International
Capital
Market
Association

Briefing note

ESMA Q&A updates on MiFID II / MiFIR transparency and investor protection

published on 3 October 2017

The European Securities and Markets Authority (ESMA) has published on 3 October further Q&A updates with respect to transparency and investor protection. Topics include pre- and post-trade transparency requirements for trading venues and systematic internalisers, deferrals, package orders, best execution on OTFs, order record keeping requirements, information on costs and charges, and client categorisation. Below is an executive summary of selected key points followed by a summary of relevant clarifications provided by ESMA.

Executive summary:

Transparency:

- **Trading venues are responsible for designing their RFQ systems in compliance** with the pre-trade transparency requirements. Arrangements may differ, but **indications of interest have to be disclosed no later than when they become actionable**, and, in any case **before the conclusion of a transaction**.
- **Real-time post-trade transparency requirements apply equally to trading venues and systematic internalisers.**
- The **deferral regime applicable to OTC trades is determined** by the deferral regime applicable in the Member State **where the investment firm** that has to make the transaction public **is established**. The location of the APA through which a transaction is made public is not relevant.
- National regulators can, in conjunction with an authorisation for deferred publication, request the publication of several transactions in aggregated form during the time period of deferral. This only applies where a minimum number of 5 transactions have been executed on the same day.
- **ESMA expects trading venues and market participants trading packages to document how the *requirement of meaningful economic and financial risk related to all the other components* (mefrroc) is met**.
- Package orders/transactions have to be exclusively composed of non-equity instruments.

Systematic internalisers:

- **For pre-trade transparency obligations to apply at package order level […] an investment firm must be a systematic internaliser (SI) in all financial instrument components of the order.**
- If it is an SI for some components only, the investment firm can decide either to provide a firm quote for the whole package or only for the components for which it is an SI.

- **Transactions in a non-equity instrument that take place *outside a trading venue* during the *normal trading hours* of the trading venues trading that instrument should be published as close to real-time as possible**.
- Where an investment firm passes the relevant thresholds in a bond it will be considered to be a systematic internaliser in all bonds belonging to the same class of bonds [ie sovereign bond, other public bond, convertible bond, covered bond, corporate bond, other bond]. **The debt seniority of a bond does not constitute a different class.**
- For the purpose of the SI determination, **ESMA considers that in all circumstances where an investment firm is dealing with a counterparty that is not a financial institution** authorised or regulated under Union law or under the national law of a Member State ('financial institution'), **the investment firm is deemed to be executing a client order and the transaction should count towards the calculations**.
- Where the investment firm is dealing with a financial institution, **investment firms need to assess which of the two parties to the transactions acts in the capacity of executing client orders**. Investment firms may determine this either on a **transaction by transaction basis** or by **type of transactions or type of counterparties**.
- In terms of restricting access to quotes, the SI's commercial policy should determine meaningful categories of clients to which quotes are made available, based on non-discriminatory criteria taking into consideration the counterparty risk, or the final settlement of the transaction.
- **Systematic internalisers may limit the number of transactions they undertake to enter into with clients to one transaction. However, they should make these limits public and provide a justification.**

Best execution:

- The operator of an OTF should be implementing its own best execution policy when executing orders from third-party brokers. The broker should determine that the OTF it selects allows it to comply with its best execution obligations towards its own clients.

Information on costs and charges:

- **Investment firms shall use actually incurred costs as a proxy when calculating expected costs and charges** on an **ex-ante basis**. Where data on actually incurred transaction costs are not available, the investment firm shall make reasonable estimations of these costs.
- The price of a position of the firm […] should be understood as the current (fair market) value of the financial instrument held by the firm when the firm offers the instrument to the client (ex-ante) or when it sells it to the client (ex-post).
- **Mark-ups and structuring costs that are embedded in the transaction price need to be identified and disclosed to clients by the investment firm** by calculating the difference between the price of the position for the firm and the price for the client.

Client categorisation:

- Firms only have to notify information on their categorisation to new clients and clients whose categorisation has changed under MiFID II.

