International and European Business Law
by Schulze / Lehmann

European Financial Services Law

Article-by-Article Commentary

Lehmann / Kumpan

BECK · HART · NOMOS

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edited by

Matthias Lehmann
Christoph Kumpan

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Foreword

European regulation in the area of financial services has become increasingly voluminous and complex. Finding its way through the jungle of directives and regulations, regulatory and implementing technical standards and guidelines presents formidable challenges for the legal practitioner. Yet locating the relevant provision is insufficient; it is also necessary to be familiar with its background, interpretation and role in the broader context of EU law.

Therefore, we have decided to provide the reader with a tool to master European financial services law. This volume assembles the most important acts of the EU in this area. It contains such pivotal texts as MiFID II and MiFIR, MAR and MAD, EMIR, the UCITS-Directive and the AIFMD, to name a few. The acts have been divided into six distinct areas: (1) securities markets and services, (2) market behaviour, (3) market transparency, (4) funds, (5) securities clearing and settlement, and (6) payments. Each act is commented on article by article, explaining the provision's function, history, context and interpretation. Level 2 and Level 3 acts are listed at the beginning of each article and discussed in the context in which they are relevant. The pertinent recitals are reflected in the comments. Examples and existing case law are provided, and bibliographies invite further reading.

The method of explaining a legal act article by article may be unfamiliar to some readers, yet it has already proven its virtues in many areas. There are major advantages in explaining the law through its black letters. Understanding the relevant provision, its background, interpretation and the surrounding debate is indispensable for lawyers, who must be able to comprehend the rule's implications for concrete and often unknown problems in order to evaluate and state their case. The high level of technicality and the abundance of details in European financial services regulation makes this task particularly difficult. By making pinpointed comments for each article, we hope to provide essential assistance to regulators, counsels, judges and academics. We would like to contribute to a well-informed debate on EU regulation, which matches the sophistication of the existing texts.

Of paramount importance for our commentary has been the principle of autonomous interpretation, which is firmly established in the case law of the CJEU and requires EU law to be constructed in a uniform way, independent from the legal systems of the Member States. Bearing this principle in mind, the authors have been asked to provide a truly European view of the articles on which they comment. They had to abstain from opinions tainted by the doctrine of a particular Member State. References to national legislation or case law are made only where it is necessary and helpful to elucidate the problems and issues raised by the EU provision that is the subject of the comment.

The breadth of EU regulation in the area of financial services prevented us from including each and every act of the Union. Therefore, we have decided to omit all matters that are specific to credit institutions (banks), e.g. the Capital Requirements Directive (CRD) IV and the Capital Requirements Regulation (CRR). Furthermore, we have not commented on directives and regulations that are specific to certain actors and not of general importance, e.g. the Central Securities Depositories Regulation (CSDR). Finally, some provisions within the selected acts that are merely of a technical nature and unlikely to create issues in private litigation have been left aside, e.g. the provisions on the cooperation of Member State authorities among themselves and with ESMA.

The writing of this commentary has been a daunting task. Accomplishing such a monumental work would not have been possible without the help of others. Our first thanks go to the authors, who have worked incessantly and made great strides under

considerable time pressure. Furthermore, we are indebted to our assistants, in particular Eric Arbizo and Brian Thompson for reviewing the language, as well as Jannik Becker, Lena Daams, Nicolas Deising, Ronny Grütze, Karl Kulike and Finn Schmidt for their assistance in finalising the manuscripts. We would also like to thank Stefan Simonis and Matthias Knopik from Nomos for their tireless efforts in completing this book.

Bonn/London/Halle, January 2019 The editors

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Abbreviations

ACER	Agency for the Cooperation of Energy Regulators
ADR	American Depositary Receipts
AIF	Alternative Investment Funds
AIFMD	Alternative Investment Fund Managers Directive (2011/61)
AMF	Autorité des marchés financiers (Financial Markets Regulator, France)
AML	Anti-Money Laundering
AMP	Accepted Market Practices
APA	Approved Publication Arrangement
ARM	Approved Reporting Mechanism
Art	Article
BaFin	Bundesanstalt für Finanzdienstleistungsaufsicht (Federal Financial Supervisory Authority, Germany)
BBAN	Basic Bank Account Number
BGBl.	Bundesgesetzblatt (German Federal Law Gazette)
BGHSt	Entscheidungen des Bundesgerichtshofes in Strafsachen (Decisions of the German Federal Court of Justice in criminal matters)
BIC	Bank Identifier Code
BKR	Zeitschrift für Bank- und Kapitalmarktrecht (Journal)
BörsG	Börsengesetz (German Stock Exchange Act)
BRRD	Bank Recovery and Resolution Directive (2014/59)
BT-Drs	Bundestags-Drucksache (German Parliament Document)
CARD	Consolidated Admissions and Reporting Directive (2001/34)
CCP	Central Counterparty
CCZ	Corporate Compliance Zeitschrift
CDS	Credit Default Swap
CEIOPS	Committee of European Insurance and Occupational Pensions Supervisors
CESR	Committee of European Securities Regulators
CET	Central European Time
CfD	Contracts for Difference
CFREU	Charter of Fundamental Rights of the European Union
CFS	Condensed Financial Statements
CFTC	Commodity Futures Trading Commission
CISE	Channel Islands Securities Exchange
CJEU	Court of Justice of the European Union
CMLJ	Capital Markets Law Journal
CMLR	Common Market Law Review
CORE	Compensation Retail
CPV	Common Procurement Vocabulary
CR	Computer und Recht (Journal)
CRA	Credit Rating Agency
CRD	Capital Requirements Directive (2013/36)
CRR	Capital Requirements Regulation (575/2013)
CSD	Central Securities Depositary
CSDR	Central Securities Depository Regulation (909/2014)
CSES	Comparative Study of Electoral Systems
CTP	Consolidated Tape Provider

Abbreviations

DAX	Deutscher Aktienindex (German Stock Index)
DB	Der Betrieb (Journal)
DEA	Direct Electronic Access
DLT	Distributed Ledger Technology
DR	Depository Receipts
DTR	Disclosure and Transparency Rules
DvP	Delivery versus Payment
EAMP	Emission Allowance Market Participant
EBA	European Banking Authority
EBOR	European Business Organization Law Review
ECB	European Central Bank
ECFR	European Company and Financial Law Review
ECJ	European Court of Justice
ECLI	European Case Law Identifier
EDR	European Depositary Receipts
EEA	European Economic Area
EIOPA	European Insurance and Occupational Pension Authority
EITI	Extractive Industry Transparency Initiative
ELRev.	European Law Review
ELTIFR	European Long-term Investment Funds Regulation (2015/760)
ELV	Elektronisches Lastschriftverfahren (electronic direct debit)
EMMI	European Money Markets Institute
EPC	European Payments Council
ERCL	European Review of Contract Law
ESEF	European Single Electronic Format
ESM	European Stability Mechanism
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
ETD	Exchange Traded Derivative
ETF	Exchange-Traded Fund
ETS	Emissions Trading Scheme
EUR	Euro(s)
EURIBOR	Euro Interbank Offered Rate
EuSEFR	European social entrepreneurship funds Regulation (346/2013)
EuVeCaR	European venture capital funds Regulation (345/2013)
FATF	Financial Action Task Force (on Money Laundering)
FIRDS	Financial Instrument Reference Data System
FLEGT	Forest Law Enforcement, Governance and Trade Action Plan
FSA	Financial Services Authority (Great Britain)
FSAP	Financial Services Action Plan
GAAP	Generally Accepted Accounting Principles
GDR	Global Depositary Receipts
HMS	Home Member States
IAS	International Accounting Standard
IASR	International Accounting Standards Regulation (1606/2002)

IBAN	International Bank Account Number
ICOs	Initial Coin Offerings
IDD	Insurance Distribution Directive (2016/97)
IFLR	International Financial Law Review
IFRS	International Financial Reporting Standards
IIP	Insurance-based Investment Product
IMD	Insurance Mediation Directive (2002/92)
IORP	Occupational Retirement Provision
IOSCO	International Organization of Securities Commissions
IRD	Interim Reporting Directive (79/279)
ISDA	International Swaps and Derivatives Association
ISIN	International Securities Identification Number
ITS	Implementing Technical Standards
JCLS	Journal of Corporate Law Studies
JIBLR	Journal of International Banking Law & Regulation
JODI	Joint Organisations Database Initiative
JRF	Journal of Risk Finance
JZ	JuristenZeitung (Journal)
KID	Key Information Document
KIID	Key Investor Information Document
KWG	Kreditwesengesetz (German Banking Act)
LCD	Listing Conditions Directive (79/279)
LCIA	London Court of International Arbitration
LEI	Legal Entity Identifier
LME	London Metal Exchange
→ mn	margin number (within this Commentary)
MAR	Market Abuse Regulation (596/2014)
MIC	Market Identifier Code
MiFID I	Markets in Financial Instruments Directive (2004/39)
MiFID II	Markets in Financial Instruments Directive II (2014/65)
MiFIR	Markets in Financial Instruments Regulation (600/2014)
MMFR	Money Market Funds Regulation (2017/1131)
MMR	MultiMedia und Recht (Journal)
MREL	Minimum Requirement for Own Funds and Eligible Liabilities
MTF	Multilateral Trading Facilities
NA	Notification Authority
NAV	Net Asset Value
NCA	National Competent Authority
NJW	Neue Juristische Wochenschrift (Journal)
NZG	Neue Zeitschrift für Gesellschaftsrecht (Journal)
OAM	Officially Appointed Mechanism
OGH	Offene Handelsgesellschaft (commercial partnership under German law)
OJ	Official Journal
OLG	Oberlandesgericht (Higher Regional Court)
OTC	Over the Counter
OTF	Organised Trading Facilities
OUP	Oxford University Press

Palandt-BGB	Palandt, Bürgerliches Gesetzbuch: BGB (77th edn, Munich 2018)
PFMI	Principles for Financial Market Infrastructures
PRIIPR	PRIIP Regulation (1286/2014)
PRIMA	Place of the Relevant Intermediary Approach
RdF	Recht der Finanzinstrumente (Journal)
REMIT	Regulation on Energy Market Integrity and Transparency (1227/2011)
RIS	Regulated Information Services
RM	Regulated Markets
RPS	Retail Payment Systems
RPT	Related Party Transactions
RTS	Regulatory Technical Standards
SDD	SEPA Direct Debit
SE Regulation	Regulation on the Statute for a European Company (SE) (2157/2001)
SEPA	Single Euro Payments Area
SFC	Small Financial Counterparties
SFD	Settlement Finality Directive (98/26)
SPV	Special Purpose Vehicles
SSR	Short Selling Regulation (236/2012)
STOR	Suspicious Transaction and Order Reporting
SWIFT	Society for Worldwide Interbank Financial Telecommunication
TARGET	Trans-European Automated Real-time Gross Settlement Express Transfer
TD	Transparency Directive (2004/109)
TFEU	Treaty on the Functioning of the European Union
TISE	The International Stock Exchange
TOTV	Traded on a Trading Venue
TR	Trade Repositories
UCITS	Undertakings for Collective Investments in Transferable Securities
UCITSD	UCITS Directive (2009/65)
UK	United Kingdom
UNCTAD	United Nations Conference on Trade and Development
UNIFI	Universal Financial Industry message scheme
UPI	Unique Product Identifier
URD	Universal Registration Document
UTC	Coordinated Universal Time
UTI	Unique Trade Identifier
WM	Wertpapier-Mitteilungen (Journal)
WpHG	Wertpapierhandelsgesetz (German Securities Trading Act)
ZBB/JBB	Zeitschrift für Bankrecht und Bankwirtschaft / Journal for Banking Law and Banking
ZGR	Zeitschrift für Unternehmens- und Gesellschaftsrecht (Journal)
ZHR	Zeitschrift für Handels- und Unternehmensrecht (Journal)
ZIP	Zeitschrift für Wirtschaftsrecht (Journal)
ZVertriebsR	Zeitschrift für Vertriebsrecht (Journal)

1. Security Markets and Services

Introduction to MiFID II and MiFIR

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I. Overview

The Markets in Financial Instruments Directive (MiFID) is the **cornerstone of EU securities law**. It spans over a wide range of issues, covering trading venues and various types of investment service providers, such as financial advisers, stockbrokers and portfolio managers. To illustrate its importance, it is useful to draw a comparison to US law: MiFID combines the rules to be found in the US Securities Act, Securities Exchange Act, 1

Investment Adviser's Act and in large parts those of the Dodd-Frank Act. It is therefore no exaggeration to say that MiFID is the "constitution" of the European market in financial services.

2 The **predecessor MiFID I** was adopted in 2004 and applied as of 1 November 2007.[1] The current second version of MiFID (**MiFID II**) is in force since 3 January 2018. MiFID II brings a number of changes with regard to MiFID I. The most visible of those is that it is now accompanied by a regulation, the **MiFIR** (Markets in Financial Instruments Regulation).[2] While MiFID needs to be transposed into the national law of the Member States, MiFIR applies directly throughout the European Union. This marks a significant strengthening of the uniformity of the market governance.

3 The substantive rules of MiFID II and MiFIR as well depart in many ways from those of MiFID I. While the fundamental pillars have been left untouched, a number of innovations have been introduced. They include, inter alia:

(1) the introduction of Organised Trading Facilities (**OTF**) as a new form of alternative trading venues;
(2) the inclusion of **emission allowances** and **structured deposits** into the Directive's scope of application;
(3) increased pre- and post-trade **transparency requirements for non-equity instruments**;
(4) an obligation to trade certain **derivatives on trading venues**;
(5) rules on non-discriminatory **access to clearing**;
(6) the possibility to impose **position limits for commodity derivatives**;
(7) the regulation and supervision of **data reporting services providers**;
(8) the increased regulation of **trading on own account**, especially in the case of **high frequency trading**;
(9) the prohibition of **inducements**;
(10) the clear distinction between **independent and non-independent advice**;
(11) the prohibition of **non-paid research by investment services**;
(12) rules on **product governance and product intervention**;
(13) a partly harmonised **third-country regime**.

4 MiFID II and MiFIR are complemented by around 100 delegated and implementing acts that have been adopted by the Commission on **Level 2** as of the end of 2017. These acts are binding and directly applicable for authorities and courts in the Member States. Furthermore, there are non-binding guidelines, recommendations and questions and answers (Q&A) published by ESMA on **Level 3** that are necessary to understand the legislation on the upper levels and to ensure their uniform application.

5 The implementation of the revised rules presents a significant challenge to firms and supervisors alike. Because of this, the introduction of MiFID II and MiFIR, which was originally scheduled for 2017, had been **postponed by one year**. Still the supervisory authorities have not adopted all Level 2 acts that are foreseen on Level 1. There remains thus considerable uncertainty over the shape of the full set of rules.

6 MiFID II, MiFIR and the Level 2 and 3 acts encompass a myriad of texts. Furthermore, they are closely entangled with Member State law that transposes MiFID II and which also has different levels (e.g. legislation by Parliament, ministerial decrees, interpretations by the supervisor). This mishmash of different sources increases the **complexity** of their application.

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[1] Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments [2004] OJ L145/1.

[2] Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments, [2014] OJ L 173/84.

II. Economic rationale

The original purpose and justification of MiFID, which continues to exist today in MiFID II and MiFIR, was the **opening up of national markets** for competition between financial service providers and trading venues. They were allowed to provide their services throughout the Single Market, being submitted solely to the control by their home country.[3] It is a fact that increased competition serves the interests of investors and issuers by **reducing transaction costs**. It also leads to **wider investor choice** and **access to finance** for companies. 7

Another key goal of MiFID II and MiFIR is the **protection of investors**,[4] in particular by overcoming **information asymmetries**. Traders often have crucial information about the issuer and the products, which investors lack. This creates inefficiencies and could deter investors from engaging on the financial market. Disclosure rules and the obligation to conduct a suitability or appropriateness tests are designed to overcome these obstacles.[5] Insufficient information also may affect trading. Pre- and post-trade transparency rules improve the information supplied to intermediaries and investors with regard to the most efficient trading venue.[6] The best execution duty obliges the intermediary to make use of them.[7] 8

Financial services rendered by an intermediary are frequently plagued by **principal-agent problems**. Service providers may be induced to recommend a product that is not fully aligned to the needs of the investor. This may lead to the inefficient allocation of capital. Therefore, the EU legislator obliges intermediaries to identify, prevent and disclose conflicts of interests, and prohibits inducements.[8] 9

Besides reasons related to the efficiency of capital markets, MiFID II and MiFIR also serve **non-financial goals**. An example are the rules on position limits for commodities derivatives, which aim to limit the negative effects of speculation on the provision with goods and services.[9] 10

While the economic benefits of MiFID II and MiFIR can be hardly disputed, they must be weighed against the substantial **compliance costs** created by them. Independent studies claim that the costs of implementation in 2017 alone reach Euro 2.1 bn,[10] while the initial estimates of the whole (!) costs by the Commission ranged between a quarter and one third.[11] These costs will be pushed down by the industry and ultimately have to be borne by the investor. 11

III. Key principles

It is easy to lose sight in the bewildering labyrinth of regulatory texts. Some key principles underlying MiFID II and MiFIR may serve as guiding threads. 12

[3] See Recital 2 MiFID I.
[4] See Recital 2 MiFID I.
[5] Art 25 MiFID II.
[6] Art 3-21 MiFIR.
[7] Art 27 MiFID II.
[8] Art 23 MiFID II.
[9] Part IV MiFID II.
[10] IHS Markit, 'Counting the Cost of MiFID', available at https://www.markit.com (15.6.2018).
[11] Commission, Staff Working Paper, Impact Assessment Accompanying the Document 'Proposal for a Directive of the European Parliament and of the Council on Markets in Financial Instruments (Recast), SEC(2011) 1226 final, p. 64.

