EUROPEAN
COMMISSION

Brussels, 18.5.2016
SWD(2016) 157 final

COMMISSION STAFF WORKING DOCUMENT

IMPACT ASSESSMENT

Accompanying the document

COMMISSION DELEGATED REGULATION

supplementing Regulation (EU) No 600/2014 of the European Parliament and of the Council with regard to definitions, transparency, portfolio compression and supervisory measures on product intervention and positions

{C(2016) 2860 final}
{SWD(2016) 156 final}

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Executive Summary

Executive Summary Sheet
Impact assessment on Delegated Acts implementing Directive 2014/65/EU of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU(recast) and Regulation (EU) No 600/2014 of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012.
A. Need for action
Why? What is the problem being addressed?
The delegated acts address problems in 4 areas: i) Without these measures investor protection would not be ensured to the extent intended by the Directive, e.g. client assets might not be safeguarded sufficiently and retail investors might invest in investment instruments which are sub-optimal for their needs because of biased advice or services. ii) Markets for financial instruments might lack transparency if, e.g. rules applicable to different instruments with regard to what constitutes a 'liquid market' under MiFID would differ without obvious reasons. Similarly, if the minimum requirements for multilateral trading facilities to be registered as an SME growth market were not defined in a harmonised way, the 'SME growth market' label could reflect different features in different Member States. Investors could not conclude from the label what kind of market they face. iii) Without the delegated acts market integration and integrity as well as iv) the functioning of securities markets could not be ensured to a sufficient degree, e.g. commodity derivatives markets, foreign exchange markets or high frequency traders. Most affected would arguably be retail investors, but in the worst case all market participants could be affected with knock-on effects on the economy as seen in the Lehman crisis.
What is this initiative expected to achieve?
The objective of the initiative is to ensure investor protection and to improve transparency, integration and integrity of financial markets in the Union. This, in turn, should result in better investment decisions by retail investors as well as deeper and more liquid financial markets. Ultimately, this initiative will enhance the efficiency, resilience and integrity of financial markets and should thus contribute to the creation of jobs and economic growth in the Union.
What is the value added of action at the EU level?
The specifications provided with these delegated acts ensure a level of harmonisation which could not be achieved through action by Member States alone as national legislation (or the lack thereof) would result in a patchwork of rules which would be less transparent and would make it difficult for investors to find out what the applicable rules would be and how differences would impact investment outcomes, it would hinder market integration across the Union and thereby most likely lead to inefficiencies and higher costs for market participants, including SMEs trying to access financial markets.
B. Solutions
What legislative and non-legislative policy options have been considered? Is there a preferred choice or not? Why?
The impact assessment was carried out for those measures for which more significant impacts are to be expected, where MiFID II/MiFIR allow the Commission a genuine choice of options and for the central topics that bring innovations under the Directive and Regulation (inducements, safeguarding of client assets, the definition of liquid equity markets, the enlarged regime for systematic internalisers, the reasonable commercial basis, SME growth markets, the delineation of foreign exchange spot contracts versus foreign exchange derivative contracts, commodity derivatives). The preferred options in these areas are selected to strike a balance between achieving the objectives and adding legal clarity to the level 1 provisions on the one hand and the possible adverse impacts on market participants, in particular compliance costs, on the other hand.
Who supports which option?
Organisations representing retail investors generally prefer a strict regime on inducements and the safeguarding of client assets. Banks and financial advisers providing investment advice have argued for a more 'flexible' approach. Trading venues do support transparency, but only up to a certain level of granularity. Trading venues also highlight the importance of a level playing field in securities markets (for example with reference to the transparency rules applied to trading venues and systematic internalisers). The buy side for market data is more supportive of comprehensive rules on prices for market data than the sell side.
C. Impacts of the preferred option
What are the benefits of the preferred option (if any, otherwise main ones)?

The benefits of the preferred options are more transparent and safer financial markets. These benefits have been weighed against the costs incurred for each of the options in the key policy areas assessed in the main part of the impact assessment. The preferred option is generally the one that provides the most cost-efficient solution to achieving the objectives of MiFID II/MiFIR. As the options in most cases have different impacts on many diverse actors currently operating under different circumstances it was not possible to quantify the resulting costs with a sufficient degree of accuracy.

What are the costs of the preferred option (if any, otherwise main ones)?

Costs triggered by the delegated acts discussed in this impact assessment should not be significant for market participants given the fact that they are already required to implement the rules under the MiFID II level 1. Costs for investment firms must also be seen in the overall context of achieving more transparency in the markets and better protection for investors. This transparency should then lead to lower search and monitoring costs for intermediaries and investors.

How will businesses, SMEs and micro-enterprises be affected?

The measures will have a direct impact only on actors active in financial markets. Depending on their current business model some investment firms, many of which are SMEs, might face higher costs. On the other hand, MiFID II/MiFIR and the measures considered in this impact assessment should result in greater investor confidence which in turn should lead to greater business opportunities for these investment firms, as should the new SME growth markets. Non-financial companies, SMEs and micro-enterprises should benefit from safer, more harmonised and integrated financial markets and greater transparency and should also improve their access to finance. In particular the SME growth markets should help with regard to the latter.

Will there be significant impacts on national budgets and administrations?

No, the delegated acts will not have significant impacts on national budgets and administrations.

Will there be other significant impacts?

No, there will not be any other significant impacts besides economic ones. The proposed measures do not have any specific regional impacts and do not affect the environment. The measures are not of a nature that could impact on fundamental rights.

D. Follow up

When will the policy be reviewed?

The Commission will have to review MiFID II before 3 March 2019 and MiFIR with regard to different provisions in the Regulation by 3 July 2016, 3 March 2019, 3 July 2019 and 3 July 2021 respectively.

1. INTRODUCTION

The subject of this impact assessment (IA) report are the delegated acts of the Markets in Financial Instruments Directive (2014/65/EU, 'MiFID II') and the Markets in Financial Instruments Regulation ((EU) No 600/2014, 'MiFIR'), which are intended to specify certain aspects of the Directive and Regulation in view of a consistent implementation throughout the Union. MiFID II/MiFIR are to enhance investor protection and financial market transparency across the Union.[1]

The predecessor of MiFID II/MiFIR, the Markets in Financial Instruments Directive (2004/39/EC[2], 'MiFID I') entered into force in 2007, just before the financial crisis.

While MiFID I contributed to a more competitive and integrated EU financial market for the instruments (shares) and markets (regulated markets) under its scope, the events of the financial crisis and market developments highlighted a need to further strengthen investor protection and to extend the scope of MiFID to financial market instruments other than shares as well as to market participants and activities not regulated under MiFID I in order to even out the regulatory playing field in those areas. Closing the gaps in the scope of MiFID I was also necessary in order to bolster investor confidence in financial markets, which had been badly shaken during the crisis.

The European Council Conclusions of the meeting of 18/19 June 2009[3] state: "The financial crisis has clearly demonstrated the need to improve the regulation and supervision of financial institutions, both in Europe and globally. Addressing the failures exposed by the present crisis will contribute to preventing future ones. It will also help restore confidence in the financial system, in particular by enhancing the protection of depositors and consumers, and will thus facilitate the recovery of the European economy."

MiFID II/MiFIR extend the scope of transparency regulation of markets in financial instruments to equity instruments other than shares and to non-equity instruments. The objectives were, amongst others, to improve oversight and transparency with regard to commodity derivative markets, to ensure their functioning for hedging and price discovery as well as to tackle loopholes and less regulated and more opaque parts of the financial system in line with G20 commitments[4].

Updates of the regulatory package were also necessary in light of developments in market structures and technology (such as high frequency trading) in order to ensure fair competition and efficient markets. MiFID II/MiFIR also aim to reinforce supervisory convergence across the single market and harmonise the treatment of third countries.

Finally, the overarching aim of the MiFID II/MiFIR regulatory package is to level the playing field in financial markets and to enable them to work for the benefit of the economy, supporting jobs and growth.

[1] A glossary of the technical terms used in this report can be found in Annex 1.
[2] http://ec.europa.eu/finance/securities/isd/mifid/index_en.htm
[3] https://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/108622.pdf
[4] http://www.treasury.gov/resource-center/international/g7-g20/Documents/pittsburgh_summit_leaders_statement_250909.pdf

1.1. Procedural Issues

1.1.1. Impact assessment steering group

The Steering Group for this Impact Assessment (IASG) was formed by representatives of a number of services of the European Commission, namely the Secretariat General, the Legal Service, the Directorates General for Financial Stability, Financial Services and the Capital Markets Union; Competition; Agriculture & Rural Development; Climate Action; Energy; Economic and Financial Affairs, Taxation and Customs; Internal Market, Industry, Entrepreneurship & SMEs; Justice; and Trade. This Group met 5 times. The last meeting prior to the presentation to the Impact Assessment Board took place on 18 March 2015.[5] One further meeting of the steering group was held on 8 May 2015 to present the changes requested by the Impact Assessment Board and to discuss the relevant draft legislative texts.

1.1.2. Impact Assessment Board

The Impact Assessment Board analysed this Impact Assessment and delivered its opinion on 24 April 2015.. In the course of this procedure the members of the Board provided the services of Directorate General for Financial Stability, Financial Services and the Capital Markets Union with comments to improve the content of the Impact Assessment that led to some modifications to the text. The following changes were made in response to the comments of the Board:

- The scale and scope of impacts has been better described and reference has been made to current practices in Member States and to how the proposed options differ from these practices.

- The summary of impact sections have been redrafted to more clearly demonstrate how the preferred option in the key policy areas discussed in this report achieve the objectives of investor protection, transparency and market integration.

- The views of different stakeholder groups (e.g. investors vs. investment firms) have been better put into relief and an explanation has been given for how different views have been taken into account.

- The report has been redrafted to better explain how the preferred options presented address the identified problems.

- The baseline scenario now lays out in more detail how investor protection and financial market transparency would develop without additional EU action.

- The report now better links monitoring arrangements to the specific objectives of the initiative and details the planned evaluation arrangements.

- Additional terms have been added to the glossary and the overall presentation of the arguments in the analysis has been improved (layout, coherence between different sections).

[5] In accordance with the rules for the elaboration of Impact Assessments the minutes of the last meeting of the Steering Group prior to the meeting of the Impact Assessment Board have been submitted to the Impact Assessment Board together with this Impact Assessment.

1.2. Consultation of interested parties

In accordance with Article 19 of the ESMA Regulation,[6] the European Securities and Markets Authority (ESMA) should serve as an independent advisory body to the Commission, and may, upon a request from the Commission or on its own initiative provide opinions to the Commission on all issues related to its area of competence.[7]

The Commission mandated ESMA to provide it with technical advice on possible delegated acts concerning MiFID II and MiFIR. On 23 April 2014, the Commission services sent a formal request for technical advice (the "Mandate") to ESMA on possible delegated acts and implementing acts concerning MiFID II/MiFIR.[8] On 22 May 2014 ESMA published a consultation paper with regard to its technical advice on delegated acts. ESMA received 330 responses by 1 August 2014. ESMA delivered its technical advice on 19 December 2014[9].

On 16 May 2014, the Commission sent a mandate to the European Banking Authority (EBA) for advice on possible delegated acts concerning MiFID II[10] regarding the framework for EBA intervention powers in respect of structured deposits. EBA held a public consultation on its consultation paper from 5 August 2014 to 5 October 2014 and delivered its technical advice on 11 December 2014[11].

2. PROBLEM DEFINITION

MiFID II/MiFIR aim to remedy the loopholes and weaknesses in regulation and market self-regulation revealed by the financial crisis and cover relatively new activities, such as high frequency trading, which had not been dealt with in MiFID I. They also take into account international commitments (e.g. G20 commitments in the area of derivatives[12]). MiFID II/MiFIR address insufficiencies in three key areas:[13]

Transparency: they extend transparency requirements to equity-like and non-equity instruments and to market players that had not previously or to a lesser extent been regulated;

Market integration: they strive to extend these transparency requirements in a level fashion across trading venues and between trading venues and bilateral trading systems, while taking into account their respective specificities and

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[6] Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC. OJ L331/84, 15.12.2010, p.84.

[7] Commission Decision 2009/77/EC of 23 January 2009 establishing the Committee of European Securities Regulators, OJ L25, 29.1.2009, p.18.

[8] Available at: http://ec.europa.eu/internal_market/securities/docs/isd/mifid/140423-esma-request_en.pdf

[9] http://www.esma.europa.eu/content/Technical-Advice-Commission-MiFID-II-and-MiFIR

[10] Available at: http://ec.europa.eu/internal_market/securities/docs/isd/mifid/140516-request-for-eba-technical-advice-concerning-mifid-2_en.pdf

[11] http://www.eba.europa.eu/documents/10180/657547/EBA-OP-2014-13+-+Technical+Advice+on+Structured+Deposits.pdf

[12] http://www.treasury.gov/resource-center/international/g7-g20/Documents/pittsburgh_summit_leaders_statement_250909.pdf

[13] Other areas of the regulatory framework under MIFID II provide for implementation measures in the form of regulatory technical standards and thus are not covered by this Impact assessment, for example non-discriminatory access to trading venues, central counterparties and benchmarks. Concerning transparency, some elements are dealt with in this impact assessment; others are also partially or mainly dealt with in the draft technical standards, and hence fall outside the scope of this impact assessment.

Investor protection: amongst others, by strengthening the inducements regime and introducing additional safeguards concerning clients' assets.

However, many of the level 1 provisions in these areas require further specification at level 2. Without such further specification uncertainty as to their precise application and implementation would surround many of the provisions introduced in MiFID II/MiFIR and differing interpretations of the level 1 provisions would again lead to different regimes on investor protection, market transparency and market integration, suggesting that market participants and regulators have drawn no lessons from the crisis or latest market developments and practices.

Certain of the issues to be addressed at level 2 have been identified as crucial because of their decisive impact on the overall ability of the MiFID II/MiFIR to meet its objectives in an efficient manner. Therefore, these specific issues will be addressed in more in detail in this impact assessment.[14] The remainder of the issues, though important in themselves, either would not be expected to have a significant impact, or the empowerments in the Level 1 Directive or Regulation leave very limited or no discretion. These issues will therefore not be discussed in detail but are briefly explained and discussed in Annex 3.

The problems that are to be addressed in the delegated acts are related to investor protection, market integration and integrity as well as transparency. The impacts of these problems do not necessarily stop there but may have knock-on effects on jobs and growth. This will be discussed in some more detail in section 4 below.

2.1. Investor Protection

The unfavourable financial market conditions due to the financial crisis made apparent that a number of provisions in MiFID I were not stringent enough to ensure that investors were benefitting from appropriate protection. As a consequence, investors might have been sold financial products not appropriate for them, or they might have made sub-optimal investment choices due to, in certain cases, insufficient information or biased services. Furthermore, the assets they bought might have been insufficiently protected. MiFID II has strengthened the existing rules on investor protection. However, some of these rules need to be further specified in delegated acts.

Safeguarding of Client Assets

MiFID II (Article 16 (8) and (9)) requires that an investment firm, when holding funds or financial instruments belonging to clients, makes adequate arrangements to safeguard investors' ownership and other similar rights in respect of securities and the investor's rights in respect of funds entrusted to a firm.

Drivers: As MiFID II sets out only principles, there is still considerable uncertainty as to what is expected from investment firms in terms of organisational requirements. This lack of clarity could result in unintentional and/or intentional lawful or unlawful discrepancies in investor protection across Member States and across investment firms.

Problem: Investors might not be fully aware of such differences and consequences attached thereto and therefore take decisions on the basis of erroneous assumptions. Investment firms

[14] A problem tree summarising the logic can be found in Annex 2.

might try to stretch the (lower) limits of the Level 1 principles, e.g. by not properly safeguarding and segregating client assets or by re-using client assets, thereby putting them at risk, without the investor's' consent or full understanding of the potential implications on their rights. Furthermore, the possibility to hold client funds with financial institutions which are part of the same group creates conflicts of interest for investment firms as they might weigh investors' interests against interests of the group, such as liquidity, fees and interests. In addition to the potential risks resulting from the concentration of assets in one entity, there would be a risk of contagion if problems at one financial institution would affect other parts of the same group.[15] When a firm/group is approaching insolvency, there is an increased risk that the firm will attempt to use clients' assets to prevent the firm and/or group from failing. Also, firms may be incentivised to place funds within the group as it is generally cheaper (increased liquidity and higher return) to hold money within the group as opposed to with third parties. Therefore firms have an incentive to maximise the amount of client monies held within the group rather than diversifying as might be optimal from a client perspective.

Consequences: This could result in a situation where client assets which should have been properly segregated are subject to risks of diminution, loss or poor administration or become part of insolvency procedures and cannot be returned promptly. In a crisis situation with high asset price volatility, such a delay in establishing the claim of a specific client might result in significant financial losses for this client. Where clients' money is deposited by the investment firm at a bank within the same group (and it is treated as an ordinary deposit at the bank), there is a risk that the bank will enter insolvency proceedings and not all money deposited in client bank accounts will be available for prompt return to the underlying clients (as illustrated with the failure of Lehman Brothers).

Inducements

The implementation of MiFID I resulted in different approaches to the application and interpretation of the inducements regime. MiFID II addresses these issues by preventing investment firms providing independent advice or portfolio management from accepting and retaining fees, commissions or any monetary or non-monetary benefits other than, under certain conditions, minor non-monetary benefits. In all other cases, investment firms are allowed to receive an inducement provided that disclosure is provided and that the inducement is designed to enhance the quality of the relevant service to the client and it does not impair compliance with the investment firm's duty to act honestly, fairly and professionally in accordance with the best interest of its clients.

Drivers: MiFID II only establishes principles-based requirements. Without further guidance on situations in which the reception of certain payments or benefits may constitute an inducement or in which inducements may enhance the quality of the service to the client and may therefore be acceptable, existing (pre-MiFID II), differing, approaches to the application and interpretation of the inducements regime may carry on, leading to circumventions of the Directive and defeating the purpose of the review, with detrimental effects for investors.

[15] Concentration risk simply describes the increased risk of loss if all funds are held collectively. Investment firms would have to consider, as part of their due diligence requirements, diversifying the external entities with which they deposit client funds. Contagion risk, on the other hand, arises from the fact that, for a given level of default risk, the correlation between the failure of an intermediary and a group bank would generally be higher than the correlation between the failure of the intermediary and a third party bank.

Problem: Investor protection would be at risk as inducements might bias investment firms in favour of products or services which would provide them with higher inducements, without such products or services necessarily being the best choice for the investor or without the reception of inducements bringing an enhancement of the services provided to the client. Also, certain practices by which investment research is provided to portfolio managers as a side product of the execution process, without a transparent assessment of the costs and quality of the research provided and with the corresponding risk of conflicts of interests and breach of execution requirements, may continue, putting at risk the objective under MiFID II to have a stricter approach towards inducements[16] .

Consequences: Without further specifications of the new framework for inducements, investors would potentially continue to suffer from conflicts of interests, distorted advice and services of investment firms, or might end up with higher execution rates or turnover or with a portfolio which consists of a sub-optimal choice of instruments. The lack of legal clarity and certainty around the inducements regime would also be detrimental for investment firms, in particular when providing services using the freedom of establishment as they would have to comply with potentially different national rules.

2.2. Transparency

Transparency is a key principle to enable informed price formation by market participants as well as by investment firms on behalf of their clients, mainly through the comparison of trading opportunities, based on published post-trade data (price, volume and time of transactions), and of results across trading venues by better assessing how trading at certain venues, the efficiency in timing and the costs of executing their orders influence the value of their portfolios. MiFIR has strengthened the existing rules on transparency. However, some of the rules need to be further specified in delegated acts.

Delineation of what constitutes a liquid market for equity and equity-like instruments

The four factors 'free float', 'being daily traded', 'average daily number of transactions' and 'average daily turnover' were already used to define a liquid market for shares under MiFID I, but under MiFIR they have to be applied also to equity-like instruments other than shares. The liquidity test employing these factors therefore also has to be calibrated for depositary receipts, exchange traded funds (ETFs), certificates and similar instruments in order to ensure a harmonised liquidity test for these instruments across Member States.

The definition or classification as a 'liquid market' under MiFID II/ MiFIR has several consequences: it determines the application of *restrictions regarding the price at which a negotiated transaction can be executed* under the rules of a trading venue; it sets *quantitative limits* (the double volume cap mechanism) *on the total volume of trading which can be*

[16] "UK investment managers pay an estimated £3bn of dealing commissions per year to brokers, with around £1.5bn of this spent on research. These transaction costs are borne directly by investment managers' customers" while only a few firms "exercised the same standards of control over these payments that they exercised over payments made from the firms' own resources". (UK FCA, Discussion paper on the use of dealing commission regime, July 2014.) A CFA Society UK 2014 survey (CFA Society UK, The market for research, February 2014, Annex C.) noted that only 16% of respondents agreed that the current UK market for research was transparent in terms of value and cost.

carried out under the reference price waiver and to certain types of negotiated trades;[17] it determines the *quoting obligations for systematic internalisers.*

Drivers: Diverging interpretations could lead to discrepancies in the application across Member States and have adverse implications for the transparency regime applicable to shares, depositary receipts, exchange traded funds, certificates and other similar financial instruments.

Problem: Transparency would suffer if the rules applicable to different instruments would deviate without obvious reasons.

Consequences: This could result in unjustified price differences for different players and hamper market integration and integrity[18].

Extension of the systematic internaliser regime

Systematic internaliser means "an investment firm which, on an organised, frequent, systematic and substantial basis, deals on own account by executing client orders outside a regulated market, a multilateral trading facility or an organised trading facility without operating a multilateral system"[19]. There are only very few investment firms registered as Systematic internaliser under MiFID I.[20]

MiFID II supplements the qualitative definition of systematic internaliser in MiFID I by introducing quantitative criteria to ensure an effective and objective application of this definition. MiFID II also extends the systematic internaliser regime from shares to equity-like instruments and non-equity instruments.

Drivers: Without further technical specification this definition could lead to a non-level playing field in terms of transparency (requirements) for instruments traded on different types of execution venues.

Problem: Market integration and transparency could be hampered.

Consequences: This, in turn, could unduly influence the choice of financial instruments and execution venue both by issuers and investors. Some investors and issuers might face losses or reduced profits due to a sub-optimal choice of investment products.

[17] Where there is a liquid market for an instrument, waivers to pre-trade transparency may apply to negotiated trades up to limits set under the double volume cap mechanism. National competent authorities may waive pre-trade transparency for negotiated transactions in illiquid instruments without reference to the double volume cap mechanism.

[18] In case of an application of the transparency regime that differs amongst countries, market participants may have a differing estimation of the costs of that transparency, hence costs (bid asks spreads for example) may differ due to this in different countries for the same instrument. If trades in the same instrument are transparent in one country, but not in another, this interaction may lead to pricing differences in different markets (for example in the non-transparent market slightly higher prices may be applied since investors have no view on the prices in that market, so they will have less of an overview of the volumes and prices in that market and hence have less data to decide on an appropriate price. Knowledge asymmetries with regard to price information may persist to a stronger degree in non-transparent markets, hence leading to less efficient prices for investors.)

[19] Article 4(1)(20) MiFID II

[20] http://mifiddatabase.esma.europa.eu/Index.aspx?sectionlinks_id=16&language=0&pageName=MiFIDSystematicSearch&subsection_id=0

2.3. Fees for trade data publication (Reasonable Commercial Basis)

MiFID II and MiFIR contain provisions to ensure that trading data are made available on a reasonable commercial basis. This requirement is an essential aspect of ensuring an effective transparency regime and to overcome market fragmentation. What constitutes a 'reasonable commercial basis' has to be specified in a delegated act.[21]

Drivers: Trading data in the EU are provided at elevated prices in certain cases[22], also because most of the data are only available in pre-set larger data bundles.

Problem: These high prices create barriers to the provision and use of market data, impair information flow and the price discovery and formation process. Without further technical specifications about the precise scope and substance of this obligation, market participants, competent authorities and courts would not have sufficient clarity about the rights and obligations that flow from it. This could adversely affect market integration and transparency.

Consequences: This problem could result in poorer choices for investors due to a lack of information and/or higher prices. Markets would not be as 'deep' as they could be.

2.4. Establishing an SME growth markets label

MiFID II provides for an SME growth market label that Multilateral Trading Facilities which comply with certain requirements can apply for in order to raise the visibility and facilitate the ease of access to financing for small and medium-sized enterprises (SMEs) listed on these multilateral trading facilities.

Drivers: SMEs still face greater barriers to achieving visibility and getting access to potential investors than larger companies. Due to their size, the cost of listing for an SME is also proportionally higher than for larger issuers. Currently not all multilateral trading facilities have requirements in their rulebook addressing all these aspects.

Problem: It remains more difficult and proportionally more expensive for SMEs to finance themselves compared to larger companies. MiFID II introduces an "SME growth market" label which Multilateral Trading Facilities that comply with certain conditions can benefit from. However, MiFID II could not specify these conditions in sufficient detail to ensure that all market participants would have the same, or a sufficiently similar understanding of what to expect from an SME growth market. In short, transparency and market integration and integrity could suffer.

Consequences: Insufficiently transparent and well-understood SME growth markets would be more likely to fail and the problems described above would continue to exist. This would leave SMEs in most Member States without access to liquid markets for their capital needs and therefore a perpetuation of the lack of access to finance for them with adverse impacts on their and the (national) economies' growth perspectives.

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[21] In addition, Article 12(1) MiFID sets out a mandate on the compulsory level of disaggregation of trading data which is specified in regulatory technical standards (see ESMA consultation paper p. 448). For further background please refer to annex 6 of this paper.

[22] Although the causes of high prices in the EU are disputed, available studies indicate that comparable consolidated market data can sometimes be up to seven times more expensive in the EU than in the US and that the evolution of prices for market data has not followed the downward trend similar to that of execution services following MIFID 1 (for more detail see annex 6).

2.5. Core definitions

In order to ensure a harmonised application of MiFID II/MiFIR and to provide a level playing field, it is necessary to further specify which legal entities are considered to be undertaking high frequency trading or have a direct electronic access to a trading venue, which foreign exchange (FX) contracts are considered spot contracts and which are considered to be derivative contracts and which commodity derivative contracts are considered as C6 or C7 contracts[23] under the definitions of MiFID II in order to delineate the scope of application of MiFID II/MiFIR, i.e. to determine which entities due to the specific activities they carry out or due to the financial instruments they trade are within the scope of MiFID II/MiFIR.

Drivers: Without further specification in delegated acts the definitions in MiFID II/MiFIR would not be precise enough to ensure sufficiently harmonised interpretations and applications by national competent authorities and market participants. In some cases this could also lead to an inconsistent application under different pieces of EU law (e.g. EMIR and MiFID).

Problem: Such divergences could create legal uncertainty and undermine, at least to some extent, the advances in achieving the objectives of MiFID II/MiFIR. This, in turn, could hinder the efficient functioning of securities markets across the Union.

Consequences: Inefficient markets usually result in less liquidity and transparency. This could have detrimental impacts on issuers/offers and investors as demand and supply would match less well. Different interpretations could undermine market integration in the Union.

2.6. How would the problem evolve without EU action? The Baseline Scenario

The level 2 empowerments in MiFID II/MiFIR require the specification in greater detail of certain elements of the respective level 1 provisions.

Without such delegated acts the practical details on how to achieve the objectives of the level 1 would remain largely void. Member States drafting their implementing measures would not know where they stand in relation to other Member States. The result would therefore be a patchwork of national legislation; securities markets in the Union would remain fragmented.

Technical aspects of definitions would also remain open to different interpretations and applications in Member States, creating regulatory loopholes, the possibility for forum/jurisdictional shopping, and an un-level playing field with regard to financial market transparency and investor protection in the EU Member States, for example in the area of the protection of client assets or inducements rules. A result that would clearly go against the intention of the level 1 texts as agreed by the co-legislators.

Without further incentives for harmonisation, potential SME growth markets would continue to apply very differing rules and no convergence of these rules may be expected in the future. With regard to investor protection, current practices would likely continue (for example, while there is a general due diligence requirement when placing funds, the temptation persists to place client funds within the group to fund other group activities, no incentives would be

[23] 'C6 Contracts' refers to options, futures, swaps, and any other derivative contracts mentioned in Section C.6 of Annex I of MiFID II relating to coal or oil contracts that are traded on an OTF and must be physically settled; refers to contracts ; 'C7 Contracts' refers to options, futures, swaps, forwards and any other derivative contracts relating to commodities, that can be physically settled not otherwise mentioned in Section C.6 and not being for commercial purposes, which have the characteristics of other derivative financial instruments.

provided to take concrete measures in terms of due diligence.) With regard to inducements the rules currently in force have led to cases of misselling, it is not clear how these practices would cease without any strengthening of the rules).

Without further clarification of what constitutes a liquid market in equity instruments, on the quantitative thresholds for systematic internalisers, as well as on the definitions (high frequency trading, direct electronic access, the delineation between energy and financial markets), the provisions of the Directive and the Regulation would be applied very differently in different countries with thresholds set at the national level. In this case MiFID II/MIFIR would lead to the further fragmentation of securities markets across the Union instead of harmonisation and contributing to a Single Rulebook as is the intention of the co-legislators reflected in the level 1 texts.

2.7. The EU's right to act and justification

The European Commission's and the EU's right to act is discussed in the impact assessment which accompanied the Proposal for a Directive of the European Parliament and of the Council on Markets in financial instruments [recast] and the Proposal for a Regulation of the European Parliament and of the Council on Markets in Financial Instruments (Directive 2014/65/EU and Regulation (EU) No 600/2014).

The legal basis for action at level 2 is provided (and delineated) by the power to adopt delegated acts and implementing measures conferred upon the Commission in the Directive and Regulation. The Directive and Regulation require delegated acts to be adopted in specified areas to ensure that the level 1 is implemented in a consistent way across the EU.

The analysis of concrete options for the provision of the level 2 measures considers the precise nature and extent to which harmonisation is necessary, always with the principle of subsidiarity in view. However, action solely at Member State level would not be able to effectively or efficiently address these issues given the cross-border nature of financial markets and would lead to further fragmentation of the single market with differing rules in place in different Member States with regard to financial market transparency and investor protection, which would clearly go against the letter and spirit of the level 1 texts.

The European Commission mandated the European Securities and Markets Authority to provide technical advice on the delegated acts to be adopted at level 2. The Authority delivered its technical advice on 19 December 2014. With regard to two empowerments the technical advice however raised some further questions on how to achieve harmonisation across the Union.

With regard to SME growth markets, the European Commission is empowered to take measures that take into account the need for maintaining high levels of investor protection and to promote investor confidence. Potential SME growth markets currently have very different requirements for admission to trading. The level 2 measures laid out in this report will lead to some convergence in this regard. In a future initiative, guidance could also be provided with regard to the types of admission criteria that SME growth markets have to fulfil in order to guide potential investors in their due diligence.

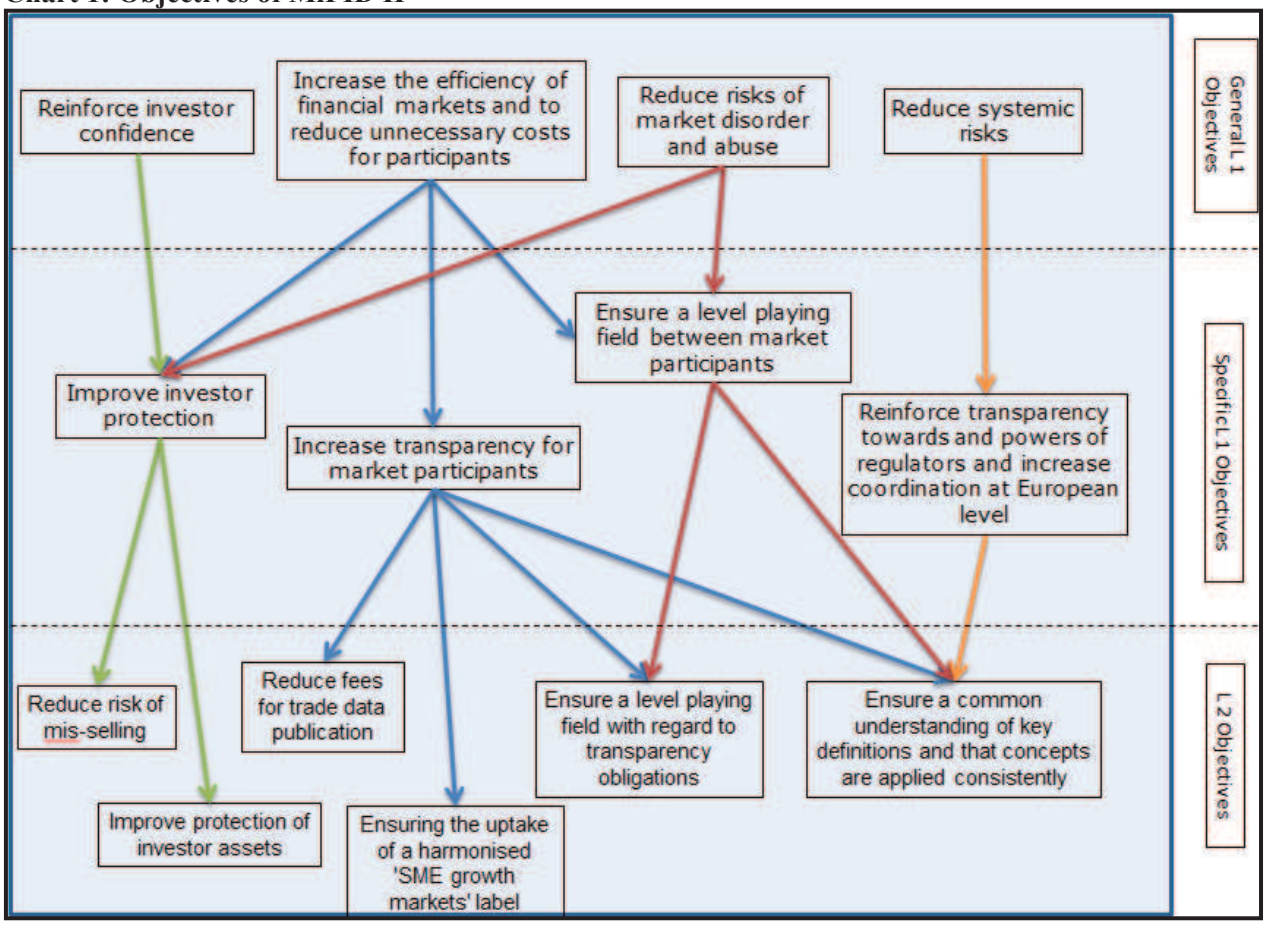
With regard to the definition of C7 derivatives, based on the ESMA advice, the provisions are open to a wide range of interpretations. The European Commission has sought to clarify the

practical application in the spirit of the level 1 and avoid undue impacts on the agricultural sector.

3. OBJECTIVES

The general objectives of MiFID II level 1 were to reinforce investor confidence, reduce risks of market disorder and abuse, reduce systemic risks and increase the efficiency of financial markets and to reduce unnecessary costs for market participants. They translated into the following specific objectives: i) ensure a level playing field between market participants; ii) increase transparency for market participants; iii) reinforce transparency towards and powers of regulators and increase coordination at European level; iv) raise investor protection; and v) address organisational deficiencies and excessive risk taking by investment firms and market operators. The objectives of the delegated acts are also linked to these objectives. They are depicted in Chart 1 below.

Chart 1: Objectives of MiFID II



3.1. Investor Protection

Safeguarding of Client Assets: To avoid the risk that client assets cannot be identified and recovered quickly in emergency situations it should be ensured that client assets are safeguarded effectively and in a harmonised way. Client assets should not be put at significant risk by placing all the funds in an institution which is part of the same group. In such cases it is important to mitigate conflicts of interests as well as concentration and

contagion risks arising when client funds are placed with an intra-group institution. Measures should be taken to improve the protection of investors' assets compared to MiFID I.

Inducements: The delegated acts should ensure that investment firms' ability to comply with their obligations towards clients and that their services are not affected or biased by third-party payments or benefits. Conflicts of interest need to be further mitigated and rules reinforced compared to MiFID I in order to do away with incentives for the mis-selling of financial instruments or sub-optimal investment decisions and services.

3.2. Transparency

Delineation of what constitutes a liquid market for equity and equity-like instruments: Ensure a uniform application of the Regulation across the Union in order to provide transparency also for equity-like instruments and foster market integration and integrity.

Extension of the systematic internaliser regime: It is important to ensure a level playing field in terms of transparency for instruments traded on different types of execution venues, while taking into account the specificities of these venues. It should be avoided that issuers and investors are influenced in their choice of financial instruments.

3.3. Fees for trade data publication (Reasonable Commercial Basis)

Charges for post-trade data in the EU should be at a reasonable level, including for appropriately granular data for the benefit of efficiently functioning markets, in particular efficient and fair price finding and price formation through increased transparency.

3.4. Establishing an SME growth markets label

Criteria and requirements for the use of the label by multilateral trading facilities should be set in a way which makes it attractive, but at the same time ensures the achievement of the Directive's overall objectives to an appropriate degree. The label should create a framework which is favourable to and supportive of the specific needs of SMEs, but does not favour them unreasonably and disproportionately vis-à-vis other market participants, in particular (retail) investors.