1) MiFID II and MiFIR transparency topics

General Q&As on transparency topics [Section 2]:

(i) When should the operator of an RFQ system provide pre-trade transparency? [Question 7]

a) **Trading venues are responsible for designing their RFQ systems in compliance with the pre-trade transparency requirements** defined in MiFIR and specified in Annex I of RTS 1 and RTS 2. The **arrangements used may differ** depending on the approach chosen by individual trading venues. Such approaches might include arrangements where trading interests become executable after a pre-defined period of time but would, in any circumstances, require the **indications of interest to be disclosed no later than when they become actionable and in any case before the conclusion of a transaction.**

b) The disclosure of the pre-trade quotes or actionable indications of interest only at the time of execution would <u>not</u> be consistent with the obligations set in Annex I of RTS 1 and 2.

(ii) Do real time post-trade transparency requirements apply equally to trading venues and systematic internalisers? [Question 8]

a) Yes, **the requirements in Articles 6 and 10 of MiFIR as further specified in Article 14 of RTS 1 and Article 7 of RTS 2 apply to both trading venues and investment firms.** ESMA expects that trading venues and investment firms, in particular systematic internalisers, that use expedient systems publish transactions as close to real time as technically possible.

b) In particular, since systematic internalisers are competing with trading venues over customers' order flow, it is important to provide for a level playing field. Therefore, trading venues and systematic internalisers using similar technology and systems should process transactions for post-trade publication at the same speed.

<u>Non-equity transparency [Section 4]:</u>

(iii) Which deferral regime applies to investment firms trading OTC? [Question 2]

a) The **deferral regime applicable to OTC trades is determined** by the deferral regime applicable in the Member State **where the investment firm that has to make the transaction public is established**.

b) **The location of the APA through which a transaction is made public is not relevant.** Where it is for an EU branch to make a transaction public, the deferral regime applicable in the Member State where that branch is located should apply.

(iv) Is it relevant in what Member State the relevant instrument is traded or admitted to trading on a trading venue? [related to Question 2]

c) No, for OTC transactions only the deferral regime applicable to the investment firm that has to make a transaction public is relevant.

(v) Publication of transactions in aggregated form (Article 11(3)(a) of MiFIR, Article 11(1)(a)(ii) of RTS 2): What happens if there are less than five transactions executed on the same day? Does this imply that no publication has to be made**? [Question 3]**

a) Article 11(3)(a) of MiFIR allows NCAs to request, in conjunction with an authorisation for deferred publication, the publication of several transactions in aggregated form during the time period of deferral.

b) This requirement is further specified in Article 11(1)(a)(ii) of RTS 2 which requires that, where NCAs make use of this supplementary deferral requirement, **transactions should be published in an aggregated form where a minimum number of 5 transactions have been executed on the same day.** Therefore, **in case less than five transactions were executed on the same day, no details of those transactions in an aggregated form have to be made public.**

(vi) How is the requirement for a package order/transaction that ‘Each component of the transactions bears meaningful economic or financial risk related to all the other components’ to be interpreted? [Question 4]

a) **The requirement of meaningful economic and financial risk related to all the other components (mefrroc)** aims at ensuring that only components that are economically and financially related can constitute a package order/transaction, and to avoid that components that are not economically or financially related in a meaningful manner are declared as a package order/transaction with the main objective of benefitting from the transparency regime for package orders/transactions.

b) **ESMA expects trading venues and market participants trading packages to document how the meffroc requirement is met**, either in the contract specifications for packages traded on trading venues or on a package-by-package basis in case of OTC-transactions.

(vii) Can package orders/transactions also include equity instruments? If yes, how is pre- and post-trade transparency applied? [related to Question 4]

c) **No they cannot. Package orders/transactions have to be exclusively composed of non-equity instruments.** The waivers/deferrals for packages are available under Articles 9 and 11 of MiFIR, which cover only non-equity instruments.