13 One of them is the **country-of-origin principle**. Under this principle, investment firms, market operators and other financial service providers active on the Single Market are authorised and supervised by the authorities of their country of origin. The so-called "EU passport" allows them to render their services in any Member State of the European Economic Area (EEA), comprising besides the 28 members of the EU also Iceland, Liechtenstein and Norway. The country-of-origin principle and the European passport are key concepts of EU law. They serve to break up national markets and create an integrated European market with increased competition.

14 The second principle is that Member States must ensure a minimum of **investor protection**. This principle is the natural counterpart of open markets.[12] Its aim is to reassure investors that engage with intermediaries from other states. Investor protection is achieved by the various obligations that intermediaries must comply with when marketing financial instruments, such as the duty to act in the best interest of the customer or the obligation to conduct a suitability or appropriateness test. The obligation to avoid or disclose conflicts of interests also serves the interests of the investor by overcoming principal-agent problems.

15 A third principle that is pervasive in MiFID II and MiFIR is that of **transparency**.[13] This principle is related to investor protection as transparent markets are in the interest of the investor, but is also justified in its own right. Besides protecting the investor, the obligations of pre- and post-trade transparency increase the overall efficiency of the market by favouring those markets that offer the best price/service ratio. Furthermore, transparent markets are usually more stable, as transparency acts as a policeman that seeks and extinguishes market imperfections and abuse. But transparency also has a cost in terms of reporting and the possible deterrence of investors to use trading venues such as dark pools, which may draw on liquidity.

16 A fourth principle under MiFID II and MiFIR is that of **non-discrimination**[14]. It applies for instance with regard to alternative trading venues, CCPs and to data service providers, which all must provide non-discriminatory access. This does not necessarily mean that every investor, customer or participant has to be treated in the same way. But where they are treated differently, there must be objective reasons for doing so.

IV. Genesis

17 For the first time, EU investment services were regulated in the **Investment Services Directive (ISD) of 1993**.[15] As with many other directives of this era, the goal of the ISD was to open up the markets in the then European Economic Community for services from other Member States. As a counterpart, the Directive introduced a number of harmonisation measures aimed at securing a minimum standard of investor protection in the laws of the various member countries. Overall, the ISD did however not achieve its goal of bringing about meaningful competition of financial service providers in the Community.[16]

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[12] See also → mn 8.

[13] See e.g. Recital 14, Art 125, Art 18(1), 47(1)(d), 51(1), 53(1) MiFID II, Recital 1, 5, 8, Title 2, 3 MiFIR.

[14] See e.g. Recital 14, 119, Art 18(3), 37(1), 47(1)(d), 48(8), 53(1), 57(9) MiFID II, Recital 28, Art 8(3) and (4), 10(2), 17(1) and (2), 18(5) and (7), 28(3), 35 MiFIR.

[15] Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field, OJ L 141, p. 27.

[16] On the ISD, see e.g. the various contributions in Ferrarini, *European Securities Markets: The Investment Services Directive and Beyond* (Kluwer Law International 1998).

The situation changed when **MiFID I entered into force in 2007**. This was the starting point of booming competition in financial services at a European scale. Crucial for that was the abolishment of the monopoly that exchanges had been enjoying under some national laws. MiFID I also introduced new trading venues, the so-called MTF, and endowed them with the right to render their services throughout the Community. Furthermore, it strengthened and extended the rules on investor protection.[17] **18**

MiFID I has been the single most important step to create a single market for financial services in Europe. However, the **global financial crisis of 2007/2008** exposed weaknesses in the functioning and the transparency of financial markets.[18] Examples include the selling of complex products to investors and the intransparency of trading in non-equity instruments. This sped up efforts that were already underway to overhaul MiFID I. Inter alia, the EC had to comply with commitments undertaken on the G20 level to bring more transparency into the trading of derivatives.[19] **19**

The work on MiFID II and MiFIR coincided with reforms of the regulatory and supervisory process. The ISD and MiFID I had been adopted under the so-called **Lamfalussy framework**, which provided for a complex interaction between the Commission, the Council, Member States and stakeholders on four different levels.[20] In 2010, however, three **European Supervisory Authorities (ESAs)** were established as part of the newly created European System of Financial Supervision. ESMA, the European Markets and Services Authority, was endowed with far-reaching competences to regulate and supervise financial markets. It plays an instrumental role in the interpretation and implementation of MiFID II, providing draft regulatory and implementing standards that are adopted by the Commission on Level 2, and publishing acts on Level 3 that national supervisors will generally follow even if they are non-binding. **20**

The reform was inspired by the **De Larosière Report**.[21] It substantially strengthened the regulatory rules by introducing fully uniform rules under MiFIR. These rules and the transposing national law will be applied by both the ESAs and the Member States authorities working in common. This represents an important juncture between the overhaul of the institutional setup and the reform of substantive rules. At this moment, it is too early to assess whether it has been sucessful or not. **21**

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[17] See Recital 2 MiFID I.

[18] See Recital 4 MiFID II.

[19] See G20 Heads of State, 'Leaders' Statement The Pittsburgh Summit' 9: http://www.g20.utoronto.ca/2009/2009communique0925.html (15.6.2018).

[20] The Committee of Wise Men, 'Final Report of the Committee of Wise Men on the Regulation of European Securities Market': https://www.esma.europa.eu/sites/default/files/library/2015/11/lamfalussy_report.pdf (15.6.2018).

[21] The High-LevelGroup on Financial Supervision in the EU, 'Report': http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf (15.6.2018).

Markets in Financial Instruments Directive (MiFID II)

Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments (OJ L 173, 12.6.2014, p. 349-496)

TITLE I
SCOPE AND DEFINITIONS

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Article 1
Scope

1. This Directive shall apply to investment firms, market operators, data reporting services providers, and third-country firms providing investment services or performing investment activities through the establishment of a branch in the Union.

2. This Directive establishes requirements in relation to the following:
- **(a) authorisation and operating conditions for investment firms;**
- **(b) provision of investment services or activities by third-country firms through the establishment of a branch;**
- **(c) authorisation and operation of regulated markets;**
- **(d) authorisation and operation of data reporting services providers; and**
- **(e) supervision, cooperation and enforcement by competent authorities.**

3. The following provisions shall also apply to credit institutions authorised under Directive 2013/36/EU, when providing one or more investment services and/or performing investment activities:
- **(a) Article 2(2), Article 9(3) and Articles 14 and 16 to 20,**
- **(b) Chapter II of Title II excluding second subparagraph of Article 29(2),**
- **(c) Chapter III of Title II excluding Article 34(2) and (3) and Article 35(2) to (6) and (9),**
- **(d) Articles 67 to 75 and Articles 80, 85 and 86.**

4. The following provisions shall also apply to investment firms and to credit institutions authorised under Directive 2013/36/EU when selling or advising clients in relation to structured deposits:
   (a) Article 9(3), Article 14, and Article 16(2), (3) and (6);
   (b) Articles 23 to 26, Article 28 and Article 29, excluding the second subparagraph of paragraph 2 thereof, and Article 30; and
   (c) Articles 67 to 75.

5. Article 17(1) to (6) shall also apply to members or participants of regulated markets and MTFs who are not required to be authorised under this Directive pursuant to points (a), (e), (i) and (j) of Article 2(1).

6. Articles 57 and 58 shall also apply to persons exempt under Article 2.

7. All multilateral systems in financial instruments shall operate either in accordance with the provisions of Title II concerning MTFs or OTFs or the provisions of Title III concerning regulated markets.

Any investment firms which, on an organised, frequent, systematic and substantial basis, deal on own account when executing client orders outside a regulated market, an MTF or an OTF shall operate in accordance with Title III of Regulation (EU) No 600/2014.

Without prejudice to Articles 23 and 28 of Regulation (EU) No 600/2014, all transactions in financial instruments as referred to in the first and the second subparagraphs which are not concluded on multilateral systems or systematic internalisers shall comply with the relevant provisions of Title III of Regulation (EU) No 600/2014.

I. General overview

1. Purpose

The first article of MiFID defines the **scope** of the Directive. 1

2. Background

In comparison to MiFID I, the scope of MiFID II has been **considerably extended**. It 2
now covers data reporting services providers and third-country firms. See → Introduction mn 3.

3. Context

Art 1 MiFID II is strongly connected to **Art 2 and 3 MiFID II**, which provide for 3
exemptions from the scope of the Directive. Basic notions used in Art 1, such as 'investment firm' or 'trading venue', are defined in **Art 4 MiFID II**.

II. Personal scope

1. Investment firms

4 The main body of the provisions of MiFID II covers **investment firms**.[1] The notion is defined by Art 4(1)(1) MiFID II, see the explanation in → Art 4 mn 4-10.

5 Many of the legal persons that render investment services or ancillary services are **banks** and as such are subject to the special legislative framework for credit institutions (CRR[2] and CRD IV[3]). When they provide investment services or ancillary services or when they are selling or advising clients in relation to structured products[4], they must in addition comply with certain of the MiFID II provisions set out in Art 1(3) and (4) MiFID II. In a nutshell, these concern the conduct requirements, whereas the organisational requirements including own funds remain subject to the CRR, the CRD IV and the national implementing legislation. The conduct requirements of MiFID II do not displace any bank specific provisions, but are 'top up regulation',[5] meaning that they apply in addition to the CRR and CRD IV.

6 The Directive also encompasses legal persons that are dealing on a professional basis **on own account,** i.e. not for third parties.[6] The purpose is to avoid circumvention of the Directive's rules, as it is very hard to distinguish between client related and own business.[7] However, Art 2(1)(d) MiFID II provides an important exception, which in practice excludes most persons dealing on own account from the Directive's scope (see → Art 2 mn 8-9). The mechanism of simultaneous inclusion and exception puts the burden of proof on the person that invokes the exception.

7 Member States may extend the definition of investment firms to **natural persons** if they fulfil certain conditions.[8] They must: (1) provide a level of investor protection equivalent to that provided by legal persons, and (2) be subject to equivalent prudential requirements. If the natural person is engaging in the holding of third party funds or securities, the requirements are even more stringent.[9] Where these conditions are met, the natural person may be authorised as an investment firm. It has to be noted that natural persons qualifying as investment firms are in some respects subject to special rules.[10]

8 Important **exemptions** from the MiFID II rules applying to investment firms are to be found in Art 2 MiFID II. They concern, for instance, insurance undertakings, firms providing investment services to members of their corporate group, or persons trading on own account.

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[1] Title II (Art 5-43) MiFID II.

[2] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, [2013] OJ L 176/1.

[3] Directive 2013/36/EU of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, [2013] OJ L 176/338.

[4] Structured deposits are bank deposits that pay a premium depending on certain circumstances such as the favourable development of a stock index or the price of a commodity. See Art 4(1)(43) MiFID II. Structured deposits were included into the scope of MiFID II because they present features similar to investment products. See Recital 39 MiFID II.

[5] Lieverse, 'The Scope of MiFID II' in Busch and Ferrarini (eds), *Regulation of the EU Financial Markets: MiFID II and MiFIR*, margin no 2.15.

[6] See Art 4(1)(6) MiFID II and Annex I Section A no 3 MiFID II.

[7] See Ferrarini and Busch, 'Who's Afraid of MiFID II? An Introduction', in Busch and Ferrarini (eds), *Regulation of the EU Financial Markets: MiFID II and MiFIR*, margin no 1.14.; Lieverse (ibid) margin no 2.37 et seq.

[8] Art 4(1)(1) subpara 2 MiFID II; see also → Art 4 mn 9.

[9] Art 4(1)(1) subpara 3 MiFID II; see also → Art. 4 mn 10.

[10] See Art 5(4)(b) and 9(6) MiFID II.

2. Market operators

MiFID II also sets out standards for market operators.[11] These are persons that manage or operate a **regulated market**,[12] which is a stringently regulated and supervised segment of a stock exchange. The operation of an alternative trading venue (MTF or OTF) is an investment service, the operator is therefore not a market operator in the sense of the Directive, but an investment firm (see → mn 5). Systematic internalisers[13] are also considered to be investment firms since they are executing clients' orders. Art 1(7) MiFID II ensures that multilateral systems and systematic internalizers comply either with the rules of Title II MiFID II or of Title III MiFIR. **9**

3. Data reporting service providers

For the first time, MiFID covers data reporting service providers.[14] These are three kinds of information transmitters: (1) approved publication arrangements (APA), (2) consolidated tape providers (CTP), and (3) authorised reporting mechanisms (ARM).[15] They are regulated in order to ensure the quality and the reliability of the data provided.[16] But data reporting service providers are not considered as investment firms. As a consequence, they do not need to comply with the obligations of the latter. **10**

4. Algorithmic traders and holders of positions in commodity derivatives

Certain provisions of MiFID II apply to persons that are neither investment firms nor market operators or data reporting service providers. **11**

This concerns, first, persons that engage in **algorithmic trading**.[17] According to Art 1(5) MiFID II, the rules of Art 17(1)-(6) MiFID II apply to algorithmic trading regardless of whether the trader needs to be authorised as an investment firm or not. The reasoning behind this extension of the MiFID to a non-investment firm are the risks of algorithmic trading,[18] such as 'flash crashes'. On the definition of algorithmic trading see → Art 4 mn 11-12. Recital 59 MiFID II clarifies that the use of algorithms in post-trading (e.g. clearing and settlement software or the 'blockchain') does not constitute algorithmic trading. **12**

The second extension of MiFID II beyond investment firms, market operators and data reporting service providers concerns the **provisions on position limits**.[19] These provisions also apply to persons that deal in commodities derivatives and are not covered by the rest of MiFID II because they benefit from an exemption under Art 2 MiFID II.[20] This extension is necessary in order to limit the engagement of financial and non-financial parties on the commodities derivatives markets, which is the key objective of position limits.[21] They shall apply independently of any exemption available to the firm from the other rules of MiFID II. **13**

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[11] See Title III (Art 44-56) MiFID II.
[12] Art 4(1)(18) MiFID II.
[13] On the notion 'regulated market' see Art 4(1)(21) MiFID II.
[14] See Title V (Art 59-66) MiFID II.
[15] See Art (4)(1)(52)-(54) MiFID II for a definition of these services. See also Art 59 mn 2-4.
[16] See Recitals 116-119 MiFID II.
[17] Art 1(5) MiFID II.
[18] Recital 59 third sentence MiFID II.
[19] Art 57-66 MiFID II.
[20] Art 1(6) MiFID II.
[21] Title IV (Art 57-58) MiFID II.

III. Material scope

14 The Directive provides for rules regarding the **authorisation and operation** of the persons covered.[22] It also contains provisions on the **supervision, cooperation and enforcement** by the competent authorities.[23] In addition to those areas, which are explicitly mentioned in Art 1(2) MiFID II, the Directive also includes rules on **position limits** for commodities derivatives.[24]

IV. Territorial scope

15 MiFID II regulates investment firms, market operators and data reporting service providers that are **established in the Union**. This territorial restriction follows from the need for authorisation by the home Member State of the firm, operator or provider.[25] For legal persons, the relevant criterion for identifying the home Member State is their registered seat.[26] For natural persons, the home Member State is determined via their head office.[27] The place of the head office also decides on the home Member State of legal persons that have no registered seat under the national law applying to them.[28]

16 In addition, MiFID II covers **investment firms established in third countries**, but only under the condition that they render services or perform activities through a **branch established in the EU**.[29] Minimum requirements for cross-border investment services by third-country firms with or without a branch are provided by MiFIR.[30]

Article 2
Exemptions

1. This Directive shall not apply to:

(a) insurance undertakings or undertakings carrying out the reinsurance and retrocession activities referred to in Directive 2009/138/EC when carrying out the activities referred to in that Directive;

(b) persons providing investment services exclusively for their parent undertakings, for their subsidiaries or for other subsidiaries of their parent undertakings;

(c) persons providing an investment service where that service is provided in an incidental manner in the course of a professional activity and that activity is regulated by legal or regulatory provisions or a code of ethics governing the profession which do not exclude the provision of that service;

(d) persons dealing on own account in financial instruments other than commodity derivatives or emission allowances or derivatives thereof and not providing any other investment services or performing any other invest-

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[22] See Art 1(2)(a), (c) and (d) MiFID II. See in particular Title II (Art 5-43), Title III (Art 44-56) and Title V (Art 59-66) MiFID II.

[23] See Art 1(2)(e) MiFID II. See in particular Title VI (Art 67-88) MiFID II.

[24] Title IV (Art 57-58) MiFID II.

[25] Art 5(1) 2, Art 44(1) subpara 2 MiFID II.

[26] Art 4(1)(55)(a)(ii), (b), (c)(ii) MiFID II.

[27] Art 4(1)(55)(a)(i), (b), (c)(i) MiFID II.

[28] Art 4(1)(55)(a)(iii), (b), (c)(iii) MiFID II.

[29] Art 1(2)(b) MiFID II.

[30] Title VIII (Art 46-48) MiFID II.

ment activities in financial instruments other than commodity derivatives or emission allowances or derivatives thereof unless such persons:

(i) are market makers;

(ii) are members of or participants in a regulated market or an MTF or have direct electronic access to a trading venue;

(iii) apply a high-frequency algorithmic trading technique; or

(iv) deal on own account when executing client orders;

Persons exempt under points (a), (i) or (j) are not required to meet the conditions laid down in this point in order to be exempt.