3.5. Core definitions

The objective is to ensure a uniform application of the various concepts and definitions used in the Directive in order to create legal certainty and to provide a smooth functioning of the Internal Market and of supervision across the Union.

4. POLICY OPTIONS: DESCRIPTION, IMPACTS AND COMPARISON

4.1. Investor protection

4.1.1. Safeguarding of client assets: Policy options, impacts and comparison

No action option - the delegated acts would contain no provisions on what is expected from investment firms to appropriately safeguard client funds and reduce contagion risks arising when client funds are placed with an intra-group institution (baseline scenario).

Option 1 – An intra-group deposit limit of 20% of client funds

An investment firm must not deposit more than 20% of its clients' funds with an entity which is part of the group[24]. The 20% intra-group limit is already applicable in the UK.

Option 2 – An intra-group deposit limit of 20% of client funds and proportionality (ESMA's technical advice)

The requirement of the intra-group deposit limit of 20% is maintained. However, an investment firm would be allowed to exceed the 20% limit if it is able to demonstrate that, in view of the nature, scale and complexity of its business as well as the safety offered by the third parties considered, and including in any case the small balance of client funds it holds, this requirement is not proportionate. Investment firms would have to notify their initial and reviewed assessments regarding the reasons for exceeding the 20% limit to competent authorities, which will ensure a proper monitoring and enforcement of the use of this clause. ESMA could also play an important role in further harmonising supervisory practices, if needed. This proportionality provision could be used by SMEs which may not have large amounts of client funds to place.

Analysis of the options and impact on stakeholders

The **no action** option is discarded as it does not answer any of the concerns in relation to the protection of clients' funds. With respect to **options 1 and 2**, **investment firms** responding to the ESMA consultation argued that there is often a strong case for holding funds with a bank group if it has a better credit rating than other banks or that imposing such a limit would lead to a loss of deposit balances by credit institutions. It should be noted, however, that, at least in the bigger Member States, the likelihood that no other bank was available with a comparable rating seems to be very low. In smaller Member States with fewer banks where there might be a need for investment firms to use foreign banks the situation should improve with the implementation of the Banking Union. Investment firms also made the point that it would be difficult to comply with the 20% limit when the level of client funds can vary constantly. This argument seems to be very weak as a 20% intragroup deposit limit already exists in the UK since June 2011. Investment firms in the United Kingdom did not face problems to comply with the limit (firms operate a buffer to absorb the intra-day movements). The fact that UK investment firms constitute approximately half of all EU investment firms rather speaks in favour of option 1 as these firms should already compliant with this option[25]. The potential regulatory burden of the **options 1 or 2** will therefore be limited to the population of investment firms outside the UK. For these firms, the impact of an intra-group deposit limit will depend on the extent to which the proposed measures alter the current pattern of where client funds are held. Investment firms who currently deposit in excess of 20% of client funds with an intragroup entity would face a slight increase in compliance and administration costs. Using the UK experience to extrapolate and provide cost estimations is difficult not only due to the various patterns for depositing client funds across Member States, but also due to the proportionality clause embedded in option 2, which

[24] This threshold is already used elsewhere in the regulatory framework. For example, the Undertakings for Collective Investments in Transferable Securities (UCITS) regime prohibits UCITS schemes from depositing more than 20% of their net asset value with a single credit institution.

[25] For further description of the UK experience with the implementation of the intra-group limit please refer to Annex 4, Section C.

does not exist in the UK[26]. However, such costs should also be put in balance with the benefits of reduced concentration and contagion risks and therefore the increase in investors' confidence that their funds are properly safeguarded. Also, the intra-group deposit limit would address the risk that, as the group's financial position deteriorates, investment firms within the group are likely to deposit more client money with intra-group institutions to fund operations, leading to an inappropriate level of exposure of clients to the intra-group institution's credit risk.

As investment firms are currently required to exercise all due skill, care and diligence in selecting and periodically reviewing the entities at which client funds are deposited, some degree of diversification may already be ensured, so that the costs linked to the implementation of options 1 or 2 should not represent entirely new costs but rather a minor increase in the scale of costs for firms currently not complying with the 20% intra-group deposit limit.

The requirement in **option 2** to assess and notify to national competent authorities the reasons for exempting funds from the diversification requirement implies an additional administrative burden compared to option 1. However, this cost is justified by the flexibility embedded in option 2 and should be anyway negligible. In particular it should reduce the administrative effort and costs for SMEs which would have to split smaller amounts of client money according to the maximum percentage of 20% into several possibly very small amounts and should therefore lead to a reduction of costs for SMEs making use of this option compared to full diversification requirements.

Based on the ESMA Data Gathering exercise[27], the overall suggested measures in the area of safeguarding of client assets should not entail significant costs or practical problems. More than two thirds of the respondents to the data gathering exercise considered that the ESMA suggestions would be easy to implement.

Under option 1 or 2, **investors** would benefit from reduced concentration and contagion risks and reduced conflicts of interests. This should improve investor confidence in financial services. The protection of client money and assets is fundamentally important, as also underlined by several international work-streams[28], for the establishment of a secure environment which would foster investments and growth. For option 2 the impact might be countered to some extent by the flexibility clause. However, this clause is limited to certain situations and would be supervised by national competent authorities and so the impact on investors should be minor. Also, as Member States have the right to impose stricter requirements in the area of safeguarding of client assets it is possible that they may also take a more restrictive approach (i.e not allow the opt-out from the 20% limit – like it is today the

[26] See Annex 4, Section C, for further details.

[27] ESMA's data gathering for the technical advice delivered by ESMA to the European Commission, 15/12/2014; http://www.esma.europa.eu/documents/overview/10?title=&doc_reference=2014%2F1569+Annex&section=All&doc_type=All&x=19&y=18. A summary is provided in Annex 4, Section C.

[28] IOSCO, Recommendations Regarding the Protection of Client Assets, January 2014, http://www.iosco.org/library/pubdocs/pdf/IOSCOPD436.pdf; FSB, Application of the Key Attributes of Effective Resolution Regimes to Non-Bank Financial Institutions: Consultative Document, August 2013, http://www.financialstabilityboard.org/publications/r_130812a.pdf and FSB, Key Attributes of Effective Resolution Regimes for Financial Institutions, October 2014, http://www.financialstabilityboard.org/wp-content/uploads/r_141015.pdf

case in the UK - or impose a different, higher limit[29]). At the same time the flexibility might also benefit investors should investment firms pass their savings resulting from it on to investors (as money placed with group entities might provide higher interest rates).

Comparison of the options: Both **option 1 and 2** would reduce the risk of loss or diminution of client funds in the event of the insolvency of the group. While option 1 would have the advantage of establishing a clear harmonised approach throughout EU, easy to implement and enforce, it would not provide any degree of flexibility and proportionality. While option 2 may entail additional costs related to the assessment by firms of their ability to benefit from the flexibility clause and reporting obligation to NCAs, the flexibility provided for smaller firms/firms with small balances of client money is likely to outweigh the administrative costs (and many respondents to the ESMA consultation have mentioned for instance that they would favour a 20% limit introduced on a "comply or explain" basis). For a further analysis of the cost impact, please refer to section B of Annex 4 on investor protection on page 101. **Option 2** appears more proportionate for investment firms without putting clients' funds at excessive risks as the volume of client money concerned should not be significant. It is the most efficient option for achieving a higher level of investor protection and more harmonisation with regard to the safeguarding of client assets (market integration). **Option 2 is therefore the preferred option.**

The investment firms opposing the 20% intragroup deposit limit argued that it should be the decision of the investment firm to safeguard its clients' funds, that there is a strong case for holding cash with a bank group if it has a better credit rating than other banks. It was suggested that, should an intragroup limit of 20% be introduced, it should be on a "comply or explain" basis, where investment firms would have the option of explaining to their national competent authorities what alternative measures they have put in place to safeguard client funds. The example of small firms dealing with small balances of client funds was commonly cited as a justified exemption from the intragroup limit and some argued that a de minims threshold could apply. It should be noted that the ESMA technical advice (option 2) allows firms to take into account, when considering diversification, the nature, scale and complexity of their business as well as the safety offered by the third parties considered, including in any case the small balance of client funds held.

Only two investor associations responded with regard to this point in the consultation. Both supported the 20% limit. A global non-profit organisation representing investment professionals also supported the limit.

Finally it should be taken into account that the co-legislators in the discussions on the level 1 text clearly expressed the intention to provide for a stronger investor protection scheme under MiFID II/MiFIR than it had been the case under MiFID I.

[29] The proportionality was deemed necessary in light of different markets/sizes of actors across the Union. Setting a limit in EU legislation under which a proportionality clause would apply was deemed inappropriate precisely in light of the varying features of markets and actors.

Table 1: Safe-guarding client assets: Summary of impacts

	Impact on stakeholders		Effectiveness	Efficiency
	Investors	Investment firms		
No action option	0	0	0	0
Option 1	+	-	++	+
Option 2	+	-/≈	++	++

Magnitude of impact as compared with the baseline scenario (the baseline is indicated as 0): ++ strongly positive; + positive; – – strongly negative; – negative; ≈ marginal/neutral; ? uncertain; n.a. not applicable

4.1.2. Inducements: Policy options, impacts and comparison

Investment Research

No action option – The prohibition for portfolio managers and independent advisers to accept and retain fees, commissions or any monetary or non-monetary[30] benefits paid or provided by any third party in relation to the provision of the service to clients would not be further specified in delegated acts (baseline scenario).

Option 1 – The direct payment option

As proposed by ESMA in its consultation paper, in order to get investment research, investment firms providing independent investment advice and portfolio management would need to have a clear, separate contractual agreement with a broker and pay for such research on a distinct and separate basis.

Option 2 – Breaking the link between brokerage fees and research (ESMA's technical advice with certain operational amendments)

Investment research by third parties should not be regarded as an inducement if it is received in return for direct payments by the investment firm out of its own resources or from a separate research payment account funded by a specific research charge to the client and not linked to the volume and/or value of transactions executed. This option would try to re-establish the signalling function of prices for brokerage and research while keeping the costs of implementation at a minimum. It would confirm, with some minor operational adjustments, the solution ESMA proposed in its final technical advice to the Commission.

Analysis of the options and impact on stakeholders

If no further clarification is provided at Level 2, each Member State will still have to develop its own approach in order to specify how managers and independent advisers may continue to receive investment research from third parties. Rules would not be applied in a harmonised way in the Union. This would create cross-border problems for the provision of services. The **no action option** would also ignore transparency and conflicts of interest problems in this area and is therefore disregarded.

Both **options 1 and 2** would address the regulatory concerns around the supply of investment research and would therefore provide the necessary legal certainty required by the new MiFID II inducements regime. However, several respondents to ESMA's consultation (brokers, portfolio managers) argued that **option 1** could lead to a number of unintended consequences such as an increase in costs for managers and a competitive disadvantage for

[30] Only minor non-monetary benefits may be received under certain conditions.

smaller managers, a reduction in the provision of research, and especially in the coverage of SMEs in research. Notwithstanding the criticism, many respondents (including managers and brokers) also recognised that the current models for payment and reception of research raise concerns in terms of transparency, conflicts of interests or duty to ensure fair treatment of clients.

Both options would require that a specific value is attributed to investment research and would act as an incentive on portfolio managers to monitor the research that is effectively needed and the value and quality of research that they receive, in terms of its contribution to portfolio performance[31].

Concerning arguments that it is difficult for brokers to price research or that it is provided "for free", it should be noted that independent research providers price research and that according to the Financial Conduct Authority of the United Kingdom "most of the large brokers already set a hard or soft expectation that investment clients should pay a minimum amount of £50,000-£100,000 per year in gross dealing commissions to access their research portal or distribution list for their written products. Beyond this minimum service and payment level, investment banks strictly ration further value added services, such as access to analysts or bespoke work, according to their highest paying clients – whether in dealing commissions or wider revenues. Investment banks closely monitor levels of commissions paid, versus the total research resources (or 'touch points') they provide to clients. If a client is deemed to be 'under paying' in this ranking, the brokers would first look to secure higher commission payments in future for their services, or if not to lower service levels to that client or cut off access accordingly. This indicates broker do implicitly set a revenue expectation and put a value on their services, which implies they could set a price"[32].

Also, this rationing by brokers/investment banks of their more value-added research services, as well as minimum commission levels to access their core written product, "undermines the claim that the bundled model provides significant cross-subsidies between larger and smaller investment managers. Several smaller investment managers stated they do not gain access to any value added broker services where they have lower commission levels"[33].

However, it appeared from responses to the ESMA consultation that under **option 1** portfolio managers and independent advisers would have to make considerable changes to how they pay for research as all payments for research would have to come directly out of the management firms profit and loss, with an alleged subsequent risk that smaller managers would reduce their consumption of research. While payments for transactions and research would be clearly separated, **option 2** would grant investment firms the choice to either pay for research directly, or establish a research payment account funded by specific client charges. This option would also ensure a higher degree of transparency towards the clients than the status quo. While there would be some costs involved for portfolio managers in setting up separate accounts to pay for research and negotiate the relevant budget with clients, investment firms (and clients) would have a better view on how much exactly was spent on research and whether it was worth it. Managers may also have access to a wider range of research providers as they can go beyond the circle of their brokers to obtain it. The option

[31] https://secure.cfauk.org/assets/2670/0914___ResearchValuation___web.pdf
[32] UK FCA, Discussion paper on the use of dealing commission regime, July 2014, page 38.
[33] UK FCA, Discussion paper on the use of dealing commission regime, July 2014, page 39.

would likely lead to a better matching of supply and demand in the market and allow for a more efficient allocation of resources[34].

A decoupling of payments and consumption of research from transactions may give a viable chance to independent research providers in particular in niche areas (such as SMEs) that brokers may not cover. In its Data Gathering exercise, ESMA had asked specific questions to try and assess the significance of SME research received currently by firms. Questions were put to firms providing portfolio management services about the percentage of research covering SMEs received through bundled execution arrangements and through commission sharing arrangements. The very low level of research currently received through bundled execution arrangements or commission sharing arrangements appears to indicate on the contrary that the existing market practices do not foster the production of SME research[35].

Paying for research separately from execution and hence portfolio managers having to think more clearly about the areas of research needed and reflecting on its value added may provide better opportunities for independent research providers to compete on the quality of the research provided (instead of managers' selection being based on the allocation of trade flows) and may expand the research universe available to portfolio managers through the ability to pay a wider variety of research producers and not just the brokers they have ties with.

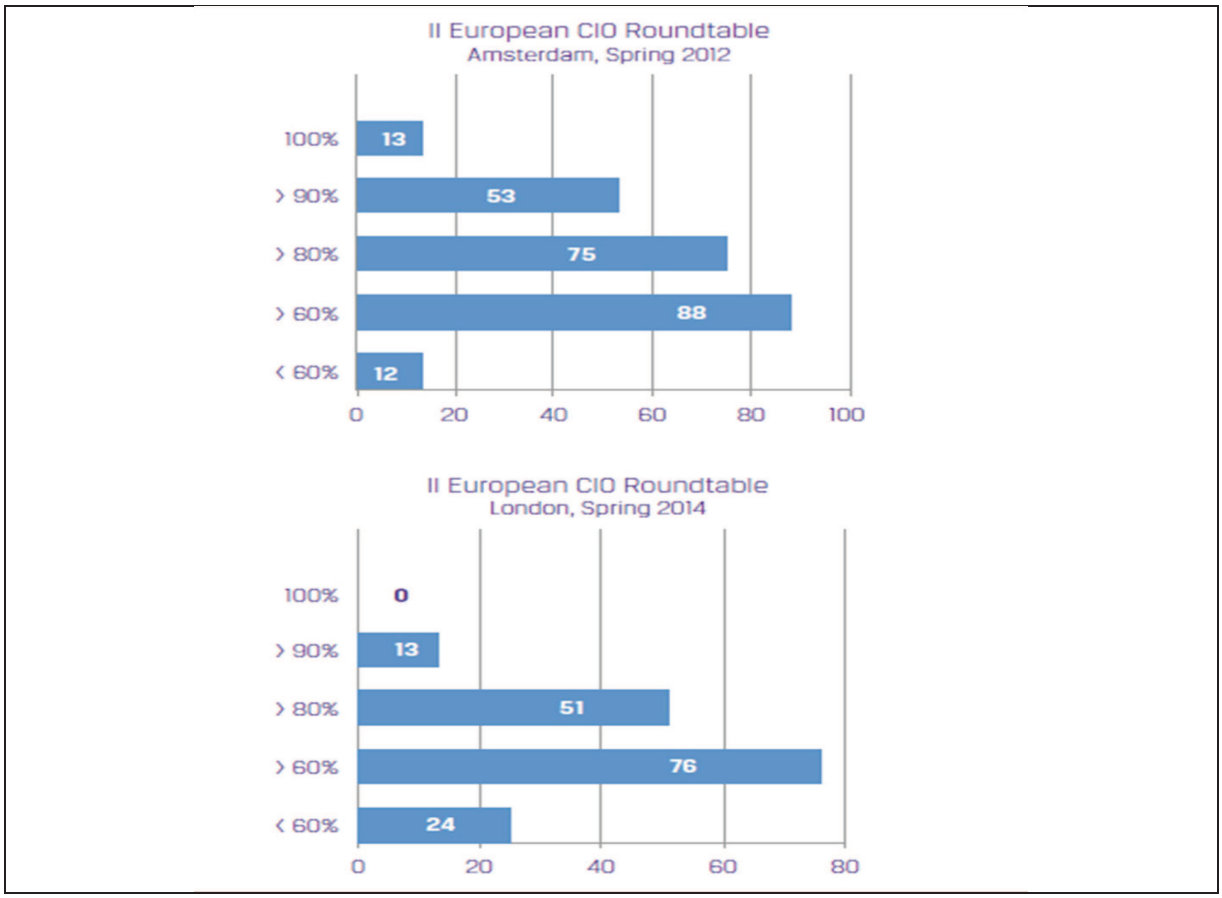
Already the use of commission sharing arrangements as an example for a partial unbundling of research and execution appears to have "expanded the content universe available to investment managers"[36] allowing them to pay a wide variety of research producers with commissions (not just banks/brokers)". Chart 2 below illustrates this.

[34] Europe Economics, Data gathering and cost-benefit analysis of MiFID II, L2 p. 195

[35] ESMA's data gathering for the technical advice delivered by ESMA to the European Commission, 15/12/2014; http://www.esma.europa.eu/documents/overview/10?title=&doc_reference=2014%2F1569+ Annex &section=All&doc_type=All&x=19&y=18

[36] CFA Society UK, Investment research valuation approaches: a framework and guide for investment managers and asset owners, Position paper, September 2014, page 25.

Chart 2: Percentage of total external research budget spent on research products/services from investment banks



Note: The vertical axis depicts the percentage of investment manager external research spending that goes to investment bank research products. The blue bars illustrate what percentage of the investment managers surveyed fell into which buckets (figures are aggregated from 100% down to 60%, and from 0% up to <60%. The chart indicates that bank research products/services are still an important input for most investment managers, although declining in importance between 2012 and 2014. CFA suggests that the apparent decline in the aggregate bank research market share may be a function of managers making greater use of some of the alternatives mentioned such as independent research providers.
Source: CFA Society UK, Investment research valuation approaches: a framework and guide for investment managers and asset owners, September 2014, p. 25.

Unbundling payments for research from payments for transactions should finally shift the focus from the amount of transactions channelled to brokers/research providers to the actual quality of the research as the dominant decision criterion.

It can be expected that **investors** will appreciate the added transparency of setting a research budget together with their portfolio manager and the receipt of information on the actual amounts spent. Investors would benefit from the reduction of the current principal-agent problems (whereby investment firms should act in the best interest of their clients yet have no clear idea of the monetary value of the research they consume and which is paid out of client money[37]). Investors could also be confident that best execution requirements are complied with and that their portfolio managers do not agree to higher execution rates to allow them to also obtain research from a broker (i.e. the additional service – research – from the broker is

[37] Europe Economics, Data gathering and cost-benefit analysis of MiFID II, L2, p. 196

cross-subsidised by the transaction charges paid by clients) or do not direct order flow to certain brokers or 'churn' client portfolios to gain access to more research services for "free". Moreover, knowing the exact costs that impact investments would enable investors to compare the return and viability of investments[38]. Currently, these fees for transaction and research are paid by but not disclosed to the client and come on top of 'visible charges' such as the Annual Management Charge[39].

Comparison of the options

In comparison with option 1, option 2 would better fit with several business models/sizes of investment firms (for instance investment firms that spend small amounts on research may prefer to pay directly while firms engaging with several research providers and various types of clients and strategies may favour the use of the ring-fenced research account). Option 2 should lead to a priced research market that would in turn lead to more competition between brokers and independent research providers, resulting in more innovation and specialisation in their goods and services, enhanced transparency, and allowing investment firms to better demonstrate their compliance with the inducements and best execution requirements and wider conflicts of interest provisions.[40] **Option 2 is therefore the preferred option.**

*A majority of respondents to ESMA's consultation (brokers, portfolio managers) did not agree with **option 1** although many recognised that the reception of research by portfolio managers from a broker may raise concerns regarding the fair treatment of clients. These respondents often suggested the use of certain existing arrangements (such as commission sharing agreements) associated with additional measures and controls such as the use of research budget not influenced by trading volumes, a separate internal governance process for research, separation of trading and investment functions, meaningful and complete disclosure towards clients. It should be noted that most of these underlying principles are included in the ESMA technical advice (option 2). It appears, based on subsequent meetings with stakeholders (portfolio managers, brokers, independent research providers), that the alternative granted by option 2 was welcomed, even more so if certain operational adjustments concerning the requirement for firms to agree the research charge with clients would be included, such as clarifying that the agreement could be obtained at the point of first agreement with clients, in same way as for the annual management charge for instance.*

[38] Financial Services User Group, Asset Management: FSUG Position Paper, November 2014, http://ec.europa.eu/finance/finservices-retail/docs/fsug/papers/1411-asset-management_en.pdf
Investment costs: an unknown quantity, A report for the Financial Services Consumer Panel, November 2014, http://www.fs-cp.org.uk/publications/pdf/investment_%20david_pitt_%20watson_et_al_final_paper.pdf
Collective Investment Schemes Costs and Charges, Implications for Consumers, Executive Summary; A Report for the Financial Services Consumer Panel, Rajiv Jaitly, May 2014; http://www.fs-cp.org.uk/publications/pdf/investment_report_executive_summary_for_the_%20fscp.pdf

[39] Legalised Fraud: True and Fair Responses to the Financial Services Consumer Panel Paper, 17 November 2014; http://www.trueandfaircampaign.com/wp-content/uploads/2014/11/true-and-fair-campaign-responses-FSCP-report-november-2014.pdf

[40] A more detailed discussion of the issue can be found in Annex 4, Section A.

Table 2: Summary of the options on investment research

	Impact on stakeholders		Effectiveness (increasing transparency on research costs)	Efficiency
	Investors	Investment firms		
No action option	0	0	0	0
Option 1	+	-	+	+
Option 2	+	-	+	++

Magnitude of impact as compared with the baseline scenario (the baseline is indicated as 0): ++ strongly positive; + positive; – – strongly negative; – negative; ≈ marginal/neutral; ? uncertain; n.a. not applicable

4.2.2. The quality enhancement criterion

In all other cases than the ones mentioned above (independent advice and portfolio management), inducements may be paid to or provided by investment firms only under certain conditions, one of which is that the inducement is designed to enhance the quality of the relevant service to the client.

No action option – Delegated acts would contain no further specification on the implementation of the quality enhancement criterion (baseline scenario).

Option 1 – a restrictive approach of the quality enhancement criterion

Option 1, based on the ESMA consultation paper, would establish negative and positive examples of situations for the assessment of the quality enhancement criterion. More specifically, inducements could not be used to pay or provide for goods or services that are essential for the recipient firm in its ordinary course of business (1st negative condition). Also, inducements would not be allowed where they would not provide for additional quality services to the client above regulatory requirements (2nd negative condition). A situation in which a firm essentially relies (exclusively or mainly) on inducements in order to provide services could not be seen as compliant with the conditions for the acceptance of inducements. Under this option, certain positive situations in which inducements could be considered acceptable would also be identified and strictly framed (where the firm is providing high quality non-independent advice to the client by enabling the client to receive access to a wider range of suitable financial instrument or by providing advice on an on-going basis).[41]

In line with the Level 1, clients should be informed prior to the provision of the service, about the existence, the nature and amount of the inducement or, where the amount cannot be ascertained, the method of calculating that amount.

Option 2 – alternative approach on the quality enhancement criterion: strengthening of certain positive market practices (ESMA's technical advice)

The first two negative conditions under option 1 would be replaced with the requirement that the level of inducements received should be proportionate to and justified by the provision of an additional or higher level service to the relevant client. A wider list of positive situations in which the benefit for the client is more direct and tangible would also be included. The disclosure of inducements would remain the same as mandated by the Level 1.

Analysis of the options and impact on stakeholders

[41] http://www.esma.europa.eu/system/files/2014-549_-_consultation_234paper_mifid_ii_-_mifir.pdf, p. 124

Without specifications of the quality enhancement criteria current divergent practices would persist, to the detriment of investors as well as investment firms which would have to cope with different supervisory practices. The **no action option** is therefore not consistent with the objectives of MiFID II.

Stakeholders[42] raised concerns that certain elements embedded in **option 1** could have unintended effects of reducing clients' access to investment advice, discourage so-called "open architecture" models or not take into account the non-advisory area of services. Indeed one investor association also warned against detrimental side effects for 'open architecture' models which, in their view, tend to offer better performing products. Some investment firms argued strongly against the condition that inducements cannot be deemed to enhance the quality of the service if they were used to pay or provide for goods or services that are essential for the recipient firm in its ordinary course of business. On the other hand, investor associations[43] welcomed this condition in accordance with which, where an investment firm is dependent on inducements for sustaining its business model (e.g. to pay for the entire staff or IT infrastructure), the quality enhancement test is not met. According to these investor associations, business models which basically tie the survival of intermediaries to a small numbers of product providers prevent them from acting in the best interest of their clients.

In the context of the ESMA Data Gathering Exercise, firms were asked to indicate the magnitude of the impact expected on their revenue if the inducements they currently received were considered as not meeting the quality enhancement test under option 1. Among the 48 answers received, 32 respondents quoted among the categories of circumstances which would have a high impact on their revenues the condition concerning the use of inducements to pay for good or services essential in the ordinary course of business and the condition that inducements provide for additional quality services above regulatory requirements.

Option 2 is likely to have a more limited impact on investment firms while trying to ensure investors' rights are not significantly impaired. The two above mentioned negative conditions under Option 1 had been deleted and, in addition to the two positive situations listed under option 1, a broader list of situations in which the benefit for the client is more direct and tangible is identified (when the inducements facilitate access to good quality non-independent advice, such as when advice is provided together with periodic reports of the performance and costs and charges associated with the financial instruments or the provision of access, at a competitive price, to a wide range of financial instruments that are likely to meet the needs of the target market, including an appropriate number of instruments from third party product providers having no close links with the investment firm, together with the provision of added-value tools and information, such as objective online tools enabling the relevant client to monitor, model and adjust the range of financial instruments in which they have invested and providing periodic reports of the performance and costs and charges associated with the financial instruments).

The ESMA Data Gathering exercise tried to assess to what extent non-independent advice currently provided on an on-going basis and/or the range of products offered would meet the quality enhancement test. In particular, with regard to the positive condition on the range of products, the majority of respondents (41, half of them being German banks) answered that their firm was offering a large range of products. Some respondents, especially from

[42] For a summary of stakeholder responses see ESMA's technical advice, P. 134 – 137. For individual responses please refer to: http://www.esma.europa.eu/consultation/Consultation-Paper-MiFID-IIMiFIR

[43] BEUC (Bureau Européen des Unions de Consommateurs), Finance Watch.

Germany, specified that their offer was not limited to financial instruments produced in their own group, a characteristic that would likely contribute to meeting the quality enhancement test.

It should also be noted that the impact of the measures will be mitigated for investment firms from Member States having already adopted strict approaches in relation to inducements. Indeed, several Member States have restricted inducements in certain cases: UK (a ban on inducements for investment advice provided to retail clients), Netherlands (a ban on inducements in relation to the provision of portfolio management, investment advice and execution only services to retail clients), Germany (a ban inducements for "independent advisers") and Sweden (decision to ban inducements in relation to investment advice). It is however difficult to determine or extrapolate from these national experiences the costs at EU level as their scope (services concerned), the clients targeted (often a focus on retail clients only) as well as the degree of restriction (strict ban in UK, German ban when advisers choose to call themselves independent, certain exemptions under Dutch rules for certain benefits) differ.

Comparison of the options

While **option 1** is more restrictive with regard to situations which could be regarded as quality enhancement and therefore might better limit the risk of biased advice/services, it might also carry the risk of discouraging investment firms to consider a broader range of instruments and restrict advice/services to in-house products. **Option 2** encourages open-architecture models and investment firms' robust focus on the benefits to clients when receiving inducements and appears to better preserve client's access to high-quality advice or non-advisory services. Indeed, despite certain concerns in relation to Option 2 from investor representatives, the implementation of option 1 may have disadvantaged open architecture models or may have led to a reduction of advisory services and therefore of the access of certain investors (not willing or able to pay for advice) to investment advice. One investor association has referred to this risk too. While it is not disputed that the success of option 2 depends to a higher degree on monitoring and enforcement by national competent authorities, option 2 appears to better take into account the various interests at stake and potential risks mentioned above and preserve the conditions imposed at Level 1. Furthermore, the disclosure of the level of inducements should enable investors to make a more informed opinion about the quality of the services provided and potentially challenge investment firms/refer matters to national regulators. **Option 2** is the more effective and cost-efficient solution and is hence **the preferred option**.

The majority of investment firms did not agree with one or more of the circumstances and situations identified under option 1 and argued that these circumstances would introduce a de facto ban of inducements. Most of these respondents focused on investment advice, arguing that option 1 would reduce investors' access to advice. Others emphasized the need not to favour 'closed architecture' models. These investment firms focused on the two negative conditions (inducements cannot be used to pay or provide goods or services that are essential for the recipient firm in its ordinary course of business and inducements cannot be received if they do not provide for additional or higher quality services above the regulatory requirements), arguing that setting standards so high would lead to a de facto ban of inducements. Few other respondents, including consumers' and investors' representatives, supported option 1 or suggested stricter solutions and argued that option 2 is not delivering

the level of investor protection required by MiFID II by allowing business models which tie the survival of intermediaries to a small numbers of product providers.

However some investor associations also raised concerns with regard to option 1 in particular with regard to possible negative effects on 'open architecture' models.

Table 3: Summary of the options on the quality enhancement criterion

	Impact on stakeholders: Investors	Impact on stakeholders: Investment firms	Effectiveness	Efficiency
No action option	0	0	0	0
Option 1	+	--	+	+
Option 2	+	-	+	++

Magnitude of impact as compared with the baseline scenario (the baseline is indicated as 0): ++ strongly positive; + positive; – – strongly negative; – negative; ≈ marginal/neutral; ? uncertain; n.a. not applicable

4.2. Transparency

4.2.1. Delineation on what constitutes a liquid market for equities and equity-like instruments: Policy options, impacts and comparison

MiFID I imposed transparency requirements only for shares. MiFID II/MiFIR extend transparency requirements to all other financial market instruments (other equity instruments and non-equity instruments). The full transparency regime under MiFID II/MiFIR however only applies to liquid instruments, for illiquid instruments there are a number of exemptions.[44]

ESMA in its 2014 consultation elaborated six scenarios for shares and depositary receipts as well as for ETFs and four scenarios for certificates to test the interaction of the four liquidity criteria proposed (daily trading, free float, average number of trades per day and average daily turnover). These liquidity criteria are already used for the determination of the liquidity of shares under MiFID I, but not on a cumulative basis (the average daily number of transactions and average daily turnover are criteria that are not cumulatively used).

The scenarios proposed by ESMA are included in this report in Annex 5.

For shares (and depositary receipts for which the liquidity is linked to the underlying shares) as well as ETFs, the scenario which maximised the number of instruments and percentage of turnover classified as liquid was chosen (maximum transparency in line with the objective of the MiFID II/MiFIR to increase transparency). The thresholds chosen are further detailed in option 2 including footnote 44 below.

Europe Economics, the external contractor carrying out a study for the Commission, also tested the thresholds proposed by ESMA on a sample available to the contractor and came to a very similar conclusion with regard to the number of instruments and percentages of turnover captured by the thresholds proposed. Their analysis is also presented in tables in annex 5 of the report.

[44] Article 2(1) point 17(b) of MiFIR defines what a liquid market is with respect to equity instruments for the purposes of waivers for equity instruments (Article 4 of MiFIR), the application of the volume cap mechanism (Article 5) and the obligation for systematic internalisers to make public firm quotes (Article 14 MiFIR).

No action option

Were the definitions not further detailed, a harmonised application of MiFID II/MiFIR could not be ensured.

Option 1 – Extend current criteria for shares to equity-like instruments

Apply the criteria as currently applied to shares in Article 22 of the MiFID Implementing Regulation (traded daily with a minimum EUR 500 000 000 free float and either on average 500 trades per day or an average daily turnover of EUR 2 000 000) also to other equity instruments.

Option 2 – Calibrated (lower) thresholds for equity and equity-like instruments (ESMA's technical advice)

This option consists in lowering the existing thresholds for shares under MiFID I and applying existing criteria cumulatively to all equities except where a Member State would be the most relevant market for fewer than five liquid instruments per asset class, the Member State may designate, for each asset class, one or more additional liquid instruments provided that the total number of instruments which are considered in consequence to be liquid is no greater than five per asset class.[45]

Analysis of the options and impact on stakeholders

The **no-action option** would provide insufficient guidance for a harmonised definition of a liquid market for equity instruments and would not achieve the objective of more transparency in financial markets and market integration. It would lead to differing interpretations of what constitutes a liquid market for equity instruments, market participants would therefore not know to which extent they would need to comply with the provisions of MiFID II/MiFIR. Although **option 1** seems to be straightforward and the easiest way to ensure a level playing field, it would be difficult to apply to equity instruments other than shares due to their differing characteristics and since some of the criteria used for shares will not work equally well for other equity instruments, it may also be ineffective in achieving the objectives of the level 1 texts. By not effectively improving transparency, **option 1** would **hamper market integration** to the detriment of both investors and investment firms, with potentially the exemption of those trying to exploit this situation to the detriment of investors. **Option 2** would provide for calibrated thresholds for each type of equity instrument and take into account the different characteristics of different types of equity instruments (for example

[45] Shares are considered liquid if they are traded daily, have a free float of not less than EUR 100 000 000 for shares admitted to trading on a regulated market or not less than EUR 200 000 000 for shares that are only traded on multilateral trading facilities, an average daily number of transactions of 250 and an average daily turnover of EUR 1 000 000. For shares only traded on MTFs and for which no prospectus is available, the market capitalisation should be used as a proxy for the free float. (ESMA's technical advice, p. 211).
Depositary receipts will be deemed to have a liquid market if they are traded daily, have a free float of not less than EUR 100 000 000, the average number of transactions in the depositary receipts is not less than 250 and the average daily turnover for the depositary receipts is not less than EUR 1 000 000. The size of the free float should be determined by the market capitalisation.
ETFs will be deemed to have a liquid market if they are traded daily, if a de minimis number of 100 units has been issued, the average daily number of transactions in the ETF is not less than 10 and the average daily turnover for the ETF is not less than EUR 500 000.
Certificates will be deemed to be liquid if they are traded daily, the free float is not less than EUR 1 000 000, the average number of transactions in the certificates is not less than 20 and the average daily turnover for the certificates is not less than EUR 500 000.

for some free float may not be a useful criterion to measure liquidity). It should also increase the share of instruments classified as liquid while it should not lead to a change in the number of SMEs listed on regulated markets of a market capitalisation of EUR 200 000 000 or less for which shares are considered liquid.[46] The criteria would hence achieve more transparency for shares, be calibrated to the specificities of equity instruments, while limiting the regulatory burden on SMEs. It seems also likely that very few instruments that are currently listed on potential SME growth markets would fulfil the liquidity criteria, hence be classified as liquid and therefore subject to the full transparency regime under MiFID II/MiFIR.[47] **Option 2** would require a greater effort by investment firms and, to a lesser extent, investors to adapt to the new framework. But its positive impact on transparency and market integration should help both sides of the market in their investment and business decisions, respectively. In particular issuers of and investors in equity-like and equity instruments other than shares should benefit.

Comparison of the options

The **no-action option** and **option 1** would not improve the situation with regard to shares. Whether the application of the same criteria that apply to shares to other equity instruments[48] would in fact lead to an improvement compared to 'no action' is difficult to say as the criteria proposed in option 1 would not achieve much by way of transparency in other equity classes than shares.[49] Option 1 would therefore most likely result in an inappropriate patchwork of transparency regimes for the various instruments across the EU. **Option 2** is the option that would therefore be most effective and efficient in achieving the objective of more transparency in financial markets, i.e. provide clarity with regard to the thresholds to be applied and implemented that determine when there is a liquid market in an equity instrument**.** Option 2 should provide legal clarity and also clear guidelines for the practical application, taking into account the specific characteristics of all equity instruments. Option 2 will also enhance market integration across EU financial markets.

