

# Nasdaq Nordics Introduction to the main MiFID II requirements.

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## Background

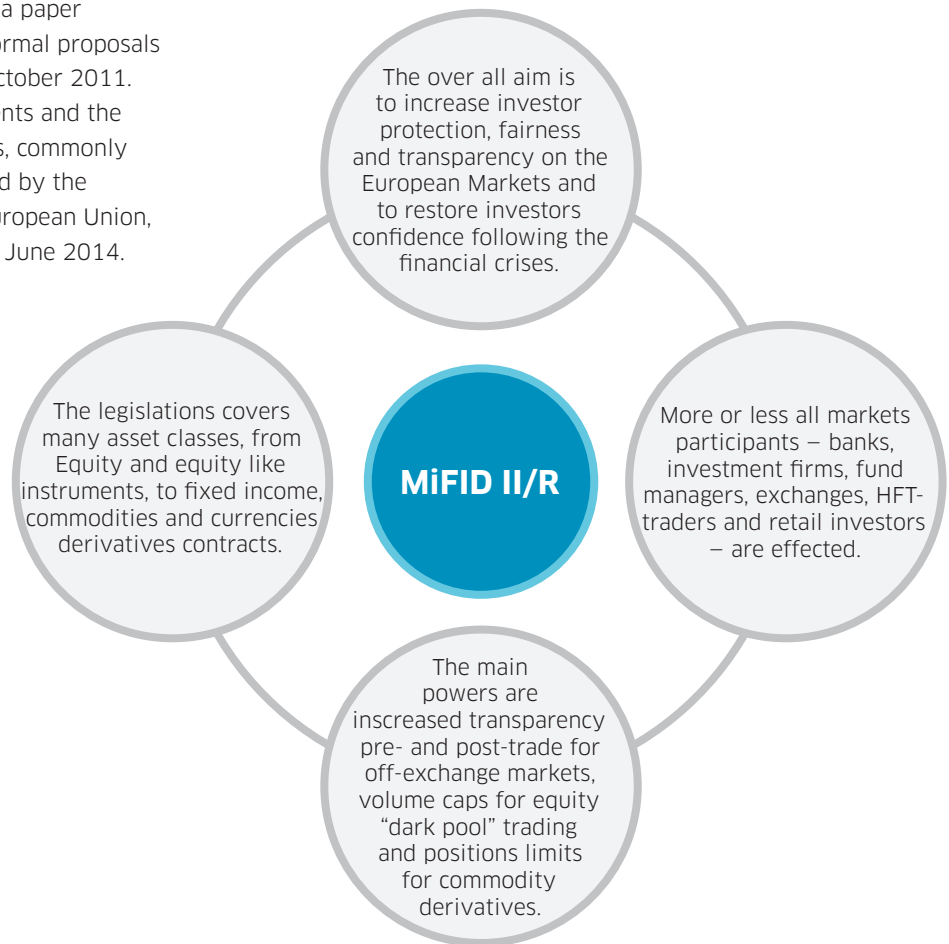
The Markets in Financial Instruments Directive (“MiFID”) came into force 1 November 2007 as part of the European Single Market Programme to remove barriers to cross border financial services within Europe, foster a competitive and level playing field between EEA trading venues for financial instruments and ensure appropriate levels of financial service consumer/ investor protections across the EEA.

The financial crisis in 2008 exposed weaknesses in the regime, including a lack of transparency, particularly in the non-equities market and many thought that the legislation needed to be updated to keep pace with the growing complexity of technology and financial innovation. The Commission also conducted a review of certain provisions of MiFID as required by the terms of the Directive.

In December 2010, the Commission published a paper consulting on changes to MiFID, followed by formal proposals for a recast Directive and new Regulation in October 2011. The Directive on Markets in Financial Instruments and the Regulation on Markets in Financial Instruments, commonly referred to as MiFID II and MiFIR, were adopted by the European Parliament and the Council of the European Union, and published in the EU Official Journal on 12 June 2014.

will reshape European financial markets and the products and services that market participants provide. It will also impact the relationship between market participants and their customers. On an overall level, MiFID II forms the framework and structure of investment firms and trading venues, whereas MiFIR regulates the operation of investment firms and trading venues when acting in the secondary market.

