

## MAD and MiFID revisited – the EU agenda for reform

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### Overview

There are wide ranging reviews underway of the **Markets in Financial Instruments Directive** (“MiFID”). This is one of the key pieces of EU legislation on financial markets, along with the **Market Abuse Directive** (“MAD”), which is also subject to review - considered below - (and the Prospectus, Takeover and Transparency Directives).

There are a number of drivers for this process and a disparate set of issues being considered. These include:

- Unfinished business from the work on MiFID I; in particular the original legislation required a series of specific issues to be reviewed to resolve issues on which agreement could not be reached in 2004/6 such as the Commodity regime/exemption.
- The financial crisis and the international work at G20 and FSB levels has identified areas of reform which will impact the MiFID regime such as
  - The reform of the OTC derivative markets ([click here to read a full report](#))
  - Extensive changes to financial rules - enhanced capital (more and higher quality) and trading book penalties, liquidity and leverage including implementation of Basel changes, such as Basel III, which are being implemented via a series of changes to CRD (such as CRD IV).
- The more general review of the effectiveness the MiFID that is required for 2010, three years after implementation. CESR is currently carrying out consultations in the areas mentioned below with a view to [? which are for this purpose?] providing the Commission with information so that this review (being referred to as MiFID II) can be undertaken.

The Commission currently has an evolving reform agenda that comprises an inter-connected mix of ‘business as usual’ reforms (often with a single market motivation) and a variety of responses to the financial crisis (which has influenced the measures in the pipeline before the crisis such as the AIFM). The post crisis measures are a mix of implementation of international work (e.g. Basel III), more EU specific measures (such as ESA and ESRB) and some follow-on from the reform debate nationally (e.g. in the UK) and internationally at FSB/G20 levels.

### Background

The MiFID agenda needs to be viewed in this rather complex context and in the context of some of the other areas of reform which include –

#### **Business as usual/pre-crisis/single market –**

- UCITS IV,
- Solvency II (levels 2 and 3) and AIFM (both with heavy addition of post crisis measures)
- Continuing talk of the maximum harmonisation

#### **Post crisis measures –**

- Broad lessons/themes for micro-prudential regulation such as improved corporate governance
- Improved supervision - the ESAs (to replace CESR, CEBS and CEIOPS) and, in relation to MiFID, the new ESMA (European Securities and Markets Authority) with potentially greater intervention powers, harmonisation of supervisory standards and tools/penalties
- Systemic/macro-prudential issues - the new regulatory regime for credit rating agencies, the new ESRB, pan-European Financial Stability contribution and Financial Activities Tax (levies and taxes on banks/financial

institutions), improved crisis management i.e. early intervention tools, special resolution regimes and the existing directives on winding up of financial institutions, revisions to the deposit guarantee directive and potential legislation a guarantee scheme for insurance

There are also a number of semi-submerged issues lurking in the background –

- The future of the single market priority and the single passport – more Europe/less Europe, the ESA powers, direct EU regulation of systemically important firms, group regulation (particularly cross-border) etc

## MiFID

The Commission anticipated the 2010 MiFID review with requests to CESR to supplement on-going/completed MiFID work with further specific investigations and reports by mid 2010. The Commission is also appointing external consultants to assist with the review.

At the heart of the review is the success, or otherwise, of the key MiFID reform of empowering alternative trading platforms (for example by abolishing concentration requirements requiring execution on the official stock exchange) and boosting competition between trading platforms with pre and post trade transparency requirements. The end objective being reduced costs. Whilst new platforms were launched to take advantage of MiFID, there are widespread concerns that the net reduction in costs, particularly for retail investors, has not been achieved. Indeed with smaller transaction sizes, there is concern that liquidity and transparency have declined in the more complex post-MiFID world.