(e) operators with compliance obligations under Directive 2003/87/EC who, when dealing in emission allowances, do not execute client orders and who do not provide any investment services or perform any investment activities other than dealing on own account, provided that those persons do not apply a high-frequency algorithmic trading technique;

(f) persons providing investment services consisting exclusively in the administration of employee-participation schemes;

(g) persons providing investment services which only involve both the administration of employee-participation schemes and the provision of investment services exclusively for their parent undertakings, for their subsidiaries or for other subsidiaries of their parent undertakings;

(h) the members of the ESCB and other national bodies performing similar functions in the Union, other public bodies charged with or intervening in the management of the public debt in the Union and international financial institutions established by two or more Member States which have the purpose of mobilising funding and providing financial assistance to the benefit of their members that are experiencing or threatened by severe financing problems;

(i) collective investment undertakings and pension funds whether coordinated at Union level or not and the depositaries and managers of such undertakings;

(j) persons:

(i) dealing on own account, including market makers, in commodity derivatives or emission allowances or derivatives thereof, excluding persons who deal on own account when executing client orders; or

(ii) providing investment services, other than dealing on own account, in commodity derivatives or emission allowances or derivatives thereof to the customers or suppliers of their main business;

provided that:

— for each of those cases individually and on an aggregate basis this is an ancillary activity to their main business, when considered on a group basis, and that main business is not the provision of investment services within the meaning of this Directive or banking activities under Directive 2013/36/EU, or acting as a market-maker in relation to commodity derivatives,

— those persons do not apply a high-frequency algorithmic trading technique; and

— those persons notify annually the relevant competent authority that they make use of this exemption and upon request report to the competent authority the basis on which they consider that their activity under points (i) and (ii) is ancillary to their main business;

(k) persons providing investment advice in the course of providing another professional activity not covered by this Directive provided that the provision of such advice is not specifically remunerated;

(l) associations set up by Danish and Finnish pension funds with the sole aim of managing the assets of pension funds that are members of those associations;

(m) 'agenti di cambio' whose activities and functions are governed by Article 201 of Italian Legislative Decree No 58 of 24 February 1998;

(n) transmission system operators as defined in Article 2(4) of Directive 2009/72/EC or Article 2(4) of Directive 2009/73/EC when carrying out their tasks under those Directives, under Regulation (EC) No 714/2009, under Regulation (EC) No 715/2009 or under network codes or guidelines adopted pursuant to those Regulations, any persons acting as service providers on their behalf to carry out their task under those legislative acts or under network codes or guidelines adopted pursuant to those Regulations, and any operator or administrator of an energy balancing mechanism, pipeline network or system to keep in balance the supplies and uses of energy when carrying out such tasks.

That exemption shall apply to persons engaged in the activities set out in this point only where they perform investment activities or provide investment services relating to commodity derivatives in order to carry out those activities. That exemption shall not apply with regard to the operation of a secondary market, including a platform for secondary trading in financial transmission rights;

(o) CSDs that are regulated as such under Union law, to the extent that they are regulated under that Union law.

2. The rights conferred by this Directive shall not extend to the provision of services as counterparty in transactions carried out by public bodies dealing with public debt or by members of the ESCB performing their tasks as provided for by the TFEU and by Protocol No 4 on the Statute of the European System of Central Banks and of the European Central Bank or performing equivalent functions under national provisions.

3. The Commission shall adopt delegated acts in accordance with Article 89 to clarify for the purposes of point (c) of paragraph 1 when an activity is provided in an incidental manner.

4. ESMA shall develop draft regulatory technical standards to specify, for the purposes of point (j) of paragraph 1, the criteria for establishing when an activity is to be considered to be ancillary to the main business at a group level.

Those criteria shall take into account at least the following elements:

(a) the need for ancillary activities to constitute a minority of activities at a group level;

(b) the size of their trading activity compared to the overall market trading activity in that asset class.

In determining the extent to which ancillary activities constitute a minority of activities at a group level ESMA may determine that the capital employed for carrying out the ancillary activity relative to the capital employed for carrying out the main business is to be considered. However, that factor shall in no case be sufficient to demonstrate that the activity is ancillary to the main business of the group.

The activities referred to in this paragraph shall be considered at a group level.

The elements referred to in the second and third subparagraphs shall exclude:

(a) intra-group transactions as referred to in Article 3 of Regulation (EU) No 648/2012 that serve group-wide liquidity or risk management purposes;

(b) transactions in derivatives which are objectively measurable as reducing risks directly relating to the commercial activity or treasury financing activity;

(c) transactions in commodity derivatives and emission allowances entered into to fulfil obligations to provide liquidity on a trading venue, where such obligations are required by regulatory authorities in accordance with Union law or with national laws, regulations and administrative provisions, or by trading venues.

ESMA shall submit those draft regulatory technical standards to the Commission by 3 July 2015.

Power is delegated to the Commission to adopt the regulatory technical standards referred to in the first subparagraph in accordance with Articles 10 to 14 of Regulation (EU) No 1095/2010.

I. General

1. Purpose

The provision **exempts** certain persons from the scope of the Directive. Limiting the reach of MiFID II is in line with the principle of proportionality, which requires not to exceed what is necessary to achieve the objective of regulatory action.[1] **1**

2. Level 2 and 3 measures

Commission Delegated Regulation (EU) 2017/592 of 1 December 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to regulatory technical standards for the criteria to establish when an activity is considered to be ancillary to the main business, JO 2017 L 87/492 **2**

[1] Cf. Art 5(4) Treaty on European Union.

II. Exempted persons

3 Art 2 MiFID II lists a number of persons that are exempted from MiFID's scope. The exemptions mainly relate to the activities of the person in question. Recital 50 MiFID summarises the purpose of these exemptions as follows:

> *Since the scope of prudential regulation should be limited to those entities which, by virtue of running a trading book on a professional basis, represent a source of a counterparty risk to other market participants, entities which deal on own account in financial instruments other than commodity derivatives, emission allowances or derivatives thereof, should be excluded from the scope of this Directive provided that they are not market makers, do not deal on own account when executing client orders, are not members or participants of a regulated market or MTF, do not have direct electronic access to a trading venue and do not apply a high-frequency algorithmic trading technique.*

4 It is possible that the same person fulfils more than one of the cases mentioned in Art 2(1) MiFID II. There is no need to decide between them as the exemptions apply cumulatively.[2]

1. Insurances

5 Art 2(1)(a) MiFID II exempts **insurance and reinsurances** from the scope of the Directive. This is justified by the fact that these businesses are subject to supervision by prudential supervisors and regulated by a set of specific rules.[3] There are certain insurance products that closely resemble financial instruments governed by MiFID II, but the Directive leaves them to the special rules applying to insurances.[4] Art 91 MiFID II aligns those rules insofar as insurance-based investment products are concerned. Moreover, the supervision of insurances is coordinated with that of investment firms.[5]

2. Intra-group service providers

6 Legal persons that are part of a group of companies and provide investment services solely to other members of the group are excluded from the Directive under Art 2(1)(b) MiFID II. This "**intra-group exemption**" is based on the fact that the firm does not deal with outside investors.[6] There is no counterparty risk to persons outside the group.

3. Other regulated professions

7 Art 2(1)(c) MiFID II exempts persons that provide incidental investment services or conduct incidental investment activities in the course of another profession that is regulated or subject to a code of ethics. Examples are **tax advisers, lawyers, consultants and accountants**. These professions may involve investment services, e.g. giving investment advice, but are already governed by their own regulatory and ethical rules. There is thus no need to submit them to the MiFID II rules, provided that the investment service is of minor importance in relation to the professional activity.

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[2] See Recital 22, second sentence MiFID II. For a case in point explicitely addressed, see Art 2(1)(d) subpara 2 MiFID II.

[3] See Recital 27 MiFID II. In particular, these businesses are subject to the Solvency II Directive (Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance, OJ L 335, 17.12.2009, p. 1).

[4] See Recital 87.

[5] See e.g. Art 68(2), 84(2) MiFID II.

[6] See also Recital 28 MiFID II.

4. Persons dealing on own account

Dealing on own account is an investment service.[7] Firms dealing on own account on a professional basis are thus covered as investment firms by the scope of the Directive.[8] Nevertheless, Art 2(1)(d) MiFID II excludes persons dealing on own account from the scope of the Directive, provided that they do not fulfil one of the **counter-exceptions** (exceptions from the exception) that are defined there. The provision does not cover persons that are dealing on own account in commodity derivatives and emissions allowances, as these persons are governed by a special rule in Art 2(1)(j) MiFID II (see → mn 18-25). **8**

The practically most important counter-exception under Art 2(1)(d) MiFID II concerns persons that are dealing on own account while at the same time **executing a client order**.[9] The counter-exception seeks to exclude circumvention strategies. These strategies are possible because the line between dealing on own account and on a client's account is very thin. **9**

Market makers are always subject to MiFID II, even when they are dealing on own account.[10] Market makers are defined as persons holding themselves out on the market on a continuous basis as being willing to deal on own account by buying and selling financial instruments, and which use their own capital and define prices.[11] Market makers provide liquidity that is essentially for the smooth functioning of trading venues. MiFID II subjects them to the full rules in order to avoid any potential misuse of exemptions.[12] **10**

Members or participants in Regulated Markets or Multilateral Trading Facilities (MTF)[13] are always subject to the Directive according to Art 2(1)(d)(ii) MiFID II. The provision does not include members or participants in Organised Trading Facilities (OTF); but see → mn 12.[14] **11**

According to the same provision, persons that have **direct electronic access** to a trading venue are also subject to the obligations under the Directive.[15] The notion 'direct electronic access' is defined in Art 4(1)(41) MiFID II and further specified on Level 2.[16] 'Trading venue' includes OTF, so that persons having direct electronic access to them fall into the scope of the Directive. The persons covered by Art 2(1)(d)(ii) MiFID II must comply with the Directive even if they are solely dealing on own account. The legislator regards the connection to a trading venue as being of such importance that it requires regulation and supervision of the person connected. **12**

High-frequency algorithmic traders are equally submitted to MiFID II regardless of whether they deal on their own or another's account.[17] The reason is the potential danger flowing from this type of trading,[18] such as a flash crash. Algorithmic traders that do **13**

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[7] Annex I Section A no 3 MiFID II.
[8] See Art 1(1), 4(1)(1) MiFID II.
[9] Art 2(1)(d)(iv) MiFID II.
[10] Art 2(1)(d)(i) MiFID II.
[11] See the definition in Art 4(1)(7) MiFID II. On the obligation of persons pursuing a market making strategy to enter into a market making agreement, see Art 1 Delegated Regulation 2017/578 of 13 June 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council on markets in financial instruments with regard to regulatory technical standards specifying the requirements on market making agreements and schemes, OJ 2017 L 87/183.
[12] Recital 23 MiFID II.
[13] For a definition of the notion 'multilateral trading facility' see Art 4(1)(22) MiFID II.
[14] For a definition of the notion 'organised trading facility' see Art 4(1)(23) MiFID II.
[15] Art 2(1)(d)(ii) MiFID II.
[16] Art 20 Delegated Regulation 565/2017.
[17] Art 2(1)(d)(iii) MiFID II. For a definition, see Art 4(1)(4) and comment on → Art 4 mn 14-16.
[18] Not clearly explained by Recital 23 MiFID II.

not use high frequency techniques and only deal on own account are exempted from the Directive's scope.

5. Operators in emissions allowances

14 The trading in emissions allowances is a special area following its own rules.[19] Operators in this market are highly regulated and therefore exempted from MiFID II.[20]

6. Administrators of employee participation schemes

15 The administration of employee participation schemes is an activity inside an enterprise that has no effect on third parties. MiFID II therefore grants generous exemptions for administrators of such schemes.[21] These apply regardless of whether the scheme is for their own enterprise or for another enterprise of the same group.

7. Public debt management

16 Art 2(1)(h) MiFID II excludes public bodies that manage state debt from the Directive's scope. This exemption applies e.g. to the **European Central Bank**, the **national central banks** and the **European Stability Mechanism** (ESM). The fact that these institutions manage a portfolio or give investment advice does not submit them to the rules for investment firms. The counterparties to such debt transactions may also not invoke the rights conferred under the Directive.[22]

8. Investment funds

17 Investment funds – mutual funds in American parlance – are specially regulated entities. They are therefore exempted from the obligations under the Directive by Art 2(1)(i) MiFID II. This provision also encompasses investment **fund managers and depositories**. Note that the exemption not only covers funds coordinated by EU law, such as UCITS and AIFM, but also those regulated by autonomous national law.

9. Persons dealing on own account and providing services in commodities or emission allowances

18 MiFID II does not cover firms who deal on their own account or provide investment services in commodity derivatives or emission allowances (and derivates of emission allowances) where this activity is **ancillary** to their main business, Art 2(1)(j) MiFID II. The main business of the firm must be non-financial, i.e. neither related to the provision of investment services under MiFID II nor to banking services within the meaning of the CRD IV.[23] The idea of this exemption is to exclude non-financial parties who are hedging risks via commodity derivatives from the Directive's scope. These parties do not present a counterparty risk to other market participants.[24]

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[19] Directive 2003/87/EC of 13 October 2003 establishing a scheme for greenhouse gas emission allowance trading within the Community and amending Council Directive 96/61/EC, [2003] OJ L 275/32. On the rules of emissions allowances trading, see e.g. Kruger and Pizer, 'The EU Emissions Trading Directive: Opportunities and Potential Pitfalls' http://www.rff.org/files/sharepoint/WorkImages/Download/RFF-DP-04-24.pdf (15.6.2018).

[20] Art 2(1)(e) MiFID II.

[21] Art 2(1)(f), (g) MiFID II.

[22] Art 2(2) MiFID II.

[23] Art 2(1)(j) MiFID II. See also Recital 20 MiFID II.

[24] Cf. Recital 50 MiFID II.

Details are set out on **Level 2**.[25] Accordingly, the activities are to be assessed on a group level.[26] The Delegated Regulation introduces two thresholds in this regard: an overall market threshold and a main business threshold.[27] An activity is not considered as ancillary if it exceeds either of those two thresholds. While the overall market threshold compares the share of the group's activity with the overall market, the main business threshold considers the importance of the relevant activity for the group. As a consequence of this double threshold, it is possible that an activity that is relatively minor for the non-financial firm is nevertheless considered to be a "main" activity because of its impact on the market. **19**

There are, however, a number of **counter-exceptions**. Most of them resemble those that apply to trading in own account.[28] **20**

First, non-financial firms are covered by MiFID II if they are **executing client orders** while dealing on own account.[29] This counter-exception seeks to preclude avoidance strategies.[30] **21**

Second, persons applying a **high-frequency algorithmic trading** technique are covered by MiFID II.[31] This exception is testimony to the EU's worries about high-frequency trading (see → mn 13). As it presumes that this technique may disturb the orderly function of the market, it extends the breadth of its regulation to traders using such techniques.[32] On the notion of high-frequency algorithmic trading see → Art 4 mn 14-16. **22**

Third, **market makers** in commodity derivatives or emission allowances that provide investment services to others and do not deal on their own account are not exempted from MiFID II. Art 2(1)(j)(ii) first indent includes them into the Directive's scope.[33] Market makers in commodity derivatives or emission allowances that deal on their own account are exempted, see Art 2(1)(j)(i) MiFID II. On the notion of 'dealing on their own account', see Art 4(1)(6). **23**

Finally, the Preamble makes it clear that non-financial firms dealing in commodity derivatives **in a disproportionate manner** shall be covered by MiFID II.[34] ESMA is authorised to develop more precise standards on this point, which not only will take into account the importance of the activities for the non-financial firm in question, but also the size of their trading when compared with the overall market activity in the particular asset class.[35] It has done so with the Delegated Regulation 2017/592 concerning ancillary services (see → mn 19). **24**

If firms fulfil the criteria of Art 2(1)(j) MiFID II, they are exempted from the duties under the Directive, except for the rules on position limits in commodities derivatives.[36] In order to benefit from the exception of MiFID II, non-financial firms that deal in commodity derivatives or emission allowances must **notify** the competent authority each year that they make use of the exception.[37] Upon request, they must also **report** to the **25**

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[25] Commission Delegated Regulation (EU) 2017/592.
[26] Art 1 and Recital 1 Commission Delegated Regulation (EU) 2017/592.
[27] See Art 2 and 3 Commission Delegated Regulation (EU) 2017/592.
[28] See → mn 8-13.
[29] Art 2(1)(j)(i) MiFID II.
[30] See already → Art 1 mn 6.
[31] Art 2(1)(j)(ii) second indent MiFID II.
[32] Cf. also Art 2(1)(d)(ii) MiFID II.
[33] Cf. also Art 2(1)(d)(i) MiFID II.
[34] Recital 20 MiFID II.
[35] Art 2(4), second sentence MiFID II.
[36] Art 1(6) MiFID II.
[37] Art 2(1)(j) last indent MiFID II.

competent authority why they consider that this activity is ancillary to their main business.[38]

10. Persons giving free advice

26 Art 2(1)(k) MiFID II exempts persons that provide investment advice in the course of another profession that is not subject to the Directive. As examples, one might think of a **journalist or TV reporter** who give investment advice through the media. Since they have another profession not falling under the Directive, they are not subject to MiFID II. In contrast to Art 2(1)(c) MiFID II, it is not necessary that this profession is regulated or subject to a code of ethics. It also does not matter whether the advice is provided on an incidental basis or not.

11. Peculiar national exemptions

27 There are two exemptions specific to **Denmark, Finland and Italy** in Art 2(1)(l) and (m) MiFID II.[39]

12. Transmission systems operator

28 There is an exemption for transmissions systems operators in Art 2(1)(n) MiFID II. A systems operator is a natural or legal person that is responsible for the operating and maintenance of a transmission system for **electricity or natural gas**.[40]

13. Central securities depositories

29 Finally, central securities depositories (CSD) are exempted by Art 2(1)(o) MiFID II. They provide depository services and thus investment services, but are subject to special regulations under the **CSDR**.[41] The exemption only applies to CSDs that are regulated as such under Union law. It follows that it does not cover unregulated or third-country CSDs without equivalence status.

Article 3
Optional exemptions

1. Member States may choose not to apply this Directive to any persons for which they are the home Member State, provided that the activities of those persons are authorised and regulated at national level and those persons:

(a) are not allowed to hold client funds or client securities and which for that reason are not allowed at any time to place themselves in debit with their clients;

(b) are not allowed to provide any investment service except the reception and transmission of orders in transferable securities and units in collective investment undertakings and/or the provision of investment advice in relation to such financial instruments; and

[38] Id.
[39] Art 2(1)(k) MiFID II.
[40] See Art 2(4) Directive 2009/72/EC and Art 2(4) Directive 2009/73/EC.
[41] Regulation EU No 909/2014 of the European Parliament and of the Council of 23 July 2014 on improving securities settlement in the European Union and on central securities depositories [2014] OJ L 257/1.