Option 2 is therefore the preferred option.

The majority of respondents to ESMA's consultation (stock exchanges, banks, industry associations) agreed with the new thresholds proposed by ESMA in order to enhance transparency in equities. A group of respondents mentioned that the increase in transparency under the scenarios simulated by ESMA would not be material enough in order to warrant a change of thresholds. Some market participants and stock exchanges highlighted the need to take into account the lower liquidity of SME shares. ESMA's final advice therefore includes thresholds for shares with a specific calibration for SME shares. Stakeholders also considered ETFs as highly liquid, therefore ESMA suggested a low threshold with regard to the daily number of transactions.

More transparency in securities markets is one of the key objectives of the level 1 texts as endorsed by the co-legislators (more transparency is in line with lower thresholds for shares).

[46] Europe Economics, Data gathering and cost-benefit analysis of MiFID II, L2, p. 11.
[47] Ibid, p. 12.
[48] See Annex 5 for a further discussion on the appropriateness of certain criteria such as free float to equity-instruments other than shares.
[49] Europe Economics, Data gathering and cost-benefit analysis of MiFID II, L2, p. 12-17.

Table 4: Summary of the options on liquid markets for equities and equity-like instruments

	Impact on stakeholders: Investors	Impact on stakeholders: Investment firms	Effectiveness	Efficiency
No action option	0	0	0	0
Option 1	+	-	-	-
Option 2	++	+/-	++	++

Magnitude of impact as compared with the baseline scenario (the baseline is indicated as 0): ++ strongly positive; + positive; – – strongly negative; – negative; ≈ marginal/neutral; ? uncertain; n.a. not applicable

4.2.2. Extension of the Systematic Internaliser regime: Policy options, impacts and comparison

The purpose of the systematic internaliser regime is to ensure that firms which deal on own account of a large magnitude by executing client orders are also subject to trade transparency requirements on a level playing field with trading venues, while at the same time taking into account the different market participants' characteristics.

With regard to equity instruments, ESMA recommends that an investment firm internalises on a **frequent and systematic basis** if the number of OTC transactions executed by the investment firm on own account when executing client orders in liquid instruments was, during the last six months, equal or larger than 0.4% of the total number of transactions in the relevant financial instrument in the Union executed on any trading venue or OTC during the same period.

At a minimum the investment firm shall deal on own account in such an instrument on average on a daily basis to be considered as meeting the frequent and systematic basis criteria (**'De minimis' threshold**).

For equity instruments for which there is not a liquid market in accordance with Article 2(1)(17)(b) of MiFIR, the condition is deemed to be met when the investment firm deals on own account OTC in the same financial instrument on average on a daily basis during the last six months.

As for the **substantial basis** criterion:

The investment firm internalises on a substantial basis if the size of OTC trading carried out by the investment firm on own account when executing client orders is, during the last six months, equal or larger than either:

15% of the total turnover in that financial instrument executed by the investment firm on own account or on behalf of clients and carried out on any trading venue or OTC; or

0.4% of the total turnover in that financial instrument executed in the European Union and carried out on any EU trading venue or OTC.

Investment firms shall assess whether they meet these conditions on a quarterly basis (on the first working day of the months of January, April, July and October based on the data from the previous six months).

For non-equity instruments, ESMA could not reach an agreement on precise numeral thresholds within the timeframe allocated to it (the deadline for delivering its advice was

December 2014) and has therefore provided ranges in its advice within which the final thresholds should be set:

Table A1: Thresholds for non-equity financial instruments

		Bonds	SFP	Derivatives	Emission allowances
Frequent and systematic basis threshold (liquid instruments)	Number of transactions executed by the investment firm on own account OTC / total number of transaction in the same financial instrument in the EU	2 to 3% and at least once a week	3 to 5% and at least once a week	2 to 3% and at least once a week	3 to 5% and at least once a week
Frequent and systematic basis threshold (illiquid instruments)	Minimum trading frequency	at least once a week	at least once a week	at least once a week	at least once a week
Substantial basis threshold Criteria 1	Size of OTC trading by investment firm in a financial instrument on own account / total volume in the same financial instrument executed by the investment firm	25%	30%	25%	30%
Substantial basis threshold Criteria 2	Size of OTC trading by investment firm in a financial instrument on own account / total volume in the same financial instrument in the European Union	0.5 to 1.5%	1.5 to 3%	0.5 to 1.5%	1.5 to 3%

Further information on ESMA's advice is laid out in Annex 3 of this report. The main challenges to further specify the appropriate thresholds are that, unlike in the equity sphere, there is currently no consolidated data available on the overall size of markets and there are no existing Systematic internalisers (in a regulatory sense) which could be used as a benchmark. In order to make the regime workable in practice however, numeral thresholds need to be specified.

No action option:

The precise level of the quantitative criteria has not been stated at level 1. Without the respective delegated act Member States and market participants would have to interpret the criteria, possibly in different ways.

Option 1 – Specific thresholds for frequent and systematic and substantial basis using the upper bounds of the ranges suggested by ESMA.

Under this option the highest percentages within the ranges provided by ESMA with regard to the 'frequent and systematic basis' threshold for liquid non-equity instruments and criterion 2[50] with regard to the 'substantial basis' would be used as the numeral threshold.

Option 2 – Specific thresholds for frequent and systematic and substantial basis using the mid-point in the ranges suggested by ESMA.

Under this option the mid-point in the ranges provided by ESMA, taking into account that the thresholds should be proportionate and should create a level playing field amongst market participants, would be used as the numeral threshold with regard to the 'frequent and systematic basis' threshold for liquid non-equity instruments and criterion 2 with regard to the 'substantial basis'.

Option 3 – Specific thresholds for frequent and systematic and substantial basis using the lower bounds of the ranges suggested by ESMA.

[50] Size of OTC trading by an investment firm in a financial instrument on own account/total volume in the same financial instrument in the European Union.

Under this option the lower bounds in the ranges provided by ESMA with regard to the 'frequent and systematic basis' threshold for liquid non-equity instruments and criterion 2 with regard to the 'substantial basis' would be used as the numeral threshold.

Analysis of the options and impact on stakeholders

The **no action option** would not specify the thresholds. They could therefore be set differently by different Member States, which would not be in line with the intention of the level 1 texts of implementing a harmonised systematic internaliser regime. **Option 1** should result in the lowest number of entities identified as systematic internalisers amongst the options presented, entailing the lowest level of transparency amongst the options proposed. **Option 2** would be a compromise between options 1 and 3 and taking into account the data scarcity and uncertainty regarding the future systematic internaliser population under MiFID II, as well as take into account the need to arrive at a proportionate regime that achieves a level playing field for market participants. **Option 3** results in a higher number of entities identified as systematic internalisers compared to the previous two options. This option would therefore ensure maximum transparency within the ranges provided in ESMA's technical advice.

The population of systematic internalisers in scope of MiFID II will only become clear once MiFID II/MiFIR and their implementing acts enter into force and market participants will make a choice whether they want to carry out multilateral trading or bilateral trading and be regulated accordingly for all instruments now under the scope of MiFID II/MiFIR. With the extension of the scope of the systematic internaliser regime to equities other than shares and to non-equities more firms will be captured. There will be a regulatory burden on market players that have not been regulated in this respect before. However, this is in line with the intention of level 1 to bring more transparency to securities markets. With regard to smaller players and for illiquid instruments a test for easy reference has been built into the requirements, which provides for proportionality in the calculations that have to be carried out, i.e. if the investment firm deals on own account in a financial instrument, type of emission allowance or class of derivatives at least on a daily/weekly basis, it would fall under the systematic internaliser regime (and would not have to carry out more advanced calculations to determine its status).

While **option 1** would limit additional compliance costs to a minimum of market participants it would constitute the least beneficial option for investors and other market participants in that it would not significantly advance transparency on price discovery. There would be a risk that investors in many cases could still not be sure whether they are receiving best execution. **Option 3** on the other end of the spectrum of the options presented would increase transparency by a maximum, but at the cost of increasing administrative burden for the greatest number of investment firms that would have to comply with the systematic internaliser transparency rules. **Option 2** is a compromise which tries to avoid extremes in view of the high level of uncertainty and take due care of ensuring proportionality and a level-playing field.

Comparison of the options

Increasing transparency in securities markets, enhancing investor protection and furthering the price discovery process are key objectives of the Directive. Costs for market players in terms of compliance costs with the systematic internaliser regime, on the other hand, are inversely correlated with the level of transparency achieved.

The **no-action option** would not further any of the objectives of the level 1 and would create an un-level playing field in the Union due to a lack of a harmonised definition at level 1. It is therefore inferior to the other options. Compared to options 2 and 3, **option 1** would further the objectives of the level 1 the least, but would also cause direct costs to the smallest number of market participants. **Option 2** could be regarded as a compromise as it would go some length to achieve the Directive's objectives, but would avoid putting costs on many market players. **Option 3** goes the farthest in furthering the central objectives of the level 1. It would have the largest impact both in terms of investor protection, price discovery (transparency), but also in terms of compliance costs, and may in particular impact smaller potential systematic internalisers. In order to avoid a potential overshooting of option 3, **option 2 is the preferred option.**

The ranges proposed in ESMA's advice are the same as the one put forward in its consultation paper of May 2014 (the only difference concerns derivatives where the upper bounds for the frequent and systematic basis threshold and the substantial basis threshold criterion 2 were lowered in the final advice). ESMA received 59 valid responses from industry stakeholders (investment firms and trading venues) with trading venues generally supporting the proposed range (again some supporting the lower thresholds and some the upper) and investment banks proposing changes to the thresholds, for example suggesting that the thresholds presented will not capture all market makers and liquidity providers. Some suggested an alternative threshold of 300 million Euro traded on own account per quarter as a substantial basis threshold and others suggest to have different thresholds for bonds depending on issuance size or different thresholds per sub-product type of derivatives. Several of the suggestions contain capturing a certain level of liquidity (volume); this would however only be possible based on a complete data set of future systematic internalisers and their trading patterns. Respondents however provided no data analysis to support their views. Concerns were raised in particular with regard to firms that trade liquid instruments, but which trade relatively infrequently as it would be easy to meet the substantial basis threshold in those cases. Many stakeholders supported a minimum threshold of trading once a week for the frequent and systematic threshold (both for liquid and illiquid instruments).

Table 5: Summary of the options on the systematic internaliser regime

	Impact on stakeholders: SI	Impact on stakeholders: Investors and other market participants	Effectiveness	Efficiency
No action option	0	0	0	0
Option 1	-	≈ /0	≈	-
Option 2	--	+	+	++
Option 3	---	++	+	+

Magnitude of impact as compared with the baseline scenario (the baseline is indicated as 0): ++ strongly positive; + positive; – – strongly negative; – negative; ≈ marginal/neutral; ? uncertain; n.a. not applicable

4.3. Fees for trade data publication (reasonable commercial basis): Policy options, impacts and comparison

No action option

This option would stop with the level 1 provision without further specification at level 2. It would be left to either Member States or national competent authorities to interpret and implement what constitutes a reasonable commercial basis. The consequences would be those

described in the baseline scenario. However, as this option would be in clear conflict with the intentions of the co-legislators expressed as legal requirements in MiFID II/MiFIR it is discarded.

Option 1 – Principles-based transparency

Under the principles-based approach, data prices, and the other terms on which trading data is supplied, should be fair, reasonable and non-discriminatory. Trading data providers should provide comprehensive transparency about their pricing.

Option 2 – Revenue share limitation

Trading data providers would have to set their data charges in a way which is limited by a share in total revenues. For example, revenues from trading data services as a proportion of total revenues should not exceed a certain percentage.

Option 3 – Long-run incremental cost (LRIC) basis

Trading data providers would have to set their data charges so as to recover only the Long Run Incremental Cost of providing a data service plus an appropriate share of common costs (LRIC+).

Option 4 – Transparency 'plus'

This option combines elements of options 1 and 3 with additional improvements. Fees charged by trading data providers would have to be cost-based and transparent. Additional safeguards such as unbundling, non-discrimination and per user charging would apply. This is the option proposed by ESMA.

Analysis of the options and impact on stakeholders

Under **option 1** trading data providers should provide comprehensive **transparency**. A large part of the respondents to ESMA's consultation, in particular trading venues and banks, favoured option 1; many of them stating that it would be easier to implement than a revenue share limitation or the long-run incremental cost basis. However, it would not be enough in terms of the desired regulatory intervention. Transparency on fees alone would be of little value because the trading data from different exchanges are generally not a substitute for one another.

In terms of stakeholder impact, this option would trigger some costs for providers of trading data as they would have to set out their fees. However, option 1 would not provide much benefit for the buy side of data as it unlikely to achieve the objective of having data priced at a reasonable commercial basis because of the lack of competition. For competent authorities, the cost of set-up and supervision would be low.

Although it seems to be a straightforward solution at first glance, the threshold limit under option 2 would be difficult to calibrate for individual trading venues in such a way that it is low enough to trigger a price reduction but high enough to ensure that the data is still provided, i.e. it is still profitable for the provider. It would be even more difficult to do so for different providers using various business models in which data provision is of different importance. There would be a high risk that the limit would favour some business models and

harm others. This would lead to distortion in the competition, something which the measure is supposed to foster.

This option would have severe negative impacts on trading venues as their (compliance) costs would go up, in a potentially uneven manner, by adapting to a particular revenue structure. It would also be difficult for national competent authorities to effectively monitor and enforce such limits and therefore cause a significant burden on them. Benefits to data users would be very difficult to ascertain. On the one hand, they would benefit from lower costs if the limit was low enough to be effective. On the other hand, there would be a risk of a reduced offer of trading data due to hampering of investments if set too low.

Option 3 (Long run incremental cost+) The benefit of this option would be that it is not linked to total revenues, i.e. it does not depend on the other revenue sources of a trading venue but only on the cost structure related to the data provision. It would nevertheless result in substantial initial costs of constructing and implementing such a model as well as significant on-going monitoring costs for both trading venues and national competent authorities. It was pointed out that recovering incremental costs only would not necessarily be enough to cover production costs in an industry with high fixed costs and low marginal costs.[51] Setting a cost model for the whole industry would risk harming investment if the cost+ level was set too low or be ineffective (or even harmful leading to price increases) if set too high.

There is no experience with this type of regulation in the financial sector. While it could be an effective approach to reducing market data costs, it is also a very intrusive approach with possibly far reaching impacts on the business models of trading venues.

The stakeholder impact is analogous to that under option 2. Just as for the revenue cap, if prices were to be set appropriately, the buy side would benefit from reasonable prices of trading data. However, there is also a risk that thresholds are set at inappropriate levels, thereby allowing artificially elevated prices (if set too high) or harming investments (if set too low).

Option 4 avoids the significant cost of an outright cost regulation under option 3 but incorporates some well-defined guiding principles in relation to cost from this option. In doing so it should be more effective than option 1 as competent authorities and customers would be better informed about the fees and, at least in the case of competent authorities, on the cost structure of the trading data provider and could, in case of doubt, challenge prices either through administrative procedures or through judicial action. Over time, best practices by trading data providers should evolve, which reflect the increased transparency and competition in the sector

This option is much less costly to implement for trading data providers than options 2 and 3, and probably only slightly more expensive than option 1. But it may offer a larger choice and better fee levels for the buy side of trading data and also ensure basic principles such as non-discriminatory access to trading data. Costs to competent authorities should not be significant.[52]

Comparison of the options

[51] Oxera. 'Reasonable commercial terms for market data services'. 4 September 2014.
[52] For more detail about reasonable commercial basis and the options, please refer to Annex 6.

Option 1 would have the advantage of being the least costly solution. It is, however, questionable whether it would achieve the objective of prices of trading data set at a reasonable level.

Option 2 could be more effective if the percentage of the revenue cap for trading data is set right. But as it would be much more expensive to implement and supervise and because of the great risk that it is not established in a fair and appropriate manner across the Union - leading to un-level playing field and regulatory arbitrage - it is questionable whether this option would be preferable to option 1.

Option 3 faces the similar challenges and could lead to the same consequences as option 2. As it would be easier to apply the cost approach at company level than the revenue cap, option 3 would be superior to option 2.

Option 4 should be less expensive to implement than options 2 and 3, and would provide greater clarity on the precise obligations of trading data providers. It therefore should be best suited to achieving prices for trading data on a reasonable commercial basis and transparency on these without imposing disproportionate costs to trading venues as under options 2 and 3. It is therefore also the most efficient solution to achieving market integration with regard to the reasonable commercial basis for trade data. **Option 4 is therefore the preferred option.**

Stakeholder responses to ESMA's consultation:

Generally representatives of trading venues and banks (sell-side of data) supported principles-based transparency stating that other options would be too difficult and too costly to implement, while buy-side respondents (users of data e.g. asset managers) favoured principles-based transparency in combination with revenue share limitation and LRIC or in combination only with LRIC stating that market participants should have granular information on price components.

*Many respondents to the ESMA consultation, in particular trading venues, were of the opinion that **option 2** would be too difficult to implement, might distort competition and lead to increases in overall fees. It may also not take into account the different ranges of data products offered by trading venues. Similarly, respondents to the consultation, mainly trading venues, stated that **option 3** would be difficult to model, implement and monitor and that it would therefore lead to an increase in costs with no commensurate increase in quality market information. Respondents to ESMA's data gathering exercise considered it an intrusive approach with possibly far reaching impacts on the business models of trading venues.* [53]

Table 6: Summary of the options on reasonable commercial basis

	Impact on stakeholders: Trading venues	Impact on stakeholders: Data users	Effectiveness	Efficiency
No action option	0	0	0	0
Option 1	0	0/+	0	+/0
Option 2	--	0/+	+/0	+/0
Option 3	--	0/+	+/0	+
Option 4	-	++	++	++

Magnitude of impact as compared with the baseline scenario (the baseline is indicated as 0): ++ strongly positive; + positive; – – strongly negative; – negative; ≈ marginal/neutral; ? uncertain; n.a. not applicable

[53] ESMA's technical advice to the European Commission, p. 311

4.4. SME growth market label: Policy options, impacts and comparison

There are currently around 40 multilateral trading facilities in the EU which are potential candidates for registration under the "SME growth market" label. As shown in the analysis by Europe Economics[54] (Annex 8), these have currently very diverse operating models and do not apply the same rules concerning the **initial and ongoing admission to trading** of securities on their venue ("admission rules") and the **content of the admission document in case of initial admission to trading of securities** on their venue, where a prospectus is not required ("disclosure rules").

No action option

Under this option, no further specification of the level 1 provisions would be developed. It would be left to either Member States or national competent authorities to specify the minimum requirements for multilateral trading facilities to be registered as an SME growth market. However, this option would not comply with the will of the co-legislators to further harmonise the requirements for market access for SMEs. It is therefore discarded.

Option 1 – Flexibility for market operators under national control (ESMA's technical advice)

This option leaves it up to the operators of SME growth markets – under the supervision of their respective national competent authority – to establish their own admission and disclosure rules. With regards to admission rules, the operator of an SME growth market would be required to demonstrate to its competent authority that it applies criteria which are effective in ensuring that issuers are 'appropriate' for admission to trading on its venue. Likewise, this operator would be free to adopt the approach it sees best suited to define the content of admission documents, either by setting up a list of minimum information to be included in this document or by dis-applying specific categories of disclosures required under the prospectus regime.[55]

Option 2 – Harmonisation of admission and disclosure rules under MiFID II

Common minimum requirements for all SME growth markets in the EU would be set out in level 2, with regard to both admission and disclosure rules. Level 2 would define the admission criteria which SME growth markets should establish in their rules in order to determine whether candidates for initial listing are appropriate. Such criteria would be designed to ensure sufficient public distribution of the securities to allow the orderly interaction of supply and demand (e.g. by defining a minimum free float and/or a minimum value for any capital raised accompanying an admission), appropriateness of the issuer's management and board, appropriateness of the issuer's systems and controls, and minimum operating history of applicants. Level 2 would also provide a set of minimum disclosures for an issuer on an SME growth market, along the lines of the proportionate disclosure regime for SMEs and companies with reduced market capitalisation set out in the Prospectus Regulation.

Option 3 – Partial harmonisation of admission rules / harmonisation of disclosure rules through the review of the Prospectus Directive

[54] Europe Economics, Data gathering and cost-benefit analysis of MiFID II, L2, p. 95

[55] Annex 7 of this paper contains further details on the ESMA's technical advice.

The delegated act would list the types of admission criteria that SME growth markets would be required to set out in their rules (sufficient public distribution of the securities to allow the orderly interaction of supply and demand, minimum operating history of applicants, appropriateness of the issuer's management and board, appropriateness of the issuer's systems and controls), but their precise calibration (minimum free float, minimum capitalisation, ways to assess the adequacy of the management team, minimum operating history of candidates for listing etc.) would remain the responsibility of the operator, under the control of its national competent authority. Regarding the content of the admission document, harmonisation of disclosure would be postponed to the review of the Prospectus Directive, which is ongoing and will address the issue of the proportionate disclosure regime for SMEs admitted to trading on multilateral trading facilities[56].

Analysis of the options and impact on stakeholders

Option 1: This option is the least costly option for the operators of multilateral trading facilities, and it maximises the chances that existing markets will adopt the label.

With regard to the content of the admission document which an issuer is required to produce upon initial admission to trading of its securities on an SME growth market, where the requirement to publish a prospectus pursuant to Directive 2003/71/EC does not apply, it is appropriate that competent authorities retain discretion to assess whether the rules set out by the operator of the SME growth market achieve the proper information of investors. While full responsibility for the information featured in the admission document should lie with the issuer, it should be for the operator of an SME growth market to define how the admission document should be appropriately reviewed. This should not necessarily involve a formal approval by the competent authority or the operator.

Option 2 would not provide any scope for "forum shopping" or regulatory arbitrage by companies seeking a first listing, as all operators of SME growth markets would apply the same admission criteria and require the same disclosures from issuers seeking first-time admission. Although not regulated as thoroughly as issuers on regulated markets, issuers on SME growth markets would have to comply with minimum requirements common to all SME growth markets in the Union. Operators of existing multilateral trading facilities focusing on SMEs would have to adapt to the harmonised criteria. This could represent a relevant cost; some of the existing operating models might even be incompatible with those criteria. This might deter some operators from registering as SME growth markets, thus putting the take-up of the label at risk. Should the criteria be well calibrated so that several SME growth markets were established across the Union, investors would benefit from clear harmonised rules. Offers would be comparable across venues, enabling investors to better choose among various investment opportunities. This in turn would benefit SMEs as demand for their securities would increase. Eventually, a liquid market for SME securities could develop.

Option 3 would increase investor protection in so far as all SME growth markets would be required to set out admission criteria in their rules. Some of the multilateral trading facilities would have to complete their rulebook with additional admission criteria, but would still retain the discretion to define them quantitatively and could take local specificities into account. For instance, out of the 22 multilateral trading facilities analysed by Europe Economics, 9 do not require candidates to first-time admission to ensure a minimum

[56] See public consultation launched by the Commission on 18 February 2015.

distribution of shares in the public (e.g. through a minimum free float or a minimum amount of money raised upon first admission) and only 7 of them require a minimum operating history (of up to 3 years) from candidates. These amendments to existing rulebooks are unlikely to have adverse impacts on issuers already admitted to trading on these multilateral trading facilities, as the new criteria would only apply to subsequent applications for admission, with no retroactive effect. They might however be felt as too constraining for market operators who may be forced to adopt a "one-size-fits-all" approach to admission rules which would not necessarily help them in assessing the appropriateness of candidates for listing on a case-by-case basis.

Comparison of the options

Option 1 is the least burdensome and costly of all options for operators of and it will not hamper their choice to adopt the label. Given the diversity in operating models of existing MTFs with a focus on SMEs in the Union, and to ensure the success of the new category of SME growth market, it is appropriate to grant SME growth markets an appropriate degree of flexibility in evaluating the appropriateness of issuers for admission on their venue. In any case, an SME growth market should not have rules that impose greater burdens on issuers than those applicable to issuers on regulated markets.

Options 2 and 3 would trigger higher compliance costs for multilateral trading facilities, especially option 2, which may make the label unappealing to operators who might thus forego a registration. On the contrary, option 1 maximises the chances that existing multilateral trading facilities will register under the label, while this is much less likely for option 2, with option 3 falling in-between in this respect.

Option 1 is therefore at this moment the most efficient solution for achieving market integration in this area. **It is therefore the preferred option.**

In choosing option 1, the Commission is conscious of the fact that option 2 or 3 would have ensured a more appropriate level of harmonisation. It is, however, expected that the acceptance of the SME Growth Market label by multilateral trading facilities will lead to some degree of convergence in the requirements. These developments will be monitored by the Commission and will be part of a future review of the legislation. With regard to the content of the admission document, option 1 is probably not the definitive solution, as the ongoing review of the Prospectus Directive might lead to further amendments. This is considered more suitable because the Prospectus Directive is the most appropriate legislative vehicle to harmonise disclosure requirements. It is also in line with the approach set out in the Green Paper on Capital Markets Union published on 18 February 2015 which expressed the Commission's ambition to take advantage of the review of the prospectus framework in order to boost the take-up of SME growth markets.

Stakeholder responses to the ESMA consultation:
Respondents to the Consultation Paper broadly agreed that SME growth markets should retain flexibility to develop operating models that take account of the characteristics of local markets, under the supervision of their national authority. The large majority of them agreed that the operator of an SME growth market should be able to adopt the approach they believe to be the most adequate regarding admission documents where a prospectus is not required.

Table 7: Summary of the options on SME growth markets

	Impact on stakeholders: SME GM operators	Impact on stakeholders: Investors and issuers on SME GM	Effectiveness	Efficiency
No action option	0	0	0	0
Option 1	+	-	+	++
Option 2	--	++	+	+
Option 3	-	+	+	-

Magnitude of impact as compared with the baseline scenario (the baseline is indicated as 0): ++ strongly positive; + positive; – – strongly negative; – negative; ≈ marginal/neutral; ? uncertain; n.a. not applicable

4.5. Core definitions: Policy options, impacts and comparison

Defining High Frequency Algorithmic trading and Algorithmic trading

MiFID II provides that investment firms engaging in algorithmic trading and trading venues where such trading takes place are subject to particular regulatory scrutiny and have to have organisational requirements in place to ensure that high frequency trading does not create a disorderly market and cannot be used for abusive purposes. Furthermore, high frequency traders will have to comply with more comprehensive data recording requirements and might face higher fees at trading venues that reflect the additional burden on system capacity. Furthermore, MiFID II stipulates that any person that applies a high frequency algorithmic trading technique is required to be authorised as an investment firm. High frequency trading is a subset of algorithmic trading.[57] These additional requirements might provide an incentive to some traders to manipulate their trading strategies in order to escape these rules.

No action option

In this option, no further specification of what high frequency trading entails as opposed to algorithmic trading is provided.

Option 1 - Specifying infrastructure and an absolute threshold of messages per instrument

This approach would further specify the requirements a firm would have to meet in order to be considered using high frequency trading. The first element would be to meet the requirements of Article 4(1) 40 MiFID II in terms of infrastructure intended to minimise

[57] Article 4(1)(39) of MiFID II defines Algorithmic Trading as "trading in financial instruments where a computer algorithm automatically determines individual parameters of orders such as whether to initiate the order, the timing, price or quantity of the order or how to manage the order after its submission, with limited or no human intervention, and does not include any system that is only used for the purpose of routing orders to one or more trading venues or for the processing of orders involving no determination of any trading parameters or for the confirmation of orders or the post-trade processing of executed transactions";
Article 4(1)(40) of MiFID II defines High Frequency Algorithmic Trading Technique as "an algorithmic trading technique characterised by: (a) infrastructure intended to minimise network and other types of latencies, including at least one of the following facilities for algorithmic order entry: co-location, proximity hosting or high-speed direct electronic access; (b) system-determination of order initiation, generation, routing or execution without human intervention for individual trades or orders; and (c) high message intraday rates which constitute orders, quotes or cancellations".

network and other types of latencies. The second element would be the specification of mechanisms for the identification of 'high message intraday rates". A participant/member in a trading venue would be deemed to have a "high message intraday rate" when the average number of messages sent per trading day with regard to any liquid instrument traded on a venue is above an absolute threshold of 2 messages per second. If both requirements are fulfilled a firm would be considered to engage in high frequency trading.

Option 2 - Specifying infrastructure and an absolute threshold of messages per instrument and across instruments per trading venue

In addition to the first element of option 1, a participant or member of a trading venue submitting on average at least 4 messages per second with respect to all instruments across a venue or 2 messages per second traded with respect to any single instrument traded on a venue would be deemed to have a "high message intraday rate".

Option 3 - Specifying infrastructure and a relative threshold of messages per instrument

This option would include the first element of option 1 and would seek to impose a relative threshold to measure the number of intra-day messages. A member or participant of a trading venue would be deemed to have a "high message intraday rate" if the median daily lifetime of its modified or cancelled orders in all instruments on a venue stays under a threshold set by the Commission. ESMA recommends setting this threshold between the 40th and the 20th percentiles of the daily lifetime of modified or cancelled orders from all members or participants on a trading venue.

Views at ESMA were split on the relative advantages and disadvantages of the options consulted on by ESMA. ESMA's Technical Advice therefore covers options 1, 2 and 3 above based on the proprietary order flow of investment firms[58]. Option 2 was brought forward by ESMA late in its process of formulating the technical advice as a compromise solution and was not consulted upon in the general open consultation during the summer of 2014.

4.5.1. Analysis of the options and impact on stakeholders

The **'no action' option** would lead to an uneven implementation of the requirements for high frequency traders as the definitions provided in level 1 do not provide enough clarity to be implemented in a consistent manner, hence leading to regulatory uncertainty for investment firms that may qualify as high frequency trading firms while not providing any additional safeguards. **Options 1 and 2** include criteria that will be met or not for each individual investment firm. It will therefore be relatively easy to assess for investment firms whether they qualify as high frequency trading firms or not. Option 2 adds an alternative criterion compared to option 1 and is therefore likely to capture a broader population of firms.

Option 3 sets a relative threshold per venue to identify a specific percentage as high frequency traders. Due to the relative threshold, a certain percentile of investment firms will always be identified as high frequency traders independent of their actual absolute trading frequency. This option is likely to be more difficult to game due to the external factor in the

[58] ESMA's technical advice to the European Commission on MiFID II/MiFIR, ESMA/2014/1569, 19 December 2014, p. 339.

determination of whether an investment firm is a high frequency trading firm or not. Either the trading venue or a competent authority would have to collect and analyse the data and then to inform the traders about whether or not they were identified as trading at high frequency. Whether this option would result in a greater number of traders classified as trading at high frequency would obviously depend on the respective thresholds. What is more important is that this option would qualify traders with different trading frequencies as high frequency trading, i.e. a trader on one venue might not be considered a high frequency trader, while a trader with a lower frequency in absolute terms might be considered to engage in high frequency trading on another venue. The determination for a firm whether it would have to fulfil the requirements under MiFID II for high frequency trading is therefore more complex and arbitrary under this option as it is not possible for investment firms to directly assess whether they will qualify as high frequency trading firms only based on their own behaviour. Thus market participants cannot judge from their own trading whether they will be in or out of scope of the high frequency trading requirements under MiFID II.

Comparison of the options

While options 1 and 2 could lead to investment firms circumventing the threshold for the high message intraday rate by, for example, using an algorithm which trades just below the respective threshold, implementing the relative threshold in option 3 would always identify some investment firms as high frequency traders, therefore carrying the risk of false positives, i.e. identifying investment firms due to the rule that there is always a certain percentile of orders that by the relative threshold is identified as stemming from high frequency traders. However gaming is also possible for market participants by extending the lifetime of orders (and hence increasing the median to which the threshold is set).

On the other hand, options 1 and 2 can become technically obsolete and may have to be revised frequently in case of increases in transaction speed resulting in more and more traders being classified as high frequency traders.

While Option 3 would always capture the fastest segment of the market, it may still not identify all HFT traders if they are relatively slower than other market participants on the same venue. So this option may not cover high frequency trading activity that is 'relatively slower' than other trading on the same venue. Also this option could be circumvented by choosing a venue with relatively faster trading and then try and stay below the trading speed of a certain percentage of the traders of the venue.

The scope for option 1 compared to options 2 or 3 may be more narrow in that it only covers single-instrument strategies, while options 2 and 3 cover both single and multi-instrument strategies.

ESMA carried out an empirical analysis[59] to assess the coverage resulting from options 1 and 3. Under option 1, 16 out of 181 (total population identified based on a direct approach, i.e. the identification of market participants based on their primary business using information on the firms' websites, business newspaper articles and industry events or the use of co-location) were identified. Under option 3, depending on the percentage thresholds used, i.e. either 20th or 40th percentile, between 84 and 145 firms were identified compared to a direct

[59] ESMA's technical advice to the European Commission on MiFID II/MiFIR, ESMA/2014/1569, 19 December 2014, p. 325-334.

identification of 118 firms. Option 2 was not assessed separately, but would identify a higher number of HFT firms than option 1 since it also covers multi-instrument strategies.

Considering its narrow coverage, it would seem to be difficult to reconcile Option 1 with the objectives of MIFID II which is to ensure a broad coverage of high frequency trading activity (cf recital 63 "it is desirable to ensure that *all* high frequency algorithmic trading firms be authorised to ensure they are subject to organisational requirements under the Directive and are properly supervised" (emphasis added)). Therefore, any identified advantages of this option would seem to be outweighed by the sub-optimal coverage in terms of firms, proportion of trading and type of strategies. Another major shortcoming of this option is that it would cover only single-instrument strategies, an artificial limitation of the scope which does not seem to be intended by level 1.

As regards the choice between Options 2 and 3, while an empirical exercise was not undertaken for Option 2, by adding the criterion to cover multi-instrument strategies, it will clearly provide a broader coverage than Option 1. At the same time, it provides a degree of simplicity and clarity and would appear be significantly less costly to implement and administer than Option 3. The concern of un-level playing field and gaming also appears to be more problematic under Option 3 than under Option 2.

Option 2 is therefore the preferred option since it has a broader coverage than option 1 and, on balance, appears to be more workable and less costly to implement and administer than Option 3. Furthermore, option 3 carries the risk of unintended coverage of firms that do not trade at high frequency but only more frequent than most other traders on a certain venue.

Stakeholder responses to the ESMA consultation:

A majority of the respondents to the consultation supported option 1, among these were many regulators, stock exchanges, banks and their associations. They underlined that this approach would be more straightforward, and that it would also capture organisations with high frequency trading capabilities, but who only chose to use these occasionally. On the other hand the threshold of 2 messages per second was criticised as too low and that the threshold could be easily circumvented. Stakeholders also criticised that a firm could exhibit a high intra-day message rate in a number of instruments, but stay just below the single instrument threshold of two messages per second. Stakeholder responses with regard to the relative threshold included comments that this option would be more difficult to circumvent, but also that the calculation would be strongly impacted by the general activity on a trading venue and that firms would have to constantly assess their high frequency trading status, which might change frequently for some traders while not depending on their own behaviour alone. A large part of the respondents had reservations about both option 1 and 3 and instead supported a modified option 1 or a combination of both options consulted on in the ESMA consultation.[60]

[60] As option 2 had only been developed at a later stage there are no stakeholder responses to it.

Table 8: Summary of the options on the definition of High Frequency Trading

	Impact on stakeholders: HF traders	Impact on stakeholders: other market participants	Effectiveness	Efficiency
No action option	0	0	0	0
Option 1	-	+	+	+
Option 2	-	++	++	++
Option 3	--	+	+	-

Magnitude of impact as compared with the baseline scenario (the baseline is indicated as 0): ++ strongly positive; + positive; – – strongly negative; – negative; ≈ marginal/neutral; ? uncertain; n.a. not applicable

4.5.2. Foreign Exchange – Delineating between spot and derivative transactions

The consistent application of the clearing and reporting obligations under EMIR and of investor protection and other requirements under MIFID II across the Union depends on clear and consistent definitions, in this case specifically with regard to foreign exchange (FX) derivative vs. spot contracts.

Under the implementing measures for MiFID II there is the possibility to bring legal certainty on what an FX contract is, based on the outcome of the work previously conducted by the European Commission in order to delineate between spot and derivative FX transactions. For further background please consult Annex 9 on 'A harmonised definition for FX spot contracts'.

No action option

EMIR reporting obligations to trade repositories and investor protection and other requirements under MiFID II/MiFIR would be applied unevenly across Member States depending on how FX spot contracts were defined by national legislators or regulators[61].

Option 1 – Defining FX spot contracts as contract with a settlement of up to T+2

FX contracts with a settlement period of more than two days (T+2) would be automatically considered as FX derivative contracts and hence qualified as financial instruments in scope of the MiFID II requirements.

