EU-Directive

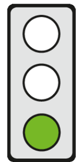
MIFID II CORONA QUICK FIX

cep**PolicyBrief** No. 2020-9

KEY ISSUES

Objective of the Directive: The Commission wants to remove administrative burdens in MiFID II rules to support Europe's recovery from the severe economic consequences of the COVID-19 pandemic.

Affected parties: Investors, investment firms, trading venues and other financial market participants.



Pro: (1) The abolition of several information requirements lowers the administrative burden for investments without significantly impairing the protection of investors.

(2) The abolition of the position limits regime except for agricultural and significant or critical commodity derivatives makes the regime more effective.

(3) The extension of the hedging exemption eliminates structural disadvantages and does not endanger the stability of the financial system.

Contra: –

Proposal: The research unbundling rule should be completely repealed. It is sufficient to require investment firms to disclose potential conflicts of interests to their clients and the costs for each service.

The most important passages in the text are indicated by a line in the margin.

CONTENT

Title

Proposal COM(2020) 280 of 24 July 2020 for a **Directive** of the European Parliament and the Council amending Directive 2014/65/EU **[MiFID II] as regards information requirements, product governance and position limits to help the recovery from the COVID-19 pandemic** and
Commission Delegated Directive (EU) …/… amending Delegated Directive (EU) 2017/593 **as regards the regime for research on small and mid-cap issuers and on fixed-income instruments** to help the recovery from the COVID-19 pandemic

If not mentioned otherwise, page and article numbers refer to the Commission proposal.

Brief Summary

- **Context and objectives**
  – The Markets in Financial Instruments Directive [MiFID II, 2014/65/EU, see cep**PolicyBrief**] establishes the EU framework for investment services and trading venues.
  – The proposed Directive amending MiFID II and the proposed amendment to the Delegated Directive contain amendments to the applicable [p. 1]
    - information requirements for investment firms, especially vis-à-vis qualifying clients,
    - requirements to separate costs on investment research and trade execution costs ("research unbundling rule"),
    - requirements on the trading of derivatives.
  – The amendments shall reduce the administrative burden for investment firms and foster the nascent derivatives markets, especially with respect to energy derivatives [p. 1].
  – The proposal is part of an EU Capital Markets Recovery Package. The package also includes amendments to
    - the Prospectus Regulation [(EU) 2017/1129, see cep**PolicyBrief**] creating a new short form „EU Recovery Prospectus" to facilitate the raising of capital in public markets [see cep**PolicyBrief**];
    - the Securitisation Regulation [(EU) 2017/2402, see cep**PolicyBrief**] and the Regulation on prudential requirements for banks concerning securitisations [(EU) No 575/2013] entailing measures to facilitate the securitisation of loans [see cep**PolicyBrief**].

- **Client categorisation in MiFID II**
  MiFID II applies to qualifying and retail clients [SWD(2020) 120, p. 12; Art. 4 No. 11 MiFID II].
  – "Qualifying clients" are
    - eligible counterparties, i.a. financial institutions, national governments and central banks and
    - professional clients, i.e. clients qualifying as eligible counterparties as well as i.a. large undertakings.
  – "Retail clients" are all clients not qualifying as professional clients.

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- **Information requirements**

  Default option for client information

  – MiFID II requires investment firms to provide information to their clients in a "durable medium", e.g. paper, e-mail, CD-ROM [Art. 4 (1) (62) MiFID II]. The default option for such information provision is on paper, except if the provision in another medium is "appropriate" with respect to the business conducted, and clients specifically opt-in for another medium [Art. 3 (1) Delegated Regulation (EU) 2017/565].

  – In future, "electronic format", instead of paper, will be the default option. Retail clients may, however, opt-in for receiving the information on paper and free of charge. [Art. 1 (2), Art. 1 (4)]

  Requirement to provide information on costs and charges

  – MiFID II requires investment firms to provide information on costs and charges – e.g. the cost of investment advice – to their clients [Art. 24 (4) MiFID II]. Information provision may, subject to certain conditions, be less comprehensive vis-à-vis qualifying clients [Art. 50 (1) Delegated Regulation (EU) 2017/565].

  – In future, the information requirements on costs and charges will no longer apply to qualifying clients, except with respect to investment advice and portfolio management services [Art. 1 (7) and Art. 1 (8)].

  – MiFID II requires investment firms to provide information on costs and charges "in good time" before the provision of investment services (ex ante) [Art. 24 (4) MiFID II].