(c) in the course of providing that service, are allowed to transmit orders only to:
   (i) investment firms authorised in accordance with this Directive;
   (ii) credit institutions authorised in accordance with Directive 2013/36/EU;
   (iii) branches of investment firms or of credit institutions authorised in a third country and which are subject to and comply with prudential rules considered by the competent authorities to be at least as stringent as those laid down in this Directive, in Regulation (EU) No 575/2013 or in Directive 2013/36/EU;
   (iv) collective investment undertakings authorised under the law of a Member State to market units to the public and to the managers of such undertakings; or
   (v) investment companies with fixed capital, as defined in Article 17(7) of Directive 2012/30/EU of the European Parliament and of the Council the securities of which are listed or dealt in on a regulated market in a Member State; or

(d) provide investment services exclusively in commodities, emission allowances and/or derivatives thereof for the sole purpose of hedging the commercial risks of their clients, where those clients are exclusively local electricity undertakings as defined in Article 2(35) of Directive 2009/72/EC and/or natural gas undertakings as defined in Article 2(1) of Directive 2009/73/EC, and provided that those clients jointly hold 100 % of the capital or of the voting rights of those persons, exercise joint control and are exempt under point (j) of Article 2(1) of this Directive if they carry out those investment services themselves; or

(e) provide investment services exclusively in emission allowances and/or derivatives thereof for the sole purpose of hedging the commercial risks of their clients, where those clients are exclusively operators as defined in point (f) of Article 3 of Directive 2003/87/EC, and provided that those clients jointly hold 100 % of the capital or voting rights of those persons, exercise joint control and are exempt under point (j) of Article 2(1) of this Directive if they carry out those investment services themselves.

2. Member States' regimes shall submit the persons referred to in paragraph 1 to requirements which are at least analogous to the following requirements under this Directive:

(a) conditions and procedures for authorisation and on-going supervision as established in Article 5(1) and (3), Articles 7 to 10, 21, 22 and 23 and the corresponding delegated acts adopted by the Commission in accordance with Article 89;

(b) conduct of business obligations as established in Article 24(1), (3), (4), (5), (7) and (10), Article 25(2), (5) and (6), and, where the national regime allows those persons to appoint tied agents, Article 29, and the respective implementing measures;

(c) organisational requirements as laid down in the first, sixth and seventh subparagraph of Article 16(3) and in Article 16(6) and (7) and the corresponding delegated acts adopted by the Commission in accordance with Article 89.

Member States shall require persons exempt from this Directive pursuant to paragraph 1 of this Article to be covered by an investor-compensation scheme recognised in accordance with Directive 97/9/EC. Member States may allow in-

vestment firms not to be covered by such a scheme provided they hold professional indemnity insurance where, taking into account the size, risk profile and legal nature of the persons exempt in accordance with paragraph 1 of this Article, equivalent protection to their clients is ensured.

By way of derogation from the second subparagraph of this paragraph, Member States that already have in place such laws, regulations or administrative provisions before 2 July 2014 may until 3 July 2019 require that where the persons exempt from this Directive pursuant to paragraph 1 of this Article provide the investment services of the reception and transmission of orders and/or of the provision of investment advice in units in collective investment undertakings and act as an intermediary with a management company as defined in Directive 2009/65/EC, those persons are jointly and severally liable with the management company for any damages incurred by the client in relation to those services.

3. **Persons exempt from this Directive pursuant to paragraph 1 shall not benefit from the freedom to provide services or to perform activities or to establish branches as provided for in Articles 34 and 35 respectively.**
4. **Member States shall notify the Commission and ESMA of the exercise of the option under this Article and shall ensure that each authorisation granted in accordance with paragraph 1 mentions that it is granted in accordance with this Article.**
5. **Member States shall communicate to ESMA the provisions of national law analogous to the requirements of this Directive listed in paragraph 2.**

I. General features

1. Purpose

1 The provision introduces an **option for the Member States** to exempt certain persons from the scope of the Directive. The relevant national legislator is the home Member State that would be competent to authorise the firm in the hypothetical case in which it would fall under the Directive.[1] In contrast to Art 2 MiFID II, Art 3 is not mandatory, meaning that the persons covered are not exempted unless the national legislator explicitly makes use of the option provided. This optionality leads to a **fragmentation** of the European securities market.

2. Background

2 Some of the optional exemptions in Art 3 MiFID II were originally intended as mandatory exemptions under Art 2 MiFID II. This concerns in particular Art 3(1)(d) MiFID II. During the trilogue procedure, the European Parliament, the Council and the Commission nevertheless agreed to leave it to the Member States whether they provide this exemption in their law or not.[2]

3. Context

3 Art 3 MiFID II is strongly connected to the rule on the general scope in **Art 1 MiFID II** and to the mandatory exemptions under **Art 2 MiFID II**. An additional exemption under Art 3 MiFID II and the corresponding national legislation is of no effect

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[1] For the definition of the home Member State, see Art 4(1)(55) MiFID II.
[2] Moloney, *EU Securities and Financial Markets Regulation* (3rd edn, Oxford University Press 2014) 351.

where a firm is already excluded from the scope of the Directive under either of these two provisions.

II. Exempted persons

The structure of Art 3(1) MiFID II is confusing. Art 3(1)(a)-(c) MiFID II provide three conditions that investment firms must **cumulatively** fulfil in order to be exempted, while Art 3(1)(d) and (e) MiFID II contain two further exemptions that apply **alternatively**. This follows from the word 'or' at the end of Art 3(1)(c) and (d) MiFID II. **4**

1. Investment service providers not holding clients' funds or securities

Art 3(1)(a)-(c) MiFID II contains an optional exemption for firms that are not allowed to hold funds or securities for their clients and therefore cannot become indebted to their clients. The idea underlying this optional exemption is that the firms do not present **any counterparty risk**.[3] Besides not holding client's funds or securities, there are two further conditions for the exemption to apply. The firm must (1) exclusively deal or advise in equity instruments or UCITS shares, and (2) forward orders only to authorised firms. Firms dealing in bonds or derivatives are therefore always covered by MiFID II, as are firms that deal in shares and forward the orders to non-authorised firms. **5**

2. Investment service providers for local electricity and natural gas undertakings

Art 3(d) MiFID II allows Member States to exempt investment firms that provide investment services solely in commodities, emission allowances and related derivatives for the **sole purpose of hedging their clients' risk**. The option is only available for firms whose clients are exclusively local electricity undertakings and natural gas undertakings. The notions 'local electricity undertaking' and 'natural gas undertaking' are defined by the EU's energy market regime.[4] Crucially, the clients must also **fully own** the investment service providers or at least exercise **joint control** over them. Finally, the clients must qualify for an exemption of Art 2(1)(j) MiFID II in the hypothetical case that they would carry out the investment services themselves. Basically this rule allows Member States to grant a **privilege for the energy sector**, traditionally dominated by state monopolies, who can create their own investment firms for hedging purposes without being subject to MiFID II should the Member State introduce the exemption.[5] **6**

3. Investment service providers for emission allowances

Art 3(1)(e) MiFID II contains an optional exemption that is similar to that under lit d of the same paragraph.[6] It concerns firms that provide investment services exclusively in emission allowances or derivatives thereof. The clients must be **operators of an installation that emits greenhouse gases**.[7] They must fully own or jointly control the investment firm, and qualify for an exemption under Art 2(1)(j) MiFID II if they were to exercise the investment service themselves. **7**

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[3] Cf. Recital 50 MiFID II.
[4] Article 2(35) of Directive 2009/72/EC and Article 2(1) of Directive 2009/73/EC.
[5] On earlier drafts, see Moloney, *EU Securities and Financial Markets Regulation*, p. 351 (footnote 183).
[6] Ibid 351.
[7] See Art 3(f) Directive 2003/87/EC.

III. Conditionality

8 Even though Member States have the option of exempting the above-mentioned firms from MiFID II, certain conditions apply. First, Member States shall foresee authorisation requirements and supervision, conduct of business obligations and organisational requirements that are '**at least analogous**' to many of those imposed by the Directive's provisions.[8] One can speak insofar of a **parallel national regime** that is aligned to MiFID II and must be communicated to ESMA.[9] Second, the firms exempted **do not enjoy the European passport**, meaning that they cannot offer services outside of their home Member State.[10] Third, all exemptions must be **notified to the Commission and ESMA** and mention that they are granted under Art 3(1) MiFID II.

Article 4
Definitions

1. For the purposes of this Directive, the following definitions apply:

(1) 'investment firm' means any legal person whose regular occupation or business is the provision of one or more investment services to third parties and/or the performance of one or more investment activities on a professional basis.

Member States may include in the definition of investment firms undertakings which are not legal persons, provided that:

(a) their legal status ensures a level of protection for third parties' interests equivalent to that afforded by legal persons; and

(b) they are subject to equivalent prudential supervision appropriate to their legal form.

However, where a natural person provides services involving the holding of third party funds or transferable securities, that person may be considered to be an investment firm for the purposes of this Directive and of Regulation (EU) No 600/2014 only if, without prejudice to the other requirements imposed in this Directive, in Regulation (EU) No 600/2014, and in Directive 2013/36/EU, that person complies with the following conditions:

(a) the ownership rights of third parties in instruments and funds must be safeguarded, especially in the event of the insolvency of the firm or of its proprietors, seizure, set-off or any other action by creditors of the firm or of its proprietors;

(b) the firm must be subject to rules designed to monitor the firm's solvency and that of its proprietors;

(c) the firm's annual accounts must be audited by one or more persons empowered, under national law, to audit accounts;

(d) where the firm has only one proprietor, that person must make provision for the protection of investors in the event of the firm's cessation of business following the proprietor's death or incapacity or any other such event;

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[8] Art 3(2) MiFID II.
[9] See Art 3(5) MiFID II.
[10] Art 3(3) MiFID II.

(2) 'investment services and activities' means any of the services and activities listed in Section A of Annex I relating to any of the instruments listed in Section C of Annex I.

The Commission shall adopt delegated acts in accordance with Article 89 measures specifying:

(a) the derivative contracts referred to in Section C.6 of Annex I that have the characteristics of wholesale energy products that must be physically settled and C.6 energy derivative contracts;

(b) the derivative contracts referred to in Section C.7 of Annex I that have the characteristics of other derivative financial instruments;

(c) the derivative contracts referred to in Section C.10 of Annex I that have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are traded on a regulated market, an MTF or an OTF;

(3) 'ancillary services' means any of the services listed in Section B of Annex I;

(4) 'investment advice' means the provision of personal recommendations to a client, either upon its request or at the initiative of the investment firm, in respect of one or more transactions relating to financial instruments;

(5) 'execution of orders on behalf of clients' means acting to conclude agreements to buy or sell one or more financial instruments on behalf of clients and includes the conclusion of agreements to sell financial instruments issued by an investment firm or a credit institution at the moment of their issuance;

(6) 'dealing on own account' means trading against proprietary capital resulting in the conclusion of transactions in one or more financial instruments;

(7) 'market maker' means a person who holds himself out on the financial markets on a continuous basis as being willing to deal on own account by buying and selling financial instruments against that person's proprietary capital at prices defined by that person;

(8) 'portfolio management' means managing portfolios in accordance with mandates given by clients on a discretionary client-by-client basis where such portfolios include one or more financial instruments;

(9) 'client' means any natural or legal person to whom an investment firm provides investment or ancillary services;

(10) 'professional client' means a client meeting the criteria laid down in Annex II;

(11) 'retail client' means a client who is not a professional client;

(12) 'SME growth market' means a MTF that is registered as an SME growth market in accordance with Article 33;

(13) 'small and medium-sized enterprises' for the purposes of this Directive, means companies that had an average market capitalisation of less than EUR 200 000 000 on the basis of end-year quotes for the previous three calendar years;

(14) 'limit order' means an order to buy or sell a financial instrument at its specified price limit or better and for a specified size;

(15) 'financial instrument' means those instruments specified in Section C of Annex I;

(16) 'C6 energy derivative contracts' means options, futures, swaps, and any other derivative contracts mentioned in Section C.6 of Annex I relating to coal or oil that are traded on an OTF and must be physically settled;

(17) 'money-market instruments' means those classes of instruments which are normally dealt in on the money market, such as treasury bills, certificates of deposit and commercial papers and excluding instruments of payment;

(18) 'market operator' means a person or persons who manages and/or operates the business of a regulated market and may be the regulated market itself;

(19) 'multilateral system' means any system or facility in which multiple third-party buying and selling trading interests in financial instruments are able to interact in the system;

(20) 'systematic internaliser' means an investment firm which, on an organised, frequent systematic and substantial basis, deals on own account when executing client orders outside a regulated market, an MTF or an OTF without operating a multilateral system;

The frequent and systematic basis shall be measured by the number of OTC trades in the financial instrument carried out by the investment firm on own account when executing client orders. The substantial basis shall be measured either by the size of the OTC trading carried out by the investment firm in relation to the total trading of the investment firm in a specific financial instrument or by the size of the OTC trading carried out by the investment firm in relation to the total trading in the Union in a specific financial instrument. The definition of a systematic internaliser shall apply only where the pre-set limits for a frequent and systematic basis and for a substantial basis are both crossed or where an investment firm chooses to opt-in under the systematic internaliser regime;

(21) 'regulated market' means a multilateral system operated and/or managed by a market operator, which brings together or facilitates the bringing together of multiple third-party buying and selling interests in financial instruments – in the system and in accordance with its non-discretionary rules – in a way that results in a contract, in respect of the financial instruments admitted to trading under its rules and/or systems, and which is authorised and functions regularly and in accordance with Title III of this Directive;

(22) 'multilateral trading facility' or 'MTF' means a multilateral system, operated by an investment firm or a market operator, which brings together multiple third-party buying and selling interests in financial instruments – in the system and in accordance with non-discretionary rules – in a way that results in a contract in accordance with Title II of this Directive;

(23) 'organised trading facility' or 'OTF' means a multilateral system which is not a regulated market or an MTF and in which multiple third-party buying and selling interests in bonds, structured finance products, emission allowances or derivatives are able to interact in the system in a way that results in a contract in accordance with Title II of this Directive;

(24) 'trading venue' means a regulated market, an MTF or an OTF;

(25) 'liquid market' means a market for a financial instrument or a class of financial instruments, where there are ready and willing buyers and sellers on a continuous basis, assessed in accordance with the following criteria, taking into consideration the specific market structures of the particular financial instrument or of the particular class of financial instruments:

(a) the average frequency and size of transactions over a range of market conditions, having regard to the nature and life cycle of products within the class of financial instrument;

(b) the number and type of market participants, including the ratio of market participants to traded instruments in a particular product;

(c) the average size of spreads, where available;

(26) 'competent authority' means the authority, designated by each Member State in accordance with Article 67, unless otherwise specified in this Directive;

(27) 'credit institution' means a credit institution as defined in point (1) of Article 4(1) of Regulation (EU) No 575/2013;

(28) 'UCITS management company' means a management company as defined in point (b) of Article 2(1) of Directive 2009/65/EC of the European Parliament and of the Council;

(29) 'tied agent' means a natural or legal person who, under the full and unconditional responsibility of only one investment firm on whose behalf it acts, promotes investment and/or ancillary services to clients or prospective clients, receives and transmits instructions or orders from the client in respect of investment services or financial instruments, places financial instruments or provides advice to clients or prospective clients in respect of those financial instruments or services;

(30) 'branch' means a place of business other than the head office which is a part of an investment firm, which has no legal personality and which provides investment services and/or activities and which may also perform ancillary services for which the investment firm has been authorised; all the places of business set up in the same Member State by an investment firm with headquarters in another Member State shall be regarded as a single branch;

(31) 'qualifying holding' means a direct or indirect holding in an investment firm which represents 10 % or more of the capital or of the voting rights, as set out in Articles 9 and 10 of Directive 2004/109/EC of the European Parliament and of the Council, taking into account the conditions regarding aggregation thereof laid down in Article 12(4) and (5) of that Directive, or which makes it possible to exercise a significant influence over the management of the investment firm in which that holding subsists;

(32) 'parent undertaking' means a parent undertaking within the meaning of Article 2(9) and 22 of Directive 2013/34/EU of the European Parliament and of the Council;

(33) 'subsidiary' means a subsidiary undertaking within the meaning of Articles 2(10) and 22 of Directive 2013/34/EU, including any subsidiary of a subsidiary undertaking of an ultimate parent undertaking;

(34) 'group' means a group as defined in Article 2(11) of Directive 2013/34/EU;

(35) 'close links' means a situation in which two or more natural or legal persons are linked by:

(a) participation in the form of ownership, direct or by way of control, of 20 % or more of the voting rights or capital of an undertaking;

(b) 'control' which means the relationship between a parent undertaking and a subsidiary, in all the cases referred to in Article 22(1) and (2) of Directive 2013/34/EU, or a similar relationship between any natural or legal person and an undertaking, any subsidiary undertaking of a subsidiary undertaking also being considered to be a subsidiary of the parent undertaking which is at the head of those undertakings;

(c) a permanent link of both or all of them to the same person by a control relationship;

(36) 'management body' means the body or bodies of an investment firm, market operator or data reporting services provider, which are appointed in accordance with national law, which are empowered to set the entity's strategy, objectives and overall direction, and which oversee and monitor management decision-making and include persons who effectively direct the business of the entity.