Option 2 – Defining FX spot contracts as contracts with a settlement of up to T+2 with qualifications

Option 1 amended with some qualifications to ensure that the definition does not include contracts which by their nature are payments rather than financial instruments. More specifically: the T+2 settlement period would apply to European and other major currency pairs, the "standard delivery period" to other currency pairs to define an FX spot contract; using the market settlement period of the transferrable security linked to an FX spot contract in an FX security conversion to define the FX spot contract with a cap of (for example) five

days; add a qualification for FX contracts that are used as a means of payment to facilitate payment for goods and services.[62]

Analysis of the Options and impact on stakeholders

No action would preserve the status quo of having a widely different implementation of MiFID with regard to FX spot contracts and FX derivatives and may lead to regulatory arbitrage. Most Member States currently define FX spot contracts as settling up to T+2. However, the United Kingdom, representing almost 80% of the EU's FX market[63], and Ireland define FX spot contracts as contracts for the purchase of a currency with a delivery of between two and seven business days. Under the **no action** option transactions would therefore be treated differently in different EU jurisdictions. This lack of harmonisation of legal terms is not a desirable outcome, in particular for a cross-border business which FX contracts are per definition. In particular for cross-border transactions stakeholders may therefore need to consider different sets of rules when trying to establish whether an FX transaction is being classified as a spot or derivative transaction.

Option 1 would set a clear delineation. However, there would be no room for acknowledging different market practices, in particular in non-EU countries with regard to the settlement cycles of securities purchased. **Option 1** would therefore require some reshaping of market practices and in particular would impact the UK market where investment firms who trade FX contracts at present with a delivery of between two and seven business days would be required to get a MIFID authorisation that they were not previously required to get, as these contracts would become financial instruments. **Option 2** caters for these special cases and thereby ensures that unintended consequences, e.g. for non-financial corporates, would be avoided. It would also minimise the impact on market practices is the United Kingdom and Ireland. In fact, this option would most likely have very little direct impact on market participants. Its main benefit would be to harmonise the rules around current practices in the Union. Annex 9 includes a table on outright forwards with a settlement of over 7 business days. The figures for the United Kingdom and Ireland combined give an indication of the upper bound of these contracts that may be concerned by a reclassification under this option.

Comparison of the options

While the 'no action' option would not lead to the necessary harmonisation in definitions and hence not remedy the uneven application of rules to FX financial derivatives in financial markets today, **option 1** would require a substantial change in how business is done today and would particularly impact commercial transactions linked to an FX transaction (payments and purchases of foreign securities). **Option 2** sets a clear settlement period for FX spot contracts, but takes into account specific cases for security purchases and payments which are well-established and where a non-EU jurisdiction is involved and for commercial purposes. It is therefore less intrusive than option 1 but achieves a sufficient degree of harmonisation within an appropriate framework. As it is also the most efficient option, **option 2 is the preferred option.**

[62] Please find further information on the suggested qualifications in Annex 9.
[63] Europe Economics, Data gathering and cost-benefit analysis of MiFID II, L2, p. 231

Stakeholder responses to the public consultation carried out by the European Commission[64]:

Public authorities and non-market related non-governmental organisations welcomed the clarification of the notion of an FX spot transaction. However, they also noted that inconsistencies between EU regulation and regulation in third countries should be avoided bearing in mind that the FX market is global and that any differences in global approaches would create difficulties for market participants and the economy. Market participants (such as FX traders) strongly advocated special rules for security conversions (considering that they are concluded for payment purposes) and that they should not be treated as financial instruments. Non-financial companies stressed uses of FX contracts for payment purposes and underlined that onerous requirements for these should be avoided. Some market participants (credit institutions, payment institutions) suggested to rely on market practice rather than to implement new legislation on a harmonised definition.

Table 9: Summary of the options on the definition of FX spot contracts

	Impact on stakeholders: Parties to FX contracts	Impact on stakeholders: other market participants	Effectiveness	Efficiency
No action option	0	0	0	0
Option 1	-	+/0	+	-
Option 2	+/≈	+	+	++

Magnitude of impact as compared with the baseline scenario (the baseline is indicated as 0): ++ strongly positive; + positive; – – strongly negative; – negative; ≈ marginal/neutral; ? uncertain; n.a. not applicable

4.5.3. Clarifying the boundary between commodities and commodity derivatives in energy contracts traded on organised trading facilities

C6 – Contracts that 'must be physically settled'

MiFID II requirements apply to a broad range of commodity derivatives. In particular recitals 8, 9 and 10 of MiFID II make clear that commodity derivatives and others which are constituted and traded in a similar way to traditional financial instruments should be subject to the requirements of MiFID II. Nevertheless, MiFID II acknowledges that certain contracts which are subject to other EU regulations, in particular Regulation (EU) No 1227/2011 on wholesale energy market integrity and transparency (REMIT), should not be covered by the definitions of financial instruments (see below on the REMIT framework). MiFID II excludes wholesale energy contracts (gas and power) that must be physically settled from the definition of a financial instrument.

REMIT

REMIT introduces, for the first time, an EU-wide and sector-specific market integrity framework:

- defining market abuse, in the form of market manipulation, attempted market manipulation and insider trading in wholesale energy markets;

[64] The Commission issued a consultation document on 10 April 2014, http://ec.europa.eu/internal_market/consultations/2014/foreign-exchange/docs/consultation-document_en.pdf. It also consulted the European Securities Committee on the issue.

- introducing explicit prohibitions of market manipulation, attempted market manipulation and insider trading in wholesale energy markets;
- establishing a new framework for the monitoring of wholesale energy markets through ACER at pan-European level to detect and deter market abuse;
- defining a data collection scheme at pan-European level;
- providing that National Regulatory Authorities (NRAs) should be given enforcement and investigatory powers and that Member States establish a penalty regime for breaches at national level by 29 June 2013.

REMIT covers wholesale energy products traded on Venue and OTC.

Whilst ACER is responsible for the monitoring of wholesale energy markets at Union level, NRAs may monitor trading activity at national level. Where ACER suspects that there has been a breach of REMIT, it has the power to request information from NRAs, to request NRAs to commence an investigation, and to establish and coordinate investigatory groups in case the suspected breach has cross-border impacts. Where an NRA has reasonable grounds to suspect a breach of REMIT, it shall without delay inform ACER.

These provisions seek to implement the Cannes G 20 recommendations to "ensure enhanced market transparency, both on cash and financial commodity markets, including OTC, and achieve appropriate regulation and supervision of participants in these markets"[65]. This has been achieved in different ways in the main G 20 jurisdictions (See annex 10).

No action option

Without further specification, national competent authorities and market participants will have to determine on a case by case basis how to apply the exemption with regard to contractual provisions (bona fide inability to perform), operational constraints leading to offsetting/netting (operational netting) or the nature of the underlying commodity (different oil contracts).

Option 1 - Proportionate arrangements to be able to make or take delivery and specific provisions on operational netting (ESMA's Technical Advice)

This option consists of following ESMA's technical advice, i.e. to stipulate that a C6 contract 'must be physically settled' if it contains provisions which ensure that parties to the contract have proportionate arrangements in place to be able to make or take delivery of the underlying commodity. In these markets, mandated bodies who coordinate the electricity provision (such as Transmission System Operators) often ask energy companies to net out contracts and not to take full delivery in order to respond to market demand and to grid

[65] Cannes G20 Final Declaration, https://g20.org/wp-content/uploads/2014/12/Declaration_eng_Cannes.pdf

constraints. Therefore, ESMA considered that operational netting does not preclude a contract from being physically settled. In addition, such contracts would have to establish unconditional, unrestricted and enforceable obligations to ensure the contract is physically delivered, and that unilateral cash settlement is not permissible.

Option 2 - Specifying appropriate arrangement for delivery with network operators

This option would further specify option 1 by clarifying that entering into a network access and balancing agreement with the transmission system operators will qualify as having 'proportionate arrangements'. This option requires that market participants have a so-called balancing agreement with the Transmission System Operator in place, whether directly or indirectly through a Balance Responsible Party (BRP), in order for the wholesale energy products they enter into to be considered as physically settled. Such a balancing agreement makes sure that in case a contractual party fails to meet its delivery (or off-take) obligation, the TSO would physically deliver (or take off) the contracted amount to ensure overall system balance. This option would otherwise take up ESMA's advice unchanged, including with regard to operational netting.

Option 3 - Further framing option 1 regarding the contractual provisions concerning 'proportionate arrangements'

This option would determine what parameters constitute 'proportionate arrangements' in order to benefit from the exemption. It seeks to further clarify the terms of contracts which may benefit from the exemption by referring to the capacity of participants to take physical delivery while also stipulating that operational netting does not preclude a contract from being considered as must be physically settled. These specifications could relate to the necessary licenses to operate in the physical markets, or a generic requirement to have adequate production, storage or consumption facilities in relation to their commercial activities.

Option 4 – Further framing option 1 regarding contractual provisions concerning 'proportionate arrangements' with quantitative thresholds.

This option would include a provision linking the sum of obligations to be physically settled to the total production, storage or consumption capacities. For example, the obligations to be physically settled should not exceed 200% of production capacity at any time.

Analysis of the options and impact on stakeholders

The no action option would leave some leeway for stakeholders and national competent authorities to interpret the scope of 'what must be physically settled'. It does not achieve the objective of arriving at a harmonised definition in the Union. All market participants would face considerable uncertainty as to which contracts would be exempted from and which would be covered by the scope of MiFID. This could lead to distortions in competition and potentially regulatory arbitrage amongst Member States undermining the whole regime. The lack of clarification could therefore lead to very different outcomes across markets: where some physical players can effectively churn (buy and sell) contracts without effectively delivering them physically. The below figures show how prevalent the issue is in the EU (2013 figures):

Volumes, Power: - physically delivered derivatives: 5,779,940 GWh - consumption: 2,064,000 GWh

Volumes, Gas: - physically delivered derivatives: 25,693,877 GWh - consumption: 2,685,000 GWh

Value of derivatives trading that (can/must) be physical delivered: ca 936 billion Euros.

Option 1 will provide certainty as to the contractual terms of the contracts and place a generic requirement that parties have proportionate arrangements in place. This will ensure that the exemption captures only those contracts covered by REMIT. The lack of further description of what proportionate arrangements are may lead to an un-even application of the exemption. However, it would be difficult to specify ex-ante which further elements should be defined without seeing how the exemption is used in practice. Any such ex-ante specification would likely have consequences for the liquidity of markets and would be ill-tailored. Therefore, it is optimal to keep the flexible wording for the initial application of the legislation. This may be complemented at a later date with Level 3 measures which would benefit from specific concerns arising from the implementation of the exemption.

Option 2 would provide the same certainty as option 1 with regards to the contractual terms of the contracts. At the same time, option 2 would define the meaning of 'proportionate arrangements' as a balancing agreement with a Transmission System Operator leaving no room for diverging interpretations and levelling the playing field across the Union. It would benefit market liquidity by allowing all kinds of participants (with access to transmission networks) to classify their contracts as non-financial instruments. This would ensure a continued wide participation in wholesale power and gas markets. This option will allow market participants to roll their contracts until delivery and engage in buying and selling of contracts up until delivery. In large part, wholesale participants with such licenses would still be allowed to buy and sell contracts on organised trading facilities, as long as the ultimate delivery is made at the end of the contract.

Options 3 and 4 would impose more stringent restrictions on the use of the exemption and would largely constrain it to players who own, control or have otherwise access to storage, production or consumption facilities. Many energy participants and energy regulators consider that these options would deter participation in the markets, and damage liquidity.

Liquidity may be impaired because the exemption would only apply to participants with sufficient production/consumption capability; potentially meaning that intermediaries who help physical market participants hedge their risks or arbitrage between EU prices would not be able to use the exemption. In turn, this may reduce the ability of such counterparties to intermediate because they would not wish to become investment firms subject to capital requirements. Currently commodity trading firms are exempt from capital requirements; but the Capital Requirements Regulation envisages a review of this exemption by the end the year 2017. Should intermediation fall, it could have an effect on consumers and suppliers since they would no longer be able to procure energy in quantities, profiles, volumes and maturities they prefer. Instead they would need to solely rely on what producers are ready to offer them. Product diversification would be limited and hedging would likely to become impossible as no consistent forward curve could be maintained, resulting in inefficient price signals. In result, investment into energy infrastructure would likely be deterred.

Overall, lower hedging and risk management opportunities for energy firms will likely increase both wholesale and retail prices for energy products.

Should intermediation indeed be made more difficult, it is possible that liquidity would drop substantially but it is unclear whether this would actually happen or whether intermediaries would rather adapt and trade in financial instruments. It is also worth noting that this option would not prohibit trading, but merely classify those contracts as financial instruments unless the intermediary has access to storage, transport or consumption/production facilities.

Option 3 seeks to bring more clarity to what is meant by 'proportionate arrangements' in a flexible way. However, there has been limited experience to date on how to best specify which qualitative elements should be further described. This may therefore impact liquidity, in unexpected ways as described above. In turn it may not be the right moment to develop such specification, without first studying how the exemption works in practice.

Option 4 would bring more legal certainty and further harmonisation of EU rules compared with Option 3. However, a single figure would not do justice to the wide variety of EU firms which trade wholesale energy products. Then again, using different figures for the various types of contracts and products could create a large number of thresholds which would not be transparent and cost efficient. Furthermore, such a quantitative threshold would have very uneven effects on firms which could lead to distortions in the market. The quantitative threshold envisaged by option 4 may also severely impact energy markets, which was not the intention of the Directive.[66] In particular, the imposition of a limit on capacity would likely reduce the ability of energy producers to sell forward their production with the unintended consequence of a dramatically reduced liquidity in these markets. Option 4 could therefore have adverse impacts not only on parties to the contracts in question but more widely on the liquidity and functioning of commodity markets.

Comparison of the options

The **'no action' option** does not seem to go far enough in harmonising the definitions on C6 contracts that 'must be physically settled' in order to allow for a harmonised application across the Union. This risks undermining the implementation of the G20 recommendations.

Option 1 seeks to limit the exemption using a flexible approach so that parties have physical arrangements in place. Furthermore the proposed wording should not impact market liquidity too much and will ensure that the exemption applies to non-REMIT contracts. Should further clarification be required, this could be achieved by Level 3 measures once the legislation has been applied and specific concerns identified.

Option 2 largely leaves the market structure unchanged, but could easily be abused by market participants to cash-settle contracts. **Option 3** further harmonises the criterion of 'proportionate arrangements' as introduced by ESMA, but it is currently not possible to specify further elements without possibly harming market liquidity and the aims of the Energy Union[67].**Option 4** carries the risk that it would limit the activities of market participants in an unintended way by setting a numeral threshold on the 'proportionate arrangements' to be in place.

Option 1, **on balance, is therefore the preferred option.**

[66] The intention of MiFID II is to properly distinguish between financial market regulation and the regulation of energy markets.

[67] http://ec.europa.eu/priorities/energy-union/index_en.htm

Stakeholder views:

ESMA did not consult on whether C6 should include 'proportionate arrangement' for delivery of the physical production. However, most energy companies, as well as energy regulators, believe that these provisions, if applied too strictly, may impair market liquidity and raise prices for energy firms.

Energy regulators generally agree that ESMA's wording, 'proportionate arrangements' is a useful addition to the advice if it is not constrained or further specified.

Regarding the other aspects of the advice, energy firms agreed that the focus should be on contractual provisions providing enough flexibility to cater for the existence of various operational netting systems in the EU.

Table 10: Summary of the options on the definition of 'must be physically settled'

	Impact on stakeholders	Effectiveness (delineating financial markets and energy markets)	Efficiency
No action option	0	0	0
Option 1	+	++	++
Option 2	+	0	0
Option 3	-	+	+
Option 4	--	-	--

Magnitude of impact as compared with the baseline scenario (the baseline is indicated as 0): ++ strongly positive; + positive; – – strongly negative; – negative; ≈ marginal/neutral; ? uncertain; n.a. not applicable

Definition of C7:

'C7 financial instruments' are defined in MiFID II as "Options, futures, swaps, forwards and any other derivative contracts relating to commodities, that can be physically settled not otherwise mentioned in point 6 and not being for commercial purposes, which have the characteristics of other derivative financial instruments". The starting point for this delegated act to specify some technical elements of the definition and to ensure the uniform application of MiFID II are the current level 2 rules under MiFID I. It is to be analysed whether any changes to them are necessary and proportionate, in particular in view of the introduction in MiFID II of the organised trading facility venue and the removal of a previous half-sentence in MiFID I on clearing/margining requirements in order to avoid any circularity with EMIR, which now establishes which derivative contracts as defined under MiFID should be centrally cleared.

No action option

MiFID II does not specify which contracts should be considered other derivative contracts, and does not specify the meaning of spot contract and commercial purpose. Without such specification, each competent authority will have to determine how to apply these definitions, leading to uncertainty and non-level playing fields for market participants.

Option 1 – ESMA's technical advice

ESMA has modified the existing MIFID I implementing rules to take into account the new organised trading facility category and to remove the reference to clearing. C7 instruments are defined by specifying that they should be standardised, traded on an EU or third country venue and not be spot contracts. It reasserted the view that commodity spot contracts should be understood as for delivery within two trading days or the period generally accepted in the market. Following responses from its consultation process, ESMA decided to retain the existing definition of a contract being for commercial purposes (Article 38 of Regulation (EC) No 1287/2006): "it is entered into with or by an operator or administrator of an energy transmission grid, energy balancing mechanism or pipeline network and it is necessary to keep in balance the supplies and uses of energy at a given time". This definition is narrowly framed and limited to the energy sector.

Under ESMA's advice, over-the-counter contracts will be considered C7 financial instruments if they are equivalent to exchange traded ones with regard to any of the main terms of the contracts such as price, lot or delivery date. This is a major change from the MIFID I rules where parties to contracts had to expressly state equivalence (i.e. opt in) in order for an over-the-counter contract to be considered C7.

Option 2 – Narrow the equivalence test

This option would largely take ESMA's advice, but would seek to narrow which over-the-counter instruments can be deemed equivalent to exchange- traded contracts. In particular, only those over-the-counter contracts which have all the same main features as exchange traded contracts (such as price and delivery and lot) will be considered C7 financial instruments. This will ensure that 'physical forwards' used by commodity producers to sell their produce forward will not be considered financial instruments.

Option 3 - Widen the commercial purpose exemption

In this option, the definition of what constitutes contracts for commercial purposes would be widened, in order to exempt ex-ante many commercial players from MIFID requirements. In this option, commercial purpose would be evidenced by both parties to the contracts having proportionate delivery arrangements. In addition these contracts would establish unconditional obligations which cannot be cash-settled.

Analysis of the options and impacts on stakeholders

The **no action option** would likely lead to an un-level playing field with rules applied differently across the Union. This could lead to regulatory arbitrage. It would create uncertainty for market players who would not be able or only with considerable effort to determine how each contract will be treated. This would represent an unnecessary burden for stakeholders who would have to cope with differing requirements across the Union.

Option 1 suitably updates the MIFID I text to take into account developments of organised trading facilities and clearing. It widens the scope of the equivalence test to over-the-counter contracts that share some of the features of exchange traded contracts. In turn, this may lead to many smaller commercial entities being captured by MIFID authorisation requirements. **Option 1** would therefore disproportionately impact stakeholders who rely on forwards which are linked to exchange traded contracts for their physical transactions. Indeed many commodity physical producers use forward contracts linked to exchange traded products to sell their production forward. These physical forwards are linked to the settlement price of

the exchange traded contracts, but are often adjusted for the specifics of the trade (delivery date or place). Under option 1, these contracts will be considered C7 financial instruments. For some sectors, like agriculture, which rely on forwards for the majority of their sales of physical products, it is possible that the entirety of the activity will consist in financial instruments; and thus these businesses will fail the ancillary activity test.[68] This would involve, in extremis, many small businesses, such as farmers and agricultural cooperatives, needing to be MiFID authorised.

Option 2 would narrow the equivalence tests so as to exclude over-the-counter contracts that are not exactly equivalent to exchange traded contracts. Analysis indicates that the vast majority of contracts used for physical delivery would not be captured by this definition. As such, option 2 would meet the co-legislators' intent to focus the MIFID provisions on non-commercial entities. It would also allow businesses which have different capital structures to industrial companies such as cooperatives, which buy and sell production forward, not to be unduly impacted by the legislation. Finally, whilst option 2 would limit the scope of MIFID II compared to option 1, it would considerably increase the coverage compared to MIFID I rules, where parties had to explicitly opt-in for contracts to be considered C7 financial instruments. **Option 3** seeks to solve similar problems as option 2, but could risk creating much wider exemptions for commercial entities. This would allow any commercial entity with some production capacity to benefit from the exemption.

Option 2 and 3 would likely allow for stakeholders to continue their commercial activity.

Comparison of the options

The **no action** option does not go far enough in the harmonisation of definitions to allow for a harmonised application of definitions in all EU Member States and would therefore create regulatory uncertainty. **Option 1** does not cater for businesses which rely on forwards to conduct physical business. **Option 3** allows the majority of physical forwards to be exempt from MiFID, but may make it too easy for market participants to circumvent the rules. **Option 2** seems to be the right approach to extend the existing level 2 provisions to cater for a wide variety of contracts, whilst also respecting the level 1 text. **Option 2 is therefore the preferred option.**

Table 11: Summary of the options on the definition of C7

	Impact on stakeholders: Market participants affected	Impact on stakeholders: other market participants	Effectiveness	Efficiency
No action option	0	0	0	0
Option 1	--	+	+/-	-
Option 2	-	++	++	++
Option 3	≈	≈	--	-

Magnitude of impact as compared with the baseline scenario (the baseline is indicated as 0): ++ strongly positive; + positive; – – strongly negative; – negative; ≈ marginal/neutral; ? uncertain; n.a. not applicable

[68] A test whether a commodity firm's trading activities compared to physical delivery are so substantial that the trading can no longer be considered ancillary, and hence a MiFID authorisation would be required.

5. OVERALL AND SPECIFIC IMPACTS OF THE MEASURES

By ensuring a harmonised implementation and application of MiFID and MiFIR, the delegated acts will make sure that the objectives of level 1 can be achieved without imposing an inordinate additional burden on stakeholders.

It is worth noting again that the impacts of the delegated acts discussed in this impact assessment are relatively minor as the (often not so) broad lines have already be determined in MiFID II and MiFIR level 1 texts.

The transparency regime implemented through the level 2 measures should allow to enhance the price discovery process for investors, i.e. investors should be able to access information on trades in an instrument they are interested in, published across venues, in one place (the consolidated tape). Investors should therefore be better informed about the prices for a specific financial instrument across trading venues. They will also be able to compare prices executed for their trades to other trades executed in the same financial instruments at the same or other trading venues across the Union.

Market integration should lead to the transparency regime being applied across trading venues (regulated markets, multilateral trading facilities, organised trading facilities and also by systematic internalisers). Prices should therefore become more efficient across venues.

It should also become easier for investors to invest in SME shares in other countries as shares listed on SME growth markets gain further visibility. This should make it easier for SMEs to finance themselves.

The enhanced investor protection measures should mean that investment research should be treated as a stand-alone product and therefore be priced according to its value for the investment product, instead of being regarded as a side product of execution services. This should mean that investment firms get better value for money, that independent investment research providers (who do not provide execution services that were until now bundled with investment research) can compete on an equal footing and also in niche areas of research with brokers offering both execution services and investment research. Hence price discovery with regard to investment research should improve and more competitors may enter the market for investment research. Investors' money should no longer be used to pay for investment research that is not properly priced and which benefits their investments.

Market participants (trading venues, systematic internalisers, organised trading facilities, SME growth markets, HFT traders) will incur costs in setting up trade data publication and in some instances applying for authorisation (in particular for SIs, SME GMs, HFT traders). Investment firms will also incur costs for implementing the enhanced investor protection regime, putting in place monitoring for the placement of client funds, pricing models for investment research as well as training and quality checks in order to provide investment advice according to the quality enhancement criteria. It is clear, however, that these costs will be to large extent one-off. Annex 11 provides some tentative assessment through a study conducted by external consultants of the compliance costs triggered by the Level 2 provisions.

Impacts on SMEs

The measures discussed in this impact assessment affect SMEs in different ways. They impact those SMEs directly which are participants in financial markets. It is important to note that many of the investment firms to which the measures apply primarily are themselves SMEs. They might face higher compliance costs if they do not already comply with the standards required by the delegated acts. It can be argued that in some cases these costs might be disproportionately higher for SMEs than for bigger investment firms. This has been addressed, however, by the introduction of proportionality clauses, e.g. regarding the exemption from the 20% limit for deposits held in intra-group bank accounts. Furthermore, many of these SMEs are part of a larger financial group and will therefore benefit from economies of scale within the group, e.g. with regard to the development of information technology tools. These potential increases in compliance costs stand against gains in the form of greater liquidity and transparency of markets and fairer competition among market participants of all sizes and in all financial markets. This should help smaller players to compete with bigger players. For example, it will be more difficult for the latter to use their market power in trading venues to get more research for free or at a very low price.

SMEs that are (potential) market participants, e.g. as issuers of debt or shares, should be among the main beneficiaries of these delegated acts as they would also benefit from greater liquidity and transparency of financial markets as well as more and fairer competition in these markets. In particular, the creation of the SME Growth Market label should significantly improve SMEs' access to capital markets. But also SMEs which are not and intend not to access financial markets directly should nevertheless benefit from the measures discussed here as they will be influenced by financial markets and investment firms in one way or another; be it through more stable and predictable interest rates or commodity prices, be it through more competition for banks in the provision of capital which should improve SMEs' negotiation power.

Social impacts

Some of the preferred options will increase investor protection, reinforce the means of regulators for controlling financial markets and financial operators, and make financial markets more transparent and more secure. Therefore, there will be a direct benefit to all market participants: investors, retail or institutional, as well as issuers. The suggested measures should help to improve investor confidence and participation in financial markets. In addition, by contributing to reducing market disorder and systemic risks, these options should improve the stability and reliability of financial markets.

In addition, by requiring investment firms to disclose further information to investors and to learn more about their investment criteria, MiFID II and MiFIR might encourage investments in specific types of business, such as social, environmental, ethical, etc.

The investment plan for Europe highlights reducing fragmentation in the financial markets and contributing to enhanced and more diversified supply of finance to SMEs and long-term projects as key elements of the strategy to improve the framework conditions for growth. Both are necessary to establish a genuine single capital market, increase investor confidence and reduce the cost of funding for the real economy. Besides banks, financial markets are the most important channel for the optimal allocation of capital within the European economy. However, capital will only flow frictionless through this channel if these markets are stable and trusted by all market participants. A clearly defined legal framework will therefore help

to achieve the Commission's top priority to get Europe growing again and increase the number of jobs without creating new debt.

Environmental impacts

No relevant direct or indirect impacts on environmental issues had been identified for MiFID II and MiFIR. At best, some positive indirect environmental impacts could be expected because of better oversight of commodities markets which could contribute to a more stable environment for producers of physical commodities which in turn could improve overall allocation of resources and possibly better take into consideration environmental constraints. Improving transparency and oversight of the emission allowances market would contribute to a better functioning of the EU Emissions Trading Scheme which is a cornerstone of the EU's policy to combat climate change.

It is not to be expected that the delegated acts will have any significant impact on these potential indirect environmental effects or other relevant environmental impacts.

Impacts on fundamental rights

In the IA for the Commission proposal for MiFID II an assessment was made of the policy options to ensure compliance with fundamental rights.[69] It was found that the proposal is in compliance with the charter. Any limitation on the exercise of these rights and freedoms will be provided for by the law and respect the essence of these rights and freedoms. The policy options in this present impact assessment relating to telephone and electronic recording ensure that access to telephone and data records is subject to appropriate safeguards. These policy options, including the preferred option, will contribute to market integrity by facilitating the detection of market abuse within the EU as well as facilitating the monitoring of compliance with MiFID II conduct of business rules.

Impacts on third countries and impact on EU competitiveness

As explained in the IA for the Commission proposal for MiFID II, financial markets, including commodity derivatives markets, are global markets; therefore any modification in the EU legislation will have an impact on third countries. But at the same time several of the modifications proposed to the current legal framework are steps taken in order to put into effect G20 or other international agreements. However, the possibility of regulatory arbitrage will still exist within the G20, but even more so with countries that are not part of the G20.

The delegated acts discussed in this IA do not address specific requirements vis-à-vis market participants from third countries. They will have to comply with these provisions the same way as market participants in the Union.

As regards competitiveness of EU market participants, it has been argued that the higher costs triggered by the MiFID framework and also some of the level 2 measures would be detrimental to the EU's competitiveness. This argument, however, ignores the expected positive impacts on investor protection, market efficiency and stability. That this is an important trade-off is demonstrated by the fact that investors deliberately chose to invest in established, well-supervised markets and do not all flock to cheap off-shore markets.

[69] Based on (COM (2010) 573), Strategy for the effective implementation of the Charter of Fundamental Rights by the European Union, October 2010, particularly the check list.

Furthermore, the preferred options have been designed in a way that minimises the administrative burden and compliance costs to achieve a given objective. In the case of the safeguarding of client assets, for example, the preferred option introduces a proportionality clause instead of applying a strict rule across the board.

6. CHOICE OF LEGAL INSTRUMENT FOR THE DELEGATED ACTS

The main aim of the level 2 measures is to specify provisions in MiFID II and MiFIR in order to ensure consistent implementation and application of the level 1 provisions across all Member States. This is important in order to ensure that the objectives of level 1 can be achieved. The best legal instrument to ensure such consistency is a regulation. A regulation, as part of a single rulebook, guarantees full harmonisation and provides all stakeholders with full legal certainty and ensures market integration.

The implementation by means of a Directive, on the other hand, may leave some uncertainty for players and would risk that objectives like the reduction of systemic risks, increased efficiency of financial markets or improved investor protection could not be fully achieved.

7. MONITORING AND EVALUATION

The impact assessment for MiFID II already outlined a detailed monitoring programme which should provide indicators and other information to evaluate both the level 1 and level 2 provisions. For the issues discussed in this impact assessment the following reports would be of particular relevance:

- on the functioning in practice of the tailor-made regime for SME growths markets;
- on the impact in practice of the newly introduced requirements regarding automated and high-frequency trading;
- on the impact in practice of the newly designed transparency rules in bonds, structured products and derivatives trading and in particular on whether these have been implemented across venues so as to achieve a level playing field, taking into account the venues characteristics (market integration);
- on the impact of the proposed measures in the commodity derivatives markets; and
- on experiences regarding the measures designed to strengthen investor protection.

Conformity check, transposition and implementation planning

The subject of this proposal/impact assessment consists of delegated and implementing measures to MiFID II and MiFIR due to enter into force on 3 January 2017. These are so-called Level 2 measures that specify details of the Level 1 Directive. They will take the form of regulations and will therefore contain detailed requirements that will leave Member States little or no latitude for interpretation. They are directly applicable and should not be implemented at national level. Furthermore, the regulations (at least at their current drafting stage) do not envisage requiring Member States to adopt supporting measures. Hence, there is no need for a transposition/implementation plan. For the same reasons a conformity check is not necessary in the case of Level 2 regulations.

However, as part of the implementation of the level 1 measures, the Commission has asked Member States to designate contact persons for transposition purposes. Together with Commission staff in charge of the file, the designated contact persons form the so-called transposition network for MiFID II. So far, only bilateral contacts have taken place and informal comments have been exchanged, but it is envisaged that a transposition workshop will be organised before the implementation deadline. The transposition network may also be used for the exchange of information regarding the concrete application of Level 2 measures.

Annexes

Annex 1: Glossary of main technical terms employed in the report

Admission to trading	The decision for a financial instrument to be traded in an organised way, notably on the systems of a trading venue.
Algorithm	An algorithm is a set of defined instructions for making a calculation. They can be used to automate decision making, for instance with regards to trading in financial instruments.
Algorithmic trading	Algorithmic trading is trading done using computer programmes applying algorithms, which determine various aspects including price and quantity of orders, and most of the time placing them without human intervention.
Asset Backed Security (ABS)	An Asset Backed Security is a security whose value and income payments are derived from and collateralized (or "backed") by a specified pool of underlying assets which can be for instance mortgage or credit cards credits.
Automated trading	The use of computer programmes to enter trading orders where the computer algorithm decides on aspects of execution of the order such as the timing, quantity and price of the order. A specific type of automated or algorithmic trading is known as high frequency trading (HFT). HFT is typically not a strategy in itself but the use of very sophisticated technology to implement traditional trading strategies.
Best execution	MiFID (article 21) requires that firms take all reasonable steps to obtain the best possible result for their clients when executing orders. The best possible result should be determined with regard to the following execution factors: price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of an order.
Bid-ask spread	The bid-ask spread is the difference between the price a market maker is willing to buy an asset and the price it is willing to sell at.
Bilateral order	An order which is only discussed and disclosed to the counterparties to the trade.
Classification of clients	Protection requirements are calibrated in MiFID to three different categories of clients, notably clients, professionals, and eligible counterparties. The high level principle to act honestly, fairly and professionally and the obligation to be fair, clear and not misleading apply irrespective of client categorization.
Client assets	Client assets are assets (cash, equities, bonds, etc) which belong to the client, but which are held by investment firms for investment purposes.
Committee of European Securities Regulators (CESR)	The Committee of European Securities Regulators was one of the advisory committees, composed by national security regulators advising the Commission and coordinating the work of securities regulators, and has now been succeeded by the ESMA (cf below).

Commodities Futures and Trading Commission (CFTC)	The CFTC is a regulatory body responsible for the regulation of the commodity futures and option markets in the United States.
Commission Sharing Arrangement (CSA)	A CSA is an agreement between the investment manager and the broker, which allows part of the execution commission to be separated and set aside to pay for research. At the point of execution the broker receives the execution component of the commission, but the research component goes into a separate account, held by the broker on behalf of the investment manager.
Commodity derivative	A financial instrument the value of which depends on that of a commodity, such as grains, energy or metals.
Competent authority	A competent authority is any organization that has the legally delegated or invested authority, capacity, or power to perform a designated function. In the context of MiFID, it refers to the body which is in charge of supervising securities markets.
Conflicts of interest	The term conflict of interest is widely used to identify behaviour or circumstances where a party involved in many interests finds that two or more of these interests conflict. Conflicts of interest are normally attributed to imperfections in the financial markets and asymmetric information. Due to the diverse nature of financial markets, there is no general definition of a conflict of interest; however they are typically grouped into Firm/Client, Client/Client and Intra Group Conflicts. MiFID contains provisions for areas where conflicts of interest commonly arise and how they should be dealt with.
Consolidated tape	A consolidated tape is an electronic system which combines sales volume and price data from different exchanges and certain broker-dealers. It consolidates these into a continuous live feed, providing summarised data by security across all markets. In the US, all registered exchanges and market centres that trade listed securities send their trades and quotes to a central consolidator. This system provides real-time trade and quote information.
Dealer	A dealer is an entity that will buy and sell securities on their own account, acting as principal to transactions.
Depositary receipts	Those securities which are negotiable on the capital market and which represent ownership of the securities of a non-domiciled issuer while being able to be admitted to trading on a regulated market and traded independently of the securities of the non-domiciled issuer.
Derivative	A derivative is a type of financial instrument whose value is based on the change in value of an underlying asset.
Direct Market Access (DMA)	Participants require access to a market in order to trade on it. Direct market access is a form of sponsored access and refers to the practice of a firm, who has access to the market as a Member, to allow another 3rd party firm to use its own systems to access the market. It is different from tdirect sponsored access in which the orders of the third party are sent directly to the market through a dedicated system provided by the sponsoring Member.
Directive	A directive is a legislative act of the European Union, which requires Member States to achieve a particular result without dictating the means

	of achieving that result. A Directive therefore needs to be transposed into national law contrary to regulation that have direct applicability.
EMIR	European Market Infrastructure Regulation.
EU Emission Allowance (EUA)	An allowance to emit one tonne of carbon dioxide equivalent during a specified period, as more specifically defined in Article 3(a) of Directive 2003/87/EC.
ESMA	The European Securities and Markets Authority is the successor body to CESR, continuing work in the securities and markets area as an independent agency and also with the other two former level three committees.
ETS	European Union Emission Trading Scheme a 'cap and trade' system: it caps the overall level of emissions allowed but, within that limit, allows participants in the system to buy and sell allowances as they require. These allowances are the common trading 'currency' at the heart of the system. One allowance gives the holder the right to emit one tonne of CO2 or the equivalent amount of another greenhouse gas. The cap on the total number of allowances creates scarcity in the market.
Exchange Traded Fund (ETF)	A fund of which at least one unit or share class is traded throughout the day on at least one trading venue and with at least one market maker which takes action to ensure that the price of its units or shares on the trading venue does not vary significantly from its net asset value and, where applicable, from its indicative net asset value.
Execution-only service	Investment firms may provide investors with a means to buy and sell certain financial instruments in the market without undergoing any assessment of the appropriateness of the given product - that is, the assessment against knowledge and experience of the investor. These execution-only services are only available when certain conditions are fulfilled, including the involvement of so-called non-complex financial instruments (defined by article 19 paragraph 6 of MiFID).
Fair and orderly markets	Markets in financial instruments where prices are the result of an equilibrium between supply and demand, so that all available information is reflected in the price, unhindered by market deficiencies or disruptive behaviour.
Financial instrument	A financial instrument is an asset or evidence of the ownership of an asset, or a contractual agreement between two parties to receive or deliver another financial instrument. Instruments considered as financial are listed in MiFID (Annex I).
Free float	The outstanding capital (number of issued shares times the share price), under MiFID I and MiFID II: minus shareholdings exceeding 5% of the total voting rights of the issuer, unless such voting rights are held by collective investment undertakings or pension funds. Voting rights shall be calculated on the basis of all the shares to which voting rights are attached, even if the exercise of such a voting right is suspended.
Hedging	Hedging is the practice of offsetting an entity's exposure by taking out another opposite position, in order to minimise an unwanted risk. This can also be done by offsetting positions in different instruments and markets.