  – In future, investment firms can, if trading is pursued via distance communication means (e.g. by phone), provide such information also "without undue delay" after the transaction (ex post). However, the client has to agree to the delay, and must be given the option to delay the transaction until receiving the information. [Art. 1 (4)]

  Cost-benefit analysis in case of switching

  – MiFID II requires investments firms to undertake an assessment of the suitability for their retail and professional clients when they provide investment advice or portfolio management services; i.a. assess whether their clients have sufficient knowledge in a specific investment field. In case such services involve the switching of financial instruments, investment firms must show that the benefits of such switching outweigh the costs. [Art. 25 (2) MiFID II; Art. 54 (11) Delegated Regulation (EU) 2017/565]

  – In future, such cost-benefit analysis in case of switching will only be required vis-à-vis retail clients. However, professional clients may opt-in to still receive the analysis. [Art. 1 (5) and (7)]

  Ex-post service and best execution reports

  – MiFID II requires investment firms to provide ex-post reports to their clients on the services they received, i.a. in the case of a 10% portfolio loss [Art. 25 (6) MiFID II; Art. 59-63 Delegated Regulation (EU) 2017/565].

  – In future, investment firms will no longer have to provide such reports to qualifying clients. However, professional clients may opt-in to still receive the reports. [Art. 1 (7)]

  – MiFID II requires trading and execution venues to periodically publish reports on the quality of execution of transactions on their venue ("best execution reports") [Art. 27 (3) MiFID II; Delegated Regulation (EU) 2017/575].

  – In the next two years, trading and execution venues will no longer have to publish such reports [Art. 1 (6)].

  Product governance requirements for corporate bonds

  – MiFID II requires investment firms to fulfil product governance requirements, i.e. rules that ensure that financial instruments fit the identified target markets of clients. They apply to all financial instruments. [Art. 24 (2) and Art. 16 (3) MiFID II]

  – In future, the product governance requirements will no longer apply to corporate bonds with "make-whole clauses" [Art. 1 (3) and (4)].

  – Make-whole clauses [Art. 1 (2)]
    - allow issuers to call bonds before maturity and, in this case,
    - protect the investors by forcing the issuers to return the principal amount of the bonds and the net present value of the coupons.

- **Unbundling of research costs and execution costs ("research unbundling rule")**

  – MiFID II requires investment firms to unbundle research costs from costs for the execution of orders ("research unbundling rule"). If they want to use research offered by third parties, they have to pay for it [Art. 24 (13) MiFID II; Art. 13 Delegated Directive (EU) 2017/593]
    - out of their own resources, or
    - from a separate research payment account funded by a research charge paid by their investing clients.

  – In future, investment firms will be able to opt-out from these requirements, if the research is provided on [Art. 1, Delegated Directive (EU) …/… amending Delegated Directive (EU) 2017/593]
    - issuers with a market capitalisation of less than 1 billion euros in the last 12 months, or
    - fixed income instruments.

  – In case investment firms make use of said opt-out, they will be able to pay for research and execution services jointly. However, investment firms and research providers must agree on the height of the payments attributable to research. Investment firms must inform their clients about the joint payment. [Art. 1, Delegated Directive (EU) …/… amending Delegated Directive (EU) 2017/593]

- **Requirements for the trading of derivatives**
  Position limits for commodity derivatives
  – MiFID II enables position limits on the size of the net position an individual actor may hold in commodity derivatives that are traded on trading venues or in equivalent over the counter contracts [Art. 57 (1) MiFID II].
  – In future, position limits will apply, instead of to commodity derivatives in general, only to agricultural commodity derivatives and critical or significant commodity derivatives [Art. 1 (9)]:
    - The European Securities and Markets Authority (ESMA) must specify those derivatives in regulatory technical standards (RTS) [Art. 1 (9)].
    - When specifying critical or significant commodity derivatives, ESMA has to consider the number of market participants, the underlying commodity and the size of open interest [Art. 1 (9)].

  No position limits for derivative positions that reduce risks ("hedging exemption")
  – MiFID II specifies that position limits do not apply to derivative positions held by, or on behalf of, non-financial entities that reduce risks relating to their commercial activities ("hedging exemption") [Art. 57 (1) MiFID II].
  – In future, the non-application of position limits for derivatives held by, or on behalf of, non-financial entities that reduce risks relating to their commercial activities will be extended to derivatives held by, or on behalf of, financial entities that are part of a non-financial group and reduce risks of commercial activities of the non-financial entities of the group [Art. 1 (9)].

  Ancillary activity test
  – MiFID II does not require market actors to be authorised as investment firms, when [Art. 2 (1) (j) MiFID II]
    - they trade professionally in commodity derivatives or in emission allowances or derivatives of these, and
    - this trade is ancillary to their main business, considered at a group level.
  – Market actors must annually notify their competent authority that they make use of the exemption [Art. 2 (1) (j) MiFID II]. A regulatory technical standard sets out, based on two quantitative tests, the criteria for when a trading activity is considered ancillary [Art. 2 (4) MiFID II; Delegated Regulation (EU) 2017/592].
  – In future, market actors will no longer be required to notify that they make use of the exemption. Furthermore, ancillarity will be determined only qualitatively. The quantitative tests will no longer apply. [Art. 1 (1)]

Statement on Subsidiarity by the Commission

According to the Commission, financial markets are cross-border in nature. Thus, the rules for market actors need to be common across borders as well. National measures would lead to market fragmentation, regulatory arbitrage and competition distortions.