MiFID II/MiFIR had an initial application date of 3 January 2017. Due to implementation challenges, the European Commission in February 2016 made a proposal to delay the application of MiFID II/MiFIR by one year. This amendment was adopted by the European Parliament and the Council on 23 June 2016, and MiFID II/MiFIR will start applying on 3 January 2018.



## MiFID II – Broad overview

The following MiFID II overview summarizes the rules in areas that has been of most interest to Nasdaq Europe entities in order to give an high-level understanding of the regulatory landscape MiFID II encompasses.

### Market structure

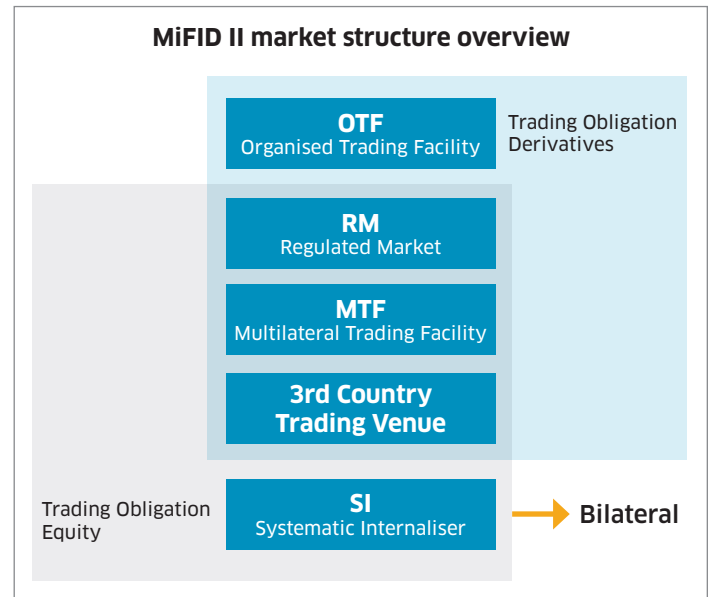
The intention of MiFID II is that all trading platforms - whether multilateral or bilateral, discretionary or non- discretionary - should be captured by the legislation. All multilateral system, meaning any system or facility in which multiple third-party buying and selling trading interests in financial instruments are able to interact, shall be regulated as either a regulated market, MTF or OTF under the legislation.

In MiFID II have the requirements for MTFs been aligned with those of RMs so that investment firms and market operators operating an MTF will be required to have (a) systems and measures in place to manage, identify and mitigate risks, (b) effective arrangements for the efficient and timely finalization of transactions executed under its systems and (c) sufficient financial resources for its orderly functioning.

An Organised Trading Facility (OTF) is defined in MiFIR as a multilateral system, other than a regulated market (“RM”) or multilateral trading facility (“MTF”), in which multiple third-party buying and selling interests are able to interact in the system in a way that results in a contract under MiFID. OTFs are limited to trading in bonds, structured finance products, emission allowances and derivatives.

The OTF regime is intended to capture broker crossing systems, which fall outside the current MiFID regime for regulating RMs, MTFs, and systematic internalisers (“SIs”), as well as systems for trading liquid derivatives that are eligible for clearing under the European Market Infrastructure Regulation (“EMIR”). Unlike RMs and MTFs, operators of OTFs will have a greater room for own discretion as to how to execute orders, subject to pre-transparency and best execution obligations. Both OTFs and MTFs will be required to have arrangements in place to identify and manage conflicts of interest.

Investment firms that operate an internal matching system which executes client orders in shares and other equity instruments on a multilateral basis must according to MiFIR be authorized as an MTF.



