MiFID II and Cross-Border Banking

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Outline of Presentation

- MiFID II and regulatory governance: market-shaping/making (section 1)
  - Single market construction/facilitation v. market shaping/prescription
- Design of MiFID II with respect to cross-border service provision: regulatory governance + supervisory governance (sections 2 and 3)
- Related institutional governance (section 4)
  - European Securities and Markets Authority (ESMA)
  - "Supervisory convergence" under MiFID II
- Impact of: Capital Markets Union + "Financial Union" (section 5)
- Impact of: the "New Settlement" for the UK, 18-19 February 2016 (section 6)

An Institutional Perspective

- MiFID II/MiFIR + CRD IV/CRR as the twin pillars of EU financial market regulation
- Scale of MiFID II
  - Co-legislators currently adopting a one year delay to its application date (to 2018)
  - Significant delays in the adoption of massive administrative 'level 2' rulebook
  - Will additional delay be required beyond one year?
- An institutional perspective on MiFID II and cross-border services
  - Why? Scale of the single rulebook
  - Regulatory governance v supervisory governance

1. MiFID II and market-making/shaping

- MiFID II context
  - Product of internal EU political, institutional, and market dynamics (scheduled MiFID I review + crisis-era context) + G20 reform agenda
    - Complex political economy shaping regulatory governance
    - Market shaping v market making…
  - "Objectives"(market shaping and market making)
    - Safer, more stable, and more transparent financial markets
      - Market microstructure (MiFIR + MiFID II)
    - Increased levels of investor protection and of consumer protection (MiFID II)
    - Enhancement of supervisory powers and enforcement (MiFID II)
    - → Strong association with Capital Markets Union agenda (market making)

1. MiFID II and market-shaping/making

- **Example of scale of MiFID II and regulatory governance (1): the recasting of trading/order execution regulation under MiFiD II:**
- MiFID I: basic conduct/prudential rules; little tailored regulation
- MiFID II/MiFIR:
  - Finessing of MiFID I order execution rules (eg, best execution)
  - New rules governing, eg: market makers; algorithmic trading; where certain instruments must be traded (liquid shares; derivatives)
  - New transparency rules governing bilateral trading between counterparties (off venue)
    - Post-trade transparency across a wide range of asset classes
    - Pre-trade transparency for 'Systematic Internalizers' across a wide range of asset classes
    - New regime for firms operating an Organized Trading Facility
  - Liquidity-constraining measures used (position management requirements)
  - → Market shaping

1. MiFID II and market-shaping/making

- **Example of scale of MiFID II and regulatory governance (2): firm governance regulation (Article 9):**
  - MiFID I: basic 'fit and proper' rules: very limited harmonization
  - MiFID II: fit and proper + board governance requirements
  - Reflects crisis-era reforms internationally and in particular on bank governance
  - Purpose: strengthen senior management oversight of risk management + provide regulatory incentives for senior management to ensure firm activities reflect client interests
  - Works in parallel with CRD IV/CRR governance regime (which includes remuneration rules)

1. MiFID II and market-shaping/making

- Applies to management body
- Comply with CRD IV/CRR (composition of body and qualification/restrictions on numbers of non-executive directorships; nomination committee)
- Specification of responsibilities of management body (in addition to CRD IV/CRR)
  - Take responsibility for client interests
  - Ensure effective and prudent management, including prevention of client interests
  - Oversight of product development processes
  - Monitor strategic objectives
- → Market making
  - But cf conduct of business regime/distribution (Article 24)

1. MiFID II and market-shaping/making

Overall:

- Important 'market-shaping' elements: prescriptive and structural in orientation, concerned with financial stability and related market structure
  - New cross-asset-class transparency regime
  - Trading obligation for liquid shares and certain derivatives
  - Restrictions on distribution structures: independent investment advice
- Nonetheless: much of MiFID II remains 'market-making' (facilitative/liberalizing) in design, reflecting long tradition of EU financial market intervention
- Supporting cross-border services

1. MiFID II and market-shaping/making

- → Facilitative, 'market making' elements: MiFID II implications for cross-border provision of services
  - 'One of the purposes of MiFID II is to ensure that there is an effective single market for investment services and activities' (UK Financial Conduct Authority, MiFID II Implementation Consultation Paper, CP/15/43, December 2015)
  - UK industry concern: asymmetric impact on smaller firms/advisers without passporting incentives
    - More limited exemptions; more harmonization of exemption conditions
  - Capital Markets Union: risk diversification + liberalization
    - Compare: risk mutualization under Banking Union
- MiFID II builds on the MiFID I liberalization model for cross-border services, but with enhancements + new/dynamic institutional governance to support cross-border market