High frequency trading	High frequency trading is a type of electronic trading that is often characterised by holding positions very briefly in order to profit from short term opportunities. High frequency traders use algorithmic trading to conduct their business.
Inducement	Inducements is a general name referring to varying types of incentives paid to financial intermediaries in exchange for the promotion of specific products or flows of business.
Information asymmetry	An information asymmetry occurs where one party to a trade or transaction has more or better information than another party to that trade or transaction, giving it an advantage in that trade or transaction.
Insurance Mediation Directive	EU Insurance Mediation Directive (2002/92/EC), introducing requirements for insurance companies such as registration with a competent authority, systems and controls standards, regulation of handling of complaints, cancellation of products.
Interest rate swap	An interest rate swap is a financial product through which two parties exchange flows; for instance, one party pays a fixed interest rate on a notional amount, while receiving an interest rate that fluctuates with an underlying benchmark from the other party. These swaps can be structured in various different ways negotiated by the counterparties involved.
Intermediary	A person or firm who acts to bring together supply and demand from two other firms or persons. In the context of MiFID, intermediaries are investment firms.
Investment services	Investment services are legally defined in MiFID (article 4 and Annex I), and cover various activities such as the reception of orders, portfolio management, underwriting or operation of MTFs.
Liquidity	Liquidity is a complex concept that is used to qualify market and instruments traded on these markets. It aims at reflecting how easy or difficult it is to buy or sell an asset, usually without affecting the price significantly. Liquidity is a function of both volume and volatility. Liquidity is positively correlated to volume and negatively correlated to volatility. A stock is said to be liquid if an investor can move a high volume in or out of the market without materially moving the price of that stock. If the stock price moves in response to investment or disinvestments, the stock becomes more volatile.
Lit market	A lit market is one where orders are displayed on order books and therefore are pre-trade transparent. On the contrary, orders in dark pools or dark orders are not pre-trade transparent. This is the case for orders in broker crossing networks.
Lit order, dark order	A lit order is one, the details of which can be seen by other market counterparts. A dark order is one which cannot be seen by other market counterparts.
Market abuse	Market abuse consists of market manipulation and insider dealing, which could arise from distributing false information, or distorting prices and improper use of insider information.
Market disorder	General trading phenomenon which results in the market prices moving away from those that would result from supply and demand.

Market efficiency	Market efficiency refers to the extent to which prices in a market fully reflect all the information available to investors. If a market is very efficient, then no investors should have more information than any other investor, and they should not be able to predict the price better than another investor.
Market fragmentation	Market fragmentation refers to the dispersion of business across different trading venues, where in the past there was only one venue. It requires traders to look for liquidity across different places.
Market integrity	Market integrity is the fair and safe operation of markets, without misleading information or inside trades, so that investors can have confidence and be sufficiently protected.
Market integration	Refers to the goal to create a level playing-field across trading venues and bilateral trading systems, in particular with regard to the applicable transparency regime, but also with regard to the applicable investor protection standards.
Market maker	A market maker is a firm that will buy and sell a particular security on a regular and continuous basis by posting or executing orders at a publicly quoted price. They ensure that an investor can always trade the particular security and in doing so enhance liquidity in that security.
Market operator	A firm responsible for setting up and maintaining a trading venue, such as a regulated market or a multi lateral trading facility.
Markets in Financial Instruments Directive (MiFID)	Directive 2004/39/EC that lays down rules for the authorisation and organisation of investment firms, the structure of markets and trading venues, and the investor protection regarding financial securities.
Multilateral Trading Facility	An MTF is a system, or "venue", defined by MiFID (article 4) which brings together multiple third-party buying and selling interests in financial instruments in a way that results in a contract. MTFs can be operated by investment firms or market operators and are subject to broadly the same overarching regulatory requirements as regulated markets (e.g. fair and orderly trading) and the same detailed transparency requirements as regulated markets.
Open architecture	Platforms that allow investors to buy financial instruments from a wide range of providers in one place.
Operational netting	Any nomination of quantities of power and gas to be fed into a gridwork upon being so required by the rules or requests of a Transmission System Operator as defined in Article 2 No. 4 of Directive 2009/72/EC or an entity performing an equivalent function to a Transmission System Operator at the national level. Any nomination of quantities based on operational netting must not be at the discretion of the parties to the contract.
Organised trading facility (OTF)	Any facility or system operated by an investment firm or a market operator that on an organised basis brings together multiple third party buying and selling interests or orders relating to financial instruments. It excludes facilities or systems that are already regulated as a regulated market, MTF or a systematic internaliser. Examples of organised trading facilities would include broker crossing systems and inter-dealer broker systems bringing together third-party interests and orders by way of

	voice and/or hybrid voice/electronic execution.
Over the Counter (OTC)	Over the counter, or OTC, trading is a method of trading that does not take place on an organised venue such as a regulated market or an MTF. It can take various shapes from bilateral trading to trading done via more organised arrangements (such as systematic internalisers and broker networks).
Placing	Placing refers to the process of underwriting and selling an offer of shares.
Position limit	A position limit is a pre-defined limit on the amount of a given instrument that an entity can hold.
Position management	Position management refers to monitoring the positions held by different entities and ensuring the position limits are adhered to.
Post-trade transparency	Post trade transparency refers to the obligation to publish a trade report every time a transaction in a share has been concluded. This provides information that enables users to compare trading results across trading venues and check for best execution.
Pre-trade transparency	Pre-trade transparency refers to the obligation to publish (in real-time) current orders and quotes (i.e. prices and amounts for selling and buying interest) relating to shares. This provides users with information about current trading opportunities. It thereby facilitates price formation and assists firms in providing best execution to their clients. It is also intended to address the potential adverse effect of fragmentation of markets and liquidity.
Pre-trade transparency waiver	A pre-trade transparency waiver is specified in MiFIR as a way for the competent authorities to waive the obligation for market operators and investment firms operating a trading venue to make public certain information.
Price discovery	Price discovery refers to the mechanism of formation of the price of an asset in a market, based on the activity of buyers and sellers actually agreeing prices for transactions, and this is affected by such factors as supply and demand, liquidity, information availability and so on.
Principle of proportionality	Similarly to the principle of subsidiarity, the principle of proportionality regulates the exercise of powers by the European Union. It seeks to set actions taken by the institutions of the Union within specified bounds. Under this rule, the involvement of the institutions must be limited to what is necessary to achieve the objectives of the Treaties. In other words, the content and form of the action must be in keeping with the aim pursued. The principle of proportionality is laid down in Article 5 of the Treaty on European Union. The criteria for applying it is set out in the Protocol (No 2) on the application of the principles of subsidiarity and proportionality annexed to the Treaties.
Prospectus Directive	Directive 2003/71/EC of the European Parliament and of the Council, which lays down rules for information to be made publicly available when offering financial instruments to the public.

Regulated Market	A regulated market is a multilateral system, defined by MiFID (article 4), which brings together or facilitates the bringing together of multiple third-party buying and selling interests in financial instruments in a way that results in a contract. Examples are traditional stock exchanges such as the Frankfurt and London Stock Exchanges.
Regulation	A regulation is a form of legislation that has direct legal effect on being passed in the Union.
Regulator /Supervisor	A regulator/supervisor is a competent authority designated by a government to supervise that country's financial markets.
Regulatory arbitrage	Regulatory arbitrage is exploiting differences in the regulatory situation in different jurisdictions or markets in order to make a profit.
REMIT	The proposed Regulation on Energy Market Integrity and Transparency, laying down rules on the trading in wholesale energy products and information that needs to be disclosed that pertains to those products.
Retail investor/client	A person investing his own money on a non-professional basis. Retail client is defined by MiFID as a non professional client and is one of the three categories of investors set by this Directive besides professional clients and eligible counterparties.
Sanction	A penalty, either administrative or criminal, imposed as punishment.
Securities and Exchange Commission (SEC)	The US regulatory body responsible for the regulation of securities and protection of investors.
Secondary listing	A secondary listing is the listing of an issuer's shares on an exchange other than its primary exchange.
Single rulebook	The single rulebook is the concept of a single set of rules for all Member States of the union so that there is no possibility of regulatory arbitrage between the different markets.
Small cap	Small cap is short for small capitalisation, and refers to the value of the shares in issue, i.e. share price multiplied by the number of shares in issue. Small cap usually refers to listed SMEs.
Small and medium sized enterprises (SMEs)	On 6 May 2003 the Commission adopted Recommendation 2003/361/EC regarding the Small and medium sized enterprise definition. While 'micro' sized enterprises have fewer than 10 employees, small have less than 50, and medium have less than 250. There are also other criteria relating to turnover or balance sheet total that can be applied more flexibly.
SME growth markets	Article 33 of MiFID II contains the criteria under which the operator of a multilateral trading facility may apply to be registered as an SME growth market to its home competent authority. Amongst others at least 50% of issuers of financial instruments admitted to trading on such an MTF must be small and medium sized enterprises, appropriate criteria for the initial and ongoing amission to trading of the financial instruments mus t be set and appropriate periodic financial reporting and regulatory information must be provided. SME growth markets are to contribute to financial market integration and guarantee that investors who want to invest in SME shares in different countries can rely on a set of minimum standards with regard to the financial instruments admitted to trading on SME growth markets so that high levels of investor

	protection can be maintained across the Union.
Spread	This can refer to the bid offer spread (see separate entry).
Standardised derivative	A standardised derivative is one with regular features based on a standard contract.
Structured deposit	A structured deposit's return may be linked to some index or underlying instrument, so that the amount repaid is dependent on this underlying performance.
Supervisor	See regulator.
Systematic Internaliser	Systematic Internalisers (SIs) are investment firms which, on an organised, frequent and systematic basis, deal on own account by executing client orders outside a regulated market or an MTF.
Tied agent	A company or sales person who can only promote the service of one particular provider (generally their direct employer).
Trading venue	A trading venue is an official venue where securities are exchanged.
Transparency	The disclosure of information related to quotes (pre-trade transparency) or transactions (post-trade transparency) relevant to market participants for identifying trading opportunities and checking best execution and to regulators for monitoring the behaviour of market participants.
Transparency Directive	Directive 2004/109/EC of the European Parliament and of the Council which lays down rules for the publication of financial information and major holdings.
Transmission System Operator (TSO)	A natural or legal person responsible for operating and ensuring the maintenance of and, if necessary, developing the transmission system in a given area and, where applicable, its interconnections with other systems, and for ensuring the long-term ability of the system to meet reasonable demands for the transmission of electricity.
Undertakings for Collective Investment in Transferable Securities Directives (UCITS)	Undertakings for Collective Investment in Transferable Securities Directives, a standardised and regulated type of asset pooling.
Underwriting	Underwriting can refer to the process of checks that a lender carries out before granting a loan, or issuing an insurance policy. It can also refer to the process of taking responsibility for selling an allotment of a public offering.
Volatility	Volatility refers to the change in value of an instrument in a period of time. This includes rises and falls in value, and shows how far away from the current price the value could change, usually expressed as a percentage.

Annex 2: Problem tree

Issue	Drivers	Problems	Consequences
Safeguarding of Client Assets	- Uncertainty regarding organisational requirements and investor protection. - Unintentional and/or intentional lawful or unlawful discrepancies across Member States and investment firms	- Retail investors not fully aware of such differences take decisions on the basis of erroneous assumptions. - Investment firms stretch limits of possible interpretations, e.g. not properly safeguarding and segregating assets or re-using client assets without investors' consent or full understanding of the risks	- Client assets part of insolvency procedures - Assets of clients not segregated properly - Losses, even permanently for investors, if assets not recovered quickly - Losses because of improper use of client assets
Inducements	- Insufficient harmonisation - Risk of circumvention or insufficient compliance by investment firms. - Existing divergent practices might lead to circumventions of rules	- Investor protection at risk - Inducements might bias investment firms to favour products which provide them with higher inducements but are not necessarily the best choice for investors	- Retail investors' portfolio a sub-optimal choice of investment instruments -lack of legal certainty for investment firms themselves
Liquid market	- Diverging interpretations lead to discrepancies in the application across MS and adverse implications for the applicable transparency regime	- Rules applicable to different instruments deviate without obvious reasons - Transparency suffers	- Unjustified price differences for different players - Market integration and integrity hampered
Extension of systematic internaliser regime	- Non-level playing field in terms of transparency (requirements) for instruments traded on different types of execution venues	- Market integration and transparency could be hampered	- Distortions in the choice of financial instruments by issuers and investors - Some might face losses due to sub-optimal choice of investment products
Fees for trade data publication (Reasonable Commercial Basis)	- Trading data in the EU provided at prices higher than in other jurisdictions	- Impaired information flow, price discovery and formation process - Rights and obligations of market participants, competent authorities and courts not sufficiently clear - Adverse effects on market integration and transparency	- Poorer choices for investors due to a lack of information and/or higher prices. - Markets not be as 'deep' as they could be
Establishing an SME growth markets label	- "SME growth market" conditions not sufficiently specific	- Transparency and market integration and integrity could suffer	- SME growth markets more likely to fail - SMEs with limited access to liquid markets - Adverse impacts on SME's and economies' growth and jobs
Core definitions	- Insufficiently harmonised interpretations and applications by national competent authorities and market participants - Risk of an inconsistent application under different pieces of EU law	- Legal uncertainty and undermine achieving the objectives of MiFID II - Efficient functioning of securities markets across the Union endangered	- Less liquidity and transparency. - Investment demand and supply match less well - Market integration undermined

Annex 3: Assessment of the need for a detailed IA for other empowerments for delegated acts

Issue 1 – Exemptions for persons providing an investment service in an incidental manner (Article 2(1)(c)[70], implementing powers: Article 2(3))

According to Article 2(1)(c), the Directive does not apply to "persons providing an investment service where that service is provided in an incidental manner in the course of a professional activity and that activity is regulated by legal or regulatory provisions or a code of ethics governing the profession which do not exclude the provision of that service". The wording of this provision is identical to Article 2(1)(c) in MiFID I. The Directive empowers the Commission to clarify when such an activity is provided in an incidental manner.

ESMA's technical advice:

ESMA considers that the exemption deserves further clarification and therefore proposes to specify circumstances under which an investment service is provided in an incidental manner. These include:

- a close and factual connection between the professional activity and the provision of the investment service to the same client such that the investment service is regarded as accessory to the main professional activity, and

- the provision of investment services does not aim to provide a systematic source of income; and

- the person providing the professional activity does not market or promote his/her availability to provide investment services, except as being accessory to the main professional activity.

Assessment of IA need:

The proposed criteria aim to further clarify the application of the exemption and introduce only technical improvements to the existing exemption in order to confirm its strict interpretation. Further impact assessment work is therefore not necessary.

Issue 2 – Definition of commodity derivative contracts (Article 4(1)(2))

- **Derivative contracts referred to in Section C10 of Annex I :**

Section C10 of Annex I defines "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, a multilateral trading facility (MTF), or an OTF". The existing MiFID I text has been

[70] As long as not stated otherwise, articles in this annex refer to MiFID II.

amended by adding the OTF as a new type of trading venue on which these instruments may be traded and by deleting the last half sentence i.e. "having regard to whether, inter alia, they are cleared and settled through recognised clearing houses or are subject to regular margin calls". Likewise for Section C7 this deletion is intended to avoid having any circularity with EMIR, which establishes which derivative contracts as defined under MiFID should be centrally cleared. The addition of the OTF category reflects the introduction of this new trading venue for the trading of non-equity instruments including derivatives.

ESMA was invited to consider whether any amendments to Article 38(3) and Article 39 of the MiFID I Commission Regulation N° 1287/2006 are necessary, in particular to reflect the addition of the OTF as a new type of trading venue on which these instruments may be traded and taking into account that clearing and margining requirement should be removed as a criteria. ESMA was also invited to consider whether the list of derivative contracts in Article 39 of that Regulation is still comprehensive or needs to be supplemented.

ESMA's technical advice:

Based on feedback received during its consultation ESMA in its advice has kept the main parts and parameters of Article 38(3) and Article (39) of Regulation (EC) No 1287/2006. It has included as an additional alternative that contracts can also qualify if they are traded on a third country venue, similar to a regulated market, MTF or OTF. As for section C7 of Annex I of MiFID II, the existence of clearing arrangements will no longer be considered as an indicator for determining whether an instrument is a financial instrument due to the circularity this creates with EMIR and to the change to the MiFID Level I text where the reference to clearing arrangements has been deleted. ESMA has also added that contracts may be traded on an OTF and that emission allowances are now financial instruments under MiFID II.

Assessment of IA need:

The wording proposed is largely similar to MiFID I, ESMA determined that the existing rules were still largely valid and the main changes suggested are clarifications reflecting the change in the scope of the level 1 texts. Therefore it is the Commission services' view that it is not proportionate to carry out a further assessment in this impact assessment.

- **Derivative contracts referred to in Sections C6 and C7 of Annex I :**

So-called C6 and C7 contracts are discussed in the main part of the impact assessment.

Issue 3 – Specification of technical elements of definitions: investment advice, money market instruments, systematic internaliser, algorithmic trading, HFT trading technique, direct electronic access (Article 4(1) paragraphs (4), (17), (20), (39), (40) and (41); implementing powers: Article 4(2)).

Under Article 4(2) the European Commission is empowered to further specify some technical elements with regard to definitions as laid down in Article 4(1) to adjust them to market developments, technological developments, and the experience of behaviour that is prohibited and to ensure the uniform application of the Directive.

The definitions with regard to 'systematic internaliser', 'algorithmic trading' and 'HFT trading technique' are discussed in the main body of this impact assessment.

A. Investment advice

MiFID II confirms the definition of investment advice outlined in MiFID I. The MiFID Implementing Directive specifies the definition of a personal recommendation, which is a core element of an investment advice service. It states that 'a recommendation is not personal if it is issued exclusively through distribution channels or to the public' (Art. 52 MiFID Implementing Directive).

ESMA's technical advice:

ESMA recommends that the content of Article 52 of the MiFID I Implementing Directive should be confirmed except for the last sentence which should be changed from:

"A recommendation is not a personal recommendation if it is issued exclusively through distribution channels or to the public."

To:

"A recommendation is not a personal recommendation if it is issued exclusively to the public."

ESMA technical advice intends to align the legal text with technical and market developments, where a personal recommendation in respect of financial instruments is provided using various distribution channels (e.g. electronic communication). The issue was addressed in the 2010 CESR Questions & Answers "Understanding the definition of advice under MiFID", where CESR clarified that a recommendation to a wide group given through a mechanism such as a mail or the Internet should not automatically exclude the provision of a personal recommendation.

Assessment of IA need:

The proposed change seeks to confirm the interpretation of 'personal recommendation' as clarified by the CESR in the 2010 Q&A under MiFID I by clarifying that, in light of the growing number of intermediaries who use internet and other similar means, personal recommendations may be provided through such distribution channels. Also, a large majority of stakeholders agreed with ESMA's technical advice. This is a technical improvement which will have no significant impact on the functioning of the investment advice market and market practice. It is therefore the view of the Commission that it is not proportionate to submit the new wording compared to Art. 52 of the MiFID Implementing Directive to further impact assessment.

B. Money market instruments

The European Commission can further specify some technical elements with regard to definitions such as the delineation between bonds, structured finance products and money market instruments. The distinction is important as pre-trade and post-trade transparency requirements under MiFIR apply to bonds and structured finance products, but not to money market instruments. The delineation between these instruments is therefore important for the exact application of the transparency requirements for non-equity instruments. The

empowerments hereto are in Article 4(2) MiFID II and Article 2(2) MiFIR. The relevant definitions are in Article 4(1), points 17 and 44, MiFID II.

ESMA's technical advice:

ESMA states that money market instruments shall be treasury bills, certificates of deposits, commercial papers and other instruments with substantially equivalent features that

- have a value that can be determined at any time;

- are not derivatives; and

- have a maturity at issuance of 397 days or less.

Assessment of IA need:

In order to achieve the objective of MiFID II/MiFIR of more transparency on financial markets, a narrow definition of money market funds, such as the one provided in ESMA's advice, provides less scope for exemptions from pre-trade and post-trade transparency obligations and is therefore preferable. There are inter-linkages with provisions on money market instruments in the UCITS IV Directive (2009/65/EC) and the Proposal of the European Commission for a Regulation on Money Market Funds[71].

Article 2(1)(o) of Directive 2009/65/EC defines money market instruments as "instruments normally dealt in on the money market which are liquid and have a value which can be accurately determined at any time" and Article 50(1)(a) refers to the definition of money market funds in Article 4(1) of MiFID I as eligible investments for UCITS. The latter definition has been preserved in Article 4(1)(17) of MiFID II: "'money market instruments' means those classes of instruments which are normally dealt in on the money market, such as treasury bills, certificates of deposit and commercial papers and excluding instruments of payment".

The CESR Guidelines on a common definition of European money market funds[72] and the European Commission Proposal for a Regulation of the European Parliament and of the Council on Money Market Funds (COM(2013) 615 final of 4 September 2013) both refer to Directive 2009/65/EC for part of the criteria on money market instruments that are eligible investments for money market funds.

The provisions for money market funds in both the CESR guidelines and the Commission proposal are however much broader than only criteria for eligible money market instruments. They also concern amongst others provisions on the maximum weighted average maturity and weighted average life of the portfolio, the ratings of the issuers of money market instruments, further investments in deposits with credit institutions, financial derivative instruments and reverse repurchase agreements.[73]

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[71] Proposal for a Regulation of the European Parliament and of the Council on Money Market Funds (COM(2013) 615 final of 4 September 2013.

72 CESR Guidelines on a common definition of European money market funds; 19 May 2010; http://www.esma.europa.eu/bg/system/files/10-049_cesr_guidelines_mmfs_with_disclaimer.pdf

[73] Article 8 of the Proposal for a Regulation of the European Parliament and the Council on Money Market Funds, COM(2013) 615 final.

Under both the CESR guidelines and the Commission proposal for money market funds money market funds can invest in money market instruments with a residual maturity of 397 days or less.[74]

It is therefore coherent that the ESMA technical advice refers to both the criterion that the value of the instruments can be determined at any time and that they have a maturity of 397-days or less.

The technical advice however refers to maturity at issuance, not residual maturity due to the particular purpose of this definition in MiFID. Using a criterion of residual maturity under MiFID would result in the frequent reclassification of financial instruments of a longer maturity as they get close to their maturity date and pass the 397 days to maturity threshold. This would result in financial instruments previously subject to the transparency requirements of MiFID as suddenly 'going dark' as they pass the 397 day threshold.

Commission services therefore are minded to accept the narrower definition provided in ESMA's technical advice as a better fit for the purpose of MiFID than a broader definition such as the one used in the Proposal for a Regulation on Money Market Funds. As these practical reasons explain the chosen definition, no further IA work had been undertaken.

C. Direct Electronic Access

"'Direct Electronic Access' means an arrangement where a member or participant or client of a trading venue permits a person to use its trading code so that the person can electronically transmit orders relating to a financial instrument directly to the trading venue and includes arrangements which involve the use by a person of the infrastructure of the member or participant or client, or any connecting system provided by the member or participant or client, to transmit the orders (direct market access) and arrangements where such an infrastructure is not used by a person (sponsored access)."[75] Unless clearly delineated, Direct Electronic Access (DEA) may qualify as infrastructure intended to minimise network and other types of latencies in the sense of the definitions of 'algorithmic trading' and 'high-frequency algorithmic trading' under Articles 4(1)(39) and 4(1)(40). It is therefore necessary to further clarify the distinction of DEA and in particular where a particular use of DEA may trigger the obligation to comply with provisions of MiFID II/MiFIR.

ESMA's technical advice:

ESMA in its technical advice identified the ability to exercise discretion regarding the exact fraction of a second of order entry and the lifetime of the orders within that timeframe as the critical element to qualify an activity as DEA. Where the submitter of the order does not have control over those parameters, the arrangement would be out of scope of DEA, this also holds for systems that allow clients to transmit orders to an investment firm in an electronic format (online brokerage). Nevertheless the investment firm would conduct algorithmic trading

[74] The CESR guidelines make a distinction between Short-Term Money Market Funds, which must limit investments in securities to those with a residual maturity until the legal redemption date of less than or equal to 397 days and Money Market Funds, which must limit investments in securities to those with a residual maturity until the legal redemption date of less than or equal to 2 years, provided that the time remaining until the next interest rate reset date is less than or equal to 397 days. The Commission proposal refers to eligible money market instruments as having (i) a legal maturity at issuance of 397 days or less, (ii) a residual maturity of 397 days or less.

[75] Article 4(1)(41) MiFID II

when submitting those client orders if it uses smart order routers and in that case, it should be compliant with Article 17 of MIFID II.

With regard to the distinction between DEA, SORs (smart order routers) and AORs (automated order routers) ESMA considers that:

- SORs are algorithms used for the optimisation of order execution processes and may determine parameters of the order other than the venue(s) where the order should be submitted. SORs fall within the definition of 'algorithmic trading' and the relevant MiFID II articles should apply to them and not those on DEA.

- AOR encompass those functionalities that determine the trading venue(s) where the order should be submitted without changing any trading parameter of the order (an SOR would be able to do the same, but also modify parameters of the order, in particular the time of submission of orders). Use of an AOR as described does not qualify or disqualify the provision of DEA in case it is embedded in DEA systems. Use of an AOR in isolation should not be considered as DEA.

Assessment of IA need:

The definition of DEA is needed to clarify when an investment firm carries out algorithmic trading according to Article 17 and has to fulfil the relevant requirements of the Directive. ESMA reached a compromise on a solution to a technical issue. It is therefore the Commission's view that it is not proportionate to subject this solution to a technical problem to further impact assessment.

D. Systematic Internalisers

The purpose of the Systematic internaliser (SI) regime is to ensure that firms which deal on own account of a large magnitude by executing client orders are also subject to trade transparency requirements on a level playing field with trading venues (while at the same time taking into account the different market participants' characteristics).

This is because such trade execution has a material impact on price formation. SIs are not allowed to bring together third party buying and selling interests in functionally the same way as trading venues (just as trading venues operators are not, with a few exceptions in OTFs, allowed to engage in own account trading with their clients).

According to Article 4(1)(20) of MiFID II "'Systematic internaliser' means an investment firm which, on an organised, frequent systematic and substantial basis deals on own account when executing client orders outside a regulated market, an MTF or an OTF without operating a multilateral system. The frequent and systematic basis shall be measured by the number of over-the-counter (OTC) trades in the financial instrument carried out by the investment firm on own account when executing client orders. The substantial basis shall be measured either by the size of the OTC trading carried out by the investment firm in relation to the total trading of the investment firm in a specific financial instrument or by the size of the OTC trading carried out by the investment firm in relation to the total trading in the Union in a specific financial instrument. The definition of a systematic internaliser shall apply only where the pre-set limits for a frequent and systematic basis and for a substantial basis are both crossed or where an investment firm chooses to opt-in under the systematic internaliser regime."

The definition will have a direct impact on the level of transparency for own account trading in line with Article 4(1)(20) of MiFID II. Under the scope of MiFID I, only about a dozen systematic internalisers were captured. However, it can be expected that the number of firms captured under MiFID II will substantially increase. This is because the definition under MiFID II has been extended with quantitative criteria and because the number of instruments within the scope has increased (not only shares but also other equity and non-equity instruments).

The thresholds to be set in the delegated act therefore also have to account for different types of instruments now under the scope of MiFID II.

ESMA's technical advice:

ESMA provided advice on the numeral thresholds to be used to assess the 'frequent, systematic and substantial basis' for equity instruments a set out below, whereas it has only provided ranges for some of the criteria with regard to non-equity instruments due to a lack of data on the entities and the volume of trades concerned and since therefore no agreement on numeral thresholds could be reached for these instruments.

ESMA has taken liquid instruments into greater consideration since NCAs are empowered waive pre-trade transparency obligations for illiquid instruments (Articles 4(1) and 9(1) MiFIR), since the obligation for SIs to make public firm quotes (Articles 14(1) and 18(1)) only applies when there is a liquid market and taking into account Recital 18 of MiFIR, which states that appropriate pre-trade transparency requirements should apply to SIs for liquid instruments.

D(1). ESMA's technical advice for Equities (shares, depositary receipts, ETFs, certificates and other similar financial instruments)

ESMA recommends that an investment firm internalises on a **frequent and systematic basis** if the number of OTC transactions executed by the investment firm on own account when executing client orders in liquid instruments was, during the last six months, equal or larger than 0.4% of the total number of transactions in the relevant financial instrument in the Union executed on any trading venue or OTC during the same period.

At a minimum the investment firm shall deal on own account in such an instrument on average on a daily basis to be considered as meeting the frequent and systematic basis criteria (**'De minimis' threshold**).

For equity instruments for which there is not a liquid market in accordance with Article 2(1)(17)(b) of MiFIR, the condition is deemed to be met when the investment firm deals on own account OTC in the same financial instrument on average on a daily basis during the last six months.

As for the **substantial basis** criterion:

The investment firm internalises on a substantial basis if the size of OTC trading carried out by the investment firm on own account when executing client orders is, during the last six months, equal or larger than either:

15% of the total turnover in that financial instrument executed by the investment firm on own account or on behalf of clients and carried out on any trading venue or OTC; or

0.4% of the total turnover in that financial instrument executed in the European Union and carried out on any EU trading venue or OTC.

Investment firms shall assess whether they meet these conditions on a quarterly basis (on the first working day of the months of January, April, July and October based on the data from the previous six months).

ESMA has set the thresholds for internalising on a frequent and systematic and substantial basis taking into account feedback to its consultation paper. These thresholds seem acceptable as indeed an investment firm should qualify as a systematic internaliser if it internalises a sizeable amount of transactions or if its transactions represent a larger part of its turnover or of the total turnover in a financial instrument executed in the Union. The criterion with reference to the total turnover in the Union also seems reasonable as the population of SIs in equity instruments will likely include a few large firms, but also a larger number of smaller firms.

In particular for smaller firms the de minimis threshold may be a useful additional reference to determine whether they fall within the scope of the SI regime. For equity instruments for which there is no liquid market, the threshold of trading on average on a daily basis may also be appropriate and proportionate, in particular as in those markets data to calculate the total turnover in a financial instrument in the EU may be more difficult to obtain.

Assessment of IA need:

ESMA has reached an agreement on thresholds for systematic internalisers trading equity instruments and has put forward these thresholds in its advice.

Neither ESMA nor a study carried out by an external contractor for the European Commission has been able to provide granular data on the entities and volumes of trading that can be expected to be captured under this new regime precisely because the will be applied to a market that has previously been dark.

Stakeholders largely agree with the thresholds proposed, in particular taking into account the proportionality elements and the specific regime for illiquid instruments included.

The European Commission's assessment is therefore that the thresholds proposed for equity instruments are appropriate and proportionate and that there is no need for further impact assessment of these thresholds.

D(2). ESMA's technical advice for Non-Equity Instruments (bonds, structures finance products, derivatives, emission allowances).

As regards non-equity instruments, ESMA has on the other hand only recommended ranges for the quantitative thresholds within which to set the final thresholds. The main challenges to further specify the appropriate thresholds are that unlike in the equity sphere there is currently no consolidated data available on the overall size of markets and there are no existing SIs (in a regulatory sense) which could be used as a benchmark. Possible concentration levels in markets are also uncertain since it is not at this stage clear what choices existing or new trading platforms will make in transforming themselves to comply with the new regulatory framework which will clearly separate multilateral and bilateral trading.

Table A1 below presents the thresholds and ranges that ESMA has provided in its final technical advice with regard to liquid non-equity instruments.

Table A1: Thresholds for non-equity financial instruments

		Bonds	SFP	Derivatives	Emission allowances
Frequent and systematic basis threshold (liquid instruments)	Number of transactions executed by the investment firm on own account OTC / total number of transaction in the same financial instrument in the EU	2 to 3% and at least once a week	3 to 5% and at least once a week	2 to 3% and at least once a week	3 to 5% and at least once a week
Frequent and systematic basis threshold (illiquid instruments)	Minimum trading frequency	at least once a week	at least once a week	at least once a week	at least once a week
Substantial basis threshold Criteria 1	Size of OTC trading by investment firm in a financial instrument on own account / total volume in the same financial instrument executed by the investment firm	25%	30%	25%	30%
Substantial basis threshold Criteria 2	Size of OTC trading by investment firm in a financial instrument on own account / total volume in the same financial instrument in the European Union	0.5 to 1.5%	1.5 to 3%	0.5 to 1.5%	1.5 to 3%

Source: ESMA's technical advice[76]

For illiquid non-equity instruments the frequent and systematic basis test shall be deemed to be met when the investment firm dealt on own account OTC in the same financial instrument, type of emission allowance or in the same class of derivatives on average once a week during the last six months.

The definition of ***systematic internaliser for non-equity instruments*** and the delineation between ***algorithmic trading*** and ***high frequency trading*** is discussed in the main part of the impact assessment.

Issue 4 – Specifications of organisational requirements for investment firms and third country branches (Article 16(12))

A. Compliance function (Art. 16(2), empowerment: Article 16(12)).

Article 16(2) of MiFID II requires investment firms to establish adequate policies and procedures sufficient to ensure compliance of the firm with its obligations under the Directive.

ESMA's technical advice:

The proposed technical advice builds on the existing compliance requirements, further specified in MiFID Implementing Directive and on the principles set out in the ESMA 2012 compliance guidelines. ESMA advises to introduce a few modifications aimed at strengthening the monitoring and reporting responsibilities of the compliance function:

- reporting to the management body on the implementation and effectiveness of the control environment, identified risks and on the complaint-handling reporting as well as remedies;

- monitoring the operations of the complaints-handling process;

[76] ESMA's Technical Advice to the Commission on MiFID II and MiFIR, page 230. http://www.esma.europa.eu/system/files/2014-1569_final_report_-_esmas_technical_advice_to_the_commission_on_mifid_ii_and_mifir.pdf

- conducting an assessment to establish a risk-based monitoring programme;

- direct reporting to the management body whenever the firm has detected a significant risk of failure to comply with its obligations under MiFID II.

Assessment of IA need:

ESMA noted that all national competent authorities have declared compliance with the compliance guidelines and therefore the suggested amendments should not add an additional burden for investment firms. The Commission therefore sees no need to carry out a further impact assessment with regard to this issue.

B. ***Complaints-handling (Art. 16(2), empowerment: Article 16(12)).***

Art. 16(2) MiFID 2 requires investment firms to establish adequate policies to ensure compliance of the firm with the MiFID 2. In addition, Art. 75 MiFID 2 specifies requirements for setting-up out-of-court settlement procedures.

ESMA's technical advice:

ESMA proposes to enhance complaints-handling requirements and use guidelines developed by ESMA in conjunction with EBA and EIOPA in 2014 (complaints guidelines). ESMA recommends introducing additional requirements regarding:

- complaints management policy for clients, which should be endorsed by the management body;

- the process to be followed when handling a complaint;

- information to clients about the firm's position on the complaint and alternative redress mechanisms;

- analysis of complaints handling data to identify and address any risks and issues.

Assessment of IA need:

The proposed requirements reflect the ESAs' guidelines and fine-tune existing obligations. These changes would not result in substantial compliance costs and an impact assessment is thus not required.

A. Record keeping (Article 16(6), empowerment: Article 16(12)).

MiFID 2 does not introduce any substantial changes compared to MiFID 1 in respect of general record-keeping obligations. It solely emphasises that records should enable the NCAs to fulfil their supervisory tasks and perform enforcement actions under MiFID2/MiFIR as well as under MAD and MAR. ESMA was invited to provide advice on any possible improvements to the current record-keeping obligations.

ESMA's technical advice:

ESMA proposes to adjust the existing provisions on records of client orders, transactions and order processing with some further elements and to introduce a list of records, largely based on the 2007 CESR Recommendations.

Assessment of IA need:

The advice is based to a large extent on the existing CESR (ESMA's predecessor) list of minimum records and does not impose substantial costs on the investment firms. Consequently, the revision of record-keeping requirements is without major impacts which would require further impact assessment work.

B. Recording of telephone conversations and electronic communications (Article 16(7), empowerment: Article 16(12))

As part of their organisational requirements, investment firms shall keep records including the recording of telephone conversations or electronic communications relating to, at least, transactions concluded when dealing on own account and the provision of client order services that relate to the reception, transmission and execution of client orders, including conversations and electronic communications intended to result in transactions even where they do not result in the conclusion of such transactions or in the provision of client order services.

Delegated acts are to specify the concrete organisational requirements to be imposed on investment firms and branches of third-country firms authorised and performing investment and ancillary services. This is in order to help detect and deter market abuse and to facilitate enforcement in this area.

ESMA's technical advice:

ESMA proposes:

- to specify internal control and oversight arrangements to ensure compliance with MiFID 2 requirements on recording conversations and electronic communications;

- to set out the minimum information to be recorded with regard to face-to-face conversations with clients;

- to further specify the requirements related to notification to clients that a conversation is being recorded and that a copy of the recording will be available on request for a period of at least 5 years;

- to specify the requirements for storage and retention of recordings.