Systematic internalisers (SIs) are investment firms which, on an organized, frequent, systematic and substantial basis, deal on own account by executing client orders outside a regulated market, MTF or OTF without operating a multilateral system. The systematic internaliser (SI) regime was introduced already by MiFID I in 2007 for equity instruments. In MiFID II, the regime will be extended and apply to almost all instruments covered by the legislation. The distinction between a systematic internaliser and a trading venue lays in the fact that a systematic internaliser is counterparty and not a multilateral system. Trading venues are systems in which multiple third-party buying and selling interests can interact while a systematic internaliser is not allowed to bring together third party buying and selling interests in functionally the same way.

## Trading obligation

### SHARES

According to MiFIR, transactions in shares admitted to trading on an RM or traded on a trading venue shall take place on an RM, MTF or SI, or an equivalent third country trading venue, unless they are carried out in a non-systematic way on an ad-hoc, irregular and infrequent basis. Transactions that are carried out between eligible and/or professional counterparties and do not contribute to the price discovery process, like give-up or a give-in transaction, securities financing transactions, transaction is part of a portfolio trade or is executed by a management company, are also exempted from the trading obligation.

### DERIVATIVES

In order to meet G20 commitments, derivative contracts declared subject to the trading obligation by ESMA will be required to be traded on an RM, MTF, or OTF according to MiFIR. Transactions may be conducted on an OTF even if the derivative is traded on an RM or MTF. The trading obligation will only apply to classes of derivatives declared subject to the clearing obligation in accordance EMIR and excludes intra-group transactions and portfolio compression exercises. ESMA will determine which classes of derivatives are subject to the trading obligation. In order for the trading obligation to take effect, the class of derivatives must be sufficiently liquid. ESMA has consulted on how to implement the trading obligation and which instruments that shall be covered. ESMA has concluded that interest rate swaps, which have standardized characteristics, in EUR, USD and GBP together with some index CDS are subject to the trading obligation as of 3 January 2018.

## Pre and post Trade Transparency

The current transparency regime under MiFID, which is limited to shares, will be extended to cover other equity-like instruments such as depositary receipts and exchange-traded funds (ETFs), as well as non-equity instruments including bonds, structured finance products, emission allowances, and derivatives, in each case including actionable indications of interest. Pre-trade transparency may be waived, and post-trade disclosures deferred, in certain circumstances. Pre- and post-trade transparency for non-equity instruments may also be temporarily suspended if liquidity falls below a given threshold.

### PRE-TRADE TRANSPARENCY AND WAIVERS

Pre-trade transparency requirements expand to cover all equity instruments (also including equity like instruments) and it is possible to use the negotiated transactions waiver for on-exchange trade reporting, the reference price waiver, order management waiver (like reserve iceberg orders) and the large in scale waiver. These waivers are possible to use in the current regime as well but will be adjusted in details in some cases in MiFID II.

MiFID II imposes a cap on the usage of the reference price and negotiated transaction pre-trade transparency waivers. The Double Volume Cap (DVC) applies to equities and equity like instruments for which there is a liquid market. The caps reference total EU on venue volume and are calculated on a per symbol basis at 4% on any particular venue and 8% market-wide in any 12-month rolling period.

In the case of non-equity instruments, there will be substantial difference compared with the current rules and market practice. If a waiver has not been granted by the regulators, indicative pre-trade bid and offer prices must be published continuously during trading hours. Waivers will be available for instruments for which there is no liquid market, large-in-scale (LIS) orders and orders held pending disclosure and actionable indications of interest in request-for-quote and voice trading systems above a specified size (SSTI, Size-specific-to-the-instrument). Thresholds for LIS and SSTI order and liquidity assessment will be published by ESMA and updated on a frequent basis depending on instrument type.

Member State regulators may withdraw waivers for non-equity instruments in certain circumstances. Regulators may also temporarily suspend pre-trade transparency requirements for non-equity instruments if liquidity falls below a specified threshold. ESMA will coordinate the operation of waivers and suspension of obligations by competent authorities.

