as MiFID should work.

The French approach was that MiFID should harmonise all EU rules, including how all EU countries handle incoming third country business. The French proposal was, in effect, to ban cross-border services and to require third country firms to set up EU-regulated subsidiaries or branches to carry out business in the EU.

The UK approach was to leave such decisions to individual Member States, on the basis that MiFID was intended to harmonise what happened within the EU, rather than the external relations of EU Member States. This approach would have preserved the UK's Overseas Persons Regime, which is seen as providing liberal levels of access to the UK market for non-UK firms. Ultimately, these discussions ended with a compromise, which is evident in the MiFID equivalence regime.

The regime is complex but, essentially, third country firms may continue to conduct business into the EU in accordance with individual national regimes (such as, pre-Brexit, the UK's Overseas Persons Regime) unless an equivalence finding is made. Upon such a finding, firms from the relevant third country jurisdiction are permitted to do business throughout the EU in accordance with the equivalence finding and any requirements placed on that third country by the EU. The approach seemed to suit UK and French authorities. From the UK point of view, the key goal — retention of national discretion — was retained, and any equivalence finding could only seem to be a "good thing" because it would liberalise access in other EU Member States. From the French point of view, there was thought to be no appetite at EU level for making political determinations to provide equivalence and access, meaning that the status quo would be retained — in other words, no third countries would be found to be equivalent.

Post-Brexit, the equivalence regime became a legislative hot potato.

For the first time, there was a potential third country — the UK — that would have identical rules to the EU. On the other hand, the ability for the UK's financial services market to continue to access the EU post-Brexit was unthinkable politically. Despite ongoing discussions on both sides, it became clear that no equivalence finding for the UK was imminent.

Therefore, the post-Brexit position is as follows:

- The UK started off with almost identical rules post-Brexit to those it had pre-Brexit.
- The UK does not have the benefit of an equivalence determination from the EU, meaning that (unless an exemption or situation such as reverse solicitation applies) UK firms do not have permission to do business into the EU.

- EU firms do have permission to do business into the UK without a licence, provided that they can work within the relatively liberal confines of the Overseas Persons Regime (although the UK is currently reviewing this regime).
- No earnest ongoing work to achieve equivalence findings appears to be underway at present.

Post-Brexit, the UK has retained any national legislation and regulation that implemented the parts of MiFID that had to be transposed into national law. The UK has also "onshored" the parts of MiFID that applied directly when the UK was an EU Member State. The UK made minor amendments to ensure that the regime operated effectively in a UK-only context (for example, moving ESMA's functions to the FCA). However, none of these amendments were intended as policy changes.

The result was that immediately post-Brexit we ended up with two separate, but parallel, regimes — UK MiFID (which was the same as EU MiFID, but with some minor changes), and EU MiFID.

The UK now has rule-making flexibility and is beginning to alter rules in UK MiFID that it does not think are appropriate for the UK market. Similarly, the EU continues to evolve EU MiFID, and those evolutions are not effective as law in the UK. Similarly, although pre-Brexit level 3 measures remain relevant in the UK, any changes to those measures do not apply unless the FCA expressly adopts them. Therefore, over time, a degree of divergence will emerge and continue to widen the gap between the EU and UK regimes. It appears that the only question is around the speed and breadth of that divergence.

ORGANISATIONAL REQUIREMENTS

MiFID sets out the authorisation requirements for investment firms, including detailed information that firms must provide to the relevant national regulator. MiFID also contains some rules relating to changes of control over investment firms.

MiFID sets out requirements relating to the "management body" (a European phrase which, in UK terms, refers to the board). The board has overall responsibility for ensuring that a firm is managed properly and in a way that promotes the integrity of markets and the interests of clients. In a limited way, firms are encouraged to "avoid group think" and to ensure their leadership is "sufficiently diverse".

Under MiFID, firms must meet detailed organisational requirements, including in relation to:

- Conflicts of interest
- Business continuity
- Outsourcing
- Control procedures and security mechanisms
- Recordkeeping

One of the most important level 2 measures sets out the organisational rules that apply to investment firms. This is commonly referred to as the MiFID Org Regulation, which includes additional provisions relating to the recording of telephone conversations, the risk, compliance and internal audit functions, and remuneration policies and practices.