Where this Directive refers to the management body and, pursuant to national law, the managerial and supervisory functions of the management body are assigned to different bodies or different members within one body, the Member State shall identify the bodies or members of the management body responsible in accordance with its national law, unless otherwise specified by this Directive;

(37) 'senior management' means natural persons who exercise executive functions within an investment firm, a market operator or a data reporting services provider and who are responsible, and accountable to the management body, for the day-to-day management of the entity, including for the implementation of the policies concerning the distribution of services and products to clients by the firm and its personnel;

(38) 'matched principal trading' means a transaction where the facilitator interposes itself between the buyer and the seller to the transaction in such a way that it is never exposed to market risk throughout the execution of the transaction, with both sides executed simultaneously, and where the transaction is concluded at a price where the facilitator makes no profit or loss, other than a previously disclosed commission, fee or charge for the transaction;

(39) 'algorithmic trading' means trading in financial instruments where a computer algorithm automatically determines individual parameters of orders such as whether to initiate the order, the timing, price or quantity of the order or how to manage the order after its submission, with limited or no human intervention, and does not include any system that is only used for the purpose of routing orders to one or more trading venues or for the processing of orders involving no determination of any trading parameters or for the confirmation of orders or the post-trade processing of executed transactions;

(40) 'high-frequency algorithmic trading technique' means an algorithmic trading technique characterised by:

(a) infrastructure intended to minimise network and other types of latencies, including at least one of the following facilities for algorithmic order entry: co-location, proximity hosting or high-speed direct electronic access;

(b) system-determination of order initiation, generation, routing or execution without human intervention for individual trades or orders; and

(c) high message intraday rates which constitute orders, quotes or cancellations;

(41) 'direct electronic access' means an arrangement where a member or participant or client of a trading venue permits a person to use its trading code so the person can electronically transmit orders relating to a financial instrument directly to the trading venue and includes arrangements which involve the use by a person of the infrastructure of the member or participant or

client, or any connecting system provided by the member or participant or client, to transmit the orders (direct market access) and arrangements where such an infrastructure is not used by a person (sponsored access);

(42) **'cross-selling practice' means the offering of an investment service together with another service or product as part of a package or as a condition for the same agreement or package;**

(43) **'structured deposit' means a deposit as defined in point (c) of Article 2(1) of Directive 2014/49/EU of the European Parliament and of the Council, which is fully repayable at maturity on terms under which interest or a premium will be paid or is at risk, according to a formula involving factors such as:**

(a) **an index or combination of indices, excluding variable rate deposits whose return is directly linked to an interest rate index such as Euribor or Libor;**

(b) **a financial instrument or combination of financial instruments;**

(c) **a commodity or combination of commodities or other physical or non-physical non-fungible assets; or**

(d) **a foreign exchange rate or combination of foreign exchange rates;**

(44) **'transferable securities' means those classes of securities which are negotiable on the capital market, with the exception of instruments of payment, such as:**

(a) **shares in companies and other securities equivalent to shares in companies, partnerships or other entities, and depositary receipts in respect of shares;**

(b) **bonds or other forms of securitised debt, including depositary receipts in respect of such securities;**

(c) **any other securities giving the right to acquire or sell any such transferable securities or giving rise to a cash settlement determined by reference to transferable securities, currencies, interest rates or yields, commodities or other indices or measures;**

(45) **'depositary receipts' means those securities which are negotiable on the capital market and which represent ownership of the securities of a non-domiciled issuer while being able to be admitted to trading on a regulated market and traded independently of the securities of the non-domiciled issuer;**

(46) **'exchange-traded fund' means a fund of which at least one unit or share class is traded throughout the day on at least one trading venue and with at least one market maker which takes action to ensure that the price of its units or shares on the trading venue does not vary significantly from its net asset value and, where applicable, from its indicative net asset value;**

(47) **'certificates' means certificates as defined in Article 2(1)(27) of Regulation (EU) No 600/2014;**

(48) **'structured finance products' means structured finance products as defined in Article 2(1)(28) of Regulation (EU) No 600/2014;**

(49) **'derivatives' means derivatives as defined in Article 2(1)(29) of Regulation (EU) No 600/2014;**

(50) **'commodity derivatives' means commodity derivatives as defined in Article 2(1)(30) of Regulation (EU) No 600/2014;**

(51) **'CCP' means a CCP as defined in Article 2(1) of Regulation (EU) No 648/2012;**

(52) 'approved publication arrangement' or 'APA' means a person authorised under this Directive to provide the service of publishing trade reports on behalf of investment firms pursuant to Articles 20 and 21 of Regulation (EU) No 600/2014;

(53) 'consolidated tape provider' or 'CTP' means a person authorised under this Directive to provide the service of collecting trade reports for financial instruments listed in Articles 6, 7, 10, 12 and 13, 20 and 21 of Regulation (EU) No 600/2014 from regulated markets, MTFs, OTFs and APAs and consolidating them into a continuous electronic live data stream providing price and volume data per financial instrument;

(54) 'approved reporting mechanism' or 'ARM' means a person authorised under this Directive to provide the service of reporting details of transactions to competent authorities or to ESMA on behalf of investment firms;

(55) 'home Member State' means:

- **(a) in the case of investment firms:**
  - **(i) if the investment firm is a natural person, the Member State in which its head office is situated;**
  - **(ii) if the investment firm is a legal person, the Member State in which its registered office is situated;**
  - **(iii) if the investment firm has, under its national law, no registered office, the Member State in which its head office is situated;**
- **(b) in the case of a regulated market, the Member State in which the regulated market is registered or, if under the law of that Member State it has no registered office, the Member State in which the head office of the regulated market is situated;**
- **(c) in the case of an APA, a CTP or an ARM:**
  - **(i) if the APA, CTP or ARM is a natural person, the Member State in which its head office is situated;**
  - **(ii) if the APA, CTP or ARM is a legal person, the Member State in which its registered office is situated;**
  - **(iii) if the APA, CTP or ARM has, under its national law, no registered office, the Member State in which its head office is situated;**

(56) 'host Member State' means the Member State, other than the home Member State, in which an investment firm has a branch or provides investment services and/or activities, or the Member State in which a regulated market provides appropriate arrangements so as to facilitate access to trading on its system by remote members or participants established in that same Member State;

(57) 'third-country firm' means a firm that would be a credit institution providing investment services or performing investment activities or an investment firm if its head office or registered office were located within the Union;

(58) 'wholesale energy product' means wholesale energy products as defined in point (4) of Article 2 of Regulation (EU) No 1227/2011;

(59) 'agricultural commodity derivatives' means derivative contracts relating to products listed in Article 1 of, and Annex I, Parts I to XX and XXIV/1, to, Regulation (EU) No 1308/2013 of the European Parliament and of the Council;

(60) 'sovereign issuer' means any of the following that issues debt instruments:
- **(i) the Union;**
- **(ii) a Member State, including a government department, an agency, or a special purpose vehicle of the Member State;**
- **(iii) in the case of a federal Member State, a member of the federation;**
- **(iv) a special purpose vehicle for several Member States;**
- **(v) an international financial institution established by two or more Member States which has the purpose of mobilising funding and provide financial assistance to the benefit of its members that are experiencing or threatened by severe financing problems; or**
- **(vi) the European Investment Bank;**

(61) 'sovereign debt' means a debt instrument issued by a sovereign issuer;

(62) 'durable medium' means any instrument which:
- **(a) enables a client to store information addressed personally to that client in a way accessible for future reference and for a period of time adequate for the purposes of the information; and**
- **(b) allows the unchanged reproduction of the information stored;**

(63) 'data reporting services provider' means an APA, a CTP or an ARM.

2. The Commission shall be empowered to adopt delegated acts in accordance with Article 89 to specify some technical elements of the definitions laid down in paragraph 1, to adjust them to market developments, technological developments and experience of behaviour that is prohibited under Regulation (EU) No 596/2014 and to ensure the uniform application of this Directive.

I. General features

1. Purpose

The provision defines the most important terms used in MiFID II. **1**

2. Level 2 measures

Delegated Regulation 565/2017 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, OJ L 87/1. **2**

II. Definitions

3 The definitions contained in Article 4 MiFID II will be **explained in the context** in which they are employed. The following comments are limited to some overarching notions.

1. Investment firm

4 The notion 'investment firm' is of crucial relevance for the whole Directive, including its scope.[1] Its meaning is specified in Art 4(1)(1) MiFID II. Several categories of persons fall into this definition.

5 The first category comprises legal persons who render **investment services to third parties** or engage in an **investment activity** on a professional basis.

6 The notions 'investment services' and 'investment activities' are explained in Annex I to the Directive. The main examples are:
- order reception and transmission
- order execution
- portfolio management
- investment advice
- securities underwriting
- operation of an alternative trading venue (Multilateral Trading Facility (MTF) or an Organised Trading Facility (OTF)).[2]

7 The notion 'investment service and activity' also covers a number of **ancillary services**, such as securities custody, foreign exchange (forex) services and investment research.[3]

8 The definition of investment services and ancillary services hinges on the notion of '**financial instruments**'. It is defined in the Annex of the Directive in a fairly broad manner.[4] In particular, it is not restricted to 'transferable securities', but also includes a wide array of derivatives. The definition has been extended further to also cover emissions allowances.[5] More detailed provisions over certain instruments can be found on Level 2.[6]

9 The second category of persons that may fall under the notion 'investment firm' are **natural persons** who render investment services or engage in investment activities. This category not only covers single natural persons, but also **partnerships and other forms of companies** that do not have legal personality under national law. It is left to the Member States whether they want to include these natural persons or other entities in the definition of an investment firm. This means that national law will decide and govern whether natural persons may be authorised to render investment services or engage in investment activities. It can only do so under two conditions: first, that the legal status of the natural persons ensures a level of protection equivalent to that afforded by legal persons, and second, that they are subject to equivalent prudential supervision appropriate to their legal form.[7] The first point requires a liability regime that is at least as stringent as that for legal persons, the second requires the control of the founders and managers of the firm as well as its capital.

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[1] See Art 1(1) MiFID.
[2] Annex I Section A MiFID II.
[3] Annex I Section B MiFID II.
[4] Annex I Section C MiFID II.
[5] See Annex I Section C no 11 MiFID II. On the reasons for the extension, see Recital 11 MiFID II.
[6] Art 5-8 Delegated Regulation (EU) 565/2017. See also the exception in Art 10 of the same Delegated Regulation concerning certain derivatives relating to currencies.
[7] See Art 4(1)(1) subpara 2 MiFID II.

The conditions are even stricter where **the natural persons provide services involving the holding of third party funds or transferrable securities**, such as in the case of order execution or portfolio management. In these cases, they must comply with four conditions listed in Art 4(1)(1) subpara 4 MiFID II. First, ownership rights of third parties (i.e. the clients) must be safeguarded, particularly in the event of the insolvency of the firm or one of its proprietors. Since the natural person *is* the investment firm, it does not seem to make sense to distinguish between the two; yet one has to bear in mind that a partnership or other company without legal personality can also own the firm. The condition set out by MiFID II is of high importance to protect the rights and interests of the client. Ways in which the natural person can ensure compliance is to either outsource the handling of client funds and securities to a deposit bank or by using a trust, a *fiducie* or a similar legal construct under national law that guarantees insolvency remoteness. The second condition is that the firm must be subject to rules designed to monitor its solvency and that of its proprietors. In essence, this requires the establishment of prudential supervision. Third, the natural person's annual accounts must be subject to audits by authorised accountants. Fourth, in case the firm has only one proprietor, provisions must be made for the case of his death, incapacity or similar event that deprives him of the ability to run the business. **10**

2. Algorithmic trading

A number of provisions of MiFID II apply to algorithmic trading.[8] The definition of the notion 'algorithmic trading' is to be found in Art 4(1)(39) MiFID II. Accordingly, algorithmic trading is the **use of a computer software that automatically determines whether, when and where a trade is placed**.[9] The fact that the definition concerns an action ('algorithmic trading') and not a person ('algorithmic trader') demonstrates that anybody can fall under this notion, not only investment firms. Hence, it does not matter whether it is an investment firm or another person that engages in this activity. **11**

Level 2 adds that algorithmic trading can take place at any of the stages of initiating, generating, routing or executing orders or quotes according to pre-determined parameters.[10] However, the notion must not be extended too far, given that nearly every investment service or activity involves some use of computers. The Directive therefore sets some limits. It makes clear that algorithmic trading does not include the use of software to route orders to one or more trading venues, to process orders without determining the trading parameters, or to confirm orders.[11] The use of algorithms in post-trading (e.g. clearing and settlement software or the 'blockchain') also does not constitute algorithmic trading.[12] A firm pursing a market making strategy falls into the scope of the provisions on algorithmic trading only under the condition that it carries out the market making activity continuously during a significant portion of the trading hours in comparison to the total trading hours.[13] **12**

Algorithmic traders can be **exempted** from MiFID II where they only deal for their own account, unless they are market makers, members of a trading venue, have direct electronic access to such a trading venue, engage in high-frequency trading or execute client orders.[14] On the notion 'dealing on own account', see Art 4(1)(6) MiFID II. **13**

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[8] See Art 1(5) and Art 17(1)-(6) MiFID II.
[9] Cf the definition in Art 4(1)(39) MiFID II.
[10] Art 18 Delegated Regulation (EU) 565/2017.
[11] See Art 4(1)(39) MiFID II.
[12] Art 4(1)(39) MiFID II. See also Recital 59 MiFID II.
[13] Recital 59 fourth and last sentence MiFID II.
[14] Art 2(d) MiFID II. See → Art 2 mn 8-13.

3. High-frequency algorithmic trading

14 A subset of algorithmic trading is high-frequency algorithmic trading. The Preamble contains a very palpable description, according to which high-frequency algorithmic trading consists of analysing data or signals from the market at **high speed** and then **sending or updating large numbers of orders** within a **very short time period** in response to that analysis.[15] The preamble adds that "[h]igh-frequency algorithmic trading is typically done by the traders using their own capital to trade and rather than being a strategy itself, it is usually the use of sophisticated technology to implement more traditional trading strategies such as market making or arbitrage."[16]

15 The technical definition of high-frequency algorithmic trading techniques is contained in **Art 4(1)(40) MiFID II**, which lists three characteristics that must be present simultaneously. First, high-frequency algorithmic trading techniques try to minimise latency, i.e. the delay of the transmission of data, through various means. Among them is 'co-location' and 'proximity hosting', i.e. the sharing of the same or a close space between their computer system and the exchange or trading platform, which increases the speed of data transfer. Second, high-frequency algorithmic trading is characterised by the fact that orders are initiated, generated, routed or executed without the intervention of a human being. Third, orders, quotes and cancellations are sent out at particularly high intra-day rates.[17] Level 2 defines these rates in absolute numbers as meaning at least two messages per second regarding a single financial instrument traded on a trading venue and at least four messages per second regarding all financial instruments traded on a trading venue.[18]

16 The fact that a person uses a high-frequency algorithmic trading technique has a number of **consequences**. While the legislator identifies some benefits of this type of trading, such as the increase of liquidity and the reduction of short-term volatility, it also warns against its risks, such as the overloading of trading venues or electronic glitches.[19] That is why it subjects this technique to special provisions. In particular, a person engaging in high-frequency algorithmic trading will not be able to benefit from various exemptions, such as those for persons only dealing in financial instruments on own account or that provide investment services in commodity derivatives as an ancillary activity to their main business.[20] Those who use this technique will be subject to the same provisions as algorithmic traders and a certain number of additional provisions.[21]

III. Challenges

1. The categorisation of robo-advice

17 Robo-advisors are computer programmes that **automatically rank and match investments to customers**.[22] Almost all robo-advisors are web-based. They profile the

[15] Recital 61 first sentence MiFID II.
[16] Recital 61 last sentence MiFID II.
[17] Art 4(1)(40) MiFID II.
[18] Art 19 Delegated Regulation (EU) 2017/565.
[19] Recital 62 para 1 MiFID II.
[20] See Art (2)(1)(d) and (j) MiFID II.
[21] See e.g. Art 17(2) last subpara MiFID II.
[22] Baker and Dellaert, 'Regulating Robo Advice Across the Financial Services Industry', 103 *Iowa Law Review* 712, 720 (2018); Garvía, 'Towards a Taxonomy of Robo-Advisors', available at www.repositorio.comillas.edu (15.6.2018); Financial Industry Regulatory Authority (FINRA), Report on Digital Investment Advice, March 2016, p. 2.

clients through questionnaires, e.g. about their knowledge, experience and investment objectives, and then calculate a portfolio of assets adapted to the saver by using modern portfolio theories. Some of the programmes **merely provide advice**, while others **purchase and sell the assets themselves**.[23] The latter type are more properly called 'robo-portfolio managers'.

Among the many legal questions raised by robo-advisors and robo-portfolio managers, the one that is most pressing under the MiFID II is their categorisation. There can be hardly any doubt that advice or portfolio management provided by computers are '**investment services**' in the sense of Art 4(1)(2) MiFID II. As a consequence, the providers of these services are obliged to comply with the requirements of the Directive. For instance, they must provide fair, clear and direct information in order to not be misleading, e.g. regarding the financial institution, the services offered and the risks involved.[24] **18**

Robo-portfolio management services qualify in addition as '**portfolio management services**' in the sense of Art 4(1)(8) MiFID II. Consequently, they must act in conformity with the special provisions intended for such services, e.g. in Art 24(8) and Art 25(6) subpara 4 MiFID II. Where they also initiate the trades without any human intervention, they equally fulfil the definition of **algorithmic trading**, see Art 4(1)(39) MiFID II. **19**

A salient question concerns the identification of the proper **addressee** of regulatory obligations. One may hesitate in this regard between the owner of the computer, the programmer or even the computer itself.[25] The answer given by MiFID II is relatively simple: The addressee of the provisions is the '**investment firm**'. Thus it is the offeror of the automated service who must comply with the regulatory rules. The legal situation is insofar not very different from that of a classic investment firm that uses computers as a support for its services. It is always the offeror who bears the ultimate responsibility for its compliance with the regulatory provisions. **20**

2. The categorisation of Initial Coin Offerings (ICOs)

One of the most interesting questions is whether Initial Coin Offerings (ICOs) fall under the provisions of MiFID II. ICOs are a new way of raising funds on the internet.[26] Investors pay in cryptocurrencies like Bitcoin or Ethereum. In return, they receive '**tokens**', which can have very different attributes. They can be roughly classified into currency tokens, utility tokens and investment tokens.[27] '**Currency tokens**' are a new cryptocurrency, which can be used as a means of payment or for speculative purposes. '**Utility tokens**' allow access to a product or service, such as the right to store data. '**Investment tokens**' typically confer the right to a cash flow and/or voting rights. **21**

Whether ICOs fall under MiFID depends on whether they are 'investment services and activities'. According to Art 4(1)(2) MiFID II, this notion covers only the activities specified in Annex I Section A. The **issuance** of financial instruments is **not** among **22**

[23] For the different types of services, see Garvía, 'Towards a Taxonomy of Robo-Advisors', available at www.repositorio.comillas.edu (15.6.2018).