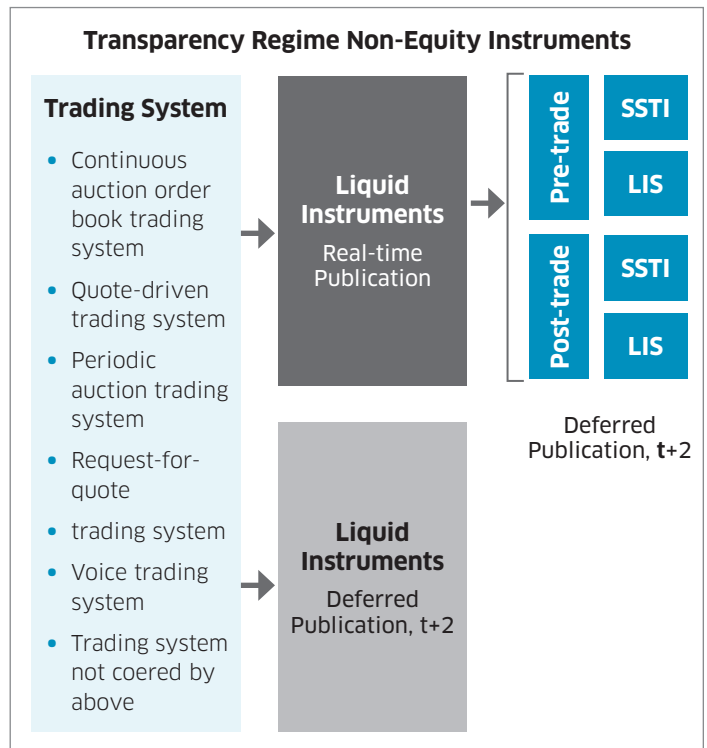
For both equity and non-equity instruments, pre-trade transparency requirements will be calibrated for different types of trading systems including order-book, quote-driven, hybrid, and periodic auction trading systems. Pre-trade transparency for non-equity instruments will also be calibrated for voice trading systems.

### DEFERRED PUBLICATION OF POST-TRADE INFORMATION

As is currently the case for shares, the publication of post-trade information may be deferred for equity instruments in some cases, for example transactions that are of larger sizes (LIS). For large-in-scale transactions, the deferred publication time depends on the size of the order and ranges between 60 minutes and end of next trading day.



Deferred publication of trade information for non-equity instruments may be authorized for illiquid financial instruments, large-in-scale transactions, and transactions above a specified size that would expose liquidity providers to undue risk (SSTI). When authorizing deferred publication, regulators may (a) request the publication of limited and/or aggregated information during the deferral period, (b) allow aggregated publication or the omission of volume information for an extended period, and (c) in the case of sovereign debt transactions, allow aggregated disclosures for an indefinite period.



Regulators may also temporarily suspend post-trade transparency requirements for non-equity instruments if liquidity falls below a specified threshold.

### AVAILABILITY

Pre- and post-trade information must be made available by trading venues to the public separately and on a reasonable commercial basis and ensure non-discriminatory access. Information must be made available free of charge 15 minutes after publication.

In the case of SI's firm quote requirements, these are extended to cover not only share but also non-equity and other equity-like instruments traded on a trading venue, for which there is a liquid market. The minimum quote size for equity instruments is at least 10% of the standard market size. For structured finance products, emission allowances and derivatives traded on a trading venue for which there is no liquid market, SIs must disclose quotes to clients on request if they agree to provide a quote, subject to pre-trade transparency waivers.

As in the case for equity instruments, SIs must make their published firm quotes for non-equity instruments available to their other clients. However, they may decide the clients to whom they give access to quotes. SIs won't be required to publish a firm quote for financial instruments that fall below a liquidity threshold. Firm quote requirements will not apply to non-equity transactions above a specified size (SSTI) since that would expose liquidity providers to undue risk.

Post-trade disclosure requirements for investment firms, including SIs, have been extended to include non-equity and equity-like instruments. This information will be published through an “approved publication arrangement” (“APA”) under MiFID II. The APA shall make the information public as close to real time as technically possible, on a reasonable commercial basis. The information shall be made free of charge 15 minutes after publication. Like post-trade transparency for trading venues, post-trade disclosures by investment firms may be deferred in certain circumstances.