The issues for the review include –

- Reinforcing transparency - possibly with a single tape for post trade data (rejected at the time of the original directive) and extending pre-trade requirements
- Levelling the playing field – additional obligations on MTFs. Should dark pools and networks be allowed to account for an excessive share of trading, by simply importing prices from transparent trading platforms with a small share of trading.
- Clarifying best execution
- European harmonisation of clearing and settlement (complimentary directive)
- Other measures including the work on extending transparency requirements to non-equity markets.

The Commission's list of issues for CESR included a range of questions including trade transparency, transaction reporting scope (including commodity derivatives (and IOSCO concerns re volatility and use of derivatives to influence physical commodity markets)), MiFID provisions on the divide between complex and non-complex instruments and the appropriateness test, client categorisation, tied agents, scope of MiFID re underwriting issues, provision of lending/credit to MiFID clients, suitability and investment advice

In line with the review provisions embedded in MiFID, CESR has been working on assessing the functioning of the Directive since 2008. To date CESR has issued reports relating to the following:

- Commodity and exotic derivatives trading (<http://www.cesr.eu/index.php?docid=5306>);
- Inducements and investment advice;
- The impact of MiFID on equity secondary markets functioning in June 2009 (<http://www.cesr.eu/index.php?docid=5771>); and
- The transparency of corporate bond, structured finance product and credit derivatives markets in July 2009 (<http://www.cesr.eu/index.php?docid=5798>).

CESR has now launched a review of further aspects of MiFID. On 13 April 2010, CESR published the following three consultation papers on its technical advice to the Commission on the review of MiFID (papers: <http://www.cesr.eu/index.php?page=consultation&mac=0&id=>; press release: <http://www.cesr.eu/popup2.php?id=6549>):

- Investor protection and intermediaries – "Consultation on CESR's advice in the context of the MiFID Review";
- Transaction reporting – "Consultation on CESR's advice in the context of the MiFID Review"; and
- The impact of MiFID on equity secondary markets functioning – "Consultation on CESR's advice to the Commission in the context of the MiFID Review".

CESR will provide the European Commission with its technical advice by July 2010 so that the Commission can report to the European Parliament on possible changes to the directive in early 2011. A public hearing will be held to cover the issues

raised by the papers on 17 May 2010 in the premises of the CESR Secretariat in Paris. The deadline for comments on the papers is 31 May 2010.

Furthermore, on 7 May 2010 CESR issued a consultation on non-equity markets transparency. CESR has already analysed the eventual extension of MiFID transparency requirements to non-equity financial instruments in its response to the Commission on non-equities transparency in July 2007 ([http://www.cesr.eu.org/index.php?page=document\\_details&id=4708&from\\_id=53](http://www.cesr.eu.org/index.php?page=document_details&id=4708&from_id=53)) and its report on transparency of corporate bond, structured finance products and credit derivatives markets of July 2009 (see above). This consultation paper presents possible ways of developing the recommendations in the July 2009 report in the context of the MiFID Review to be launched by the European Commission in the course of 2010. The closing date for responses to this paper is 4 June 2010.

Michel Barnier, the Member of the European Commission responsible for the Internal Market and Services Financial regulation in Europe, has recently highlighted the need for more transparency in securities transactions following their contribution to the crisis. He has called for greater standardization and transparency in derivatives markets and will present proposals dealing with this in the summer – click here for our report on OTC reform. He has also said that he will revise MiFID to increase transparency on alternative trading platforms and will look at the MAD to extend its coverage. Further, as part of general work that he is undertaking on short selling, he has proposed to introduce a framework of rules and transparency in this area.

The FSA is working with UK regulated exchange and trading firms to ensure that reforms to MiFID are not detrimental to the European equity market.

## MAD

The financial crisis produced concerns about market abuse, particularly regarding the short selling of shares in financial institutions by hedge funds. As a reaction to this, emergency measures were introduced internationally. In the UK there was no firm legal basis for the short-selling ban, the measures were announced as a declaration of unacceptable market conduct under the Market Abuse Directive (MAD). However, the government has now legislated to give FSA clear powers to regulate short selling in all sectors and related disclosure (see below).