Telephone recordings and accounts of face-to-face conversations will contain certain personal data items, however, typically and mainly only the name of the client. Data will only be collected for 'specified, explicit and legitimate' purposes as required by the Data Protection Directive[77], i.e. in order to help detect and deter market abuse and increase investor protection. A client will be informed in advance that the telephone conversation is being recorded. The data are to be stored in a medium so that they are available to clients on request and accessible to national competent authorities in the performance of a task carried out in the public interest (investigation of cases of market abuse or in the enforcement of MiFID requirements. The period of storage is determined in MiFID II text.

Assessment of IA need:

[77] Directive 95/46/EC of the European Parliament and of the Council

ESMA has addressed in its advice comments received by stakeholders during its consultation to clarify certain aspects regarding notification and monitoring requirements. The proposed measures further specify the Level 1 requirements and do not impose any significant costs in addition to what is provided for in Level 1 text. The advice strikes the right balance between investor protection, administrative burden as well as privacy and data protection. For these reasons, it does not seem proportionate to submit these organisational requirements to a further impact assessment.

Issue 5 – Specification of the organisational requirements on product governance (Art. 16(2) – 16(10); empowerment: Article 16(12)) and specification of the measures to ensure investment firms' compliance (Art. 24; empowerment: Article 24(13)).

MiFID II introduces for the first time requirements regarding product governance in order to avoid or reduce, from an early stage on, potential risks for investors and for market integrity. To achieve this, it imposes relevant requirements on manufacturers and distributors of the products. ESMA was invited to provide advice on detailed product governance arrangements for investment firms manufacturing and distributing financial instruments and structured deposits.

ESMA's technical advice:

ESMA proposes to introduce product governance arrangements for:

i. investment firms when manufacturing products (conflicts of interest analysis, staff expertise, the management body's control over the product governance process, requirement to undertake a scenario analysis of the product) and

ii. investment firms when deciding on the range of products and services they intend to offer to clients (staff expertise, management body's control, responsibility for product governance obligations in a distribution chain).

Assessment of IA need:

The proposed changes clarify the MiFID II level 1 requirements applicable to manufacturers and distributors of financial instruments. In addition, the advice takes into consideration the relevant work of ESAs ('Joint Position on Manufacturers Product Oversight and Governance Processes) and IOSCO (Report on Regulation of retail structured products). Further impact assessment is therefore not required.

Issue 6 – Conflicts of interest

A. Specification of criteria and prevention/management of conflicts of interest (empowerment: Article 23(4))

The requirements on conflicts of interest provided for in the Directive (Articles 16 and 23) cover a broad range of situations that may occur in the provision of investment services and activities. The Commission is empowered to adopt delegated acts to further specify the appropriate steps investment firms are reasonably expected to take with respect to conflicts of interest.

ESMA's technical advice:

ESMA recommends to supplement existing level 2 rules to state that disclosure to clients should be a measure of last resort that can be used only where the effective organisational and administrative arrangements established by the investment firm to prevent or manage conflicts of interest are not sufficient to ensure with reasonable confidence that a risk of damage to the interests of the client will be prevented. The conflict of interest that arises must also be disclosed and described in sufficient detail to enable the client to make an informed investment decision. The description must explain the risks to the client that arise as a result of the conflicts of interest and the steps undertaken to mitigate those risks. Investment firms shall assess and periodically review their conflicts of interest policy (at least annually) and take all appropriate measures to address deficiencies.

It is also suggested that financial analysts involved in the production of investment research should be physically separated from other relevant persons whose responsibilities or business interests may conflict with the interests of the persons to whom the investment research is disseminated. For proportionality reasons the physical separation may be replaced by other information barriers.

Assessment of IA need:

ESMA's advice builds on existing provisions that are updated and further clarified. As further marginal changes to the requirements would not result in significantly different impacts, the Commission considers that it is not proportionate to submit these improvements in the interest of investor protection and firms' integrity to further impact assessment.

B. Specification of the organisational, conflicts of interest and conduct of business requirements to address the specificities of underwriting and placing process (Art. 16(3), empowerment: Article 16(12), Art. 23(4). **Art. 24(13))**

Article 16(3) requires investment firms to maintain and operate effective organisational and administrative arrangements with a view to taking all reasonable steps designed to prevent conflicts of interest from adversely affecting the interests of its clients. ESMA was invited to provide advice on possible conflicts of interest and conduct of business requirements that could better address the specificities of underwriting and placing process.

ESMA's technical advice:

ESMA proposes to introduce additional requirements regarding:

- the conflicts of interest policy when an investment firm both provides the service of undertaking/placing and advises the issuer clients to undertake an offering;

- conflicts of interest arising in relation to pricing of issues;

- inducements which are specific to underwriting and placing services;

- conflicts of interest arising where the firms engage in the placement of financial instruments issued by themselves (or other group entities) to their clients;

- conflicts of interest arising when providing a credit to the issuer client to be repaid with the proceeds of the issue;

- record-keeping and oversight.

Assessment of IA need:

Under MiFID I requirements investment firms must implement an effective conflicts of interest policy to identify and manage conflicts of interest which entail a risk of damage to the interests of clients, when providing investment services, including the service of placing and/or underwriting. ESMA's advice confirms these requirements and further clarifies the obligations to address the specificities of the services in question. ESMA has also taken into account the IOSCO work on this topic, i.e. the 2007 IOSCO's Market Intermediary Management of Conflicts that Arise in Securities Offerings'. The Commission therefore considers it not proportionate to further assess the impact of these modalities linked to the MiFID II as well as existing requirements.

The assessment on measures on ***inducements*** and the ***quality enhancement*** criterion is dealt with in the **main part of the impact assessment**.

Issue 7 – Specification of requirements in relation to remuneration (Art. 16(3), Art. 23(1), Art. 24(4), Art. 24(10); empowerment Art. 16(12); Art. 23(4), and Art. 24(13)).

Article 9(3)(c) introduces a new, explicit requirement on the management bodies of investment firms to define, approve and oversee a remuneration policy of persons involved in the provision of services to clients aimed at encouraging responsible business conduct, fair treatment of clients as well as avoiding conflicts of interest in the relationships with clients. In addition, Article 23(1) highlights the issues related to remuneration by requiring firms to take all appropriate steps to identify and to prevent or manage conflicts of interest including those caused by the firm's own remuneration and other incentive structures. Finally, Article 24(10) provides that an investment firm which provides investment services to clients shall ensure that it does not remunerate or assess the performance of its staff in a way that conflicts with its duty to act in the best interests of its clients. In particular, the firm should not make any arrangement by way of remuneration, sales targets or otherwise that could provide an incentive to its staff to recommend a particular financial instrument to a retail client when the investment firm could offer a different financial instrument which would better meet that client's needs.

ESMA was invited to develop appropriate requirements aimed at ensuring that the remuneration policies and practices do not influence or interfere with firms' duties to act in the best interest of clients.

ESMA's technical advice:

ESMA proposes to:

- clarify the scope of the provisions by including all relevant persons who can have material impact on investment and ancillary services provided by the investment firm;

- specify requirements regarding design criteria and governance arrangements for remuneration policies and practices, including the maintenance of an appropriate balance between fixed and variable components of remuneration.

Assessment of IA need:

The technical advice builds on the 2013 ESMA Guidelines on remuneration under MiFID I and clarifies certain requirements regarding remuneration policies and practices. The possible

impact of these provisions should be relatively minor. The Commission considers that an impact assessment is not required.

Issue 8 – Specification of conditions for information to clients to be fair, clear and not misleading (Art. 24(3), empowerment Art. 24(13))

Pursuant to Article 24(3) of MiFID II all information provided to clients by investment firms must be fair, clear and not mis-leading. Article 24(13) of MiFID II empowers the Commission to adopt delegated acts to ensure that investment firms comply with the principles set out in this Article when providing investment or ancillary services to their clients, including the conditions with which the information must comply in order to be fair, clear and not misleading.

ESMA's technical advice:

ESMA proposes to modify the existing MiFID Implementing Directive and:

- clarify technical aspects of information requirements for retail clients, in particular its presentation;

- extend certain requirements to information items addressed to professional clients.

Assessment of IA need:

The proposed changes build on the existing requirements and clarify, to a large extent, technical aspects regarding the presentation of information to fulfil level 1 objectives. Therefore, the Commission considers it not proportionate to further assess impact of these technical specifications.

Issue 9 – Specifications on the information to clients about investment advice and financial instruments, and inducements (Art. 24(4); empowerment: Article 24(13) and (14)).

The Commission is empowered to adopt delegated acts to ensure that investment firms comply with the principles set out in Article 24 when providing investment or ancillary services to their clients, including:

(a) the conditions with which the information must comply in order to be fair clear and not misleading;

(b) the details about content and format of information to clients in relation to client categorisation, investment firms and their services, financial instruments, costs and charges;

(c) the criteria for the assessment of a range of financial instruments available on the market;

(d) the criteria to assess compliance of firms receiving inducements with the obligation to act honestly, fairly and professionally in accordance with the best interest of the client.

The assessment on measures on ***inducements*** and the ***quality enhancement*** criterion is dealt with in the **main part of the impact assessment**.

ESMA's technical advice:

ESMA advises to further specify requirements regarding information about:

- investment advice, in particular whether it is independent or not;

- the range of financial instruments that may be recommended to the client;

- the periodic assessment of suitability;

- financial instruments, including their risks and their functioning and performance.

Assessment of IA need:

The provisions above clarify further the modalities for providing information to clients within the level 1 requirements. In addition, information requirements in relation to financial instruments and investment firms' services merely modify the existing requirements set out in the MiFID Implementing Directive. The Commission therefore, does not consider it proportionate to further impact assess these modalities and technical specifications linked to the level 1 provisions.

Issue 10 – Specification of requirements in relation to information on all costs and charges (Art. 24(4); empowerment: Art. 24(13) point b))

Article 24(4) MiFID II sets additional requirements with regard to and clarifies the MiFID I provisions relating to information to clients on costs and charges. The MiFID Implementing Directive already requires investment firms to provide information on costs and charges to be paid by clients. The Commission is empowered to further develop details about content and format of information in relation to costs and charges.

ESMA's technical advice:

ESMA proposes to:

- extend certain information items to professional clients and eligible counterparties;

- clarify the scope of information to be provided ex-ante and ex-post;

- clarify certain requirements in relation to the methodology for the calculation of ex-ante figures and the disclosure of the cumulative effect of costs on the return.

Assessment of an IA need:

The proposed advice builds on the existing MiFID I Implementing Directive, which already requires information on costs and charges to be provided to clients, including information on the total price to be paid by clients and related fees. Level 2 MiFID II thus aims to clarify the scope of information to be provided in order to avoid an inconsistent interpretation. Extending information requirements to other categories of clients reflects the Level 1 requirement to strengthen investor protection rules in relation to professional clients and eligible counterparties. ESMA's technical advice adjusts the existing criteria to the new information requirements of MiFID II. Accordingly, the Commission considers that an impact assessment is not necessary.

Issue 11 – Specification of requirements in relation to the provision of investment advice on an independent basis (Art. 24(7); empowerment: Art. 24(13) and Art. 16(12))

MiFID II introduces requirements regarding investment advice on an independent basis. Investment firms providing such advice are required to assess a sufficient range of financial instruments and not accept and retain third-party payments. The Commission is empowered to adopt delegated acts concerning measures to ensure that investment firms comply with these principles, including the criteria for the assessment of a range of financial instruments available on the market.

ESMA's technical advice:

ESMA advises to:

- further specify requirements in relation to a selection process to assess and compare a sufficient range of financial instruments;

- clarify requirements for investment firms providing both independent and non-independent investment advice.

Assessment of IA need:

ESMA's advice further specifies level 1 requirements to ensure consistent application and interpretation of level 1 provisions. A detailed impact assessment is therefore not required.

Issue 12 – Specifications in relation to suitability and appropriateness of and reporting to clients (Art. 25 (1)-(6); empowerment: Article 25(8))

A. Suitability

MiFID II maintains the key requirements on the assessment of suitability and further strengthens it by detailing the elements to be taken into consideration by firms providing investment advice or portfolio management. MiFID II also requires investment advisors to provide clients with a suitability report specifying how the advice meets the client's circumstances and needs. Furthermore, where portfolio management services are provided or where the firm has informed the client that it will carry out a periodic assessment of suitability, the periodic reports should contain an updated suitability statement. The Commission is empowered to develop specifications regarding the assessment of suitability, including the information to be obtained.

ESMA's technical advice:

ESMA proposes to clarify certain aspects of the existing MiFID Implementing Directive requirements regarding suitability assessment and further detail requirements in relation to suitability reports.

ESMA's advice also builds on the 2012 ESMA guidelines on certain aspects of the MiFID suitability requirements.

Assessment of IA need:

With regard to the suitability assessment, the proposed changes merely clarify the existing requirements and are consistent, to a large extent, with ESMA's guidelines on suitability requirements. Providing a suitability report to a retail client is a MiFID II level 1 requirement and the empowerment primarily serves to clarify it. It is therefore not considered proportionate to submit the criteria and factors proposed to a further impact assessment.

B. Appropriateness

ESMA is required to advise the Commission on the appropriateness provision in Article 25(3) and (4) of MiFID II, including the criteria to assess non-complex financial instruments for the purpose of paragraph 4(a)(vi) of Article 25.

The MiFID Implementing Directive sets out several criteria by which a financial instrument should be considered non-complex, even where it is not specifically identified as such in MiFID I.

ESMA's technical advice:

ESMA recommends to update existing criteria and to add two additional specifications to Art. 38 of the MiFID Implementing Directive that an instrument not explicitly included in the list of non-complex instruments under Art. 25(4)(a) MiFID II would need to comply with, in order to also be considered non-complex. Moreover, ESMA recommends certain clarifications to ensure a consistent interpretation of the level 1 text. Finally, it proposes to require investment firms to keep records of the appropriateness assessments undertaken.

Assessment of IA need:

The ESMA's advice builds on the existing requirements and the CESR Q&A statement on complex and non-complex instruments. In addition, in light of market developments, it recommends some additional criteria. A detailed impact assessment of these requirements therefore seems not necessary.

C. Reporting to clients

There has not been any major change in MIFID 2 compared to MIFID 1 in relation to the requirements regarding reports on services provided, apart from Article 30(1), which states that transactions with eligible counterparties are no longer exempt from applying Article 25(6). There is also one other amendment which clarifies that reports include periodic communications to clients, taking into account the type and the complexity of financial instruments involved and the nature of the service provided to the client. The Commission is empowered to develop specifications regarding reporting obligations.

ESMA's technical advice:

ESMA proposes to modify the MiFID I Implementing Directive in the following areas:

- extend reporting obligations to professional clients and eligible counterparties;

- further clarifications concerning reporting obligations in respect of portfolio management and losses in respect of portfolio management or contingent liability transactions;

- reporting obligations in respect of statements to clients on their holdings of financial instruments and funds.

Assessment of IA need:

Proposed amendments strengthen the existing requirements while reflecting the objectives of the MiFID II (a better defined regime applicable to non-retail clients and improved protection

of retail clients at each stage in their relationship with investment firms). A detailed impact assessment is therefore not required.

Issue 13 – Specification of information regarding the provision of services to clients/client agreement (Art. 25(5); empowerment Art. 25(8))

Article 25(5) of MiFID II is identical to Article 19(7) of MiFID I and requires investment firms to establish a record that includes the document or documents agreed between the firm and the client that sets out the rights and obligations of the parties, and the other terms on which the firm will provide services to the client. Article 25(8) of MiFID II empowers the Commission to adopt delegated acts to ensure that investment firms comply with the principles set out in Article 25, including the content and format of records and agreements for the provision of services to clients.

ESMA's technical advice:

ESMA proposes to modify the MiFID I Implementing Directive in the following way:

- to require a written (or equivalent) agreement between the firm and professional clients, setting out the essential rights and obligations of the firm and the client;

- to require investment firms to describe in the client agreement any advice services, portfolio management and custody services to be provided.

Assessment of IA need:

The proposed clarification introduces only technical improvements to the existing requirements while reflecting the MiFID II objectives (strengthened investor protection rules for professional clients). A detailed impact assessment is therefore not required.

Issue 14 – Criteria specifying the best execution obligation (Art. 27(1), 27(5), 27(7); empowerment: Article 27(9))

MiFID II does not set out major changes to the best execution requirements. Nevertheless, there are a few additional requirements and clarifications aimed at improving investor protection and the efficiency of best execution assessment by increasing the transparency of firms' policies and procedures.

Implementing measures are to contain the criteria for determining the relative importance of the different factors that may be taken into account for determining the best possible result for the client, the factors that may be taken into account by an investment firm when reviewing its execution arrangements, the factors to determine which venues enable investment firms to obtain the best possible results and the nature and extent of the information to be provided to clients on their execution policies.

ESMA's technical advice:

ESMA advises to supplement the existing requirements of the MiFID I Implementing Directive with additional requirements, for example with regard to a customisation of execution policies depending on the class of financial instruments and type of service provided. In addition, ESMA recommends to:

- clarify firms' obligations when executing orders or dealing in OTC products

- require firms to provide information to clients about the choice of execution venues

- clarify the application of inducements requirements and the notion of 'material change' which provide a basis for the firm to review its execution or RTO/placing policy.

Assessment of IA need:

This empowerment primarily serves to adjust the existing criteria to the new information requirements of the MiFID II level 1 text. It is therefore not considered proportionate to submit the criteria and factors proposed to a further impact assessment.

Issue 15 – Criteria specifying client order handling rules (Art. 28(1)-(2); empowerment: Article 28(3))

Article 28(1) of MIFID II does not make any changes to MiFID I provisions in respect of client order-handling rules. The MiFID I Implementing Directive already set out detailed requirements for investment firms when handling clients' orders.

Delegated acts are to define the conditions and nature of the procedures and arrangements which result in the prompt, fair and expeditious execution of client orders and the possible deviations from prompt execution, as well as the different methods through which an investment firm can be deemed to have met its obligations to disclose not immediately executable client limit orders to the market.

ESMA's technical advice:

ESMA's advice is to confirm the existing provisions in the MiFID I Implementing Directive on client-order handling.

Assessment of IA need:

As the level 1 text has only been amended slightly in order to cover trading venues, there is no obvious reason to amend the respective level 2 provisions beyond that. Therefore, the Commission considers that no further impact assessment work is needed.

Issue 16 – Specifications on procedures and thresholds for being considered eligible counterparties (Art. 30(2)-(3); empowerment: Article 30(5))

The Commission is empowered to specify procedures for clients classified as an eligible counterparty to request treatment as clients whose business is subject to the investor protection rules in Articles 24, 25, 27 and 28, the procedures for obtaining the express confirmation from prospective counterparties in other jurisdictions and which are not expressly listed in this Article, but which have been classified as eligible counterparties in their Member State, that they are indeed willing to be treated as eligible counterparties. The empowerment remains unchanged compared to Article 24(5) of MiFID I, implemented by Article 50 of the MiFID I Implementing Directive. ESMA was requested to consider whether specific improvements of the provision were needed.

ESMA's technical advice:

ESMA advises not to confirm Article 50(1) subparagraph 2 of the MiFID I Implementing Directive, while amending Article 50(2) subparagraph 1 by requiring that the request from an eligible counterparty to be treated as a professional client should be done in writing,

indicating whether this treatment should be general or with regard to particular services or transactions or types of transactions and products. Clients which request to be treated as eligible counterparties should be informed by the investment firm in writing of the protections they may lose, and the client must confirm in writing that they wish to be treated as an eligible counterparty either generally or in respect of a particular investment service or transaction or type of transaction or product and that they are aware of the protections they may lose.

Assessment of IA need:

The possible impacts of these procedural provisions are relatively minor. Other options besides ESMA's advice on procedural elements would also only have marginally different impacts in this instance. A detailed impact assessment of these new requirements therefore seems, according to the Commissions assessment, not appropriate or necessary.

Issue 17 – Specifications of circumstances triggering information requirement MAR violations or system disruptions to NCAs by MTFs and OTFs (Empowerment: Article 31(4))

The European Commission is empowered to adopt delegated acts to determine circumstances constituting significant damage to the investor's interests and the orderly functioning of the market.

ESMA's technical advice:

ESMA has drafted an indicative and non-exhaustive list of signals of market abuse behaviours. The vast majority of respondents to ESMA's consultation agreed with this approach as it accommodates for the need to be flexible to take into account developments and changes in trading activity.

Assessment of IA need:

As it would be impossible to determine all possible circumstances, a non-exhaustive list is regarded the only viable solution. It is therefore, according to the Commissions view, not considered proportionate to submit the list of signals to further impact assessment.

Issue 18 – Specifications on significant damage to the investor interests and orderly functioning for the purpose of suspension and removal of financial instruments (Empowerment: Article 32(4))

The European Commission is empowered to adopt delegated acts to list situations constituting significant damage to the investors' interests and the orderly functioning of the market.

ESMA's technical advice:

ESMA has established a non-exhaustive list of situations to act as a framework for the assessment to be made by the NCAs as well as circumstances and factors to be taken into account by NCAs for both empowerments under Articles 32(4) and 52(4).

Assessment of IA need:

As no significantly different option has been promoted during the ESMA consultation or in the working group, it is, in the Commissions view, not considered proportionate to submit the thresholds proposed by ESMA to a further impact assessment.

Issue 19 – Specification of the effective market rules, systems and procedures for SME growth markets (Empowerment: Article 33(8))

This issue is being dealt with in the main part of the impact assessment.

Issue 20 – Specifications on significant damage to the investor interests and orderly functioning for the purpose of suspension and removal of financial instruments from trading on trading venues (Empowerment: Article 52(4))

The European Commission is empowered to adopt delegated acts to specify the list of circumstances constituting significant damage to the investors' interests and the orderly functioning of the market.

See the analysis under issue 12 above as ESMA developed a common list for the empowerments under Articles 32(4) and 52(4).

Issue 21 – Specifications of circumstances triggering information requirement MAR violations or system disruptions to NCAs by RMs (Empowerment: Article 54(4))

See the assessment under issue 11 above. ESMA provided a common list for both empowerments.

Issue 22 – Position reporting by categories of position holders: the measures to specify the thresholds for reporting to NCAs of daily complete breakdown of positions (Empowerment: Article 58(6))

The European Commission is empowered to adopt delegated acts to specify, having regard to the total number of open positions and their size and the total number of persons holding a position, the thresholds above which investment firms or market makers operating a trading venue which trades commodity derivatives or emission allowances or derivatives thereof, have:

- to make public a weekly report with the aggregate positions held by the different categories of persons, communicate the report to the competent authority and to ESMA, and

- to provide the competent authority with a complete breakdown of the positions held by all persons, including the members or participants and the clients thereof, on that trading venue, at least on a daily basis.

ESMA's technical advice:

ESMA recommends that the obligation applies when there are at least 30 open position holders (across all categories) in a given contract on a given trading venue and the absolute amount of the gross long or short volume of total open interest, expressed in the number of lots of the relevant commodity derivative, exceeds a level of four times the deliverable supply in that commodity derivative, expressed in number of lots. Where there are four or fewer position holders active in a given category, the number of position holders in that category shall not be published.

Assessment of IA need:

A study by an external contractor to the European Commission based[78] on data from the three bodies that currently publish the number of open position holders (CFTC in the US, ICE's European operations (in addition to its US disclosures reported via the CFTC) and the London Metal Exchange in Europe, shows that based on CFTC data smaller exchanges would have no reporting under a regime with a threshold of 30 position holders as the distribution of position holders is skewed toward the lower end (i.e. at or near 20). Also for some large exchanges such as the New York Mercantile Exchange (NYME), which has a distribution heavily skewed towards lower average of position holders, a threshold of 30 instead of, as currently implemented 20, would reduce reporting from NYME by almost half. For other large exchanges, such as the Chicago Board of Trade (CBT), which has a long tail toward higher average numbers, a threshold of 30 as opposed to 20 would not make much difference.

The CFTC data show that raising the reporting level to 30 would reduce the transparency of these markets overall significantly as compared to the status quo. However there is not necessarily a linear relation between market size and the number of participants in a specific instrument, the conclusions drawn for European securities markets are therefore not entirely straightforward on a case by case basis.

However given that ESMA has put in place sufficient safeguards with regard to the aggregation of positions so as not to disclose individual positions and given that certain trading venues in Europe also report to the CFTC and that therefore systems are already in place around a limit of 20 positions with regard to the categorisation of firms, as well as in the interest of minimising the administrative burden and supporting a level playing field in this global business, it is the European Commission's view that the threshold should be set at 20.

Issue 23 – Measures clarifying what constitutes a reasonable commercial basis to make information public with respect to information published by APAs (Empowerment: Article 64(7)).

This issue is discussed in the main part of the impact assessment.

Issue 24 – Measures clarifying what constitutes a reasonable commercial basis to provide access to data streams made available to the public by consolidated tape providers in accordance with Article 65(1) (Empowerment: Article 65(7)).

This issue is discussed in the main part of the impact assessment.

Issue 25 – Specifications on trading venues of substantial importance to determine cooperation arrangements (Empowerment: Article 79(8))

The European Commission is empowered to adopt delegated acts to establish the criteria under which the operations of a trading venue in a host Member State could be considered to

[78] Europe Economics, Data gathering and cost-benefit analysis of MiFID II, L2, p. 131-137.

be of substantial importance for the functioning of the securities markets and the protection of investors in that host Member State.

ESMA's technical advice:

ESMA advises that the criteria for determining when the operations of a regulated market become of substantial importance in a host Member State in Article 16 of the MiFID I Implementing Regulation ((EC) 1287/2006) are still relevant and should be maintained. ESMA proposes that an additional test for MTFs and OTFs should be applied in order to ensure that the cooperation agreements envisaged by Article 79(2) are not automatically triggered in the cases of small and therefore economically not highly significant MTFs and OTFs.

Assessment of IA need:

As no convincing argument has been made against ESMA's advice (to maintain the criteria defined under MiFID I and to only add an additional test for MTFs and OTFs) it is, in the Commission's view, not considered proportionate to subject this issue to further impact assessment.

Issue 26 – Extension of the scope of the exemption in Article 1(6) to other central banks (Empowerment: Article 1(9) MiFIR)

The European Commission is empowered to adopt a delegated act to extend the scope of the exemption from Articles 8, 10, 18 and 21 of MIFIR, i.e. articles with regard to post-trade transparency in non-equity instruments, for transactions where the counterparty is a member of the European System of Central Banks (ESCB) and where that transaction is entered into in the performance of monetary, foreign exchange and financial stability policy subject to prior notification.

ESMA's technical advice on Article 1(6) MiFIR

ESMA advises that the relevant transactions are carried out for the purposes of monetary policy including operations carried out in accordance with Articles 18 and 20 of the Statute of the ESCB and of the ECB or an operation carried out under equivalent national provisions for members of the ESCB in Member States whose currency is not the euro; foreign-exchange operations including operations carried out to hold or manage official foreign reserves of the Member States or the reserve management service provided by a member of the ESCB to central banks in other countries to which the exemption has been extended in accordance with Article 1(9) of Regulation (EU) No 600/2014; or are transactions carried out for the purposes of financial stability policy. Relevant transactions do not include transactions entered into by a member of the ESCB for the management of own funds, transactions conducted for administrative purposes or for the staff of the member of the ESCB including in the capacity as the administrator of a pension scheme and for its investment portfolio pursuant to obligations under national law.

Assessment of IA need:

No further impact assessment is needed in the Commission's initial view as the European Commission will publish a separate report on this subject in line with Article 1(9) MiFIR.

Issue 27 – Measures further specifying certain technical elements of the definitions laid down in paragraph 1 of the Regulation to adjust them to market developments (Article 2(2) MiFIR).

The European Commission is empowered to further specify the criteria under which an equity instrument or a class of equity instruments should be considered to be liquid to ensure a uniform application of the Regulation.

This issue is dealt with in the main part of the impact assessment.

Issue 28 – Specifications of reasonable commercial basis for the provision of pre- and post-trade data for trading venues (Article 13(2) MiFIR)

This is being dealt with in the main part of the impact assessment.

Issue 29 – Systematic Internaliser identification of what constitutes a reasonable commercial basis to make quotes public (article 15(5) MiFIR)

This is being dealt with in the main part of the impact assessment.

Issue 30 – Systematic internaliser – pre-trade transparency specifications (Article 17(3) MiFIR).

This is being dealt with in the main part of the impact assessment.

Issue 31 – Systematic Internaliser – determination of size specific to the instrument (Article 19(2) MiFIR)

This is being dealt with in the main part of the impact assessment.

Issue 32 – Systematic Internaliser – specifications on what constitutes a reasonable commercial basis to make quotes public as referred to in Article 18(8) MiFIR (Article 19(3) MiFIR)

This is being dealt with in the main part of the impact assessment.

Issue 33 – Portfolio compression (Article 31(4) MiFIR)

When carrying out portfolio compression, investment firms and market operators are exempted from the best execution obligation, some transparency obligations, as well as position limits and position reporting. Delegated acts should specify the elements of portfolio

compression and the information to be published on the volumes of transactions subject to portfolio compression and the time they were concluded.

ESMA's technical advice:

ESMA's technical advice considers amongst others that portfolio compression should respect the risk framework of the participants, that counterparties should exchange a simulation of the compression outcome in order to ensure this and that there should be prior agreement to the compression proposal by all participants. At the outcome of the portfolio compression, the notional value of the portfolio submitted by each participant should have decreased, it could have remained the same if the notional value of another participant in the compression decreases, but it cannot increase. The volume of transactions to be published should be expressed in number of transactions and in value, expressed in notional amount. The publication should cover the transactions submitted to portfolio compression, the replacement transactions and the transactions reduced or terminated. The publication should be made shortly after the compression proposal is confirmed as legally binding following the acceptance by all participants.

Assessment of IA need:

The technical specifications on the elements of portfolio compression and their publication are of no greater political or economic significance. Furthermore, ESMA's advice suggests an appropriate approach which was not contested. It is therefore the Commission services view that it is not proportionate to subject this point to further impact assessment.

Issue 34 – Criteria to frame NCAs' and ESMA's and EBA's product intervention powers (empowerments: Articles 40(8), 41(8) and 42(7) MiFIR)

Product intervention (Articles 40, 41 and 42 of MiFIR)

Implementing measures should specify criteria and factors to be taken into account by ESMA, EBA and national competent authorities in determining when there is a significant investor protection concern, or a threat to the orderly functioning and integrity of financial markets (or commodity markets) and to the stability (of the whole or part) of the financial system (of the Union or within at least one Member State, respectively).

ESMA's technical advice:

ESMA in its advice proposes a non-exhaustive list of criteria to be taken into consideration by national competent authorities and an exhaustive list for ESMA repectively when using their product intervention powers. In light of EBA's intervention powers in respect of structured deposits (Article 41 of MiFIR), EBA also delivered its advice on 11 December 2014, which is closely aligned to ESMA technical advice.

Assessment of IA need:

The consultation and assessments carried out by ESMA and EBA already provide for sufficient coverage of potential aspects that would have to be discussed in a Commission IA. The Commission therefore considers it not proportionate to repeat this exercise in this impact assessment.

Issue 35 – Criteria for ESMAs position management powers – (Empowerment: Article 45(10) MiFIR)

The European Commission is empowered to adopt delegated acts to specify the criteria and factors to determine the existence of a threat to the orderly functioning and the integrity of financial markets, including commodity derivative markets and including in relation to delivery arrangements for physical commodities, or to the stability of the whole or part of the financial system in the Union, taking into account the degree to which positions are used to hedge positions in physical commodities or commodity contracts and the degree to which prices in underlying markets are set by reference to the prices of commodity derivatives; the appropriate reduction of a position or exposure entered into via a derivative; the situations where a risk of regulatory arbitrage could arise.

ESMA's technical advice:

ESMA's advice refers in part to existing criteria under the Short Selling Regulation (No 918/2012 of 5 July 2012) to establish when there is a threat to the orderly functioning and the integrity of financial markets and adds a few factors and criteria more specific to commodity markets. It also provides a list of indicators for determining an "appropriate" reduction of a position or exposure as well as a list of criteria and factors relevant for determining the situations where a risk of regulatory arbitrage could arise as well as addresses the difference between situations caused by national competent authorities' failure to act as opposed to situations where it is unable to sufficiently address a threat (mainly by the analysis of powers available to national competent authorities).

Assessment of IA need:

Given that ESMA's advice is in part based on existing provisions under the Short Selling Regulation and that the indicators, criteria and factors provided will provide guidance in emergency situation, but that each situation will require an assessment of the overall situation, it is, in the Commission's view, considered not proportionate to submit the indicators, criteria and factors to further assessment. The more so as no additional relevant information or data would be available to further develop the discussion had at ESMA.

Annex 4: Investor protection

Section A. Investment Research

1. Market practices and regulatory concerns

Based on common market practices, research is often received by portfolio managers from brokers with whom the portfolio manager executes orders on behalf of its clients, which is considered to be an inducement. While execution and the provision of research are two distinct services, a common pricing and delivery strategy is to bundle them into a single service paid through dealing commissions (charged to clients). The charge for this bundled service is higher than the charge for an execution-only service. These arrangements present a conflict of interest for the manager which obtains benefits (research) for itself and for other clients through the use of its clients' money/assets.

The bundled service business model contains several inefficiencies that lead to suboptimal allocation of resources and higher costs and lower returns for end investors. The primary cause is the lack of price transparency with respect to the services provided. As a single dealing charge is levied for the bundled provision of execution and research services, it is not apparent what the value of the execution service is independent of the research service. Furthermore, provision of research is frequently "tiered" according to the total value of dealing fees paid to a broker over a period of time: the greater the value of the dealing fees, the more research services are provided.

The bundled service business model generates several regulatory concerns:

Principal-agent problems:

Portfolio managers are stewards of client resources and are obliged to act within theirclients' best interests. Under the bundled service arrangement, the provision and the value of research is linked to the value / volume of trade executed through the broker. As the portfolio managers are agents of the principal end investor, principal-agent problems can arise throughan incentive to "churn" a client's portfolio to receive research. Since the provision ofresearch is linked to the value / volume of trades, portfolio managers could unnecessarily execute trades on an end investor's account to generate additional brokerage and thus gain premium research services. There may be very little incentive for the portfolio manager not to do this, since ultimately it is the end investor that bears the costs. To note, this is problematic even if there is a marginal benefit to the client paying the brokerage.

Buying research with client dealing commissions that does not benefit the client.

Lack of a clear price signal. Since research services are often not separately priced from execution services, it is not clear what the value to the portfolio manager and the market price of the research provided are. The inability to value the research correctly could:

Lead portfolio managers to consume more research or lower quality research than is optimal, since a proper cost-benefit assessment of the research is difficult.

Make it difficult for portfolio managers to be transparent with clients on the allocation of asset management fees.

2. ESMA's technical advice

Taking into account stakeholders' comments, ESMA put forward a solution aiming to identify the conditions under which research does not qualify as an inducement and can therefore be

allowed beyond the limits imposed by MiFID II. The provision of investment research should not be regarded as an inducement if it is received in return for:

i. direct payments by the manager out of its own resources (which they may choose to reflect in an increase to the firm's portfolio management or advice fees), or

ii. payments from a separate research payment account controlled by the manager and funded by a specific research charge to the client. A number of other detailed requirements on the governance of the research payment account are suggested: (a) the firm must set a research budget not linked to transactions; (b) it agrees the research charge with the client (and may only increase it with the client's written agreement); (c) it has in place a number of governance arrangements to ensure the quality of research and accountability to clients; (d) ex-ante and ex-post disclosures to clients. Firms offering execution of orders and research services should also be requested to price and supply these services separately.

ESMA's technical advice (by breaking the link between research and execution) appears to address the inefficiencies identified above and should act as an important behavioural incentive for portfolio managers to obtain value for their clients in research spending.

The advice should lead to transparent pricing of research which in turn could have a number of beneficial effects, including:

- Matching supply and demand in the research market.
- Allowing for efficient allocation of resources.
- More competition in the research market[79].

The technical advice should also reduce the principal-agent problems. The cost of research would be communicated to the client. In this way, clients would have more information to hold managers accountable for research purchased. Also, there would be no more incentives to churn a client portfolio to access research since research and execution payments will be separated. Compliance with best execution requirements would also be facilitated (the execution rate will only cover the transaction costs and would not subsidise other services or products).

a) Impact on SME research

Some stakeholders argued that the ESMA proposals might impact the production of SME research. From an economic perspective, full transparent pricing would allow managers to access research at levels suitable to their needs. The result would be a research marketplace where the quantity of service supplied is equal to the quantity of service demanded, as opposed to the current environment where, arguably, such services are oversupplied or inappropriately distributed, to the detriment for instance of research on SMEs. Under current rules, there is an over-supply of low value, duplicative research coverage of large corporates. Several voices also argued that these practices, linking the receipt of research to volume/value of trading (so in the more liquid stocks), have participated to the reduced provision of research on SMEs. The separation of research from execution arrangements would reduce the payments that managers currently direct towards duplicative research through dealing commissions and would instead allow them to purchase more value-added, in-depth research on smaller companies and niche sectors.

[79] While VAT arguments should not be relevant within this debate, it should be noted that existing VAT practices do distort competition between independent research providers (which are likely to be VAT-able) and integrated brokers (for which the bundling of research and transaction costs is likely to make them VAT-exempt).

Pricing of research should therefore allow for a more efficient allocation of resources and help managers to have a clear idea of the best way to allocate resources. Also, as discussed above, transparent pricing might lead to a better correspondence between price and quality of research services.