## Organizational and system requirements

MiFID II extends and enhances requirements on trading venues’ and investment firms’ organization and the function of their trading systems. RMs, MTFs, and OTFs will be required to implement systems, procedures and arrangements to ensure that their trading systems are resilient, have sufficient capacity, are able to ensure orderly trading under conditions of severe market stress, are fully tested, and are subject to business continuity arrangements. The systems shall also be able to reject orders that exceed pre-determined volume and price thresholds or are clearly erroneous.

Trading venues must have systems, procedures and arrangements in place to prevent and manage disorderly trading conditions arising from algorithmic trading systems, including by limiting the ratio of unexecuted orders, slowing order flow, enforcing minimum tick sizes, and requiring members or participants to test algorithms. Trading venues must also be able to halt or constrain transactions if there is a significant price movement in a short period and, in exceptional cases, to cancel, vary or correct transactions.

### ALGORITHMIC TRADING

Investment firms that engage in algorithmic trading must have in place suitable systems and controls to ensure their trading systems are resilient and have sufficient capacity and have appropriate trading thresholds and limits to be able to prevent erroneous orders or create and contribute to a disorderly market.

### MARKET MAKING

Algorithmic trading for market making purposes must be carried out continuously during 50 percent of a trading venue’s trading hours, except under exceptional circumstances, in order to provide liquidity on a regular and predictable basis. Firms engaged in algorithmic trading to pursue a market making strategy must enter into a binding written agreement

with the trading venue. Trading venues shall also have market makers schemes in place to ensure a sufficient level of liquidity is provided in the market. The content of Market maker agreements must be notified to competent authorities, and trading venues must monitor and enforce compliance by investment firms.

## Commodity Derivative Position Limits and Reporting

### POSITION LIMITS

Position limits were another hotly contested topic within trilogue and the final level two rules were adopted by the commission just month before application date. Member State regulators will set limits on the size of a net position that a person can hold at all times in commodity derivatives traded on trading venues as well as economically equivalent OTC contracts. Limits will not apply to positions held by or on behalf of non-financial entities for hedging purposes.

The limits will be established in accordance with a methodology for calculation determined by ESMA, on the basis of all positions held by a person individually and on its behalf at aggregate group level. The methodology will take a number of factors into account, including maturity of the contracts, market volatility, the deliverable supply of the underlying commodities, the overall open interest in the contract and other financial instruments with the same underlying instrument. Member States can apply stricter limits on a temporary basis in exceptional cases. The purpose of setting position limits is to prevent market abuse and support orderly pricing and settlement conditions. The limits are particularly intended to ensure the convergence between prices of derivatives in the delivery month and spot prices for the underlying commodity. Competent authorities will reset position limits whenever there is a significant change in deliverable supply or open interest or another significant change in the market.

If a commodity derivative is traded in more than one jurisdiction, the regulator of the trading venue where the largest amount of trading takes place will set a single position limit for all trading in that contract. Trading venues that trade commodity derivatives will be required to apply position management controls, enabling them to monitor open interest positions, access information of the size and purpose of a position and require persons to terminate or reduce positions. Operators of a trading venue must provide the competent authority with details of these controls.

## POSITION REPORTING

As with position limits, these points were highly political, and several amendments to the Commission's original proposal were agreed. Trading venues will be required to publish aggregate positions in commodity derivatives by category of person on a weekly basis. Position holders will be classified by the nature of their main business, taking account of any applicable authorization. Reports must specify, amongst other information, the number of long and short positions by category and changes thereto since the previous report. The positions must also distinguish between hedging transactions and other positions. Weekly reports must be communicated to Member State regulators and to ESMA for centralized publication.

In addition, trading venues must provide Member State regulators at least daily with a complete breakdown of positions held by all persons, including members or participants and their clients. Members or participants of RMs and MTFs and clients of OTFs must provide reports on at least a daily basis to the relevant trading venue with details of their own positions and those of their direct and indirect clients through contracts traded on that trading venue. Investment firms trading in contracts outside a trading venue must provide a breakdown on at least a daily basis to the relevant competent authority of their positions and those of their direct and indirect clients in commodity derivatives traded on a trading venue and equivalent OTC contracts.

