

An excess of ambition

European legislators' desire to reform financial regulation through Mifid II has outpaced their ability to design and implement rules

In the immediate aftermath of the financial crisis, the European Commission (EC) launched a consultation on its proposed reforms of the Markets in Financial Instruments Directive (Mifid). Those reforms were intended to address significant weaknesses that the crisis had exposed in the European regulatory framework. The directive and separate regulation that evolved from that consultation paper fundamentally revise Mifid and are collectively known as Mifid II. The reforms set out in Mifid II are extensive and ambitious. The timetable for implementation was also ambitious; in fact – as a result of a long and convoluted legislative process – it has proven to be too ambitious. Mifid II itself requires that its rules should become effective within individual EU member states from January 2017. However, it now appears that an implementation delay of some kind is inevitable; at the time of writing, a wholesale delay of one year appears the most likely outcome. But until the precise form and length of any postponement is confirmed, national regulators and market participants remain in a state of limbo. They know that they should be making preparations for a set of rules to be implemented in less than a year, yet they are hoping and expecting European legislators will recognise that delays in their rulemaking process (and the fact that the detailed rules remain incomplete) make timely and effective implementation impossible.

Level 1/level 2 legislative progression

Already, Mifid II's legislative process has been long and arduous. Following separate consultations conducted by the EC and Committee of European Securities Regulators (CESR), the EC published its proposal for Mifid II on October 20 2011. What followed was a series of intense dialogues between the Council of the European Union (Council) and EC, with political agreement only being reached on January 14 2014 – some two years after the

publication of the EC's initial proposal.

The finalised legislative texts were published in the Official Journal of the EU on June 12 2014. But the rulemaking process is not complete. With the technical advice of the European Securities and Markets Authority (Esma) which has in the intervening period replaced CESR, the EC is due to promulgate delegated acts containing detailed rules necessary to put into effect certain principles set out in Mifid II. Simultaneously, Esma has been tasked with drafting technical standards that will define the exact approach required of firms to comply with the directive. The delegated acts and technical standards are together referred to as the Mifid II level 2 legislation. This level 2 legislation will then itself be supplemented by level 3 guidance intended to ensure uniform interpretation and application across the EU's 28 member states.

In the original timeline envisaged by European legislators, the majority of Mifid II level 2 legislation was to be finalised by January 2016. This allowed a six month period for member states to implement (to the extent necessary) the requisite Mifid II requirements at national level, and gave affected firms a further six months to prepare for compliance with the new requirements.

Esma published reports on a number of draft technical standards throughout 2015. These included standards relating to authorisation, passporting, registration of third country firms and co-operation between competent authorities (published in June), and transparency, market microstructure, data publication and access, requirements applying on and to trading venues, commodity derivatives, market data reporting, post-trading and best execution (September). But it did not publish its last and most substantial report until December 2015. That final report included draft technical standards relating to:

- standard forms, templates and procedures for cooperation arrangements in respect of a trading venue whose operations are of substantial importance in a host

member state;

- format and timing of communications relating to the suspension and removal of financial instruments from trading on a regulated market (RM), multilateral trading facility (MTF) or organised trading facility (OTF);
- standard forms, templates and procedures for the authorisation of data reporting services providers;
- position reporting;
- format and timing of weekly position reports;
- standard forms, templates and procedures for competent authorities to cooperate in supervisory activities, on-site verifications, and investigations and for the exchange of information;
- standard forms, templates and procedures for the consultation of other competent authorities before granting an authorisation; and
- procedures and forms for submitting information on sanctions and measures.

Effective implementation of (and preparation for compliance with) Mifid II is impossible until these measures are agreed and finalised.

The EC has three months to indicate if it will endorse the relevant draft technical standards from the date of the final report's publication. Even assuming they are endorsed by the Commission (which experience shows should not be taken for granted), the European Parliament and Council then have between one and six months to exercise their right of objection. Only once all these hurdles are cleared can the draft technical standards be considered finalised and come into force. Therefore, while Esma has finally published its drafts, the final outcome may not be known until October 2016 or later.

Need for implementation delay

As a result of its delay in finalising the technical standards, Esma had been hinting for a number of months that it will be necessary to postpone the implementation of Mifid II. On November 10 2015 its chairman Steven Maijoor noted in a speech that the timing for both stakeholders and regulators to implement the rules and build necessary IT systems is extremely tight, and that there were a few areas where the timetable was already unfeasible. For that reason, he explained, Esma had already raised with the EC whether uncertainty around the level 2 rules would need a legislative response by delaying certain parts of Mifid II.