2. MiFID II, Cross-Border Service Provision, and Passporting

- MiFID II authorized firms providing in-scope investment services/performing in-scope activities (investment firms and credit institutions) benefit from the MiFID II regulatory passport for services and for establishment (MiFID II, Articles 6(3), 34, and 35)
  - → Basic regulatory design model for supporting cross-border services has not changed: networked, home/host coordination
    - Notification requirements for passport
  - Supervisory colleges? Compare EMIR and CRD IV
    - Limited references
    - ESMA Regulation 2010

2. MiFID II, Cross-Border Service Provision, and Passporting

- Networked passport model
- Home Member State: the MiFID II "anchor"
- Host Member State:
  - Precautionary powers (Article 86) (+ ESMA binding mediation)
  - Branch powers (Articles 35(8) - rule application and enforcement + 86 - precautionary enforcement)
    - Extended from MiFID I in line with expanded conduct regime and transparency regulation

2. MiFID II, Cross-Border Service Provision, and Passporting

- → No crisis-era rethinking of organizational model for cross-border service provision/liberalization
- Treatment of significant/systemic branches?
  - UK and Brexit
- MS cannot require transformation into subsidiaries or prevent transformation from subsidiary into a branch (Treaty free movement rules)
  - UK and Brexit
- But risks to host market/supervisor minimized?
  - Ex: Level of harmonization: Article 9 (governance); Article 16 prudential/risk management requirements

2. MiFID II, Cross-Border Service Provision, and Passporting

- Some new thinking: 'tied agents' (Article 29)
  - MS must now allow use of tied agents
  - Light touch regulatory regime
  - + tied agents benefit from passporting regime under Articles 34 and 35
  - Varied importance across the Member States

2. MiFID II, Cross-Border Service Provision, and Passporting

- Passport eligibility: scope of the MiFID II passport
  - Largely unchanged: MiFID II and MiFID I perimeters are broadly similar re services
  - Ex: Services? Self placement of proprietary securities (Article 4(1)(5) + operation of an organized trading facility (Article 4(1)(23))
  - Ex: Instruments? Emission allowances + greater prescription at level 2
  - Exemptions? Articles 2 and 3(optional)
  - Credit institutions + passport: Article 1(3)
  - Structured deposits? Article 1(4) and application of certain MiFID II rules when sell/advise on structured deposits
    - Why included? Silo difficulties + mis-selling
    - But services in relation to structured deposits not eligible for the MiFID II passport: ref view of the UK FCA

3. Cross-Border Activity and Coordination under MiFID II

- Home Member States, applying rules to, and supervising, cross-border activity subject to:
  - MiFID II level 1 (enhanced detail)
  - MiFID II level 2 (administrative rulebook of immense depth, breath, and granularity; placing strains on administrative rule-making process)
  - MiFID II level 3 (ESMA soft law)
- Level 1 examples
  - Management and governance (Article 9)
  - Conflict of interests; Conduct of business regulation (Articles 16(3), 23, 24-25, and 27-28)
    - Maximum harmonization in practice: express concessions to the Member States with respect to tougher asset protection (Article 16)/commission + conduct rules(Article 24)
  - Extension of actors subject to conduct regulation: eligible counterparties (Article 30)

3. Cross-Border Activity and Coordination under MiFID II

- Level 2 examples
  - The single rulebook imperative
  - (1) September 2015, ESMA Binding Technical Standards Proposals
    - Market microstructure, transparency
  - (2) June 2015, ESMA Binding Technical Standard Proposals
    - Authorization, passporting, supervisory coordination
      - Market/stakeholder reaction
    - Templates, enhanced coordination
  - (3) December 2014, ESMA Technical Advice for Commission on administrative rules
    - Conduct regulation/investor protection, market microstructure
- Level 3 - awaited

3. Cross-Border Activity and Coordination under MiFID II

- But: are the risks of cross-border activity captured? Supervision?
  - Supervisory divergence, arbitrage
- Difficult questions of balance
  - Market stability/efficiency + transaction costs reduction
  - Need for a safety valve for local market conditions
    - UK position on supervision/Bank of England; financial stability
- MiFID II and supervision: single rulebook + also enhanced operational supervisory coordination
  - But: compare CRD IV and Supervisory Review and Evaluation Process (SREP) + related Guidelines from European Banking Authority + SSM

3. Cross-Border Activity and Coordination under MiFID II

- Supervisory Enhancements under MiFID II
  - Prescription of supervisors' powers (Article 69)
  - Greater harmonization in relation to supervisory coordination (Articles 79-81)
  - Significant change to enforcement, with new requirements for extensive administrative enforcement powers + requirements relating to the application of administrative sanctions (Articles 70; 72)
  - More centralized/coordination decision-making
    - Market microstructure under MiFIR; waiver decisions relating to transparency requirements + position limits decisions subject to an ESMA process.