(viii) When does an investment firm apply the systematic internaliser obligations on a package order level? [related to Question 4]

d) **For pre-trade transparency obligations** to apply at package order level, including for an exchange for physical, **an investment firm must be a systematic internaliser in all financial instrument components of the order**.

e) Where an investment firm is prompted for a quote for a package order for which it is a systematic internaliser only for some components, **the investment firm can decide either to provide a firm quote for the whole package or only for the components for which it is a systematic internaliser**.

(ix) What are normal trading hours for non-equity instruments? Are investment firms allowed to postpone publication of transactions until the opening of the next trading day in respect of trades in non-equity instruments taking place outside of normal trading hours? [Question 5]

a) Normal trading hours for non-equity instruments should be set on basis of the daily trading hours of trading venues trading non-equity instruments. Normal trading hours may therefore be different for different (classes of) non-equity instruments.

b) Transactions that take place on a given trading venue should be made public as close to real-time as possible. **Transactions in a non-equity instrument that take place outside a trading venue during the normal trading hours** of the trading venues trading that instrument **should be published as close to real-time as possible**.

c) Where more than one trading venue trades that instrument, investment firms/APAs are expected to check whether the transaction took place within the daily trading hours of any of those trading venues.

d) Transactions that take place outside the daily trading hours of trading venues trading that instrument should be made public before the opening of trading on those trading venues on the next trading day.

<u>The systematic internaliser regime [Section 7]:</u>

(x) On which level is the **systematic internaliser threshold** to be calculated **for derivatives**? On a sub-class level or on a more granular level? [Question 4]

a) **The calculation should be performed at the most granular class level as identified in RTS 2**. Where an investment firm meets the thresholds for such a class, it should be considered as a systematic internaliser for all derivatives within that most granular class. In particular, both the numerator and the denominator should refer to the same class of derivatives. […]

(xi) What constitutes a 'class of bonds' under Article 13 of Commission Delegated Regulation (EU) No 2017/56516? Do senior, subordinated or convertible bonds from the same issuer constitute different classes? [related to Question 4]

b) A class of bonds issued by the same entity, or by any entity within the same group is a subset of a class of bonds in table 2.2 of Annex III of RTS 2 (sovereign bond, other public bond, convertible bond, covered bond, corporate bond, other bond). Hence, **where an investment firm passes the relevant thresholds in a bond it will be considered to be a systematic internaliser in all bonds belonging to the same class of bonds** according to table 2.2. of Annex III of RTS 2 issued by the same entity, or by any entity within the same group.

c) It is therefore possible to distinguish between, for instance, corporate bonds and convertible bonds as different classes of bonds, but **the debt seniority of a bond does not constitute a different class**.

(xii) For the purpose of the SI determination, when should an investment firm be considered as "executing client orders" when dealing on own account outside of trading venues? [Question 7]

a) For the purposes of the SIs' determination, ESMA considers that in all circumstances **where an investment firm is dealing with a counterparty that is not a financial institution authorised or regulated under Union law or under the national law** of a Member State ('financial institution'), the investment firm is **deemed to be executing a client order and the transaction should count towards the calculations** (both the numerator and the denominator).

b) **Where the investment firm is dealing with a financial institution**, ESMA considers that one party to the transaction will always act in a client capacity. Therefore, in order to determine when an investment firm is "executing client orders" when dealing on own account outside of trading venues, **investment firms need to assess which of the two parties to the transactions acts in the capacity of executing client orders**.

c) **Investment firms may determine this either on a transaction by transaction basis or by type of transactions or type of counterparties**. Different indicators could be used for determining which party executed a client order: e.g. whether an investment firm has classified the counterparty as a professional client, who initiated the trade or who received the instruction to deal and the extent to which the counterparty relied on the other party to conclude the transaction.

(xiii) What are the limitations to the commercial policy for restricting access to quotes in accordance with Article 18(5) of MiFIR? [Question 8]

a) The commercial policy needs to be set out and made available to clients in advance. **The commercial policy should determine meaningful categories of clients to which quotes are made available.** Systematic internalisers should only be able to group clients based on non-discriminatory criteria taking into consideration the counterparty risk, or the final settlement of the transaction.

b) Furthermore, a number of provisions safeguard the ability of the systematic internaliser to properly manage risk. For example, a systematic internaliser may update its quotes at any time

(Article 18(3) of MiFIR) and can limit the number of transactions they undertake to enter into with clients pursuant any given quote (Article 18(7) of MiFIR).