## Data Reporting Services Providers

Data Reporting Services Providers (DRSPs) are persons that the new regulation is introducing to facilitate investment firms and others with some of the new reporting requirements. Broadly these can be divided into Approved Reporting Mechanisms (ARM) who facilitates transaction reports, Approved Publication Arrangements (APAs) who publish trade data, and Consolidated Tape Providers (CTP) who publish consolidated trade data from APAs and trading venues. These three new categories of Data Reporting Services Providers did not exist under MiFID 1. All of them will essentially enable the reporting of details of transactions to domestic competent authorities or ESMA on behalf of investment firms as well as publish information to the market in accordance with the extended transparency requirements in the legislation.

## Market data

MiFID II introduces measures to improve transparency and promote better trading by making market data more accessible. In order to reduce costs for market participants when purchasing market data, MiFID II is requiring trading venues to unbundle pre-trade from post-trade data. Trading venues are also required to disaggregate their data, upon client request, by asset class, the country of issue, the currency in which the instrument is traded and whether the data comes from daily auctions or is from continuous trading. Trading venues will be required to make the unbundled data available on a reasonable commercial basis.

## Transaction Reporting and Recordkeeping

### REPORTING

In addition to the obligation to report details of transactions in instruments admitted to trading or traded on an RM or MTF (and now also an OTF) to the national competent authorities, investment firms will now also have to report transactions in financial instruments where admission to trading has been requested and the underlying is a financial instrument (or an index or basket of financial instruments) traded on a trading venue. The reporting obligation applies regardless of whether the transaction is carried out on the trading venue.

The reported information has been extended compared with the required reported information in MiFID I and in total shall 65 fields of information be populated for each reported transaction. The report must include, amongst other information, the identity of the client (using legal entity identifiers where appropriate) and the person or algorithm responsible for the investment decision and execution. Short sales and any applicable waivers must also be identified.

Investment firms that transmit orders must include the relevant information in the transmission of that order. Alternatively, the firm may choose to report the executed order as a transaction, in which case the report must state that it pertains to a transmitted order. Trading venues will be required to report transactions by firms not subject to MiFIR.



Reports can be made by approved reporting mechanisms (“ARMs”) or trading venues on behalf of investment firms. Trading venues must have adequate security mechanisms, resources and back-up facilities in place to carry out this function. The firm will remain responsible for the completeness, accuracy and timely submission of the reports, other than failures attributable to the ARM or trading venue.

Trading venues must provide competent authorities with identifying instrument reference data for the purposes of transaction reporting. SIs must also provide reference data for instruments subject to reporting. The reference data must be ready to submit in an electronic and standardized format before trading commences in a financial instrument and must be updated whenever there are changes to data in respect of that instrument.

#### **RECORDKEEPING**

Recordkeeping requirements for investment firms will be extended to trading venues, and ESMA will be able to access investment firm records. Investment firms must store data relating to all orders (as well as transactions). Records maintained by trading venues must include data that constitute the characteristics of an order, including data that link orders to executed transactions.

#### **Investor Protection – Best execution**

A number of amendments and additions have been made to the investor protection provisions of MiFID. Investor protection requirements in general apply mostly to investment firms. From Nasdaq’s perspective, focus in this part of MiFID II has been on the best execution requirements with extended reporting obligations that also apply to trading venues and other executions venues.

Best execution for retail clients will be determined based on an assessment, including the price of the financial instrument and all costs and expenses related to execution. Investment firms must also inform their clients where orders have been executed. When assessing different execution venues, firms must take into account their own commissions and costs for executing the order on different venues. Trading venues, SIs and execution venues must publish at least annually data relating to the quality of execution of transactions on that venue. Investment firms must inform clients where orders have been executed. Firms that execute client orders must also publish annually the top five execution venues in terms of client orders, as well as information on quality of execution, for each class of financial instrument.