4. Institutional Governance, ESMA, and Supervisory Convergence

- Importance of supporting institutional governance in shaping the MiFID II environment
- Injection of European Securities and Markets Authority (ESMA) into MiFID II
  - Notifications; Opinions on key supervisory decisions; reporting of sanctioning; binding mediation
- But key ESMA influence: "supervisory convergence" under MiFID II
  - What is supervisory convergence?
    - Outcome: much greater coordination and consistency in practices but without formal legal/organizational change. Compare SSM.
  - → MiFID II supervisory coordination being framed by supervisory convergence
  - European Commission: Capital Markets Union and supervisory convergence
  - European Parliament: February 2016 Balz Report

4. Institutional Governance, ESMA, and Supervisory Convergence

- Benefits of the "supervisory convergence" organizational model for MiFID II coordination
  - Dialogue and cooperation
  - Standard improvement, best practice, enhancement of coordination – not top-down centralization
  - Strong resonance with "experimentalist governance"
    - Responsive coordination and learning
    - Allow feedback loops to develop

4. Institutional Governance, ESMA, and Supervisory Convergence

- ESMA's institutional incentives to pursue a vigorous "supervisory convergence" agenda in relation to MIFID II
  - Constitutional 'space' relatively clear (*Meroni* doctrine constraints on ESMA in exercising discretionary powers: 2014 Short Selling ruling from CJEU)
  - Relatively limited suite of powers required (ESMA Regulation 2010, Article 16 (guidelines), Article 29 (supervisory convergence), and Article 30 (peer review)
  - Stakeholder support

4. Institutional Governance, ESMA, and Supervisory Convergence

- Recent ESMA action
  - 2016-2020 Strategic Orientation (2015)
  - Capital Markets Union response (2015)
  - February 2016, first Supervisory Convergence Work Programme
    - MiFID II: Guidelines, Q & A, ***peer review*** (best execution; suitability), common procedures, workshops; support of MiFIR/MiFID II market microstructure data gathering and interrogation
    - → Much closer central steering by ESMA of supervisory action by its member supervisors, and implications for the cross-border market
  - But political pressures and legal strains?
    - Status of Guidelines….European Parliament concern
    - 2016 EBA Guidelines on Executive Remuneration and proportionality + UK position

5. Changes to the Current Governance Settlement: Centralization of Supervision under MiFID II?

- Incremental development of governance structures typically; but re-setting shocks lead to institutional change
- Banking Union as a driver for centralization of markets supervision?
  - Prediction: no
  - But: may lead to more assertive supervisory convergence from ESMA given dangers of institutional over-reach (conduct risk + SREP)
- Capital Markets Union as a driver?
  - Regulatory agenda, not concerned with institution building
  - Supervision? Focus on supervisory convergence
  - + Constitutional, political, operational constraints significant

5. Changes to the Current Governance Settlement: Centralization of Supervision under MiFID II

- "Financial Union" as a driver?
  - Financial Union as a means for completing Economic and Monetary Union (Five Presidents' Report, June 2015)
    - Incorporating Capital Markets Union
  - ECB and "vanguard group" of countries cooperating more closely; single capital markets supervisor
  - UK position
  - CCP experience…..2015 ESMA Report

6. The UK and the 'New Settlement'

- Agreed by the European Council, 18-19 February 2016
  - Council Decision
- Seeks to protect UK/single market interests against euro area caucusing
- Key outcome: implementing measures relating to supervision and resolution, and with respect to markets and financial institutions, are the responsibility of non-euro-area Member States and their authorities
- Particular concern with financial stability related measures, but including those relating to markets

6. The UK and the 'New Settlement'

- + acknowledgement that non-euro-area Member States can join 'common mechanisms open to their participation' in relation to supervision/financial stability – implication of future coordination for euro area
  - But 'braking mechanism' via Council and European Council, although not a veto
- → likelihood of a complex institutional ecosystem within which MiFID II will come to operate for the cross border market?
  - CMU: single market, networked supervisors, + ESMA
  - "Financial Union": some form of more centralized supervision, perhaps for systemically important market actors?