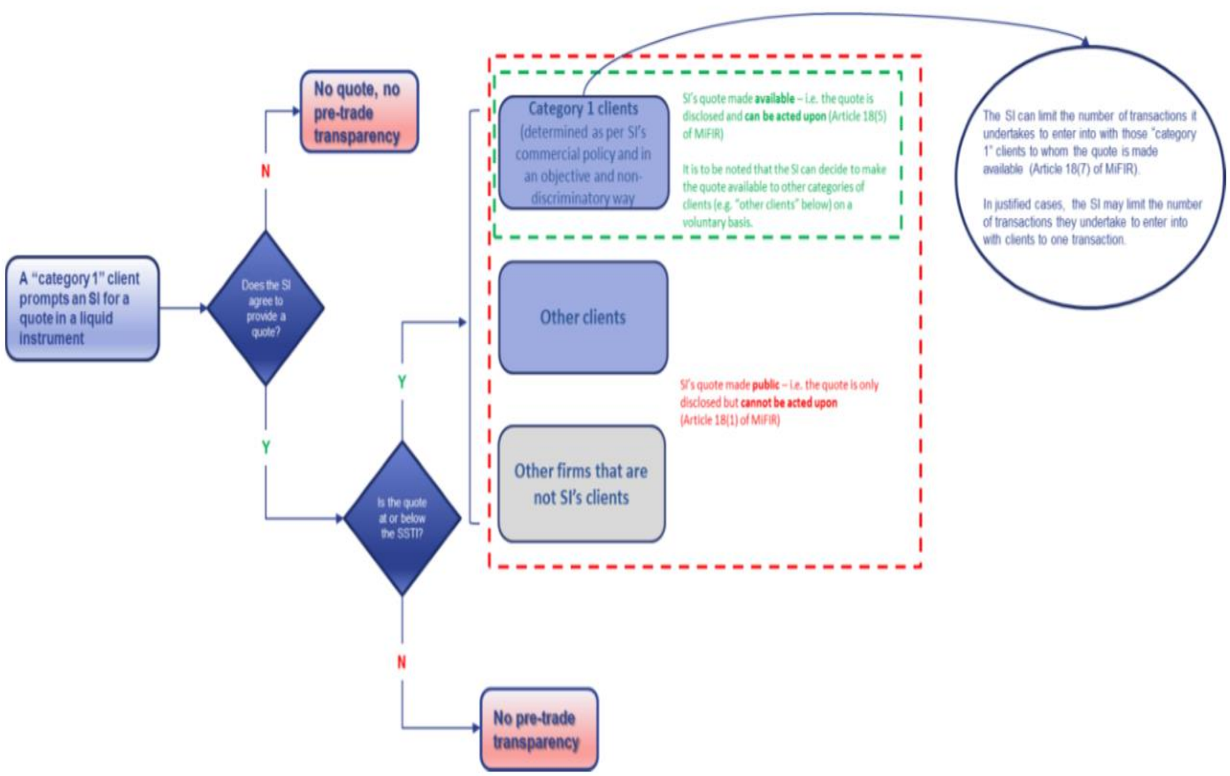
(xiv) Are systematic internalisers allowed to limit the number of transactions they undertake to enter into with clients pursuant to any given quote under Article 18(7) of MiFIR to one transaction? [Question 9]

> **MiFIR – Article 18(7):**
> Systematic internalisers shall be allowed to establish non-discriminatory and transparent limits on the number of transactions they undertake to enter into with clients pursuant to any given quote.

a) Yes, **Systematic internalisers may limit the number of transactions they undertake to enter into with clients to one transaction**.

b) As a minimum the quote provided to a client following the request for such a quote should be potentially executable by any other clients where for example the requesting client has decided not to trade against it (or to execute only part of it).

c) In any case, should SIs decide to establish non-discriminatory and transparent limits on the number of transactions they undertake to enter into with clients, **they should make these limits public and provide a justification.**