[24] Joint Committee of the European Supervisory Authorities, Report on the Automation in Financial Advice, December 2015, p. 11, margin no. 29.

[25] See the doubts by Garvía, 'Towards a Taxonomy of Robo-Advisors', available at www.repositorio.com illas.edu (15.6.2018).

[26] On the topic, see Barsan, 'Legal Challenges of Initial Coin Offerings (ICO)', *Revue trimestrielle de droit financier* 2017, no. 3, p. 54 et seq.; Hacker and Thomale, 'Crypto-Securities Regulation: ICOs, Token Sales and Cryptocurrencies under EU Financial Law', available on ssrn.com (15.6.2018); Zetzsche, Arner and Buckley, 'The ICO Gold Rush: It's a Scam, It's a Bubble, It's a Super Challenge for Regulators', *EBI working paper series* no 18 (2018).

[27] See Hacker and Thomale, ibid, p. 12.

them. In particular, the notions 'underwriting' and 'placing' (Annex I Section I no. (6) and (7) MiFIR II) only apply to the activities of the intermediaries and not to those of the issuer itself. Independently of the question whether tokens meet the definition of a 'financial instrument', the ICO – i.e. the issuance of tokens – is as such not subject to MiFID II.

23 However, the Directive may apply to transactions on the **secondary market**, e.g. the reception and transmission of orders relating to tokens, the placement of tokens or the trading of tokens on an MTF or OTF.[28] This presupposes that the tokens can be considered as 'financial instruments' in the sense of Art 4(1)(2) MiFID II. According to Art 4(1)(15) MiFID II, this notion covers the instruments specified in Annex I Section C. In particular, investment tokens that grant rights to a cash flow and/or voting rights may be characterised as securities equivalent to shares in a company and therefore fall under the definition of 'transferrable securities'.[29] Depending on the structure of the ICO, tokens may also represent units in collective investment undertakings.[30] When the token is based on the value of the company or the cash flow of the project as an underlying, it may qualify as a derivative.[31]

24 Hence MiFID II may apply to the marketing, placing and trading of tokens on the secondary market. This must be determined on a **case-by-case basis**, depending on the characteristics of the tokens. The most ardent problems are posed by those tokens that present a mix of features, e.g. utility and investment functions. On a literal reading of the Directive, all products that involve at least some investment element will fall under MiFID II. This seems also in line with the investor protection purpose.

TITLE II
AUTHORISATION AND OPERATING CONDITIONS FOR INVESTMENT FIRMS

Chapter I
Conditions and procedures for authorisation

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[28] Annex I Section A no (1), (7), (8) and (9) MiFID II.

[29] See Art 4(1)(44) MiFID II. In this sense Barsan, 'Legal Challenges of Initial Coin Offerings (ICO)', *Revue trimestrielle de droit financier* 2017, no. 3, p. 54, 62; Hacker and Thomale, 'Crypto-Securities Regulation: ICOs, Token Sales and Cryptocurrencies under EU Financial Law', available on ssrn.com (15.4.2018), p. 20 et seq.; Zetzsche, Arner and Buckley, 'The ICO Gold Rush: It's a Scam, It's a Bubble, It's a Super Challenge for Regulators', *EBI working paper series* no 18 (2018), p. 27, footnote 83.

[30] See Annex I Section C no (3) MiFID II.

[31] See Annex I Section C no (7) MiFID II.

(2nd edn, 2015); Zetzsche D, Buckley RP, Arner DW and Barberis JN, 'Regulating a Revolution: From Regulatory Sandboxes to Smart Regulation', 23:1 *Fordham Journal of Corporate & Financial Law* 31-103.

Introduction to Chapter I

Chapter I sets out the conditions and procedures for authorisation of investment firms. **1**

It is structed as follows: Art 5, 7, 8 MiFID provide the authorisation procedure, while Art 6 MiFID defines the scope of authorisation. Art 9 MiFID deals with the organisation and requirements for the investment firm's management body. Art 10-13 MiFID specify the rules on the acquisition and sale of qualifying holdings in the investment firm. Art 14, 15 MiFID lay down the capital rules, consisting of mandatory investor compensation for operational risks, and minimum prudential capital requirements. Art 16, 17 MiFID identify organisational requirements. Art 16 MiFID stipulates the mandatory organisation structure for all investment firms, while Art 17 MiFID prescribes additional rules for algorithimic and high-frequency trading firms. **2**

Article 5
Requirement for authorisation

1. Each Member State shall require that the provision of investment services and/or the performance of investment activities as a regular occupation or business on a professional basis be subject to prior authorisation in accordance with this Chapter. Such authorisation shall be granted by the home Member State competent authority designated in accordance with Article 67.

2. By way of derogation from paragraph 1, Member States shall authorise any market operator to operate an MTF or an OTF, subject to the prior verification of their compliance with this Chapter.

3. Member States shall register all investment firms. The register shall be publicly accessible and shall contain information on the services or activities for which the investment firm is authorised. It shall be updated on a regular basis. Every authorisation shall be notified to ESMA.

ESMA shall establish a list of all investment firms in the Union. That list shall contain information on the services or activities for which each investment firm is authorised and it shall be updated on a regular basis. ESMA shall publish and keep up-to-date that list on its website.

Where a competent authority has withdrawn an authorisation in accordance with points (b), (c) and (d) of Article 8, that withdrawal shall be published on the list for a period of five years.

4. Each Member State shall require that:

(a) any investment firm which is a legal person have its head office in the same Member State as its registered office;

(b) any investment firm which is not a legal person or any investment firm which is a legal person but under its national law has no registered office, have its head office in the Member State in which it actually carries out its business.

I. General features

1. Recitals

1 Recitals 7, 37-40, 43-46 MiFID.

II. Commentary

1. Authorisation requirement (Art 5(1) MiFID)

2 Art 5(1) establishes **two core principles** of European financial law. First, all investment firms must be authorized. Second, authorisation is concentrated in the hands of the firm's home NCA as defined under → Art 67.

2. Authorisation of market operators (Art 5(2) MiFID)

3 Art 5(2) MiFID provides a partial exemption from Art 5(1) MiFID because **market operators** (cf. → Art 4(1)(18)) **are already regulated** by Title II MiFiR (cf. → MiFIR Art 1(2)). While market operators operating an MTF or OTF (cf. Art 4(1)(22)(23) MiFID) must be authorized under MiFIR, the additional authorisation under MiFID for operating a MTF or OTF is only subject to Art 17 to 19 MiFID and the provisions mentioned therein. See comments there.

3. Register of investment firms (Art 5(3) MiFID)

4 Art 5(3) MiFID requires, on the one hand, the Member States to **register authorized investment firms**. Those registers are available through the NCA's websites.[1]

5 On the other hand, the provision requires the NCA to **forward the information to ESMA**. First implemented through Art 6 of the Omnibus Directive 2010/78/EU, ESMA manages a list of all investment firms active in the European Union. As at the time of writing, ESMA is working on a direct input mechanism so that data provided by the NCAs is directly fed into the ESMA register. The register is available at: https://registers.esma.europa.eu/publication/searchRegister?core=esma_registers_upreg# (17.9.2018). On withdrawals see comment on → Art 8.

4. Head office (Art 5(4) MiFID)

6 Art 5(4)(a) ensures that the **head office and the registered seat of a legal person** are always **located in the same Member State**. This principle dates back to Art 3 BCCI-Directive 95/26/EG to ensure effective enforcement of European financial law. Notwithstanding, it reduces the firm's ability to look for the best combination of corporate and financial law.

7 Art 5(4)(b) deals with the special case in which Member States allow **investment firms that are not a legal person** (see for this possibility Art 4(1), second para MiFID). In this circumstance, the head office is deemed to be located in the Member State that the firm actually carries out its business. This is where the investment firm's key functions are performed. The place of the clients does not matter since the European passport is open to cross-border business relations. The same assumption applies to investment firms that are legal persons but have no registered office under their national law; certain partnerships and associations meet this condition.

[1] See the central access point at https://www.esma.europa.eu/investment-firms (15.6.2018).

Article 6
Scope of authorisation

1. The home Member State shall ensure that the authorisation specifies the investment services or activities which the investment firm is authorised to provide. The authorisation may cover one or more of the ancillary services set out in Section B of Annex I. Authorisation shall in no case be granted solely for the provision of ancillary services.

2. An investment firm seeking authorisation to extend its business to additional investment services or activities or ancillary services not foreseen at the time of initial authorisation shall submit a request for extension of its authorisation.

3. The authorisation shall be valid for the entire Union and shall allow an investment firm to provide the services or perform the activities, for which it has been authorised, throughout the Union, either through the right of establishment, including through a branch, or through the freedom to provide services.

I. General features

1. Recitals

Recitals 7, 37-40, 43-46 MiFID. 1

2. Other regulatory texts

ESMA, Questions and Answers Relating to the provision of CFDs and other speculative products to retail investors under MiFID, 31 March 2017, ESMA35-36-794. 2

II. Commentary

1. Scope of authorisation (Art 6 (1) MiFID)

Art 6(1) establishes the principle that an **authorisation is granted per activity or ancillary activity**. In turn, not all provisions of the MiFID/MiFIR framework apply to all investment firms; rather, only provisions applicable to the activities or ancillary activities for which the investment firm is licensed to perform. In practice, each additional activity comes with associated organisational requirements and must be considered in the programme of operations, staff must be allocated to meet the requirements, and compliance with the applicable law must be ensured by adding said requirements to the internal control system. Small and mid size firms can reduce the regulatory burden by limiting their operations to certain core activities thereby restricting regulatory application and rely on other authorized entities for side activities or exemptions (cf. → Art 3). 3

MiFID defines activities that are **ancillary to authorised activities** in Art 4(1)(3) MiIFD and Section B of Annex I (cf. comments on → Art 4). Ancillary activities are activities that support the main business. For the main part, MiFID refrains from addressing ancillary services in the same level of detail as it addresses main activities; further, the focus on ancillary services only could create new conflicts of interest on the side of the intermediary unforeseen by the MiFID/MiFIR framework. For that reason, the provision of ancillary services alone requires an authorisation under MiFID from the authorisation requirement. However, MiFID exempts certain ancillary activities (cf. Art 2(1)(j) MiFID). 4

2. Extension of scope (Art 6 (2) MiFID)

5 Art 6(2) clarifies that the initial authorisation is limited to the scope and circumstances described in the application that exist at the time of submission and enables an application directed at the **extension of the authorisation's scope**. In most cases, the extension does not require a full review of the initial application; rather, the NCAs limit their review to the new activities and their impact on the organisation of the firm.

3. European passport (Art 6 (3) MiFID)

6 Art 6(3) MiFID stipulates that the **geographical scope** of authorisation extends to the entire European Union. Further, the authorisation covers the countries of the European Economic Area where the MiFID/MiFIR framework has been adopted as part of the EEA aquis.[1]

7 The authorized activities can be performed either on the basis of the **freedom to provide services** (Art 34) or through **the right of establishment** (Art 35), including through a branch passport or a tied agent passport. For details see comments to → Art 34 and → Art 35.

Article 7
Procedures for granting and refusing requests for authorisation

1. The competent authority shall not grant authorisation unless and until such time as it is fully satisfied that the applicant complies with all requirements under the provisions adopted pursuant to this Directive.

2. The investment firm shall provide all information, including a programme of operations setting out, inter alia, the types of business envisaged and the organisational structure, necessary to enable the competent authority to satisfy itself that the investment firm has established, at the time of initial authorisation, all the necessary arrangements to meet its obligations under this Chapter.

3. An applicant shall be informed, within six months of the submission of a complete application, whether or not authorisation has been granted.

4. ESMA shall develop draft regulatory technical standards to specify:

(a) the information to be provided to the competent authorities under paragraph 2 of this Article including the programme of operations;

(b) the requirements applicable to the management of investment firms under Article 9(6) and the information for the notifications under Article 9(5);

(c) the requirements applicable to shareholders and members with qualifying holdings, as well as obstacles which may prevent effective exercise of the supervisory functions of the competent authority, under Article 10(1) and (2).

ESMA shall submit those draft regulatory technical standards to the Commission by 3 July 2015.

Power is delegated to the Commission to adopt the regulatory technical standards referred to in the first subparagraph in accordance with Articles 10 to 14 of Regulation (EU) No 1095/2010.

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[1] See http://www.efta.int/eea-lex.

5. ESMA shall develop draft implementing technical standards to determine standard forms, templates and procedures for the notification or provision of information provided for in paragraph 2 of this Article and in Article 9(5).

ESMA shall submit those draft implementing technical standards to the Commission by 3 January 2016.

Power is conferred on the Commission to adopt the implementing technical standards referred to in the first subparagraph in accordance with Article 15 of Regulation (EU) No 1095/2010.

I. General features

1. Recitals

Recital 157 MiFID. **1**

2. Implementing acts

Commission Delegated Regulation (EU) 2017/1943 of 14 July 2016 supplementing **2**
Directive 2014/65/EU of the European Parliament and of the Council with regard to regulatory technical standards on information and requirements for the authorisation of investment firms; Art 1-4, 6 Commission Implementing Regulation (EU) 2017/1945 of 19 June 2017 laying down implementing technical standards with regard to notifications by and to applicant and authorised investment firms according to Directive 2014/65/EU of the European Parliament and of the Council.

3. Other regulatory texts

ESMA, Questions and Answers Relating to the provision of CFDs and other specula- **3**
tive products to retail investors under MiFID, 31 March 2017, ESMA35-36-794.

II. Commentary

1. Compliance with MiFID (Art 7(1) MiFID)

The authorisation is subject to compliance with the MiFID/MiFIR framework. Be- **4**
cause MiFID II/MiFIR is aiming for **full harmonisation**, additional requirements within the scope of MiFID/MiFIR on the national level are prohibited unless Union law grants Member States discretion in that regard (see, for example, Art 4(1), second para, 9(6), second para, Art 16(11), second para MiFID).

Art 8 and 9 Commission Delegated Regulation (EU) 2017/1943 of 14 July 2016 sup- **5**
plementing Directive 2014/65/EU of the European Parliament and of the Council with regard to regulatory technical standards on information and requirements for the authorisation of investment firms define the **assessment standard** to be applied by the NCA that reviews the application. Those additional requirements concern, in particular, the review of an application of investment firms that are natural persons (cf. Art 4(1), second para MiFID and comments thereon) and of investment firms that are legal persons managed by a single natural person. Further, Art 9 MiFID provides details on the assessment of shareholders and members with qualifying holdings.

2. Application (Art 7(2) MiFID)

6 The information submitted to the NCA are specified in Commission Delegated Regulation (EU) 2017/1943 of 14 July 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to regulatory technical standards on information and requirements for the authorisation of investment firms. Under that RTS, the investment firm must submit the following information concerning its head office (cf. → Art 5(4) MiFID) as well as any branches and tied agents:

– General information (name, contact details, list of services and activities, corporate documents) (cf. Art 1 of that regulation).
– Information on capital and financial resources as well as their source (cf. Art 2 of that regulation).
– Information on shareholders, with details on shareholders with a qualifying holding and the organisation of a corporate group, if any (cf. Art 2 of that regulation).
– Information on the management body and persons influential on the business, in particular full CVs, criminal and financial records, and evidence on the suitability assessments and time available for the mandate (cf. Art 4 of that regulation).
– Financial information on the business (cf. Art 5 of that regulation).
– Information on the organisation of the firm, in particular a programme of operations for the first three years, the organisational structure, the internal control system as well as the IT systems (cf. Art 6 of that regulation).

7 The **procedural details** are specified in Art 1 to 4 of Commission Implementing Regulation (EU) 2017/1945 of 19 June 2017 laying down implementing technical standards with regard to notifications by and to applicant and authorised investment firms according to Directive 2014/65/EU of the European Parliament and of the Council. The information must be submitted to the designated contact point; applicants must use the template set out in Annex I of that regulation and provide details on the management body using the template set out in Annex II of that regulation. Within 10 working days, the NCA is to acknowledge receipt of the application. If necessary, the NCA can request additional information from the applicant.

3. Assessment period (Art 7(3) MiFID)

8 The applicant must be informed **within 6 months of submission** whether its application is successful. The decision can be communicated by electronic means or in paper, see Art 6 of Commission Implementing Regulation (EU) 2017/1945 of 19 June 2017 laying down implementing technical standards with regard to notifications by and to applicant and authorised investment firms according to Directive 2014/65/EU of the European Parliament and of the Council. The maximum assessment period ensures transparency in diffult cases. Applicants whose application has been denied could petition a court to review the denial subject to the Member State's administrative law.

4. Implementing legislation (Art 7(4), (5) MiFID)

9 ESMA has exercised its implementing powers by proposing, as RTS under Art 7(4) MiFID, Commission Delegated Regulation (EU) 2017/1943 of 14 July 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to regulatory technical standards on information and requirements for the authorisation of investment firms, and as ITS subject to Art 7(5) MiFID Commission Implementing Regulation (EU) 2017/1945 of 19 June 2017 laying down implementing technical standards with regard to notifications by and to applicant and authorised investment firms according to Directive 2014/65/EU of the European Parliament and of the Council.

Article 8
Withdrawal of authorisations

The competent authority may withdraw the authorisation issued to an investment firm where such an investment firm:

(a) does not make use of the authorisation within 12 months, expressly renounces the authorisation or has provided no investment services or performed no investment activity for the preceding six months, unless the Member State concerned has provided for authorisation to lapse in such cases;

(b) has obtained the authorisation by making false statements or by any other irregular means;

(c) no longer meets the conditions under which authorisation was granted, such as compliance with the conditions set out in Regulation (EU) No 575/2013;

(d) has seriously and systematically infringed the provisions adopted pursuant to this Directive or Regulation (EU) No 600/2014 governing the operating conditions for investment firms;

(e) falls within any of the cases where national law, in respect of matters outside the scope of this Directive, provides for withdrawal.