The EC is reviewing MAD and is due to make proposals on how sanctions can be strengthened, harmonised and enforced. Following FSA's publication of enhanced transparency requirements on short selling for all stocks (DP 09/1); CESR has also proposed a short-selling disclosure regime. FSA is cooperating with CESR to develop an agreed European disclosure policy for short selling.

CESR has recently published a review panel report on how securities regulators across Europe have been applying the MAD regime. The MAD does allow member jurisdictions certain options and discretions when applying the directive, however CESR is recommending that greater convergence be applied.

The report presents an analysis of the discrepancies across member jurisdictions in the application of the MAD rules. The greatest levels of divergence were found over how the MAD was applied across Multilateral Trading Facilities (MTFs). CESR has proposed to wait for the outcomes of the review of the MAD by the European Commission before it undertakes any work on the area or expresses a firm position the issue of scope to MTFs. The report will be presented to CESR-Pol, CESR's policy group dealing with market abuse, for further consideration and to the European Commission as input into its MAD review.

The UK has extended the sunset provision on its super-equivalent market abuse regime (which includes provisions on the misuse of information and behavior likely to give rise to false or misleading impressions or to distort the market) until 31st December 2011. Following a full review of the MAD, this extension should give the UK the time necessary to align its regime with the rest of Europe.

## Short-selling

### European position - CESR Model for a Pan-European Short Selling Disclosure Regime

As well as the prohibitions being considered as part of the MAD review, on 2 March 2010 CESR published its proposal for a pan-European short selling disclosure regime. It is hoped that the new regime will help to identify and restrain potentially abusive behavior at an early stage and allow regulators to take timely preventive measures.

The regime proposed by CESR is a two tier-model, covering the disclosure of significant individual net short positions in all shares that are admitted to trading on an EEA regulated market and/or an EEA MTF, when the primary market of those shares is located in the EEA. The lower threshold for disclosure to the relevant competent authority is set to be at 0.2% of issued share capital. In addition, any changes of position of 0.1% (either up or down) will trigger further disclosure obligations. The higher threshold is 0.5%, and any additional steps of 0.1%, at which point the position will also need to be disclosed to the market as a whole.

CESR has said that they intend to continue to work on this issue in the forthcoming months, to ensure greater clarity is achieved on the technical details necessary to implement the regime effectively. CESR will also continue to examine whether all its members have the necessary powers to introduce emergency measures, such as bans or partial bans or the imposition of special conditions on short selling, and, if not, what steps may be required to remedy any deficiencies.

## **The UK position - The Financial Services Act 2010**

The Financial Services Act 2010 received Royal Assent on 8 April 2010. It contains a number of measures conferring new powers and duties on the FSA in the field of short selling in financial markets, which come into effect two months from the date of the Act. In particular, it gives the FSA the power to make rules to ban short selling in financial instruments and to require any person to disclose information about their short selling.

The FSA have recently released Consultation Paper CP10/11 considering how to implement relevant aspects of the Act. This considers areas such as the need to redraft provisions requiring disclosure of short-selling positions and place them in a new part of the FSA Handbook as well as the FSA's newly conferred powers to impose financial penalties or censure on those who breach short-selling rules. However, despite CESR's recommendation of a higher initial public threshold of 0.5% (as mentioned above), the FSA has said that until a detailed European framework is implemented they consider it appropriate to keep the existing thresholds for the financial sector companies and rights issue disclosure regimes as they are. Holders of net short positions of 0.25% and above in UK financial sector companies are therefore required to disclose those positions to the market as a whole. As before, when positions above 0.25% fluctuate by 0.1%, those changes are also required to be disclosed. A disclosure should also be made when a holder's net short position falls below 0.25%. This consultation closes on 25 June 2010 and the FSA will release a Policy Statement in July.

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