Source: ESMA
https://www.esma.europa.eu/sites/default/files/library/esma70-872942901-35_qas_transparency_issues.pdf, p. 43

2) MiFID II and MiFIR investor protection and intermediaries topics

Best execution [Section 1]:

(i) How do the OTF best execution obligations apply when third-party brokers are clients of the OTF […]? [Question 16]

a) When an investment firm or a market operator operating an OTF receives orders or indications of interest from a broker acting on behalf of its own clients, **the operator of the OTF should be implementing its own best execution policy when executing the order from the broker** as it owes its user clients (the broker) the duty of best execution.

b) **The broker should determine that the OTF it selects allows it to comply with its best execution obligations towards its own clients**. To that end, the broker should conduct a performance assessment of the OTF including how discretion is exercised

Recording of telephone conversations and electronic communications [Section 3]:

(ii) What is the applicable scope of the record keeping requirements set out in Article 16(7) of MiFID II in terms of products and services? [Question 13]

a) The requirements set out in Article 16(7) of MiFID II and the related Article 76 of the MiFID II Delegated Regulation[1] apply "at least" to the **provision of services (1) ie Reception and transmission of orders in relation to one or more financial instruments, (2) ie Execution of orders on behalf of clients; and (3) ie Dealing on own account**; included in Annex I, Section A of MiFID II.

b) Article 16(7) only requires the recording of communications in relation to the client order services mentioned above. However, the second subparagraph of Article 16(7) **also** requires those conversations and **communications that are "intended to result in" the provision of these services to be recorded**.

c) In practice, other investment services like investment advice (paragraph (5) of Annex I, Section A) may be provided at the point when there is an intention to provide a client order services. **In this case, the content of the advisory service would need to be recorded**, as it would de facto be in scope of Article 16(7) of MiFID II.

d) ESMA notes that Members States may also decide to extend the requirements further to other MiFID services, or non-MiFID services and products.

> **MiFID II - Article 16 [Organisational requirements] (7)**
>
> Records shall include the recording of telephone conversations or electronic communications relating to, at least, transactions concluded when dealing on own account and the provision of client order services that relate to the reception, transmission and execution of client orders. […]
>
> **MiFID II Delegated Regulation 2017/565 of 25 April 2016 – Article 76** [Recording of telephone conversations or electronic communications].
>
> *Note: This article provides a greater level of details complementing the abovementioned Article 16(7) of MiFID II.*

[1] Commission Delegated Regulation (EU) 2017/565 of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive (Text with EEA relevance.)

Post-sale reporting [Section 8]:

> **MiFID II Delegated Regulation 2017/565 of 25 April 2016 -**
> **Article 62** [Additional reporting obligations for portfolio management or contingent liability transactions]
>
> (2) **Investment firms that hold a retail client account** that includes **positions in leveraged financial instruments** or **contingent liability transactions** shall inform the client, where the initial value of each instrument depreciates by 10 % and thereafter at multiples of 10 %. Reporting under this paragraph should be on an instrument-by-instrument basis, unless otherwise agreed with the client, and shall take place no later than the end of the business day in which the threshold is exceeded or, in a case where the threshold is exceeded on a non-business day, the close of the next business day.

(iii) Article 62(2) of the MiFID II Delegated Regulation[2] states "…Reporting under this paragraph should be on an instrument-by-instrument basis, unless otherwise agreed with the client…What kind of flexibility could be allowed by such an agreement with clients? [Question 8]

a) Under Article 62(2) the MiFID II Delegated Regulation, **investment firms should have the possibility to agree with their clients on the possibility to assess the 10 % depreciation on an aggregated basis,** for example:

- on the overall value of the portfolio, as required under Article 62(1) the MiFID II Delegated Regulation;
- on the global value of all leveraged financial instruments or contingent liability transactions in the client's portfolio.

b) In any case, **the client should give his/her express consent to assess the 10% depreciation on an aggregated basis** and the client should have the capacity to terminate it at any time.