KEY CONDUCT OF BUSINESS RULES

CLIENT CLASSIFICATION

MiFID requires investment firms to identify clients and classify them as: Eligible Counterparties; Professional Clients; or Retail Clients. In summary, Eligible Counterparties tend to be national governments and other investment firms; Professional Clients need to pass quantitative and qualitative criteria; and Retail Clients are everyone else (with a limited and difficult to navigate option to upgrade certain Retail Clients to Professional Client status).

INFORMATION TO CLIENTS

MiFID requires investment firms to provide various information to clients and potential clients. This includes information relating to the status of the firm, the key terms that will apply to the business that is undertaken, and the costs and charges that the client may incur. The latter measure has proven particularly problematic and is subject to detailed level 3 guidance.

SUITABILITY AND APPROPRIATENESS

If a MiFID investment firm provides advice or takes discretionary decisions, detailed suitability requirements apply. Firms are required to obtain information from clients to enable them to demonstrate the suitability of the advice that the firm provides or the appropriateness of the discretionary decisions the firm takes.

If an interaction does not involve advice or discretionary decision-making, but does involve a complex product for a Retail Client, firms are required to undertake an appropriateness assessment. This is a more general test, and can lead to the client receiving warnings from the firm if the assessment suggests that the product may be inappropriate for that client.

REPORTING TO CLIENTS

Firms are required to put in place terms of business with most clients, and to provide them with regular reports on the type of service the firm is undertaking on their behalf. Some of these obligations are periodic, for example, those relating to costs and charges and suitability.

BEST EXECUTION AND CLIENT ORDER HANDLING

MiFID requires investment firms to obtain the best overall outcome for clients when executing transactions on their behalf. Firms must produce a Best Execution Policy that sets out how they will achieve this objective. MiFID II originally introduced measures designed to bring greater transparency on performance in this regard, which included a measure known as RTS 27 — requiring venues to publish information about the quality of execution achieved on that venue, and RTS 28 — requiring firms to provide information about the types of venue used. The utility of this information was questioned as part of the MiFID II legislative process, and is currently under review at both UK and EU level, which may lead to a repeal of the measures (either in part or in whole).

INDUCEMENTS AND RESEARCH

MiFID prohibits the payment or receipt of inducements by investment firms. The definition of an inducement is very broad. Any payment or benefit made or received by a firm that relates in any way to MiFID business being undertaken for a client must be subject to a series of tests. In particular, a firm must show that any payments could not give rise to a conflict of interest, are designed to benefit the underlying client, and are fully disclosed. Guidance is provided on the circumstances in which a benefit can properly be said to have accrued to a client, in line with a test focused on showing how the service to the client has been "enhanced". In practice, this has prohibited unearned trail commissions.

MiFID applies the inducement rules in detail to the provision of research by investment banks. MiFID firms who acquire research must do so on an "unbundled" basis, meaning that parties must agree separate execution and research payments (rather than bundling research fees alongside execution commissions). If the investment firm is the research provider, the firm is required to unbundle those services for certain clients. In practice, these measures have proved highly controversial (including in respect of their extra-territorial effect) and are currently being reviewed at both the UK and EU level.

PRODUCT GOVERNANCE

MiFID requires firms, in respect of each and every MiFID instrument, to identify the "manufacturer" and "distributor" of the product. These rules apply even if, taking into account the normal meaning of the word, no firm would consider themselves a manufacturer (for example, on an IPO, the manufacturers of the shares being listed by the company are the underwriting banks). EU/UK investment firms that fall within the definition of manufacturer or distributor are required to follow detailed product governance requirements, which ensure that manufacturers consider the needs of a specified target market and explain to distributors what the intended target market may be. Distributors then must only distribute the instrument in question in accordance with their and the manufacturer's definition of the appropriate target market.

KEY MARKETS RULES

PRE- AND POST-TRADE TRANSPARENCY

MiFID requires certain firms acting in a market-making capacity, and who either opt into the regime or who pass certain thresholds, to provide pre-trade transparency in the relevant instruments under what is known as the Systematic Internaliser Regime.