Legislative Procedure

24.07.2020 Adoption by the Commission
Open Adoption by the European Parliament and the Council, publication in the Official Journal of the European Union, entry into force

Options for Influencing the Political Process

Directorates General: Financial Stability, Financial Services and Capital Markets Union
Committees of the European Parliament: Economic and Monetary Affairs (leading), Rapporteur: Markus Ferber (EPP)
Federal Germany Ministries: Finance
Committees of the German Bundestag: Finance
Decision-making mode in the Council: Qualified majority (acceptance by 55% of Member States which make up 65% of the EU population)

Formalities

Competence: Art. 53 (1) TFEU (Freedom of Establishment)
Type of legislative competence: Shared competence (Art. 4 (2) TFEU)
Procedure: Art. 294 TFEU (ordinary legislative procedure)

ASSESSMENT

Economic impact assessment

The proposed **measures to lift a number of information requirements** are to be welcomed entirely as they **lower the administrative burden for investments without significantly impairing the protection of investors**:
First, providing information only in electronic format saves costs, lowers environmental damage and is appropriate in an increasingly digitalised economy.
Second, while information on costs and charges is crucial to make informed investment decisions, qualifying clients are usually capable of negotiating contract conditions individually with financial services providers. Thus, they are – as

opposed to retail clients – regularly not dependant on being protected by standardised costs and charges information requirements. In this spirit, the Commission should consider extending the exemption also to investment advice and portfolio management services or at least provide for opt-out options for qualifying investors.

Third, giving clients of investment firms the option to receive costs and charges information also ex post in case of trading via distance communication means ensures that orders can be processed faster, which also lowers the risk for adverse price changes between information provision and order execution. Applying the option to any client type ensures equal treatment in trading. And, as clients still have the right for ex-ante provision of information, investor protection is appropriately warranted.

Fourth, lifting the product governance provisions with respect to corporate bonds with make-whole clauses reduces costs for their issuers without substantial detriment to investor protection. Such bonds are regularly simply structured, do not change their pattern and are easily understandable also for retail clients. In contrast to the current (now planned to be changed) classification within the PRIIP Regulation [(EU) No 1286/2014, see cep**PolicyBrief**], such bonds are often non-complex. Furthermore, important safeguards in MIFID II – the suitability and the appropriateness tests – will remain in place, thus ensuring investor protection. As the proposed lifting of requirements now solely affects corporate bonds with make-whole clauses, the Commission should, in due time, thoroughly assess again, which products should be deemed complex or non-complex, in order to avoid distortions of competition among financial products and their issuers.

The "research unbundling rule" should be repealed completely. The alleviations envisaged for issuers with a market capitalisation of less than 1 billion euros in the last 12 months and for fixed income instruments should be extended to all issuers and instruments. **It is sufficient to require investment firms to disclose potential conflicts of interests to their clients** inherent to such bundling **and the costs for each service.** As a result, clients can decide independently which payment method they prefer. What is more, repealing the unbundling rule only for small issuers and fixed income instruments – that indisputably have suffered most from the unbundling rule in recent years as research on them declined – risks creating new distortions of competition among issuers and financial instruments.

MiFID II established position limits on the trading of commodity derivatives in order to tackle market abuse and to contribute to a more efficient pricing of the commodities underlying the derivatives, e.g. oil, metals, wheat. However, these targets could not be achieved, especially in markets for less significant and non-critical commodity derivatives. Instead, said limits established a barrier for some derivative markets to grow, in particular, in the energy sector, which also inhibited their liquidity. **The abolition of the position limits regime except for agricultural and significant or critical commodity derivatives makes the regime more effective.**

The possibility for non-financial entities to apply for a hedging exemption has been and still is appropriate insofar as the derivatives trading of these entities poses no systemic threats to the wider financial system. It, however, leads to a discrimination of non-financial entities part of a group that established financial entities for the sole purpose of hedging risks with respect to their commercial activities. **The** envisaged **extension of the hedging exemption** to those financial entities rightly **eliminates** these **structural disadvantages and**, as it is limited to the hedging of the activities of non-financial group**, does not endangers the stability of the financial system.**

Legal assessment

Legislative Competence of the EU

The Directive is rightly based on Art. 53 (1) TFEU concerning the taking-up and pursuit of self-employed activities, the same legal basis as MiFID II, as it harmonises national provisions regarding investment activities.

Subsidiarity and Proportionality with respect to Member States

Unproblematic.

Compatibility with EU Law in other Respects

Unproblematic.

Conclusion

The measures to lift a number of information requirements lower the administrative burden for investments without significantly impairing the protection of investors. The research unbundling rule should be completely repealed. It is sufficient to require investment firms to disclose potential conflicts of interests to their clients and the costs for each service. Limiting the position limits regime to agricultural and significant or critical commodity derivatives makes the regime more effective. The extension of the hedging exemption eliminates structural disadvantages and does not endangers the stability of the financial system.

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