Every withdrawal of authorisation shall be notified to ESMA.

I. General features; recitals

Recitals 46, 102 MiFID. 1

II. Commentary

1. Passivity (Art 8(a) MiFID)

If an investment firm does not use its license within a **reasonable amount of time** (defined as 12 months), if it **stops providing investment services for a reasonable amount of time** (defined as 6 months) or if the firm has renounced the authorisation, the authorisation shall be formally withdrawn. The objective of the withdrawal, especially in the first and second case, is to ensure sufficient expertise and professionalism on the side of the firm to pursue investment services. No business indicates there are no clients and – for the most part – no experience on the side of the firm and its organisation. Further, if a firm has no clients it can be rationally expected to get into financial difficulties within a reasonable amount of time. Finally, the provision saves ressources on the side of the NCA by enabling it to focus its monitoring activities on active firms. 2

Withdrawal of authorisation in the cases covered by Art 8(a) MiFID is **not conditional on misconduct** by the firm or its management. In this respect, the withdrawal for reasons specified in that provision is exceptional, and for that very reason withdrawal subject to Art 8(a) MiFID is not published for five years pursuant to Art 5(4), last para MiFID. 3

2. Irregular application (Art 8(b) MiFID)

An application cannot be upheld if it was **fraudulently acquired**. Irregularity can stem from **false statements**, for instance with regard to the key personnels' CVs or on the financial ressources of the shareholders. As a case of practical application of the **pro-** 4

portionality requirement in Union law,[1] minor irregularities do not provide grounds for withdrawal. Further, given that the withdrawal could create upheaval for the clients, a withdrawal is not justified if the irregularity is settled; for instance, the firm has fired the CEO whose CV was inaccurate or misleading in the application and hired an experienced CEO with a good and reputable CV instead.

3. Material changes (Art 8(c) MiFID)

5 Withdrawal due to **non-compliance** with the authorisation conditions defined in Title II, Ch. I MiIFD (Art 5 to 20) can be caused by **financial difficulties**: This is the case Art 8(c) MiFID contemplates by referring to Regulation (EU) No 575/2013. However, non-compliance with any condition of authorisation can justify a withdrawal. For instance, the license may be withdrawn if a firm **moves its head office out of the EU/EEA**, or if the authorisation relies on a programme of operations detailing an internal control system and the firm fails to employ qualified staff to supply the functions specified in the programme. Again, due to proportionality,[2] minor changes do not provide grounds for withdrawal; rather they justify a new assessment based on the firm's updated application. Art 8(c) MiFID justifies withdrawal for material changes only; the withdrawal is *ultima ratio*.

4. Material breaches (Art 8(d) MiFID)

6 Material breaches of the operation conditions stated in MiFID and MiFIR, in particular those of Title II, Ch. II MiIFD (Art 21-33) and Title III-V MiFIR (Art 14-34), justify withdrawal. In this case, and contrary to Art 8(b) and (c) MiFID, the sentence reflects the proportionality test required by primary Union law in that the **infringement must be 'serious[ly] and systematic[ally]'**. Minor breaches may be sanctioned using one of the various means provided by Art 70 MiFID. For severe breaches additional penalties are available under → Art 70 MiFID.

5. National law (Art 8(e) MiFID)

7 **National law** may provide for additional grounds for withdrawal. Examples include violations of tax and labour laws, criminal indictment of key staff as well as a director disqualification based on misconduct in firms not regulated by MiFID/MiFIR.

6. Notification to ESMA

8 Every withdrawal must be **notified to ESMA** under Art 8, last para MiFID. This requirement serves three objectives: First, to update ESMA's register of all authorized investment firms. Second, the NCA demonstrates with its notice that it effectively enforces MiFID and MiFIR. Third, the notice allows ESMA to communicate to other NCAs that the authorisation has been withdrawn, with the effect that similar business activities undertaken in other Member States by virtue of the European passport (cf. Art 6(3) MiFID) is illegal from the moment the withdrawal takes effect; this may be important if host NCAs issue complaints with regard to the formerly licensed firm. For the same rea-

[1] See Zetzsche and Preiner, 'Europäisches Kapitalmarktrecht (Intermediärsrecht)', in Gebauer and Teichmann (eds), *Enzyklopädie Europarecht, Vol. 6: Europäisches Privat- und Unternehmensrecht*, § 7 B (Nomos 2016), para 178 et seq.

[2] Zetzsche and Preiner, 'Europäisches Kapitalmarktrecht (Intermediärsrecht)', in Gebauer and Teichmann (eds), *Enzyklopädie Europarecht, Vol. 6: Europäisches Privat- und Unternehmensrecht*, § 7 B (Nomos 2016), para 178 et seq.

son, Art 5(4), last para MiFID requires ESMA, where a competent authority has withdrawn an authorisation in accordance with Art 8(b), (c), (d) MiFID to publish that withdrawal on the ESMA list of investment firms for a period of five years.

Article 9
Management body

1. Competent authorities granting the authorisation in accordance with Article 5 shall ensure that investment firms and their management bodies comply with Article 88 and Article 91 of Directive 2013/36/EU.

ESMA and EBA shall adopt, jointly, guidelines on the elements listed in Article 91(12) of Directive 2013/36/EU.

2. When granting the authorisation in accordance with Article 5, competent authorities may authorise members of the management body to hold one additional non-executive directorship than allowed in accordance with Article 91(3) of Directive 2013/36/EU. Competent authorities shall regularly inform ESMA of such authorisations.

EBA and ESMA shall coordinate the collection of information provided for under the first subparagraph of this paragraph and under Article 91(6) of Directive 2013/36/EU in relation to investment firms.

3. Member States shall ensure that the management body of an investment firm defines, oversees and is accountable for the implementation of the governance arrangements that ensure effective and prudent management of the investment firm including the segregation of duties in the investment firm and the prevention of conflicts of interest, and in a manner that promotes the integrity of the market and the interest of clients.

Without prejudice to the requirements established in Article 88(1) of Directive 2013/36/EU, those arrangements shall also ensure that the management body define, approve and oversee:

(a) the organisation of the firm for the provision of investment services and activities and ancillary services, including the skills, knowledge and expertise required by personnel, the resources, the procedures and the arrangements for the provision of services and activities, taking into account the nature, scale and complexity of its business and all the requirements the firm has to comply with;

(b) a policy as to services, activities, products and operations offered or provided, in accordance with the risk tolerance of the firm and the characteristics and needs of the clients of the firm to whom they will be offered or provided, including carrying out appropriate stress testing, where appropriate;

(c) a remuneration policy of persons involved in the provision of services to clients aiming to encourage responsible business conduct, fair treatment of clients as well as avoiding conflict of interest in the relationships with clients.

The management body shall monitor and periodically assess the adequacy and the implementation of the firm's strategic objectives in the provision of investment services and activities and ancillary services, the effectiveness of the investment firm's governance arrangements and the adequacy of the policies relating to the provision of services to clients and take appropriate steps to address any deficiencies.

Members of the management body shall have adequate access to information and documents which are needed to oversee and monitor management decision-making.

4. The competent authority shall refuse authorisation if it is not satisfied that the members of the management body of the investment firm are of sufficiently good repute, possess sufficient knowledge, skills and experience and commit sufficient time to perform their functions in the investment firm, or if there are objective and demonstrable grounds for believing that the management body of the firm may pose a threat to its effective, sound and prudent management and to the adequate consideration of the interest of its clients and the integrity of the market.

5. Member States shall require the investment firm to notify the competent authority of all members of its management body and of any changes to its membership, along with all information needed to assess whether the firm complies with paragraphs 1, 2 and 3.

6. Member States shall require that at least two persons meeting the requirements laid down in paragraph 1 effectively direct the business of the applicant investment firm.

By way of derogation from the first subparagraph, Member States may grant authorisation to investment firms that are natural persons or to investment firms that are legal persons managed by a single natural person in accordance with their constitutive rules and national laws. Member States shall nevertheless require that:

(a) alternative arrangements be in place which ensure the sound and prudent management of such investment firms and the adequate consideration of the interest of clients and the integrity of the market;

(b) the natural persons concerned are of sufficiently good repute, possess sufficient knowledge, skills and experience and commit sufficient time to perform their duties.

I. General features

1. Recitals

1 Recitals 53-55 MiFID.

2. Implementing acts

2 Art 5 Commission Implementing Regulation (EU) 2017/1945 of 19 June 2017 laying down implementing technical standards with regard to notifications by and to applicant and authorised investment firms according to Directive 2014/65/EU of the European Parliament and of the Council.

3. Other regulatory texts

Joint ESMA and EBA Guidelines on the assessment of the suitability of members of the management body and key function holders under Directive 2013/36/EU and Directive 2014/65/EU, EBA/GL/2017/12. 3

II. Commentary

1. Compliance with Art 88, 91 CRD IV (Art 9(1) MiFID)

Investment firm's management bodies must comply with Art 88 CRD IV (on **governance arrangements**) and Art 91 CRD IV (on the **management body**). Both provisions are neither self-evident, nor in themselves consistent.[1] The guidelines referred to in Art 9(1) second para MiFID, to address the items listed in Art 91(12) CRD IV, have been adopted as *Joint ESMA and EBA Guidelines on the assessment of the suitability of members of the management body and key function holders under Directive 2013/36/EU and Directive 2014/65/EU*, EBA/GL/2017/12, of 26 September 2017. Written from the perspective of CRD IV, for the main part, those guidelines do not address all issues relating to investment firms, which are often smaller organisation than credit institutions. 4

Art 88 CRD IV is partly identical, yet has some slightly **variations from Art 9(3) MiFID**. Investment firms cannot easily fulfill all of its requirements. The implications for investment firms are discussed in the context of Art 9(3) MiFID. Art 91 CRD IV deals with the board composition; it is discussed in → Art 9(4) MiFID, see comments there. 5

According to Art 4(1)(36) MiFID, 'management body' means the body or bodies of an investment firm, market operator or data reporting services provider, which are appointed in accordance with national law and are empowered to set the entity's strategy, objectives and overall direction, and which also oversee and monitor management decision-making and include persons who effectively direct the business of the entity. Where MiFID refers to the management body and, pursuant to national law, the managerial and supervisory functions of the management body are assigned to **different bodies or different members** within one body, the Member State law shall identify the bodies or members of the management body responsible in accordance with its national law, unless otherwise specified by the Directive. For the purposes of the board governance and composition, recital 55 MiFID recognizes, at least formally, the difference between unitary or dual (**one-tier / two-tier) board structures**. The term 'management body' comprises "all existing structures without advocating any particular structure. They are purely functional for the purpose of setting out rules aiming to achieve a particular outcome irrespective of the national company law applicable to an institution in each Member State. The definitions should therefore not interfere with the general allocation of competences in accordance with national company law." 6

2. Additional non-executive directorship (Art 9(2) MiFID)

Recital 54 MiFID emphasises that '[c]ombining too high a **number of directorships** would preclude a member of the management body from spending adequate time on the performance of that oversight role. Therefore, it is necessary to limit the number of directorships a member of the management body of an institution may hold at the same 7

[1] Cf. Enriques and Zetzsche, 'Quack Corporate Governance, Round III? Bank Board Regulation Under the New European Capital Requirement Directive', *Theoretical Inquiries in Law* 16.1 (2015), 211-244.

time in different entities. However, directorships in organisations which do not pursue predominantly commercial objectives, such as not-for-profit or charitable organisations, should not be taken into account for the purposes of applying such a limit."

8 Art 91(3) CRD IV, which investment firms must apply (cf. Art 9(1) MiFID), allows individual directors of **institutions that are *significant*** in terms of size, internal organisation and the nature, the scope and the complexity of its activities, to have a maximum of 4 non-executive board memberships in credit institutions, or a combination of 1 executive membership with 2 non-executive memberships. Art 9(2) MiFID vests discretion into NCAs to allow one additional non-executive directorship, up to a maximum of 5 non-executive memberships, or the combination of 1 executive with up to 3 non-executive memberships, respectively.

9 This provision sets a de facto incentive to deny the approval for the additional directorship since any granting of approval must be **notified to ESMA**. It is also doubtful that ESMA is able to review the decision without entering into micromanagement of the NCA's affairs. For the same reason, it remains unclear in which way the coordination of EBA and ESMA with regard to investment firms leads to meaningful results. Both institutions do not supervise the entities in question, which are subject to supervision by NCAs.

10 Art 91(6) CRD IV contains basically the same provision. The relationship between Art 9(2) MiFID and Art 91(6) CRD IV is uncertain, in particular whether Art 9(2) MiFID allows the addition of **one more directorship** to the directorships allowed under Art 91 CRD IV.[2] Such a reading could be based on the rationale that investment firms are, on average, smaller entities than credit institutions and therefore directors are capable to hold more directorships in different firms. If this construction is adopted, the NCA could permit up to 6 non-executive memberships, or the combination of 1 executive with up to 4 non-executive memberships.

3. Management body's duties and responsibilities (Art 9(3) MiFID)

11 Pursuant to Recital 54 MiFID, in order to have an **effective oversight and control** over the intermediaries licensed under MiFID "the **management body** should be responsible and accountable for the **overall strategy of the firm**, taking into account the firm's business and risk profile." In particular, the management body as part of its strategic function should assume responsibilities across the business cycle of the firm in the following areas:

– the identification and definition of the strategic objectives;
– the risk strategy and internal governance of the firm;
– the approval of its internal organisation;
– the criteria for selection and training of personnel;
– the effective oversight of senior management;
– the overall policies governing the provision of services and activities, including the remuneration of sales staff and the approval of new products for distribution to clients.

[2] The Joint ESMA and EBA Guidelines on the assessment of the suitability of members of the management body and key function holders under Directive 2013/36/EU and Directive 2014/65/EU, EBA/GL/2017/12, pp. 30 et seq. are silent on the matter.

Besides the strategic function, the board assumes **monitoring functions**. These relate to: 12
- Periodic monitoring and assessment of the strategic objectives of firms,
- Ensuring that the internal organisation and policies for the provision of services and activities are in line with sound and prudent management, in the interest of the integrity of the markets and the protection of investors.

The requirements in Art 9(3) MiFID and Art 88 (1) CRD IV partly overlap. The following table provides an overview of the respective provisions: 13

Table: Individual suitability under Art 9(4) MiFID, Art 91 CRD IV, Joint Guidelines

Art 9(3) MiFID	Art 88 CRD IV
Member States shall ensure that the management body of an investment firm defines, oversees and is accountable for the implementation of the governance arrangements that ensure effective and prudent management of the investment firm including the segregation of duties in the investment firm and the prevention of conflicts of interest, ***and in a manner that promotes the integrity of the market and the interest of clients.***	**(1) Member States shall ensure that the management body defines, oversees and is accountable for the implementation of the governance arrangements that ensure effective and prudent management of an institution, including the segregation of duties in the organisation and the prevention of conflicts of interest.**
Reference to Art 88 (1) CRD IV	**the management body must have the overall responsibility for the institution and approve and oversee the implementation of the institution's strategic objectives, risk strategy and internal governance**
Reference to Art 88 (1) CRD IV	**the management body must ensure the integrity of the accounting and financial reporting systems, including financial and operational controls and compliance with the law and relevant standards**
Reference to Art 88 (1) CRD IV	**the management body must oversee the process of disclosure and communications**
Reference to Art 88 (1) CRD IV	**the management body must be responsible for providing effective oversight of senior management**
Reference to Art 88 (1) CRD IV	**the chairman of the management body in its supervisory function of an institution must not exercise simultaneously the functions of a chief executive officer within the same institution, unless justified by the institution and authorised by competent authorities**
The management body shall monitor and periodically assess the ***adequacy and the implementation of the firm's strategic objectives in the provision of investment services and activities and ancillary services*****, the effectiveness of the investment firm's governance arrangements and** ***the adequacy of the policies relating to the provision of services to clients*** **and take appropriate steps to address any deficiencies.**	**Member States shall ensure that the management body monitors and periodically assesses the effectiveness of the institution's governance arrangements and takes appropriate steps to address any deficiencies.**
the organisation of the firm for the provision of investment services and activities and ancillary services, including the skills, knowledge and expertise required by personnel, the resources, the procedures and the arrangements for the provision of services and activities, taking into account the na-	**n.a.**

ture, scale and complexity of its business and all the requirements the firm has to comply with	
a policy as to services, activities, products and operations offered or provided, in accordance with the risk tolerance of the firm and the characteristics and needs of the clients of the firm to whom they will be offered or provided, including carrying out appropriate stress testing, where appropriate;	**n.a.**
a remuneration policy of persons involved in the provision of services to clients aiming to encourage responsible business conduct, fair treatment of clients as well as avoiding conflict of interest in the relationships with clients	**n.a.**
Members of the management body shall have adequate access to information and documents which are needed to oversee and monitor management decision-making.	**n.a.**

14 In addition, Art 9(3) MiFID refers to Art 88(2) CRD IV. Under Art 88(2) CRD IV, "**institutions which are significant** in terms of their size, internal organisation and the nature, scope and complexity of their activities" shall establish a **nomination committee** composed of non-executive members of the management body. The nomination committee shall, under conditions further specified in Art 88(2) CRD IV, identify suitable board candidates and assess their suitability in line with the requirements set out in Art 9(4) MiFID and the target for the representation of the underrepresented body in the management body and the applicable policies thereon. Further, the nomination committee shall review and assess the board composition, the collective and individual suitability of board members, and the procedures relating to the selection and appointment of senior management and management body. The appointment of a nomination committee is subject to the condition that the management body, under national law of the Member State where the investment firm is established, has the competence in the process of selection and appointment of any of its members.