MiFID also requires all investment firms to provide near-instantaneous post-trade transparency in instruments that they execute (usually by having the details of the transaction published on a regulated market).

TRANSACTION REPORTING

MiFID requires a large number of fields to be reported to the local regulator in respect of every transaction executed by an investment firm. In practice, the technological challenge and the level of detail required has made this a difficult standard for firms to meet.

POSITION LIMITS FOR COMMODITY DERIVATIVES

MiFID contains detailed rules that set limits and provide a degree of transparency for positions taken by investors (no matter where in the world they may be based) in certain commodity derivatives that can be traded on EU/UK markets.

This measure proved controversial when being drafted and is frequently cited as an example of an area that should be reviewed and/or repealed, both at the EU and UK level.

MANDATORY ON VENUE TRADING OBLIGATIONS

MiFID requires firms to execute certain transactions on a venue in the relevant jurisdiction, which is known as the Mandatory Share Trading Obligation (and a similar measure applies in relation to derivatives).

This obligation is sometimes described as an attempt to prefer national execution venues over a client's best execution objectives and has proven particularly problematic in respect of EU MiFID post-Brexit, as the definition of a venue that EU clients must use excludes UK venues. The same is true in reverse, although UK authorities have provided a broad degree of forbearance in respect of UK firms accessing EU venues.

MANDATORY CLEARING OBLIGATIONS

MiFID, in common with a number of other global regulatory measures, contains provisions designed to encourage transactions in certain instruments to be cleared through internationally recognised clearing houses.

ACCESS TO MARKET INFRASTRUCTURE

MiFID contains rules providing a degree of equality of access to market infrastructure providers, in order to avoid discrimination against potential members. MiFID also sets out detailed requirements that market infrastructure providers must impose on members.

ALGORITHMIC TRADING

MiFID II contains new requirements for algorithmic trading (any trading where a computer algorithm automatically determines aspects of an order) that require firms to have assistance to ensure that erroneous orders can be prevented from creating disorderly markets. High-frequency trading is subject to additional obligations, including a restriction on the ability of members of EU/UK venues to provide high-frequency trading access for non-EU/UK firms.

PASSPORTING

MiFID investment firms are authorised by the regulator in the Member State where the firm is organised. On the basis of this authorisation and compliance with the local rules (which of course are harmonised in each Member State by MiFID), the firm can conduct business on a cross-border services basis, or establish local branches, in accordance with a MiFID passport. Whilst some degree of local "gold plating" exists that can sometimes disrupt this process, to a large degree the rules are the same, and serious disruption is rare.

When local branches are established, responsibility is shared between conduct of business rules and issues relating to clients (which the host regulator leads), and organisational requirements (which are primarily the home regulator's responsibility). Furthermore, only EU firms can obtain passports — passports for a non-EU firm, even one with an established branch in the EU, do not exist. Generally speaking, passporting is not possible under UK MiFID (although arrangements are in place to allow Gibraltarian firms to continue to passport into the UK).

PRODUCT INTERVENTION

MiFID provides national regulators with specific product intervention powers to prevent the sale of products in certain circumstances. Further, MiFID also provides ESMA with powers to take measures on a pan-European basis, in more limited circumstances.

Detailed guidance exists on the circumstances in which regulators should use these powers and the means by which the use of the powers should be communicated. In practice, only limited steps have been taken in accordance with these rules, and the focus has been on complex products and retail clients.

REVIEW

Ongoing consultations at the EU and UK level are aiming to revise MiFID and, inevitably, will lead to a degree of divergence between the EU and UK (see IMPACT OF BREXIT).

As those revisions remain ongoing, and are likely to be formed by a series of separate consultations, it is beyond the scope of this note to set them all out in detail and track and their individual progress.

Where the measures are significant, our Client Alerts and Blogs keep readers up to date.

However, divergence has already been indicated, or may soon occur, in the following areas:

- Research unbundling
- The Best Execution Regime, particularly in respect of measures contained in RTS 27 and RTS 28
- The Commodity Derivatives Position Limits Regime
- Equivalence (the UK may remove these requirements as equivalence findings will actually be more restrictive than the existing UK regime for overseas persons in many circumstances)
- Costs and charges disclosures
- The scope of the Product Governance Regime

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