Thank You

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MiFID II and its implications for Cross-border Banking: Swiss Perspective

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Zurich, April 6, 2016

Regulatory Framework

EU

- Services: MiFID I / II, MiFIR
- Products: PRIIP, UCITS, AIFMD

Switzerland

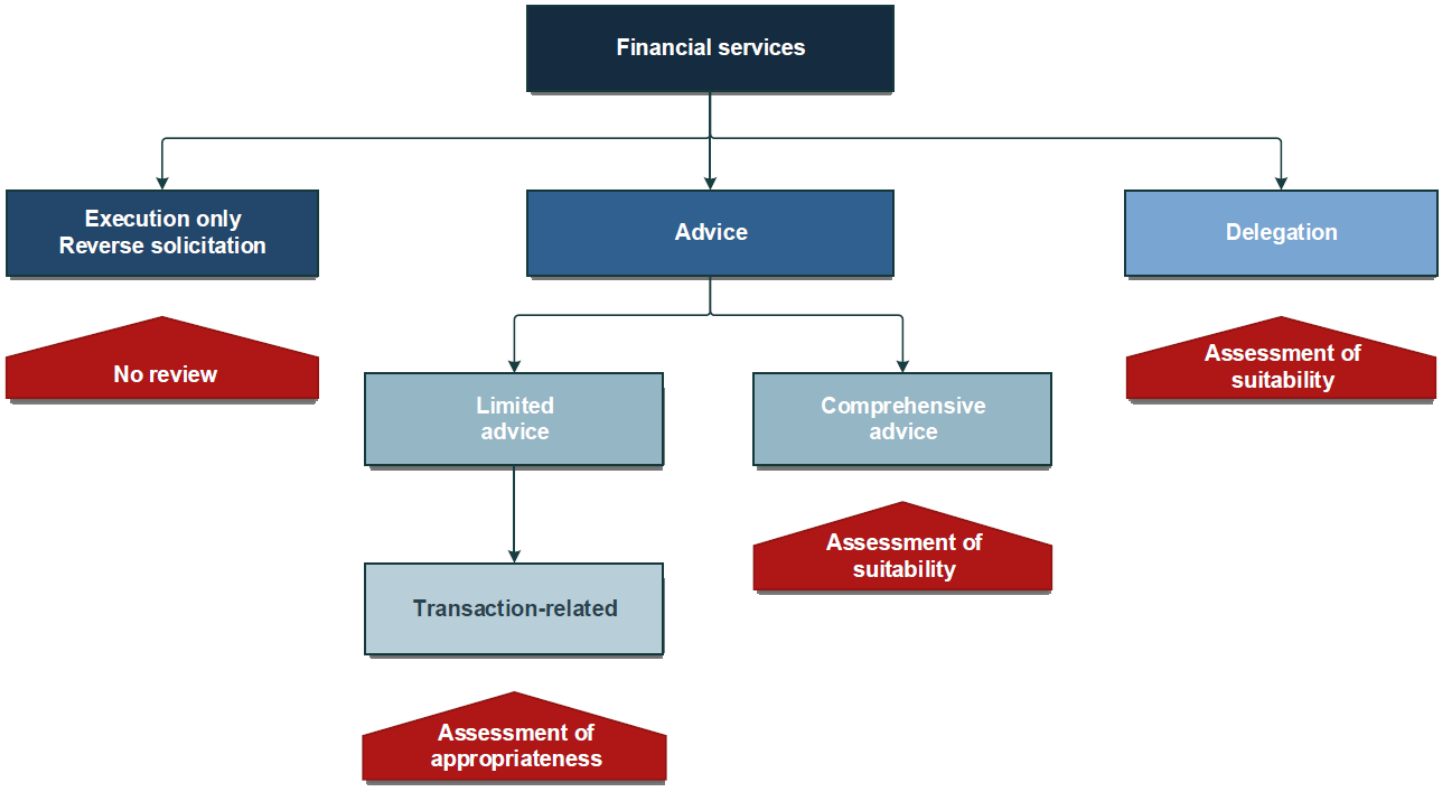
- Services: FinSA
- Products: FinSA, CISA

Main Deviations MiFID vs. FinSA (draft)

- Independent Advice
- Limited Advice (Transaction-related)
- “Complex” Products
- Product Ban
- Suitability. Risk Appetite & Tolerance?
- Dispute Resolution

Swiss Concept in FinSa (draft)

Suitability and appropriateness of financial services



Further Deviations ? (Political Decision)

Insurance Products?

Prudential Supervision of
Managers of Individual Client Assets (FinIA) ?

Uncertainty of Political Outcome

Importance of Equivalence

Client Classification

MiFID

- Eligible Counterparties
- Professional Clients
- Retail Clients

Equivalence mainly Relevant for Services Offered to Professionals