The UK FCA for instance recently confirmed "*Our evidence indicates that dealing commission arrangements currently favour the largest brokers and not the independent research providers or small brokers who supply more research on SMEs*"[80].

The flexibility for the portfolio manager to continue to pass research costs to clients can be seen as an additional argument against allegations that managers would reduce research budgets to below an optimal level, with a supposed subsequent impact on the demand for coverage of SMEs.

b) Impact on fixed-income research

The MiFID II prohibition of inducements applies to all instruments without any discrimination. Accordingly, the ESMA's technical advice applies to both equity and fixed income research. Brokers often offer fixed-income research precisely as an 'inducement' to differentiate themselves and to gain trades. Independent research providers explicitly called for the proposals to apply to fixed-income research. Without these measures they consider it is very difficult/impossible for them to access the market and be paid for such research when brokers provide fixed-income research allegedly "for free". Including research in the spread preserves a monopoly in fixed-income research for brokers, excluding competition from independent providers. Independent research providers would choose to offer fixed income and wider macro-economic research if there was a means by which they could compete and be paid.

The UK FCA statement mentioned above (FS 15/1) confirms this. "*In fixed income, costs of research, as well as some other discrete costs, are usually embedded within the negotiable bid / offer spreads quoted by brokers. We believe this would mean that, in the new regime, a manager would have the option either to pay directly for research, or use the research charge and payment account to do so, which can be applied to clients with fixed income portfolios in the same way as for equities. If research is currently a material part of a broker's costs, we would expect a narrowing of spreads as a result of the decoupling of research from trading spreads. Evidence suggests there is much less research on the credit markets produced and consumed for fixed income than for equities, and levels of payments for it are likely to be much smaller for this reason (in which case, any adjustment in spreads may be less pronounced). However, applying ESMA's approach to fixed income markets will bring transparency in an area that is currently more opaque than equity markets since research is entirely embedded in implicit transaction costs. It will open up the market for providing research on the credit markets to firms other than brokers in the bond markets. An independent research provider wishing to supply research on the credit markets currently faces a significant competitive disadvantage compared with brokers, as there is no mechanism such as CSAs to allow a third-party research provider to be paid from transaction costs and no market precedent for 'hard dollar' payments in this area*" (our underlining).

[80] UK FCA Feedback statement (FS15/1/) on DP14/3 – Discussion on the use of dealing commission regime, February 2015, P. 15. https://www.fca.org.uk/static/documents/feedback-statements/fs15-01.pdf.

To conclude, the potential benefits of these proposals (a priced research market that would lead to more competition between brokers and independent research providers, resulting in more innovation and specialisation in their goods and services, enhanced transparency, allowing investment firms to better demonstrate their compliance with the inducements and best execution requirements and wider conflicts of interest provisions) apply to fixed-income too.

c) Impact on international competitiveness

Some stakeholders mentioned the difference with the US regulations and argue that EU managers might be less competitive than US ones (were research charges made transparent).

First of all, one should bear in mind that the US system is quite complex and the rationale of US and potential EU future rules are to some extent converging. In the US managers are under strong fiduciary duties including the duty to pay the lowest commission rate on trades. A 'safe harbour' exempts managers from the duty to pay the lowest commission rate on trades and allows them to use client funds to purchase 'brokerage and research services' under certain circumstances. Several requirements need to be observed (eligible research and brokerage; requirements on the asset managers to determine that the service or product assists the manager in carrying out their investment responsibilities, make 'good faith' determinations to ensure the value of products or services are reasonable in light of amounts paid for them, and conduct 'mixed use assessments' if a product or service received may be used for multiple purposes by the manager). The logic of the ESMA proposals on assessment of quality and price of research or on the allocation of charges to clients may be seen as comparable to the above.

There are also disclosure requirements around the arrangements an asset manager has in place and the documentation on their processes for 'good faith' determinations (and again one can make a comparison with ESMA proposals which foresee appropriate controls and senior management oversight).

Already today there are important differences of approach between the US and the EU and firms already manage those differences. In practice, they often adopt a global policy based on the highest prevailing investor protection standard. Especially in the US, the overriding concept of fiduciary duty to act in clients' best interests may otherwise leave them open to litigation if they adopted a 'lower' protection.

Lastly, enhanced accountability by portfolio managers and a more competitive research market has the potential to lower costs and improve returns to customers, which should in turn make EU investment managers more rather than less competitive.

Section B. Safeguarding of client assets - Intra-group deposit limit

As mentioned in section 4.1.1, the impact of the intragroup deposit limit will depend on the extent to which the proposed measures alter the current pattern of where client funds are held and on firms' compliance with the existing due diligence requirements which imply a degree of diversification.

UK firms observe a 20% intra-group deposit limit since June 2011. UK firms comply with the 20% limit on a daily basis (firms operate a buffer to absorb the intra-day movements).

The estimation of the incremental costs of the implementation in the UK of the 20% limit also depended on the extent to which firms were previously holding client money intra-group or with third parties. Practices varied widely between firms. It was noted that firms that needed to significantly reduce the proportion of client assets held within the group would incur a one-off cost of searching for third-party banks as well as carrying out initial due diligence and opening new accounts with these institutions. As regards ongoing costs, these included the active monitoring of the creditworthiness of deposit takers; regular monitoring that limits are maintained and the identification and review of third parties who may be appropriate for placing client assets with. However, it was also noted that firms have the necessary policies already in place and as a result, incremental on-going costs in this respect were considered small.

It is however difficult to extrapolate from the UK estimations of costs, precisely because those costs were also dependent on the UK firms' pattern of depositing client funds, in addition of course to firms' compliance with existing due diligence requirements. Such extrapolation is even more difficult in light of the proportionality clause embedded in the option 2, and which does not exist in the UK. Hence the estimation of costs for UK firms was higher, while under option 2 smaller firms or firms with small balances of client funds would be able to not apply the 20% limit. And so the costs for these firms would be limited to administrative costs (notification to national competent authorities and periodic assessment).

While it is therefore difficult to quantify to what extent imposing such a limit is problematic in other Member States, the respondents to the ESMA Data Gathering Exercise seem to support the argument that the intra-group deposit limit will likely have a limited impact both in terms of implementation and costs on EU investment firms:

- Stakeholders were asked to what extent they were currently compliant with the additional obligations proposed by ESMA in relation to the safeguarding of clients assets. (…) Safeguarding of Client Assets is the area where "partly compliant" attracted most answers (50%). However, this result is largely due to a couple of countries where a vast majority (86% of German respondents), if not all respondents, assessed they were partly compliant. In contrast, almost half of the respondents from the UK, and 50% of respondents from France declared their firm was fully compliant. A respondent clarified in additional comments that the UK's current and future Client asset requirements as well as related requirements from the CSD regulation mean that the majority of requirements will be applicable to UK investment firms before the implementation of the new rules.

- Only 9% of respondents (out of 64 respondents) mentioned they were not compliant with ESMA's advice, most of which smaller firms (0-50 employees). But it is precisely for these firms that the operational risks and costs resulting for the intra-group deposit limit would be limited as they are likely to be able to benefit from the proportionality clause.

- In general, more than two thirds (68%) of the respondents considered that the ESMA advice on safeguarding client assets would be easy to implement, and less than 10% of them that it would be very challenging to implement.

- A minority of respondents (23%) considered that rules concerning safeguarding of assets will have a high impact on the business activity or market model of their firm, while 77% considered that the measures will have no or low impact.

- Finally, only 12% of respondents to ESMA's data gathering deemed measures in the area of safeguarding client assets (not limited to intragroup deposit limits) to be among ESMA's three most costly to implement proposals on organisational matters.

Annex 5: Liquid market for equities

Below are some extracts from ESMA's technical advice of 19 December 2014 with regard to the outcome of several liquidity scenarios run for criteria applied to classes of equity.

As a basis for setting the thresholds for shares ESMA conducted a data analysis exercise, collecting post-trade data from EU regulated markets on 3,669 shares from 11 EU countries. The reference period was 1 January 2013 to 31 December 2013.

On this basis **ESMA proposed six scenarios** using the liquidity criteria set out in the definition under Article 2(1)517)(b) MiFIR, but varying the liquidity criteria of size of free float, average daily number of transactions and average daily turnover. In the baseline scenario ESMA applied the liquidity criteria currently set for shares under MiFID I and according to Article 22 of the MiFID Implementing Regulation (either the daily number of transactions or the average daily turnover criteria are fulfilled, Scenario 1 applies the same criteria on a cumulative basis).

In its consultation from May to August 2014, ESMA suggested to set the liquidity thresholds in line with scenario 5 (100 mln EUR free float, 250 transactions per day, 1 mln average daily turnover) for shares. Amongst the six scenarios analysed by ESMA, scenario 5 has the highest number of shares in the sample fulfilling the liquidity criteria, the shares represent the highest total turnover over the year and they represent the highest percentage of trades in all scenarios. This scenario could therefore be called the maximum transparency scenario.

During the consultation stakeholders were split between support for the thresholds and concerns that the free float criterion would harm medium and small caps. Therefore a qualification was added to this criterion: For shares exclusively traded on MTFs and for which a prospectus is not necessarily available, the market capitalisation should be used as a proxy for the free float which should be at a minimum 200 mln EUR.

For depositary receipts ESMA suggested to pursue the same liquidity thresholds as for shares (there is a direct link between shares and depositary receipts as each depositary receipt is backed by a specific number of shares or a fraction of such shares). A large majority of responses to the consultation agreed with the proposal and the proposal was therefore maintained.

ETFs: ESMA again carried out data analysis based on data from EU regulated markets on 1646 ETFs and devised six scenarios to test the liquidity criteria. Free float was however not considered a suitable criterion due to the specific 'creation and redemption' process for ETFs, which means that ETF shares /units can at any time be issued or redeemed.

Only scenario 6 of those tested had a reasonably high number of ETFs (18.04%) and a corresponding turnover of 81.88% classified as liquid. ESMA in its 2014 consultation paper proposed therefore to set the liquidity criteria for ETFs in line with scenario 6.

ETFs are currently mostly traded OTF and are not subject to post-trade transparency under MiFID I. Stakeholder responses to the consultation underlined that the data used by ESMA did not include OTC transactions but that for ETFs OTC trading was expected to be between 70-80% of total volume with only a small portion of this volume being reported. Several stakeholders considered that the proposed thresholds would only classify a small number of ETFs as liquid, therefore it was considered appropriate to lower the average daily number of

transactions criterion to 10 trades so as to capture additional instruments and to reflect to some extent the concerns raised during the consultation.

Certificates: only two types of instruments, Spanish Participaciones Preferentes and German Genussrechte/scheine fall under this category. ESMA devised four scenarios for certificates, using a de minimis issuance size instead of free float, as the latter criterion was not considered useful for certificates. ESMA considers that trading activity for certificates seems to be limited and therefore proposed to set thresholds that capture about 23% of the volume in certificates in the sample.

Below is an overview over the scenarios as analysed by ESMA in this context:

Shares:[81]

		BASELINE SCENARIO	SCENARIO#1	SCENARIO#2	SCENARIO#3	SCENARIO#4	SCENARIO#5	SCENARIO#6
(#1) Free float (€)	(>=)	500,000,000	500,000,000	500,000,000	500,000,000	100,000,000	100,000,000	100,000,000
(#2) Average # of trades per day	(>=)	500	500	250	500	500	250	100
(#3) Num of days traded during the 1-year period	(>=)	250	250	250	250	250	250	250
(#4) Average daily turnover (€)	(>=)	2,000,000	2,000,000	2,000,000	500,000	2,000,000	1,000,000	2,000,000
# of shares meeting all the above requirements		654	587	601	619	605	747	641
representing X% of the total # of shares		17.83%	16.00%	16.38%	16.87%	16.49%	20.36%	17.47%
Total turnover over 1 Year for this category		4,457,579,499,981	4,422,734,098,787	4,432,429,055,320	4,436,172,018,670	4,438,402,443,983	4,494,305,711,534	4,460,415,872,016
representing X% of the total 1Y-turnover for all shares		94.96%	94.22%	94.42%	94.50%	94.55%	95.74%	95.02%
Total trades over 1 Year for this category		480,225,235	473,202,451	474,614,964	477,846,269	477,913,226	493,905,183	480,432,640
representing X% of the total trades for all shares		89.80%	88.49%	88.76%	89.36%	89.37%	92.36%	89.84%

ETFs:[82]

		SCENARIO#1	SCENARIO#2	SCENARIO#3	SCENARIO#4	SCENARIO#5	SCENARIO#6
(#1) Num of units issued for trading (free float)	(>=)	100	100	100	100	100	100
(#2) Average # of trades per day	(>=)	500	500	250	100	50	20
(#3) Num of days traded during the 1-year period	(>=)	250	250	250	250	250	250
(#4) Average daily turnover (€)	(>=)	2,000,000	100,000	2,000,000	1,000,000	500,000	500,000
# of ETFs meeting all the above requirements		11	11	29	71	157	297
representing X% of the total # of ETFs		0.67%	0.67%	1.76%	4.31%	9.54%	18.04%
Total turnover over 1 Year for this category		85,824,546,029	85,824,546,029	154,617,845,394	224,397,972,545	279,229,413,072	337,162,320,305
representing X% of the total 1Y-turnover for all ETFs		20.84%	20.84%	37.55%	54.49%	67.81%	81.88%
Total num of trades for this category		2,728,596	2,728,596	4,266,558	5,855,459	7,331,746	8,473,073
representing X% of the total number of trades for all ETFs		26.72%	26.72%	41.78%	57.34%	71.80%	82.98%

Certificates:[83]

		SCENARIO#1	SCENARIO#2	SCENARIO#3	SCENARIO#4
(#1) Free float (issuance size)	(>=)	1,000,000	1,000,000	1,000,000	1,000,000
(#2) Average # of trades per day	(>=)	500	20	20	50
(#3) Num of days traded during the 1-year period	(>=)	250	250	250	250
(#4) Average daily turnover (€)	(>=)	2,000,000	500,000	100,000	500,000
# of certificates meeting all the above requirements		-	1	1	-
representing X% of the total # of certificates		0.00%	1.19%	1.19%	0.00%
Total volume over 1 Year for this category		-	134,755,679	134,755,679	-
representing X% of the total 1Y-volume for all certificates		0.00%	23.48%	23.48%	0.00%

Europe Economics, the external contractor carrying out a study for the Commission, also tested the thresholds proposed by ESMA on a sample available to the contractor and came to

[81] ESMA's technical advice to the European Commission on MiFID II/MiFIR, ESMA/2014/1569, 19 December 2014, p. 201
[82] Ibid p. 206
[83] Ibid p. 209

a very similar conclusion with regard to the number of instruments and percentages of turnover captured by the thresholds proposed. Below are the results of the analysis carried out by Europe Economics:

Table A2: Proportion of ADT and equity instruments within the sample identified as liquid[84]

	Liquidity set by MiFID I criteria	Liquidity as set out in ESMA's MiFID database (i.e. MiFID 1 criteria)	Liquidity set by ESMA's preferred MiFID II criteria
ADT	93.2%	93.4%	94.9%
Instruments	21.3%	20.3%	28.1%

Source: Europe Economics analysis of ESMA and Bloomberg LLP data. As with the ESMA analysis, our data exclude OTC and negotiated transactions.

Table A3: Proportion of ADT and DRs within the sample identified as liquid[85]

	ADT	Number of DRs
Total	€737.0 million	131
Liquid DRs (based on all criteria)	€684.5 million	26
Liquid DRs as % of total	93%	20%

Table A4: Proportion of ADT and ETFs within the sample identified as liquid[86]

	ADT	Number of ETFs
Total	€497.0 million	530
Liquid ETFs (based on all criteria)	€367.9 million	103
Liquid ETFs as % of total	74%	19%

[84] Europe Economics, Data gathering and cost-benefit analysis of MiFID II, L2, p. 9
[85] Ibid p. 12
[86] Ibid p. 14

Annex 6: Reasonable Commercial Basis

Trading data

Market participants can choose between different types of trade data, and whether they purchase them directly from the trading venues (usually reducing latency), or indirectly through a broker or vendor (which may provide analysis services, but add latency). Data provided can either be real-time (or within seconds) or historic (usually after 15 minutes). Real time data are used actively in day-to-day trading, whereas historic data are more for analytical purposes (e.g. constructing trading benchmarks or evaluating trading strategies). Data includes information on the best bid and offer prices for each security as well as all executed trades and may further include market depth data to various degrees.

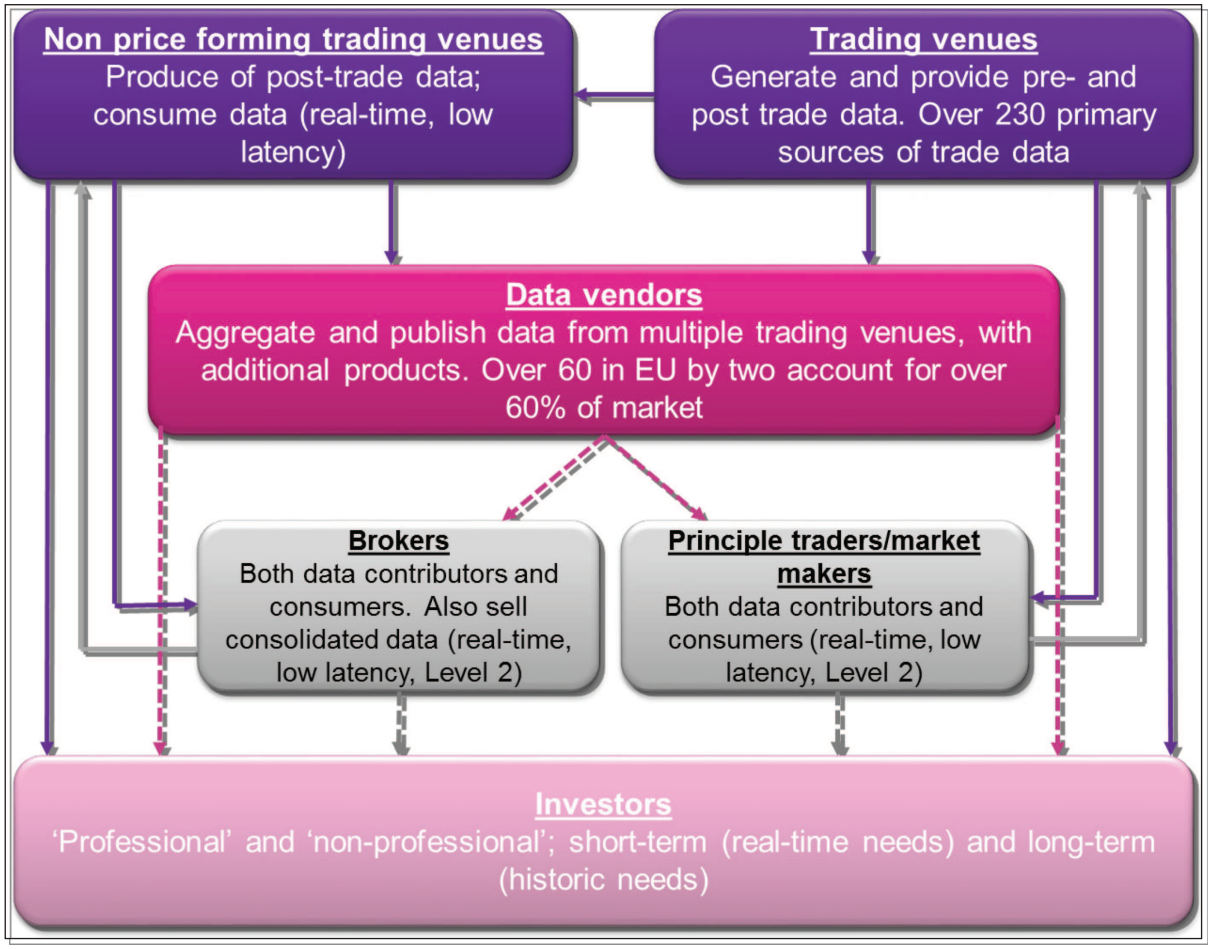
Data is also differentiated by the type of trading it refers to. Pre-trade data provides information on the number of bids and offers for a particular security at a specific point in time. These data are also known as order book data, as they convey information about the supply and demand. Pre-trade data are used inter alia to assess the market impact a given transaction would have. This type of data is usually sold in differentiated product types depending on the depth of the order book concerned. Post-trade data is information about the price and size of a given financial transaction. Typically they are used to assess the contemporaneous market price of a specific security.

Trading data supply chain

The empowerments for delegated acts under MiFID II relate to the contributors to the trading data supply chain which are within the scope of MIFID II, i.e. trading venues, systematic internalisers, approved publication arrangements and consolidated tape providers (see graph below) ("data providers").

Among these categories, the most important category for the present purpose is that of trading venues as they are today the main primary source of trading data and thus constitute the first step in the supply chain. It is estimated that there are at least 230 primary sources of trading data in the EU.[87] The empowerments for delegated acts do not regulate the downstream distribution of trading data by data vendors/aggregators since such activity is outside the scope of MIFID (see below the discussion as to the relevance of this issue for the analysis). A graphic schematic representation of the trading data supply chain in the EU is provided below.

[87] According to PWC there were 238 sources of data in the EU: 89 Regulated markets, 137 MTFs and 12 Systematic internalisers. PwC (2010) 'Data gathering and analysis in the context of the MiFID review: Prepared for Directorate General Internal Market and Services, European Commission.



Sources: Europe Economics[88] based on Oxera (2014[89]), Copenhagen Economics (2013[90]).

ESMA's technical advice:

In its technical advice, ESMA examined three main options and also consulted stakeholders on these in its public consultation.

On the option of limiting data charges by imposing a limit on the share that data revenues can have in total venue revenues (Option B in the consultation): ESMA does not recommend this option considering it neither practical nor likely to be effective. Neither does ESMA recommend the option of limiting data charges by reference to costs, defined as Long-Run Incremental Costs plus (Option C). ESMA advises that this option contains interesting ideas, but is not a workable solution as it would impose too high a cost on venues and others, including their supervisors, and would present significant challenges to implement.

ESMA in its technical advice has set out detailed advantages and disadvantages of these options. In essence they can be summarised as follows.

[88] Europe Economics, Data gathering and cost-benefit analysis of MiFID II, L2, p. 45
[89] Oxera: Pricing of market data services; February 2014; http://www.oxera.com/getattachment/33e57fa3-73c0-4462-9824-81f2bd0c77ca/Oxera-report-on-market-data.pdf.aspx?ext=.pdf
[90] Copenhagen Economics: Regulating access to and pricing of equity market data; Revised 12 September 2013;

As regards Option B, the revenue cap, the benefit of this mechanism would be, if successful, that it would constrain the overall pricing of trading venues. That is, to respect the rule that data sales cannot exceed X% of total revenues, there would be a need to constrain pricing of data taking into account the pricing of trade execution, where there is no dispute that there are generally speaking competitive conditions in the market. However, the draw-back is that the interference with trading venues' differing business models in terms of revenue generation would be arbitrary unless the threshold for a cap takes into account such differences (i.e. setting a threshold for each venue or category of venues). At the same time, elaborating such varying thresholds would be overly complex, difficult to adapt over time and hence costly.

As regards Option C, the long run incremental cost (LRIC) rule, would, if successful, provide a tool to set trading data fees at a level which would have prevailed where a supplier is subject to a normal degree of competition. However, drawbacks identified are essentially the costs of constructing a model, including defining what is a reasonable increment, the definition of common costs, finding parameters to define what data should be used and what assumptions on which to build the model can be generally accepted e.g. value of future investments, cost of capital, rate of depreciation amortisation etc.).

Due to the insufficiency of option A and strong criticism from stakeholders against options B and C, ESMA proposes option A+ (Transparency+) as a compromise solution.

Economic framework for the analysis

Analysis of data suggest that the comparatively high prices for trading data in the EU in comparison to the US[91] create barriers to the provision and usage of market data, impair information flow and the price discovery process; hence the need to ensure that trading data are provided on a reasonable commercial basis as acknowledge by the European Parliament and the Council in MiFID II/ MiFIR. According to Oxera, fees for comparable data provided in aggregated form in the US were in 2012 on average €58 compared EU levels of between €340 and €430 depending on the supplier.[92] According to Copenhagen Economics, whereas indirect evidence suggests that execution fees have decreased as a result of competition following MIFID I, prices for market data have not evolved in the same way, but rather increased in some instances, sometimes substantially, in the period between 2004 and 2014.[93] Oxera, on the other hand, provides an analysis suggesting that fee levels have not increased significantly over this period.[94] There are diverging views on the causes of higher prices in the EU.

In economic theory terms, the main opposing views are, on the one hand typically from the trading venues' perspective, that US markets due to their size deliver economies of scale for the provision of data compared to the fragmented and more complex structures of EU markets as well as a different regulatory framework (centralised system with data purchase

[91] Oxera, Pricing of market data services, February 2014, p. viii
[92] Oxera, Pricing of market data services, February 2014, p. 34.

[93] Copenhagen Economics: Regulating access to and pricing of equity market data; Revised 12 September 2013; p 13-14;

[94] Oxera, Pricing of market data services, February 2014, p. 20-21;

obligation for consumers together with a revenue share arrangement for producers in the US). They argue that the pricing of (i.e. recovery of costs of producing) trading data should not be analysed separately from execution services since they are jointly produced, i.e. competition takes place on a venue level for both trade execution and trading data together. Therefore intervening to decrease the price of one will likely only have distribution effects (increasing the price of the other). In addition, the price level comparison between the EU and the US is based on prices at the level of data aggregation and not at the level of primary data sources (Oxera[95][96]).

Against this opinion is the view expressed typically by buy-side firms, that higher prices are the outcome of market power exercised by trading venues in relation to trading data. Unlike the provision of trade execution, there is no or insufficient substitutability between the trading data offering of different trading venues. Even if trading data are jointly produced with execution services, they are separately consumed products, i.e. trading data from venue A is not substitutable for trading data at venue B for a participant wishing to trade on venue B and a market participant wishing to assess best execution for instruments traded on more than one venue must obtain data from all relevant primary sources). Therefore, pricing of trading data should be analysed separately from that of trade execution (where there is generally effective competition) (Copenhagen Economics[97,98]).

Further clarifications in relation to Option 4

It is essential in order to fulfil the level 1 mandate that there is a "substantial test", i.e. criteria which clarify what 'reasonable commercial basis' is. Merely imposing a transparency obligation on data generators would stop short of fulfilling the mandate as this is a procedural obligation rather than a rule which clarifies what reasonable commercial basis means.

For this purpose, Option 4 develops a set of criteria which would indicate whether data have been sold on a reasonable commercial basis:

- The level of prices charged for data should be based on the costs for producing and disseminating data, including an appropriate share of joint costs.

- Any increases in prices should reflect changes in costs attributable to data sales, including both the direct costs of data production/dissemination and changes to the appropriate share of joint costs.

- The differentials in prices charged to different categories of customers should be proportionate to the value of the data to those customers, taking into account:

- the scope and scale of the data (e.g. number of instruments, volume of trading);

- the field of use of the data (e.g. is it for the customer's own trading, for on-selling, or for creating value added data products?).

[95] Oxera: Pricing of market data services; February 2014; http://www.oxera.com/getattachment/33e57fa3-73c0-4462-9824-81f2bd0c77ca/Oxera-report-on-market-data.pdf.aspx?ext=.pdf

[96] Oxera: Reasonable commercial terms for market data services; 4 September 2014; http://www.oxera.com/Latest-Thinking/Publications/Reports/2014/Reasonable-commercial-terms-for-market-data-servic.aspx

[97] Copenhagen Economics: Regulating access to and pricing of equity market data; Revised 12 September 2013;

[98] Copenhagen Economics: How to ensure reasonable prices of financial market data; 11 July 2014;

Irrespective of the option chosen, ESMA recommends that to fulfil the obligation to provide trading data on a reasonable commercial basis, the provision of trading data must also be unbundled from that of other services and pricing of trading data must be based at least on the level of disaggregation foreseen in Article 12 MiFIR as further refined in regulatory technical standards.

Providers should offer the same prices , terms and conditions, to all customers who are in the same position according to published, objective criteria.

Trading venues should have scalable capacities so as to ensure that their members can always access their data feed on an equal footing with the other clients buying the same type of data feed and through the same channel.

If a trading venue makes its data feed available only in such a way that customers need to use the services of a third-party supplier (e.g. an external IT provider for decryption), then it should be the responsibility of the trading venue to ensure that the overall data service is available to customers on a reasonable commercial basis, including on a non-discriminatory basis. In order to address the issue of charging several times for the same information to a single user, trading venues should offer their clients a “per-user” based model in addition to the existing model.

Annex 7: Proposals for a further harmonisation of SME Growth Markets (Option 2)

Article 33(8) of MiFID II sets out that the Commission should adopt delegated acts to further specify the requirements laid down in Article 33(3) which a multilateral trading facility (MTF) should comply with when applying for the "SME grow market" (SME-GM) label with its competent authority. These requirements consist of:

- A quantitative criterion as to the minimum proportion of SMEs within the total number of issuers whose financial instruments are admitted to trading on the label applicants (at least 50 %).

- A series of rules to which Member States should submit the label applicants, as a precondition for registering them as SME-GMs, in the following fields:

listing criteria (Article 33(3)(b));

investor disclosure requirements (prospectus-like) (Article 33(3)(c));

transparency of financial reports (Article 33(3)(d));

market abuse (Article 33(3)(e) & (g)).

The above requirements could be important to ensure the success of the "SME grow market" label, and would need to be calibrated with a view to maintaining a high level of investor protection to promote investor confidence in these markets, ensuring the development of common regulatory standards in the Union for those markets, further fostering and promoting the use of these markets so as to make them attractive to investors, and to lessening the administrative burden for issuers as well as create further incentives for SMEs to access capital markets through these markets (Recital 132 MIFID II).

1. At least 50% of the issuers whose financial instruments are admitted to trading on the MTF are SMEs at the time when the MTF is registered as an SME growth market and in any calendar year thereafter (Art. 33(3)(a) MiFID II)

ESMA's technical advice stipulates that the 50% requirement should be calculated based on the number of issuers only (and not take into account other factors such as the size/turnover of the enterprise, the issuance size of the financial instruments or the number of different financial instruments issued by the same enterprise).

This criterion should be verified annually on the basis of the figures of 31 December of each calendar year.

A temporary failure to meet the 50% criterion should not lead to an immediate deregistration or refusal to be registered as an SME-GM in the first place. An SME-GM should only be deregistered as such if it were to fall below the qualifying 50% threshold for a number of three consecutive years.

New markets should be granted an authorisation if there is an expectation that at least fifty per cent of the prospective issuers will be SMEs.

SMEs with a history of less than three years should also be counted as SMEs if their market capitalisation upon commencement of trading or based on the end-year quote after the first year of trading or the average of the end-year quotes after the first two years of trading, is below EUR 200m.

Non-equity issuers should be considered to be SMEs for the purpose of determining whether an SME-GM meets the requirements of having at least 50% SME issuers if the overall nominal value of the debt securities issued by the issuer does not exceed EUR 200m or the issuer is classified as an SME pursuant to Article 2(1)(f) of the Prospectus Directive.

Any equity issuer having a market capitalisation will always be assessed by that market capitalisation, even if that issuer has only issued non-equity instruments on a particular market.

2. Appropriate criteria for initial and ongoing admission to trading of financial instruments on a SME growth market (Art. 33(3)(b) MiFID II)

ESMA's technical advice - With regard to the criteria that SME-GM should apply for the initial and ongoing admission to trading of financial instruments of SMEs, ESMA considers that it is inappropriate for the implementing measures of MiFID II to prescribe detailed eligibility criteria (e.g. in relation to an issuer's corporate governance or framework of systems/controls), since the investor protection objectives of the SME-GM regime can be achieved through a number of different operating models, dependent on local factors, and since the flexibility to choose amongst them is key to accommodating the existing range of successful markets catering for the needs of SMEs. According to ESMA, it is therefore sufficient that the operator of the SME-GM demonstrates to its competent authority that it applies objective criteria which are effective in ensuring that issuers are 'appropriate' for admission to an SME-GM.

3. Sufficient information to enable investors' investment decision in an appropriate admission document, on initial admission to trading of financial instruments on an SME growth market (Art. 33(3)(c) MiFID II)

ESMA's technical advice - With regard to the content of the admission document in case of initial admission to trading of securities on a SME-GM (where a prospectus is not required), ESMA considers that MTF operators may equally choose to define such a content either by dis-applying specific categories of disclosures required under the prospectus regime (top-down approach) or by setting up a list of minimum information to be included in the admission document (bottom-up approach). According to ESMA, prescribing detailed disclosure requirements is not necessary in Level 2 and should be a matter for market operators to decide, under the supervision of their NCA.

4. Appropriate ongoing periodic financial reporting by or on behalf of an issuer on the market (Art. 33(3)(d) MiFID II)

ESMA's technical advice – Keeping in mind that companies admitted to trading on an MTF are not subject to the Transparency Directive 2004/109/EC ("TD"), ESMA proposes to align the periodic financial reporting requirements applying to issuers traded on a SME-GM with those set out in Articles 4 and 5 of the Transparency Directive, as it observes that most venues which currently cater for the SME segment already require the publication of annual

and half-yearly reports, which therefore represents an acceptable minimum standard, as well a prevailing best practice.

As to the deadlines for publishing financial reports, ESMA chooses to retain **deadlines** which are less onerous than those imposed by TD on issuers listed on a regulated market: within 6 months after the end of the financial year for the annual financial report (instead of 4 months under TD) and within 4 months after the end of the semester for the half-yearly financial report (instead of 3 months). These deadlines are aligned with those mentioned in Art. 26a(2) of the Prospectus Regulation.

As to the **contents** of the financial reports, ESMA suggests that SME growth markets should not be required by MiFID II Level 2 to impose the use of IFRS on their issuers, which may therefore be allowed to use local financial reporting standards instead. In addition, ESMA reiterates its support for the possibility for MTFs to offer SMEs the option to use the specialised "IFRS for SMEs", a simplified version of the full set of IFRS standards developed by the IASB, which at present does not allow its use by listed companies, irrespective of where they are traded.

5. Compliance of issuers, managers and market operators with the Market Abuse Regulation (Art. 33(3)(e) & (g) MiFID II)

ESMA's technical advice – Given that Regulation N° 596/2014 (MAR) extends the scope of the market abuse framework to financial instruments traded on MTFs, and already contains some measures of proportionality for SME growth markets (namely the option for its issuers to disclose inside information in a simplified way under Art. 17(9) and the exemption from the obligation to draw up an insiders' list, pursuant to Art. 18(6)), ESMA considers sufficient the existing MAR requirements and does not propose any additional or different provision.

Likewise, since the obligations set out in Art. 16 MAR (to establish and maintain effective arrangements, systems and procedures aimed at preventing and detecting insider dealing and market manipulation) apply to investment firms operating an MTF, ESMA considers that no additional specifications at the MiFID level should be implemented for SME growth markets specifically.

Annex 8: Rules in potential SME Growth Markets[99]

Name	Country	Admission process	Requirement for/ role of "key adviser"	Minimum standards	On-going financial reporting	Use of IFRS (IAS) or local accounting standards
CEESEG Wiener Boerse Dritter Markt	AT	Public offer with prospectus or placement with limited information (subject to acceptance by exchange)	Mandatory "Capital Market Coach". Checks "basic fitness" of firms for Dritter Markt. Also acts as liquidity provider for auction trading.	One year history versus standard three years on the Official Market (and one year on the Second Regulated Market). No free float requirement.	Audited annual (within 5 months of year-end); unaudited semi-annual (within three months). Time limits are four and two months respectively on Main Market, which also requires quarterly reporting.	National accounting standards or IFRS (IFRS on Main Market).
Marché Libre	BE, FR	Prospectus approved by Regulators in case of public offering	N/A	Two years of past financial statements recommended. No minimum free float. No minimum market capitalization.	Annual reports NYSE	Optional IFRS or National Accounting Standards (with the accounting requirements are those determined by the company's legal form.)

[99] Europe Economics, Data gathering and cost-benefit analysis of MiFID II, L2, pp. 260-269.