(iv) When reporting to clients information required under Articles 62(1) and 62(2) of the MiFID II Delegated Regulation, **can firms agree with clients** to assess the depreciation of the overall value of the client's portfolio, or of leveraged financial instruments or contingent liability transactions included in a client's account, **on a threshold higher than the "10%** and thereafter at multiples of 10%"? [Question 9]

a) **No.** The requirements set out in Article 62 of the MiFID II Delegated Regulation do not allow firms to agree with clients to assess the depreciation on a threshold higher (e.g. 15%) than that set out in Article 62 of the MiFID II Delegated Regulation.

Information on costs and charges [Section 9]:

(v) Which methodology should an investment firm use when calculating the 'costs related to transactions initiated in the course of the provision of an investment service' **for its ex-ante cost disclosure**? **[Question 15]**

a) Based on article 50(8) of the MiFID II Delegated Regulation, **investment firms shall use actually incurred costs as a proxy when calculating expected costs and charges** on an **ex-ante** basis. Firms should ensure themselves that the incurred costs are a representative proxy for future costs, taking into account any changes that are expected to have a material impact on the transaction related costs and charges, for instance changes in broker tariff structures or significant changes in market liquidity that will affect transaction costs on an ongoing basis.

b) **Where data on actually incurred transaction costs are not available, the investment firm shall make reasonable estimations of these costs**, provided that it identifies all expected transaction costs associated with the transaction, and that it clearly discloses to clients the basis on which transaction costs have been estimated. Firms may for instance use the method provided for in paragraphs 21 to 23 of the Annex VI of the PRIIPs RTS.

[2] Ibid.

c) In accordance with Article 50(8) of the MiFID II Delegated Regulation, investment firms are also required to review ex-ante assumptions based on ex-post experience and make adjustment to these assumptions where necessary.

(vi) How is Recital 79 of the MiFID II Delegated Regulation "The costs and charges disclosure is underpinned by the principle that every difference between the price of a position for the firm and the respective price for the client should be disclosed, including mark-ups and markdowns." to be interpreted with regard to the position for the firm? [**Question 16]**

a) When an investment firm holds a financial instrument on its own account before offering it to a client, the price of the financial instrument may change due to market value fluctuations. Based on Article 24(4) MiFID II, **any costs and charges that are caused by the occurrence of underlying market risk[3] shall not be included in the aggregated information about costs and charges**.

b) Hence, **the price of a position of the firm as referred to in Recital 79 of the MiFID II Delegated Regulation should be understood as the current (fair market) value of the financial instrument held by the firm when the firm offers the instrument to the client (ex-ante) or when it sells it to the client (ex-post)**.

(vii) How should investment firms identify and disclose mark-ups and structuring costs embedded in the transaction price (Recital 79 of the MiFID II Delegated Regulation)? [**Question 17]**

a) According to Recital 79 of the MiFID II Delegated Regulation, practices where there is 'netting' of costs should not be excluded from the obligation to provide information on costs and charges. As a result, **mark-ups and structuring costs that are embedded in the transaction price need to be identified and disclosed to clients by the investment firm**.

b) **Based on Recital 79, investment firms should identify such costs by calculating the difference between the price of the position for the firm and the price for the client**. In case of PRIIPs, ESMA would expect the investment firm to apply the calculation methodology in paragraphs 36 to 46 of Annex VI of the PRIIPS RTS.

(viii) How should an investment firm assess, in accordance with Article 50(1) paragraph 3 of the MiFID II Delegated Regulation, that an eligible counterparty does not intend to offer the financial instruments to its clients? **[Question 18]**

a) Without prejudice to the obligations set out in Article 24(4) MiFID II and the requirement to provide information on all costs and charges to all clients and potential clients, investment firms providing investment services to eligible counterparties shall have the right - in accordance with Article 50 of the MiFID II Delegated Regulation - to agree to a limited application of the detailed requirements set out in Article 50, except when, irrespective of the investment service provided, the financial instruments concerned embed a derivative and the eligible counterparty intends to offer them to its clients.

b) Investment firms are expected to apply the full cost and charges disclosure regime as the default option, and only to apply the limited flexibility allowed under Article 50(1) as further explained under recital 74 when there is an agreement to do so and the eligible counterparty has indicated that it does not intend to offer the financial instrument to its clients. **ESMA expects investment firms to have procedures in place aiming at recording eligible counterparties' agreement and intention not to offer such financial instruments** to their clients.