A couple of weeks after this speech, Esma published a note (dated October 2 2015)

which identified the possible delays in the expected applicability of certain Mifid II provisions, especially those relating to the development of IT systems (by both regulators and market participants) that need to interact with each other. It also explained why those delays were hard to eliminate or manage, and set out possible alternatives for tackling them in a coordinated EU manner. In particular, Esma highlighted the technical challenges relating to what it described as one of the ‘cornerstones’ of Mifid II – the collection of reference data (for example, in respect of a particular security, its ISIN, instrument classification and relevant competent authority) – as well as transaction reporting, transparency parameters and publication, and position reporting.

There is no certainty as to the legal form or duration of any postponement

Reference datasets are particularly important as other data systems cross-refer or are otherwise dependent upon them. Esma noted that, while reference data exists for shares and bonds admitted to trading on regulated markets, the extension of Mifid II to include securities (including derivatives) traded on regulated markets, MTFs and OTFs de facto required a brand new system – calling for the development of new IT for trading venues, national regulators and the regulator itself. Esma predicts that these systems will not be operational before the third quarter of 2017. Implementation of the transaction reporting requirements is also foreseen to be particularly burdensome but of great importance, since the reports provide essential core data used for market abuse surveillance purposes. While transaction reporting is already required under Mifid, Esma notes that expanding the set of information reportable for a given transaction and the full harmonisation of the content and format of the reports collected across the EU will be additional challenges which, Esma suspects in most instances, will require further time to design new data systems.

Esma also foresaw complications arising from the extended scope of financial instruments subject to pre- and post-trade transparency obligations, as well as the need for it to calculate new thresholds and other determinations integral to the

transparency obligations and related waivers (such as those required for the double-volume cap mechanism).

Lastly in the note, Esma recognised the need for national regulators to be given sufficient time to implement new commodity derivative position reporting systems, since the requirement for market participants to commodity derivative position report was not part of Mifid.

As a result of these practical implementation challenges, Esma argued it was necessary to postpone implementation of Mifid II to enable national regulators and Esma to finalise the business requirements and develop, programme, test and deploy the systems needed for Mifid II implementation. In fact, Esma noted that in the case of the most complex systems, even a 15 month timeframe may be too short. It accepted that those market participants that will need to feed into those systems are facing similar challenges and would also need additional time.

Esma proposed four key principles to determine how any postponement should be determined:

- affected parties should be provided with legal certainty as early as possible;
- the length of the postponement should be minimised to the greatest extent possible;
- further re-adjustments or postponements to the implementation deadline should be avoided; and
- the final implementation dates should maximise the possibility of a simultaneous launch of Mifid II across all markets and member states.

Based on these four key principles Esma listed a number of options to effect the delay, for national regulators, the EC and European legislators to jointly consider. The options include a so-called level 1 fix whereby the implementation date for the whole of Mifid II is directly amended within the Mifid II text; a level 2 fix where the technical standards and Commission delegated regulations are amended to postpone the applicability of the relevant requirements; and a level 3 fix in which all the national regulators agree to postpone the implementation date beyond that contained in Mifid II level 1 and level 2 legislation. Esma noted that its board and relevant committees have discussed the implementation delay options, and that the strong preference is for a level 1 solution since it appears the best option for legal certainty and synchronicity.

The European Parliament subsequently published a press release on November 27 2015 setting out its position on a potential implementation delay. On the same day it published a letter to the EC, in which the European Parliament’s Mifid II negotiation team informed the EC that it is prepared to accept a one-year, wholesale delay to the implementation (moving the implementation date for the whole of Mifid II to January 3 2018). However, the European Parliament stated that it would only support the deferral subject to: the EC adopting the level 2 measures required under Mifid II as soon as possible, and the EC regularly reporting to the European Parliament on the progress towards implementation, including timelines and key milestones – all of which appear reasonable and achievable by the EC.

Market impact

Although Esma, the Commission and the European Parliament have all acknowledged to some degree that a delay is necessary, this has yet to be formally confirmed and there is no certainty as to the legal form or duration of any postponement. In the meantime, national regulators and market participants are in a difficult position; as it stands, the law states the rules of Mifid II will come into effect on January 17 next year. Responsible financial services firms (let alone regulators) would, by now, like to be at a stage of advanced preparation given the rules are due to take effect within such a short timeframe, and they will significant impact how their businesses operate. However, today, effective preparation is impossible. Further, executives will be rightly reluctant to commit significant financial and human resources to a compliance project with such an uncertain scope and timeframe.

Over-ambition

The underlying purpose of the Mifid II reforms was well-founded and good intentioned. But the ability of European legislators to design and implement rules has, once again, been outpaced by their regulatory ambitions. The industry knows what view a regulator would take of a firm’s failure to adapt its processes and systems to reflect new law in a timely way. It is surely appropriate that the industry, national regulators and legislators themselves take the same view of the failure to establish and adhere to a considered and reasonable implementation timetable.

By Akin Gump Strauss Hauer & Feld partner Christopher Leonard and associate Chris Poon in London

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