Name	Country	Admission process	Requirement for/ role of "key adviser"	Minimum standards	On-going financial reporting	Use of IFRS (IAS) or local accounting standards
Cyprus Emerging Companies Market	CY	If the offering is public, greater than €2.5 million and is addressed to over 100 persons, a Prospectus and approval from the Securities and Exchange Commission will be required. Otherwise Admission Document must be submitted to the CSE by Nominated Adviser, without a requirement for approval by the Securities and Exchange Commission.	Nominated adviser required (and changes in the nominated adviser are reportable). Nominated adviser presents admission document to the CES.	Two year history (versus four on the Main Market). No free float minimum. No minimum market capitalisation. (ECM also offers the possibility of flotation with simplified procedures where firm first delists from the regulated market, e.g. if they are unwilling or unable to cope with the cost of maintaining the increased obligations of the regulated market.)	Audited annual (four months); unaudited semi-annual report (two months).	N/A

Name	Country	Admission process	Requirement for/ role of "key adviser"	Minimum standards	On-going financial reporting	Use of IFRS (IAS) or local accounting standards
Zagreb Stock Exchange MTF	HR	Annual financial statement for the business year preceding the application for inclusion in trading, or half-year or quarterly financial statements, if the issuer has released a half-year or quarterly statement since the date of the latest financial statements.	N/A Member firms shall employ at least one broker licensed by the competent authority or investment adviser licensed by the competent authority and trained to use the trading system.	On admission to trading on the Domestic MTF, the issuers must not be subject to bankruptcy or liquidation proceedings initiated against them and they must have had the legal form of a joint-stock company for at least 1 (one) year. If shares are admitted to trading on the Domestic MTF, at least 10% of the shares to be admitted must be in free float. Minimum equity of HRK 400,000. Traded continuously for at least 3 years.	Annual financial statement, or half-year or quarterly financial statements, if the issuer has released a half-year or quarterly statement since the date of the latest financial statements.	Local accounting standards
Prague Stock Exchange - START	CZ	Document or Prospectus in cooperation with the Guarantor, filing an application with the Stock Exchange for admission	Any issuer applying for admission must have a Guarantor: a trading member who is to assist in entering the market and in meeting their duties	No minimum capitalisation or free float requirements or minimum trading history	Annual report, all price-sensitive information	National accounting standards or IFRS

Name	Country	Admission process	Requirement for/ role of "key adviser"	Minimum standards	On-going financial reporting	Use of IFRS (IAS) or local accounting standards
GXG First Quote	DK	Needs to submit a document, Applicant must provide audited accounts and a working Capital Statement, must have at least two Directors, and a website that provides corporate information and contact details	Company an Applicant must appoint a GXG Corporate Adviser or GXG Introducing Partner for the period of the Admission process to the Market.	N/A	An Issuing Company must publish their audited annual report and accounts, no later than five months after the end of the financial year	IFRS or a national accounting standards, equivalent to UK GAAP, US GAAP or other appropriate standard agreed with GXG.
Euronext Alternext	BE, FR, NL, PT	Public offer or private placement or direct listing. Latter two responsibility of listing sponsor/issuer.	Listing Sponsor required. Performs due diligence on issuer before and helps with on-going compliance after admission.	Two year track record. No minimum free float if placement (or €2.5m if IPO).	Audited annual; and a semi-annual report each within four months after end of period	IFRS (local GAAP for non-EU companies not making public offer, would still require reconciliation table)
DB Entry Standard (Frankfurt Stock Exchange)	DE	For public offerings: the prospectus approved and notified by the national regulator; for private placements: memorandum, which is the sole responsibility of the company.	Listing Partner is mandatory in order to assist issuer in its compliance.	At least two years trading and one set of audited accounts. No minimum size requirement. Minimum free float of 10 per cent.	Audited annual in 4 months; unaudited semi-annual in 3 months (no prescribed format to latter).	

Name	Country	Admission process	Requirement for/ role of "key adviser"	Minimum standards	On-going financial reporting	Use of IFRS (IAS) or local accounting standards
Boerse Berlin (Freiverkehr)	DE	Written application for participation in the Electronic Trading System and in Floor Trading	N/A	The issuer needs to have exercised the same operative business activities continuously for the last three years. Minimum capital of the issuer shall at least be €0.5m. Free float f at least 20 %.	The issuer needs to publish audited annual accounts and interim reports.	N/A
Boerse Stuttgart bw mit	DE	Anyone who wishes to access the exchange must have been admitted by the Board, application in writing	Listing Expert appointed by the Munich Stock Exchange assists with compliance at admission and beyond.	Minimum capitalisation €10m. At least 5% free float. Must be based in Baden-Wuerttemberg.	N/A	N/A
Munich (Bavarian) SE m:Access	DE	MSE approval.	Emissions expert required.	Minimum capital of €1m (€10m for bonds).	Audited annual (versus Audited annual; semi-annual and quarterly reporting on Regular Market).	German accounting standards (versus IFRS on Regular Market).

Name	Country	Admission process	Requirement for/ role of "key adviser"	Minimum standards	On-going financial reporting	Use of IFRS (IAS) or local accounting standards
Athex EN.A	EL	Prospectus or Information Memorandum.	Nominated adviser/ Lead underwriter mandatory pre-admission and for at least two years thereafter. Assesses appropriateness of listing and submits document (i.e. eligibility questionnaire) to ATHEX's Evaluation Committee.	Two years accounts (one year with ATHEX permission); two years tax audit. Free float at 10% (provided at least 50 people). Minimum capital of €1m.	Audited annual; unaudited semi-annual (time limits to report not stated).	IFRS or equivalent if from other country.
Irish Stock Exchange IEX (Enterprise Securities Market)	IE	No pre-vetting of ESM admission documents by the ISE unless Prospectus required.	ESM adviser must be appointed to assess suitability and assist in the admission process. This includes Admission document, financial and legal due diligence reports.	No specific admission criteria other than the requirement for an applicant to have a minimum market capitalization of €5 million. No trading record required. No minimum number of shares to be held in public hands.	Audited annual (within 6 months); unaudited semi-annual (within 3 months)	IAS if EEA; non-EEA can select from limited choice (US, Canada, AUS, Japanese GAAP).

Name	Country	Admission process	Requirement for/ role of "key adviser"	Minimum standards	On-going financial reporting	Use of IFRS (IAS) or local accounting standards
AIM Italia	IT	Admission document. No vetting by Borsa or by CONSOB (unless public offer prospectus) versus mix of CONSOB and Borsa Italiana vetting on main market.	Must have Nominated Adviser. Nomads are obliged to guarantee information transparency for investors, focus the firm's attention on the rules that apply to it as a publicly quoted company – supporting company to ensure it maximises the benefits of being admitted to AIM Italia – and, more generally, preserve the quality and reputation of the market.	No minimum free float. No minimum market capitalisation (unless investment company, when €3m). No minimum trading history.	Audited annual; unaudited semi-annual.	IFRS, Italian Accounting Standards or US GAAP
Alternative Companies List	MT	N/A	N/A	10-20% free float minimum.	N/A	N/A

Name	Country	Admission process	Requirement for/ role of "key adviser"	Minimum standards	On-going financial reporting	Use of IFRS (IAS) or local accounting standards
Warsaw NewConnect	PL	Private placements require document prepared and approved by an Authorised Advisor. A public offering requires the issuer has to comply with the same admission procedure as that binding in the regulated market with the obligatory issue prospectus approved by the Financial Supervision Commission (KNF).	Authorised Adviser required pre-admission and for at least one year thereafter. Market Maker required for two years (may be same as Authorised Adviser). This is not mandatory on bond market.	None	Annual reports and (non-audited) semi-annual reports	Free choice of accounting standards (any internationally recognised standards or standards applicable at the company's base). For bonds, EEA-based issuers need to apply international standards.
Bolsa de Madrid, MAB	ES	MAB approval.	Registered Advisor checks compliance with MAB rules at admission (including briefing paper and audited financial information) and on a continuing basis. Liquidity Provider also required.	At least €2m free float.	Audited annual (four months after year-end); unaudited semi-annual (same form as annual reports, three months after period-end). On main market the half-year reports required within two months; also requires quarterly reporting.	IFRS.

Name	Country	Admission process	Requirement for/ role of "key adviser"	Minimum standards	On-going financial reporting	Use of IFRS (IAS) or local accounting standards
Nasdaq OMX First North	SE, DK, FI, IS, EE, LT, LV	Prospectus is needed only when securities are offered to the public (versus on the Main Market a prospectus must be prepared, published and approved by the relevant authorities prior to listing).	Firms must have a Certified Adviser. The Certified Adviser ensures that the company meets the admission requirements and the continuous obligations associated with having shares admitted to trading on First North. Furthermore, the Adviser constantly monitors the company's compliance with the rules and immediately reports to the Exchange if there should be a breach of the rules.	No minimum operating history. Sufficient number of shareholders and at least 10% of shares in public hands, or an assigned Liquidity Provider. No minimum market value.	Audited annual (to be within three months of relevant period end); non-audited semi-annual reports (to be within two months); optional quarterly reports. (On "Premier" need at least one report other than annual report to be prepared under IFRS).	Home GAAP (IFRS for "Premier" segment).
Nordic Growth Market	SE, NO	Prospectus (approved by Swedish FSA or NGM dependent upon circumstances).	Not required.	At least 300 shareholders; at least 10% of shares and 10% of votes in public hands. Minimum share capital of not less than €730,000.	N/A	N/A

Name	Country	Admission process	Requirement for/ role of "key adviser"	Minimum standards	On-going financial reporting	Use of IFRS (IAS) or local accounting standards
AktieTorget AB	SE	Prospectus or Information Memorandum (latter approved by AktieTorget)	Not required.	At least 200 shareholders with at least 10% of shares in public hands. An independent member of the board is required.	Each quarter, the Company shall publish a report or statement regarding its financial position. Year-end and half-yearly reports; and quarterly statements within two months of period end. The year-end report to be audited	GAAP
LSE AIM	UK	Admission document or Prospectus dependent on form of the offer.	Firm seeking admission must appoint a Nominated Adviser (Nomad). Nomads are responsible for advising companies on the interpretation of and compliance with the rules (both for admission and on on-going compliance) - acts as "primary regulator".	No free float requirement. No minimum trading requirement.	Audited accounts (within 6 months of year-end.) Half-yearly (three months).	FRS or US, Canadian, Japanese or Australian GAAP.
ICAP Securities & Derivatives Exchange (ISDX)	UK	Prospectus or Admission Document.	Corporate Adviser required to make application for admission.	No quantitative minimums set.	Audited annual (within five months) and half-yearly (within three months).	IFRS, UK or US GAAP (others only with PLUS approval).

Annex 9: A harmonised definition for FX spot contracts

Financial instruments are defined in Section C4 of Annex I of the Directive on markets in financial instruments (MIFID II) and include derivatives related to currencies (FX). However while Article 39(2) of Regulation (EC) No 1287/2006 (MiFID L2) provides a specification of what constitutes a spot contract for the purposes of commodities, none is provided for a spot FX contract. It emerged during ESMA task force discussions related to the EMIR implementation, that there were wide differences in the national implementation of MIFID in respect of FX forwards and spots[100]. Responses to the 2014 consultation[101] suggest that classifying an FX contract would mainly have an impact in two areas:

A. Regulation on OTC derivatives, central counterparties and trade repositories (EMIR):

(1) **Mandatory reporting** of FX transactions into trade repositories *would* be required;

(2) FX contracts *may* be taken into account for the **calculation of the clearing threshold**;

(3) A **clearing obligation** and **bilateral risk mitigation techniques** for non-centrally cleared FX transactions *may* be required under level 2 measures.

B. Directive on markets in financial instruments (MIFID II): Classification of an FX contract as a financial instrument may therefore bring an entity within the authorisation requirement and subject them and this activity to other obligations such as the **investor protection** and algorithmic trading regimes.

Qualifications suggested under option 2 on the definition of FX spot contracts

Qualification I – Standard market practice/delivery period

For major currency pairs (the most common ones) T+2 (or less) may be the appropriate cut off period for a spot, but for other currency pairs longer settlement periods would likely be required and thus the "standard delivery period" should be allowed for the rest:

- T+2 settlement period to define FX spot contracts for European and other major currency pairs (Euro, UK Sterling, Croatian kuna, Bulgarian lev, Czech koruna, Danish krone, Hungarian forint, Polish zloty and Romanian leu (EU Member States currencies), US dollar, Japanese yen, Australian dollar, Swiss franc, Canadian dollar, Hong Kong dollar, New Zealand dollar, Singapore dollar, Norwegian krone and Mexican peso (BIS most traded currencies)).

- "standard delivery period" for all other currency pairs to define a FX spot contract.

Qualification II – Security Conversion Transactions

[100] ESMA's letter of 14 February 2014 to the European Commission on the classification of financial instruments as derivatives; http://www.esma.europa.eu/system/files/2014-184_letter_to_commissioner_barnier_-_classification_of_financal_instruments.pdf

[101] http://ec.europa.eu/internal_market/consultations/2014/foreign-exchange/contributions_en.htm

FX contracts may be used for the purchase of foreign securities whose settlement cycle is longer than T+2 and, as a result, this collateral FX payment contract has a longer settlement period than T+2. Classifying such contracts as derivatives could be detrimental to international capital flows and in particular to the investment fund industry, many of whose mandates do no permit dealing in derivatives. Therefore, FX contracts for such "Security Conversion Transactions" should be considered spots. Where contracts for the exchange of currencies are used for the sale of a transferable security, the accepted market settlement period of that transferable security should be used to define a FX spot contract, subject to a cap of, for example, 5 days, in order to avoid the creation of loopholes.

Qualification III – Payment purposes

Concerning FX contracts for non-investment, commercial or payment purposes, given the fact that MiFID is intended to cover financial instruments, but not payment instruments, international payments for trade and exports should not be unduly burdened, therefore an FX contract that is used as a means of payment to facilitate payment for goods and services could also be considered as an FX spot contract.

Annex 10 Commodity Derivative Definitions

USA

In the USA, the G20 commitments on derivatives have built on decades of commodity derivative regulation and been implemented through the Dodd Frank Act.

Dodd-Frank's definition of swaps excludes "any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled." This is commonly referred to as the "forward contract exclusion". Towards further clarification around the interpretation of the exclusion and the meaning of "physical settlement", the CFTC and the SEC jointly issued an Adopting Release in August 2012 to help market participants understand the factors to be considered in applying the exclusions and exemptions.

The Adopting Release is consistent with the CFTC's historical Brent Interpretation. The Brent Interpretation dates from 1990. The salient aspects of this are as follows:

- Participants entering into crude oil contracts created a binding obligation to make or take delivery "without providing any right to offset, cancel or settle on a payment-of-differences basis".

- The parties subsequently entered into a book-out agreement, which effectively extinguished the delivery obligation:

- This agreement was new and separate to the original contracts and individually negotiated.

- The participants were not under an obligation to enter into the book-out agreement.

The Brent Interpretation concluded that the book-out did not alter the nature of the original transactions, which retained a commercial character. This test applies to "commercial market participants that regularly make or take delivery of the referenced commodity in the ordinary course of their business" (book-outs are also, of course, undertaken by financial market participants who may wish to trade in physical-delivery products, but who do not want to make or take physical delivery). The term "commercial" is further clarified to be "related to the business of a producer, processor, fabricator, refiner or merchandiser". In other words, the regulator believes that if a commercial market participant requires the physical goods as part of its daily business, all its transactions related to such physical goods relate to a genuine demand and are excluded from regulatory framework. This means that even if a forward contract does not actually lead to a delivery of physical goods, as long as the parties enter into the contract with the ability and intent of taking and delivering the physical goods, such transactions would be excluded. Intent is inferred from the inclusion of a binding obligation within the contract.

However, in practice, transactions in the USA can be assessed on a case by case basis whereby other information can be brought to bear as well. This could include the size of contract (e.g. if it is large), a demonstrable commercial need for the product, and the underlying purpose of the contract.

The Adopting Release [102]has extended such exemptions to all non-financial commodities. This would include agriculture commodities and other exempt commodities. Intangible commodities can qualify provided that ownership can transfer and the commodity in question can be consumed.

The Energy Exemption was an extension of the Brent Interpretation to other energy derivatives apart from oil. Many transactions where a physical delivery of energy products occurs have product-specific settlement conventions, whereby delayed settlement provides for — inter alia — the reconciliation of physical deliveries and the book-out of transactions between the counterparties at delivery points, e.g. North American Physical Powerand European Physical Natural Gas transactions settle on a monthly cycle 20 days after the end of the delivery month. The Brent Interpretation therefore had relevance more broadly than in Brent crude.

Since the Brent Interpretation has now been extended to all non-financial commodities the Energy Exemption itself has been withdrawn. The Energy Exemption expressly permitted market participants to use different settlement mechanisms, i.e. resulting in non-physical settlement including:

- Pre-transaction netting agreements — such as the Edison Electric Institute Master Power Purchase and Sale Agreement — which contains provisions contemplating potential future offsetting transactions which could affect the physical delivery obligations. The test remains that the parties must have had the intent to take or make delivery when they entered into the transaction.

- Passing title to an intermediate buyer in a chain, provided that physical delivery is required and the delivery obligations create substantial economic risk to the parties required to make or take delivery.

- Physical exchange of one quality, grade or type of physical commodity for another quality, grade or type of physical commodity (i.e. similar to a barter trade).

- "Bona fide termination rights", provided the exercise of these was not expected at the time the contract was entered into. These include force majeure provisions, and upon counterparty insolvency, default or other inability to perform not anticipated at the time of entry into the contract.

The CFTC has confirmed that these considerations have not changed, i.e. they represented an appropriate interpretation of the Energy Exemption and hence of the Brent Interpretation. By extension, then, this pre-existing Energy Exemption guidance may now be seen as a basis for interpreting the new rules across all non-financial commodities.

The CFTC also clarified in the same Release that:

"market participants that regularly make or take delivery of the referenced commodity in the ordinary course of their business meet the commercial participant standard of the Brent Interpretation … Intent to make or take delivery can be inferred from the binding delivery

[102] CFTC and SEC, "Further Definition of ''Swap,'' ''Security-Based Swap,'' and ''Security-Based Swap Agreement''; Mixed Swaps; Security-Based Swap Agreement Recordkeeping; Final Rule", August 2012. In particular 48228–9, "(B) Brent Interpretation" and (C) Energy Exemption.

obligation for the commodity referenced in the contract and the fact that the parties to the contract do, in fact, regularly make or take delivery of the referenced commodity in the ordinary course of their business."

Physical commodity forwards are subject to widespread legislative and regulatory treatment, albeit typically separate from financial market regulation. This includes arrangements around delivery:

Participants to commodity physical forward transactions must ascertain that this ancillary infrastructure, such as facilities to transport or store the commodity, is created and maintained. This requires direct capital investment or contractual commitments generally undertaken in the medium or long term. Market participants will also need to have access to the infrastructure, either through direct access to the physical asset or through a contractual right to use the physical asset.

For example, NYMEX's Rulebook specifies with respect to its Light Sweet Crude Oil[103] contracts that — by a date set with reference to the delivery date of the contract — a clearing member taking delivery must not simply notify of intent but set out in a specified template details such as delivery method (taking into account the normal capabilities of the incoming facility) and also identifying the outgoing facility.

Market participants can have access to substantial independent storage capacity. This applies also to financial market participants. For example, Morgan Stanley has been reported as having 55 million barrels of oil-storage capacity[104] (nearly three days' worth of U.S. consumption). On the other hand, several banks are understood to have scaled back activities in these markets due to balance sheet and regulatory pressure.

Singapore

The largest oil market in Asia is in Singapore. In 2012, Singapore transferred the oversight of commodity derivatives to the Monetary Authority of Singapore (MAS). In the consultation paper, MAS proposed to "exclude physically-settled commodity forward contracts from the scope of regulation under the SFA"[105] (Securities and Futures Act). The proposal is in line with how such contracts were already treated under the Commodity Trading Act (CTA)[106].

According to the CTA, "spot commodity trading" is defined as "the purchase or sale of a commodity at its current market or spot price, where it is intended that such transaction results in the physical delivery of the commodity."[107] There is no further clarification around the definition around what circumstances would constitute "intended".

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[103] https://www.cmegroup.com/rulebook/NYMEX/2/200.pdf.

[104] http://www.wsj.com/articles/senate-report-says-banks-gained-unfair-advantages-in-commodity-markets-1416434539.

[105] IE Singapore (2012), "Transfer of Regulatory Oversight of Commodity Derivatives From IE to MAS".

[106] http://statutes.agc.gov.sg/aol/search/display/view.w3p;page=0;query=DocId%3A%226a1c2b2c-9451-4a6e-9b85-24f509f57914%22%20Status%3Ainforce%20Depth%3A0;rec=0.

[107] Singapore Commodity Trading Act (Revised Edition 2009).

Although the MAS has not set fixed parameters around the definition of "physical settlement", it has explicitly stated its intention of bringing the financial regulation in Singapore in line with global rules.

Table A5: OTC daily average foreign exchange turnover by country and FX instrument (net-gross basis[1], April 2013, millions of US$)[108]

[1] According to the BIS Triennial Central Bank Survey, net-gross basis data are 'Adjusted for local inter-dealer double-counting… [and] Data may differ slightly from national survey data owing to differences in aggregation procedures and rounding'.

[108] Europe Economics, Data gathering and cost-benefit analysis of MiFID II, L2, p. 228-230.

	Total	% of Total	Spot (settlement ≤ 2 business days)	Outright forwards	Outright forwards (settlement ≤7 business days)	Outright forwards (settlement > 7 business days)	FX Swaps	FX Swaps (settlement ≤7 business 7 days)	FX Swaps (settlement > 7 business days)	Currency Swaps	Options
Austria	17,393	0.26	2,841	5,071	4,833	238	9,044	7,033	2,011	227	211
Belgium	21,597	0.32	3,294	901	276	625	16,764	14,079	2,685	160	478
Bulgaria	1,613	0.02	1,211	37	17	19	362	249	113	4	-
Czech Republic	4,912	0.07	681	258	183	76	3,821	2,745	1,076	59	92
Denmark	102,781	1.54	34,606	8,345	5,577	2,769	55,312	39,951	15,361	1,195	3,323
Estonia	95	0.00	35	3	0	2	55	27	27	1	2
Finland	14,884	0.22	648	428	115	313	13,436	11,854	1,581	76	296
France	189,878	2.85	37,213	8,999	1,512	7,487	134,921	94,423	40,498	3,357	5,388
Germany	110,882	1.66	24,151	4,042	809	3,233	79,137	56,924	22,213	884	2,668
Greece	2,529	0.04	830	67	8	60	1,598	678	920	-	33
Hungary	3,854	0.06	1,052	207	37	170	2,500	2,113	387	21	75
Ireland	11,393	0.17	4,142	2,270	483	1,787	4,716	2,754	1,962	258	7
Italy	23,694	0.36	6,692	795	130	665	15,216	10,410	4,806	198	793
Latvia	2,034	0.03	923	3	0	2	1,108	1,061	47	-	-
Lithuania	528	0.01	167	2	0	2	357	333	25	-	1
Luxem-bourg	51,157	0.77	11,936	14,788	3,214	11,573	24,131	17,084	7,047	42	260
Nether-lands	112,268	1.68	54,623	12,435	9,980	2,454	43,254	25,443	17,811	938	1,018
Poland	7,564	0.11	2,324	464	95	369	4,581	3,844	738	125	70
Portugal	3,569	0.05	1,453	176	23	153	1,743	941	802	-	197
Romania	3,354	0.05	908	65	4	61	2,369	1,979	390	-	12
Slovakia	838	0.01	121	49	27	22	636	496	140	0	32
Spain	43,034	0.65	13,595	3,186	608	2,578	24,896	19,588	5,309	286	1,071
Sweden	43,594	0.65	9,145	1,587	447	1,141	31,780	22,913	8,867	181	901
United Kingdom	2,725,993	40.86	1,031,908	308,808	156,623	152,185	1,126,586	796,499	330,087	32,167	226,524
EU Total	**3,499,438**	**52.45**	**1,244,498**	**372,986**	**185,003**	**187,983**	**1,598,324**	**1,133,422**	**464,902**	**40,179**	**243,451**
United States	1,262,799	18.93	619,357	227,281	75,988	151,293	340,991	204,365	136,626	4,397	70,773
Hong Kong											

Annex 11: Administrative burden and compliance costs

While it is MiFID II and MiFIR that create the requirement to report or to comply with a specific provision, the specification of this requirement in a delegated act can nevertheless influence the costs of compliance for an individual entity and sometimes the number of entities that have to comply with that provision. It is therefore justified that such administrative burden or compliance costs are duly taken into account in impact assessments. At the same time it has to be borne in mind that several factors severely limit this cost assessment:

The counterfactual: As the level 1 provision will already result in a change compared to the status quo, it is not possible or adequate to compare the costs after the implementation of a level 2 provision with the 'status quo ex-ante'. It is rather necessary to compare two hypothetical situations in the future: one where level 1 would be implemented without any specification at level 2; and one assuming that level 1 and level 2 provisions were in place.

The hypothetical situation of the level 1 provision without further specification at level 2: As the very reason for a level 2 empowerment is that the co-legislators did not consider the level 1 precise enough to achieve their objectives, it is inherently difficult to envisage such a scenario, in particular as one could not exclude that Member States and national competent authorities implement the level 1 provisions in different ways.

This means that even if one had exact figures regarding the combined costs of level 1 and level 2, it would be very difficult if not impossible to draw the line between the costs of level 1 and level 2. This, in turn, makes it difficult to assess the part of the costs triggered by the delegated act alone.[109]

Furthermore, often the entities concerned already perform the action under consideration either because they are required to do so due to other provisions or because they consider it appropriate in view of their business model. It is therefore difficult to estimate the number of entities that would have to comply with a specific provision. Finally, in many cases not even the entities themselves can assess ex-ante what the costs would be as long as they do not have effectually taken the respective measures.

Study report "Data-gathering and cost-benefit analysis of MiFID II, Level 2"

The Commission services nevertheless asked a consultant to assess the compliance costs of the MiFID II delegated acts in a study. This section describes the assessment of the study "Data-gathering and cost-benefit analysis of MiFID II, Level 2".

The report provided by the consultant is based on the options presented in ESMA's consultation document in May 2014. As discussed in this report, these are not in all cases identical with the preferred options of this impact assessment or even the final technical advice by ESMA. Furthermore, the consultant had to base its calculation of the compliance costs triggered by level 1 on the basis of the Commission proposal for MiFID II as the final texts of MiFID II and MiFIR were not available when work started. Finally, the study does not use the same separation of issues

[109] For example, if companies have to report something to a competent authority the costs consist usually in the preparation of the report, the additional costs triggered by a delegated act which specifies, say, that the report has to be transmitted by mail and not by FAX or email would hardly influence the overall costs of the requirement.

as was done in this impact assessment and does not cover exactly the same issues.[110] Therefore the figures presented below should only be read as a rough indication of the magnitude of the compliance costs. The findings in this report do not necessarily reflect the views or assessments of the Commission services nor have they been approved by them.

Table A6 below sets out various 'horizontal assumptions' on employee costs used in the Standard Cost Model calculations. Further assumptions are: 240 working days per annum, and 7.5 hours per working day. An overhead multiplier of 1.5 was applied to the employee costs in Table A6.

Table A6: Horizontal assumptions on employee costs, in EUR

		Annual	Per Day	Per hour
IT worker	Low	80,000	333.33	44.44
	High	100,000	416.67	55.56
Compliance & back-office workers	Low (medium-level staff)	60,000	250.00	33.33
	High (senior staff)	80,000	333.33	44.44

In this study the consultants distinguish between one-off direct compliance costs and on-going costs. The one-off direct compliance costs are estimated to be between EUR 146 and 240 million and the ongoing costs between EUR 92 and 190 million. These costs would fall on the whole spectrum of entities and supervisors in the EU financial services sector which are affected by MiFID II. The impacts on individual entities would most likely differ substantially from one company to the other as smaller entities usually face lower costs and as not all entities would be affected by all the provisions. It is rather unlikely that any one single entity would be concerned by all cost factors.

Table A7 below provides further detail regarding the compliance costs triggered by the delegated acts. One-off costs are highly concentrated in the level 2 requirements regarding record keeping and client reporting which together represent about 80% of the compliance costs. Regarding the on-going costs it is the safe-guarding requirements which dominate the overall costs (70%). The main reason for the high total costs of these issues seems to be the fact that they apply to almost 7000 investment firms.

[110] It should also be noted that the estimates do not include any indirect cost impacts, such as competition effects, nor do they include any associated benefits. The related Technical Standards might impact on the costs triggered by the delegated acts, but since the standards are not finalised yet it was not able to take these into account in this study.

Table A7: Summary of identified direct cost impacts (in million Euro)

	One-off		Ongoing	
	€m	€m	€m	€m
Data publication				
Data publication — publication of unexecuted client limit orders on shares traded on a venue	0.4	0.7	-	-
Organisational requirements for trading venues				
Trading Venues - information requirements	0.5	1.4	-	-
Trading Venues - circumstances for referral	8.6	17.6	1.3	3.6
Micro-structural				
Micro-structural - HFT	0.8	2.0	0.1	0.3
Investor protection				
Investor protection - complaints-handling	12.1	28.0	1.8	4.6
Investor protection - record-keeping	73.8	93.5	14.8	23.4
Investor protection - recording of telephone conversations and other electronic communications	2.5	5.1	-	-
Investor protection - safe-guarding	-	-	64.6	135.6
Investor protection - client reporting	47.6	91.3	9.5	22.8
Grand Total	**146.4**	**239.6**	**92.1**	**190.3**

Source: Draft report by Europe Economics.

The consultants compare the above estimates to those they had produced as part of equivalent work on Level 1. There the estimated one-off compliance costs were at EUR 0.6–0.9 billion and the ongoing costs at EUR 400–700 million. They conclude that, clearly, the costs of the Level 2 measures are only about a quarter of the Level 1 costs.

Application of the Standard Cost Model in the study

Description of the model

On the basis of the definition of administrative costs in the EU Standard Cost Model as presented in Annex 10 to the EU Impact Assessment Guidelines[111] only the compliance cost aspects of certain of the measures in [the Europe Economics] study are relevant in constructing the Standard Cost Model estimate. The measures classified as giving rise to information obligations are as follows:

- **Data publication — publication of unexecuted orders.**
- **Organisational requirements for trading venues — Information requirements.**
- **Organisational requirements for trading venues — Determining the circumstances that would trigger the requirement to inform about conduct that may indicate abusive behaviour.**
- **Investor Protection — Record-keeping (other than recording of telephone calls or electronic communications).**
- **Investor Protection — Recording of telephone calls or electronic communications).**
- **Investor Protection — Reporting to clients.**

[111] These Guidelines have been revised in the meantime. The revised Annex, now "tool #53" can be accessed via the following link: http://ec.europa.eu/smart-regulation/guidelines/tool_53_en.htm.

In terms of estimating the Standard Cost Model both one-off costs and ongoing costs must be considered, but only in so far as they are incremental to business-as-usual costs that would be incurred in the absence of the legislation.

Assumptions made to reflect nature of the policy options

In constructing our estimate we have made a number of assumptions. We categorise the information obligations as set out below.

Table A8: Information obligations arising due to policy options

Policy option giving rise to an information obligation	Type of obligation
Data publication — publication of unexecuted orders	Non-labelling information for third parties
Organisational requirements for trading venues - Information requirements	Familiarising with the information obligation
Organisational requirements for trading venues - Determining the circumstances that would trigger the requirement to inform about conduct that may indicate abusive behaviour	Various: Retrieving relevant information from existing data; Inspecting and checking (including assistance to inspection by public authorities); and Buying (IT) equipment & supplies
Investor Protection - Record-keeping (other than recording of telephone calls or electronic communications)	Adjusting existing data
Investor Protection - Recording of telephone calls or electronic communications)	Adjusting existing data
Investor Protection - Reporting to clients	Retrieving relevant information from existing data

In terms of the administrative actions required to fulfil these information obligations the most relevant are: Training members and employees about the information obligations; Buying (IT) equipment & supplies; Designing information material (leaflets, etc.); and Inspecting and checking (including assistance to inspection by public authorities).

For wages (or "tariff per hour" in the template) the hourly labour costs derived from the annual cost estimates identified in the report were used.

Since the only asset acquisition identified is related to IT systems no depreciation period was included. It was assumed instead that the systems would be used until the company updated their IT systems as a natural part of their future development (i.e. unrelated to the introduction of the proposed rules). The one-off cost of the initial acquisition has, therefore, not been adjusted for depreciation.

Using this information, an average cost per type of company was estimated for each action.

The number of entities in the EU as a whole for each of the target groups has been estimated as part of the analysis specific to each policy option. Where this has not been available, the total number of entities identified as conducting a relevant investment service (or any investment service), as appropriate, was used.

The Standard Cost Model estimates have been derived from the cost estimates in the study. The study's cost estimates were based upon a number of more or less detailed (typically "bottom-up") assumptions. These cost estimates have then been applied to a "whole of EU" population for the purposes of establishing the cost impact of specific policy options. It follows that a further extrapolation for the purposes of the Standard Cost Model would be inappropriate.

The administrative burden estimated equates to the administrative costs. This is because the cost estimates are on an incremental basis, i.e. excluding any costs that they would be incurred in the absence of the regulation. No estimate of the Business-as-Usual costs was provided.

MIFID	Article 2(4)	**Criteria for establishing when an activity is to be considered ancillary to the main business at a group level.**	RTS	
MIFID	Article 7(4)	**Specifications for certain criteria to grant authorisation under MIFID**	RTS	**Annex 12: Regulatory Technical Standards and Implementing Technical Standards under MiFID II/MiFIR**
MIFID	Article 7(5)	**Standard forms, templates and procedures for the notification or provision of information by an investment firm when applying for authorisation.**	ITS	
MIFID	Article 12(8)	**Specifications on information requirements in relation to acquisitions of investment firms;**	RTS	
MIFID	Article 12(9)	**Forms and procedures for cooperation between NCAs in relation to acquisitions of investment firms;**	ITS	
MIFID	Article 17(7)	**Specifications for organisational requirements of investment firms in relation to algorithmic trading;**	RTS	
MIFID	Article 18(11)	**Specifications on the content and format of the description and notification to NCAs of the functioning of the MTF or OTF to be provided to the authority**.	ITS	
MIFID	Article 24(11)	**Guidelines on cross selling practices for the purposes of investor protection.**	Guidelines	
MIFID	Article 25(9)	**Specifications of criteria for knowledge and competence of staff providing investment advice.**	Guidelines	
MIFID	Article 25(10)	**Specifications on assessment of products with structures which make it difficult for clients to understand the risks and structured deposits**	Guidelines	
MIFID	Article 27(10)	**Specifications of content format and periodicity of information for best execution to be published by venues and investment firms.**	RTS	
MIFID	Article 32(2)	**Specifications on suspension and removal of an underlying derivative of financial instruments from trading on MTFs or OTFs (proportionality).**	RTS	
MIFID	Article 32(3)	**Specifications on format and timing of information requirements under article 32(2) to determine the format and timing of the communication and the publication of orders to suspend or remove financial instruments from OTF or MTF.**	ITS	
MIFID	Article 34(8)	**Specifications on the provision of information to competent authorities when starting to provide services cross-border**.	RTS	
MIFID	Article 34(9)	**Standard forms, templates and procedures for the transmission of information to competent authorities**	ITS	

MIFIR	Article 1(9)	**ESCB exemption from transparency requirements for non-equity instruments.**	RTS
MIFIR	Article 4(6)	**Pre-trade transparency for equity instruments, specifications in relation to the granting of waivers.**	RTS
MIFIR	Article 5(9)	**Volume cap on the use of transparency waivers for pre-trade equity, Standards to specify the method, including the flagging of transactions, by which it collates, calculates and publishes the transaction data.**	RTS
MIFIR	Article 7(2)	**Post-trade transparency equity, specifications on deferred publication.**	RTS
MIFIR	Article 9(5)	**Pre-trade transparency non-equity: Methods regarding waivers for non-equity instruments.**	RTS
MIFIR	Article 11(4)	**Post-trade transparency non-equity, specifications on deferrals**.	RTS
MIFIR	Article 12(2)	**Specifications on the obligation to provide pre-trade and post-trade transparency data for trading venues (disaggregation) to the public.**	RTS
MIFIR	Article 14(7)	**Systematic internalisers pre-trade transparency specifications equity.**	RTS
MIFIR	Article 20(3)	**Systemic internalisers - Post-trade transparency non-equity.**	RTS
MIFIR	Article 21(5)	**Systematic internalisers – specifications, standard to enable the publication of information required under Article 64 of Mifid (reference data).**	RTS
MIFIR	Article 22(4)	**Specifications on data reporting of trading venues, APAs and CTPs.**	RTS
MIFIR	Article 23(3)	**Specifications of what constitutes technical trades for shares.**	RTS
MIFIR	Article 25(3)	**Specifications on record keeping for investment firms for the purpose of transaction reporting.**	RTS

MIFIR	Article 26(6)	**Guidelines on legal entity identifiers** to **ensure that transaction reporting standards within the Union comply with international standards.**	Guidelines
MIFIR	Article 26(9)	**Transaction reporting standards and criteria for defining a relevant market for the purposes of information sharing among NCAs.**	RTS
MIFIR	Article 27(3)	**Specifications on financial instrument reference data details for the purpose of transaction reporting.**	RTS
MIFIR	Article 28(5)	**Specifications on trading obligation for derivatives.**	RTS
MIFIR	Article 29(2)	**Specifications on straight through processing for derivatives.**	RTS
MIFIR	Article 30(2)	**Specifications on indirect clearing arrangements for derivatives**.	RTS
MIFIR	Article 32(1)	**Determination of the trading obligation for derivatives.**	RTS
MIFIR	Article 32(6)	**Criteria for the liquidity of derivatives for the purpose of the trading obligation.**	RTS
MIFIR	Article 35(6)	**Specifications of refusal and permission of access to CCPs.**	RTS
MIFIR	Article 36(6)	**Specifications of refusal and permission of access to trading venues.**	RTS
MIFIR	Article 37(4)	**Specifications of the right of access to benchmarks.**	RTS
MIFIR	Article 46(7)	**Specifications on third country firms, EU registration with ESMA.**	RTS