(ix) Which specific limitations to the cost transparency regime may professional clients and eligible counterparties agree on? [Question 19]

[3] 25 Recital 79 of the MiFID II Delegated Regulation provides further clarifications on the concept of underlying market risk.

a) Article 50(1) of the MiFID II Delegated Regulation allows - in certain situations described in paragraphs 2 and 3 thereof - for a limited application of some of the detailed requirements set out in Article 50. The more limited application which needs to be agreed by the two parties should however never lead to disapplying the obligations imposed on investment firms pursuant to Article 24(4) MiFID II.

b) **ESMA emphasizes that Article 24(4) MiFID II requires that the information provided to clients, amongst others, includes information on all costs and charges**, including information relating to both investment and ancillary services, the financial instrument recommended or marketed to the client and any third-party payments. In addition, the **information shall be aggregated and where the client so requests, an itemised breakdown shall be provided**. The information about costs and charges shall be provided to the client in good time before the investment service is provided and, where applicable, on a regular basis, at least annually.

c) Recital 74 provides examples of detailed requirements which could be the object of such limited applications under article 50 of the Delegated Regulation. For instance, the investment firm could agree, at the request of the client, to not provide the illustration showing the cumulative effect of costs on return, not provide an indication of the currency involved and not provide the applicable conversion rates and costs where any part of the total costs and charges is expressed in foreign currency.

(x) How should the cost disclosure be made regarding the respective figures that are to be disclosed in aggregated and itemized form (see Question 13) in case the respective costs or charges are zero? **[Question 20]**

a) The firm should explicitly show a "zero" for the individual figure that is to be disclosed. As one of the purposes of the cost disclosure regime is comparability of products and services, it is important that clients receive explicit figures for every item to be disclosed, even if it is zero. **The firm should therefore not leave out a cost component which value is zero as this might lead to misinterpretations.**

(xi) At what date should investment firms send their **first annual ex-post information** to their clients? [**Question 21]**

a) When investment firms are required to provide their clients annual ex-post information about costs and charges based on article 50(9) of the MiFID II Delegated Regulation, **ESMA expects firms to provide such information on the basis of a time period that ends at the latest one year (12 months) after the date on which the ongoing relationship has started** and that this information should be provided to clients as soon as possible after the above annual anniversary of the relevant service commencing.

b) Where an existing ongoing relationship between a firm and a client ends during 2018, ESMA expects firms to provide information at that period end. Where part of the reporting period would fall under MiFID I[4] and part under MiFID II regime, investment firms may choose to calculate, on a best effort basis, the costs and charges in line with MiFID II requirements for the entire reporting period or provide this first ex-post report with a breakdown of costs for the two periods and a clear explanation of the basis on which costs have been calculated.

[4] Article 19(3) MiFID I (Directive 2004/39/EC) also requires disclosure to clients of costs and associated charges.

Client categorisation [Section 11]:

(xii) **Are investment firms required to inform of their MiFID categorisation all their clients**, including those already categorised under MIFID I, or should they just provide such information to new clients or to clients which categorisation has changed under MIFID II? [Question 1]

a) Article 45(1) of the MiFID II Delegated Regulation requires investment firms to "notify new clients, and existing clients that the investment firm has newly categorised as required by Directive 2014/65/EU, of their categorisation…."

b) ESMA's view is that under Article 45(1) of the MiFID II Delegated Regulation, **firms only have to notify information on their categorisation to: (i) new clients; and (ii) clients whose categorisation has changed under MiFID II**. Such is the case for instance for certain local public authorities or municipalities which could have been categorised as professional clients under MiFID I and will now be considered as retail clients according to paragraph 1 of section II.1 of Annex II of MiFID II.

Prepared by:
Gabriel Callsen, ICMA,
October 2017