4. Fitness & properness (Art 9(4) MiFID)

15 Investment firms wishing to select board members need to review at least **three sources of law**: 1) provisions of Member State law implementing Art 9(4) MiFID, 2) Art 91 CRD IV and 3) the *Joint ESMA and EBA Guidelines on the assessment of the suitability of members of the management body and key function holders under Directive 2013/36/EU and Directive 2014/65/EU, EBA/GL/2017/12*, providing details to the list in Art 91(12) CRD IV.

16 The following tables show how these sources of law interact, distinguishing between **individual suitability** (pertaining to the board member individually) and **collective suitability** (pertaining to the board as a whole).

Table: Individual suitability under Art 9(4) MiFID, Art 91 CRD IV, Joint Guidelines

Art 9(4) MiFID	**Art 91 CRD IV**	**Joint Guidelines**
good repute	Art 91(1) sent 1 CRD IV, Art 91(1) sent 1 CRD IV	pp. 35-37
Reference to Art 91 CRD IV	independence of mind (Art 91(8) CRD IV)	pp. 38

Art 9(4) MiFID	**Art 91 CRD IV**	**Joint Guidelines**
sufficient knowledge, skills and experience	Art 91(1) sent 1 CRD IV	pp. 32-34
Sufficient time	Art 91(2) CRD IV	pp. 28-30
Reference to Art 91 CRD IV	Number of directorships in line with nature, scale and complexity of the institution's activities (Art 91(3)	
Reference to Art 91 CRD IV	Number of directorships in *significant* institutions limited to 4 non-executive or 1 executive +2 non-executive memberships (Art 91(3)	pp. 30-31
Reference to Art 91 CRD IV	Directorships within the same group of companies count as one (Art 91(4) CRD IV)	pp. 30-31
Reference to Art 91 CRD IV	Directorships in non-commercial entities do not count (Art 91(5) CRD IV)	p. 31
Reference to Art 91 CRD IV	Discretion of NCA to grant extra non-executive directorship (Art 91(6) CRD IV)	
Reference to Art 91 CRD IV	Employee representatives under national law (Art 91(13) CRD IV)	

Table: Collective suitability under Art 9(4) MiFID, Art 91 CRD IV, Joint Guidelines 17

Art 9(4) MiFID	**Art 91 CRD IV**	**Joint Guidelines**
Reference to Art 91 CRD IV	The overall composition of the management body shall reflect an adequately broad range of experiences (Art 91(1) CRD IV), broad set of qualities and competences, diversity (Art 91(10) CRD IV)	pp. 44-45
Reference to Art 91 CRD IV	Collective suitability: adequate collective knowledge, skills and experience (Art 91(7) CRD IV)	pp. 26-27
Reference to Art 91 CRD IV	induction and training of members of the management body (Art 91 CRD IV)	pp. 42-44
Reference to Art 91 CRD IV	NCAs to collect information to benchmark diversity practices (Art 91(11) CRD IV)	
Threat to effective, sound and prudent management	n.a.	n.a.
Threat to consideration of clients' interests	n.a.	n.a.
Thread to market integrity	n.a.	n.a.

5. Notification re management and changes (Art 9(5) MiFID)

18 The ***initial*** **information on the management body** is already an authorisation requirement under → Art 7(2) MiFID (see comments there) and is detailed in Art 4 of Commission Delegated Regulation (EU) 2017/1943 of 14 July 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to regulatory technical standards on information and requirements for the authorisation of investment firms. Art 9(5) MiFID has its own meaning with regard to **changes to the membership of the management body**.

19 Art 5 (1) Commission Implementing Regulation (EU) 2017/1945 of 19 June 2017 laying down implementing technical standards with regard to notifications by and to applicant and authorised investment firms according to Directive 2014/65/EU of the European Parliament and of the Council details the procedures for notification of changes to the membership of the management body. Pursuant to that provision, an "investment firm shall **notify the competent authority of any change to the membership of its management body** before such change takes effect. Where, for substantiated reasons, it is not possible to make the notification before that change takes effect, it shall be made within 10 working days after the change." The information on the new management body member must be provided in the format set out in Annex III to Commission Implementing Regulation (EU) 2017/1945 of 19 June 2017 laying down implementing technical standards with regard to notifications by and to applicant and authorised investment firms according to Directive 2014/65/EU of the European Parliament and of the Council.

6. Four-eyes-principle (Art 9(6) MiFID)

20 Art 9(6) MiFID establishes the principle that **at least two persons** qualified under Art 9(1) MiFID **direct the business of an investment firm**. This principle helps avoid mismanagement to the same extent that it reduces the likelihood of fraud, given that the reputation of two responsible managers is at risk.

21 Deviations from the principle are allowed only under **extraordinary circumstances**. EU law vests discretion into the Member States to grant such an exemption, but details the conditions for doing so in Art 9(6), second para MiFID. Single management is acceptable only if the firm puts **alternative arrangements** in place to ensure the sound and prudent management of that investment firm. Examples include an external monitor or an organisation of the firm that makes it impossible to access the clients' assets without consent by an independent third party (for instance, a depositary bank). Interestingly, while deviation from Art 9(6) MiFID leads to greater risks than one additional non-executive directorship (cf. Art 9(2) MiFID), Art 9(6) MiFID does not require a notice to ESMA.

Article 10
Shareholders and members with qualifying holdings

1. The competent authorities shall not authorise the provision of investment services or performance of investment activities by an investment firm until they have been informed of the identities of the shareholders or members, whether direct or indirect, natural or legal persons, that have qualifying holdings and the amounts of those holdings.

The competent authorities shall refuse authorisation if, taking into account the need to ensure the sound and prudent management of an investment firm, they are not satisfied as to the suitability of the shareholders or members that have qualifying holdings.

Where close links exist between the investment firm and other natural or legal persons, the competent authority shall grant authorisation only if those links do not prevent the effective exercise of the supervisory functions of the competent authority.

2. The competent authority shall refuse authorisation if the laws, regulations or administrative provisions of a third country governing one or more natural or legal persons with which the undertaking has close links, or difficulties involved in their enforcement, prevent the effective exercise of its supervisory functions.

3. Member States shall require that, where the influence exercised by the persons referred to in the first subparagraph of paragraph 1 is likely to be prejudicial to the sound and prudent management of an investment firm, the competent authority take appropriate measures to put an end to that situation.

Such measures may include applications for judicial orders or the imposition of sanctions against directors and those responsible for management, or suspension of the exercise of the voting rights attaching to the shares held by the shareholders or members in question.

I. General features

1. Recitals

Recitals 29, 42 MiFID. 1

2. Implementing acts

Art 9, 10 Commission Delegated Regulation (EU) 2017/1943 of 14 July 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to regulatory technical standards on information and requirements for the authorisation of investment firms. 2

3. Other regulatory texts

ESMA, Questions and Answers Relating to the provision of CFDs and other speculative products to retail investors under MiFID, 31 March 2017, ESMA35-36-794, p. 9-10. 3

II. Commentary

1. Suitability of shareholders with qualifying holdings (Art 10(1) MiFID)

The suitability of shareholders with qualifying holdings is a core authorisation criterion. Experience suggests that where the shareholders are reliable and in favour of compliance, enforcement faces little difficulties since those shareholders can be expected to have a salient influence on the investment firm and its management. Art 10 MiFID provides a **two steps suitability test**. First, it makes sure that the **identity of members** or shareholders (regardless of the investment firm's legal form) with a qualifying holding (cf. Art 4(1)(33) MiFID) and their stakes, either directly or indirectly held, are **disclosed** 4

to the NCA by denying authorisation in case of non-compliance. Accordingly, information on shareholders with a qualifying holding are a crucial part of the application materials (see comment on → Art 7(2)).

5 Second, the NCA must reject the application and refuse authorisation if the **shareholders with qualifying holdings are considered suitable** to ensure the sound and prudent management of an investment firm. In assessing the shareholders' suitability, the NCA utilises the criteria laid down in Art 9 Commission Delegated Regulation (EU) 2017/1943 of 14 July 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to regulatory technical standards on information and requirements for the authorisation of investment firms. Accordingly, the NCA considers

a) the **reputation and experience** of any person who will direct the business of the investment firm;
b) the **reputation** of the proposed shareholders and members with qualifying holdings;
c) the **financial soundness** of the proposed shareholders and members with a qualifying holding, in particular in relation to the type of business pursued and envisaged in the investment firm;
d) whether the investment firm will be able to comply and continue to comply with **capital adequacy requirements** for investment firms (cf. comments on → Art 15), and where applicable for financial conglomerates (cf., for instance, Directive 2002/87/EC, as amended by Directive 2011/89/EU). In particular, the NCA will review whether the group has a structure that makes it possible to exercise effective supervision, effectively exchange information among the competent authorities and determine the allocation of responsibilities among the competent authorities. This test provides for challenges, for instance, if the parent company is established in a country whose NCA does not cooperate with European NCAs, or ESMA;
e) whether there are reasonable grounds to suspect that, in connection with the authorisation of the investment firm, **money laundering or terrorist financing** within the meaning of European AML/CTF legislation is being or has been committed or attempted, or that the authorisation of the investment firm could increase the risk thereof. Note that tax fraud is deemed to be a pre-offence in relation to money laundering.

2. Close links to other persons (Art 10(1), second para MiFID)

6 In case of close links (cf. Art 4(1)(35) MiFID) between the investment firm and other natural or legal persons, the NCA is prevented from granting authorisation if those **links are harmful to the effective exercise of the supervisory functions** of the NCA.

7 Art 10 Commission Delegated Regulation (EU) 2017/1943 of 14 July 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to regulatory technical standards on information and requirements for the authorisation of investment firms defines in which cases the NCA considers that a **group of companies** (cf. Art 4(1)(34) MiFID) provides an obstacle to the exercise of the supervisory function of the NCA. This is the case if a group

– is complex and not sufficiently transparent;
– has a geographical location of group entities;
– includes activities performed by the group entities that may prevent the competent authority to effectively appraise the suitability of the shareholders or members with qualifying holdings or the influence of close links with the investment firm.

8 The last case includes, for instance, activities that **conceal a look-through on shareholders** or that put the group in the vicinity of money laundering, drug trafficking or

terrorist financing. The underlying rationale is that the respective NCA will have difficulties in supervising compliance with the MiFID/MiFIR framework if the group is more oriented towards the group interest (which may be influenced by the circumstances in the group's main country or by dominating shareholders) than towards compliance with the Union law.

3. Relations to Third Countries (Art 10(2) MiFID)

A particular close look is warranted if a shareholder with a **qualifying holding is established in a country outside the EEA**. Such a third country relationship will prompt scrutiny in light of the criteria in Art 9 lit. d, e Commission Delegated Regulation (EU) 2017/1943 of 14 July 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to regulatory technical standards on information and requirements for the authorisation of investment firms. If a parent company is established, or a close link (cf. Art 4(1)(35) MiFID) is established to a company, in a country that is uncooperative in enforcing foreign financial laws as well as AML/CTF legislation, the NCA must deny authorisation. Note that a lack of cooperation in tax matters alone does not justify refusal of authorisation. The same refusal is warranted if the NCA, or – due to the intensified cooperation in the European supervisory system – any other authority in the EU/EEA, has experienced difficulties in enforcing claims against companies with parent companies or links in that country. As a result, difficulties with one EU/EEA country could lead to unexpected difficulties with another EU/EEA country. **9**

4. Appropriate measures to end harmful influence (Art 10(3) MiFID)

If the harmful influence of shareholders with a qualifying holding or close links to the investment firm is obvious from the outset, the NCA will **refuse authorisation**. No further steps are necessary. However, if the harmful influence on the investment firm becomes apparent only later, the NCA may be prevented from withdrawing the license altogether since the withdrawal as *ultima ratio* is potentially detrimental to investors. Art 10(3) MiFID confirms that principle and mandates the NCA to use **a number of powers to end the harmful influence** of shareholders and close links. These powers include judicial orders, sanctions against directors and those responsible for management, or suspension of the exercise of the voting rights attaching to the shares held by the shareholders or members in question. Following such orders, the legal basis of the influence is likely undermined, although an economic dependency may persist. The catalogue of Art 10 (3) MiFID is not exlcusive; the NCA could use other sanctions specified in Art 70 MiFID, but not listed in Art 10(3) MiFID. **10**

Article 11
Notification of acquisitions and disposals of qualifying holdings

1. Member States shall require any natural or legal person or such persons acting in concert (the 'proposed acquirer'), who have taken a decision either to acquire, directly or indirectly, a qualifying holding in an investment firm or to further increase, directly or indirectly, such a qualifying holding in an investment firm as a result of which the proportion of the voting rights or of the capital held would reach or exceed 20 %, 30 % or 50 % or so that the investment firm would become its subsidiary (the 'proposed acquisition'), first to notify in writing the competent authorities of the investment firm in which they are seeking to acquire or increase a qualifying holding,

indicating the size of the intended holding and relevant information, as referred to in Article 13(4).

Member States shall require any natural or legal person who has taken a decision to dispose, directly or indirectly, of a qualifying holding in an investment firm first to notify in writing the competent authorities, indicating the size of the intended holding. Such a person shall likewise notify the competent authorities if he has taken a decision to reduce his qualifying holding so that the proportion of the voting rights or of the capital held would fall below 20 %, 30 % or 50 % or so that the investment firm would cease to be his subsidiary.

Member States need not apply the 30 % threshold where, in accordance with point (a) of Article 9(3) of Directive 2004/109/EC, they apply a threshold of one-third.

In determining whether the criteria for a qualifying holding referred to in Article 10 and in this Article are fulfilled, Member States shall not take into account voting rights or shares which investment firms or credit institutions may hold as a result of providing the underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis included under point 6 of Section A of Annex I, provided that those rights are, on the one hand, not exercised or otherwise used to intervene in the management of the issuer and, on the other, disposed of within one year of acquisition.

2. The relevant competent authorities shall work in full consultation with each other when carrying out the assessment provided for in Article 13(1) (the 'assessment') if the proposed acquirer is one of the following:

(a) a credit institution, assurance undertaking, insurance undertaking, reinsurance undertaking, investment firm or UCITS management company authorised in another Member State or in a sector other than that in which the acquisition is proposed;

(b) the parent undertaking of a credit institution, assurance undertaking, insurance undertaking, reinsurance undertaking, investment firm or UCITS management company authorised in another Member State or in a sector other than that in which the acquisition is proposed; or

(c) a natural or legal person controlling a credit institution, assurance undertaking, insurance undertaking, reinsurance undertaking, investment firm or UCITS management company authorised in another Member State or in a sector other than that in which the acquisition is proposed.

The competent authorities shall, without undue delay, provide each other with any information which is essential or relevant for the assessment. In that regard, the competent authorities shall communicate to each other upon request all relevant information and shall communicate on their own initiative all essential information. A decision by the competent authority that has authorised the investment firm in which the acquisition is proposed shall indicate any views or reservations expressed by the competent authority responsible for the proposed acquirer.

3. Member States shall require that, if an investment firm becomes aware of any acquisitions or disposals of holdings in its capital that cause holdings to exceed or fall below any of the thresholds referred to in the first subparagraph of paragraph 1, that investment firm is to inform the competent authority without delay.

At least once a year, investment firms shall also inform the competent authority of the names of shareholders and members possessing qualifying holdings and the sizes of such holdings as shown, for example, by the information received at annual general meetings of shareholders and members or as a result of compliance with the regu-

lations applicable to companies whose transferable securities are admitted to trading on a regulated market.

4. Member States shall require that competent authorities take measures similar to those referred to in Article 10(3) in respect of persons who fail to comply with the obligation to provide prior information in relation to the acquisition or increase of a qualifying holding. If a holding is acquired despite the opposition of the competent authorities, the Member States shall, regardless of any other sanctions to be adopted, provide either for exercise of the corresponding voting rights to be suspended, for the nullity of the votes cast or for the possibility of their annulment.

I. General features; recitals

Recital 7, 47, 157, 158 MiFID. **1**

II. Commentary

1. Notification of acquisition and disposal of qualifying holdings by shareholder (Art 11(1) MiFID)

All **acquisitions of qualifying holdings** (which is roughly equal to a 10 percent stake **2**
in the firm, see Art 4(1)(31) MiFID) are **subject to a review by the NCA** that focuses on the acquirer's suitability and the financial soundness of the proposed acquisition (cf. Recital 47 and → Art 13 MiFID). The review is based on the same grounds as the review of the holders of qualifying holders at the occasion of the initial authorisation (cf. comments on → Art 10). The review is prompted by the **notification** under Art 11(1) MiFID. In order to ensure the effective information of the NCA on acquisitions, and in order to ensure that the NCA always has a complete picture of qualifying holdings, Art 11(1) MiFID also submits the disposal of qualifying holdings to a notification requirement. The details of the notification requirement are partly listed in Art 11(1) MiFID, and partly detailed in Art 13(4) MiFID.

a) Proposed acquisition (Art 11(1) MiFID)

The subject of notification is the '**proposed acquisition**'. This is a technical term re- **3**
ferring to any person – and persons acting in concert with the person – who has taken a decision to acquire a qualifying holding in the investment firm, or to increase its existing stake in a qualifying holding. The notification requirement is triggered regardless of whether the stake to be acquired is held directly or indirectly.

b) Notification threshold (Art 11(1), subpara 3 and 4 MiFID)

4 The notification is due if the **stake exceeds or falls below, respectively, the 10 percent threshold** (see the definition of qualifying holding in → Art 4(1)(31)), as well as the **20 percent, 30 percent and 50 percent threshold** relating to either the capital or the votings rights of the investment firms. Exceeding, or falling below, both the capital and voting threshold prompts the notification requirement which could result in multiple notifications if capital proportions are not in line with voting rights proportion; the difference does not matter however in a one share – one vote company constitution. Member State' law can replace the 30 percent threshold with a threshold of a third of capital/voting rights.

5 Further, the notification is due if, as a result of the transaction, the investment firm is **reorganized into a subsidiary or loses the status of a subsidiary** (cf. Art 4(1)(33) MiFID).

6 **Shares acquired on behalf of clients** (including investment funds) do not count for the purpose of the threshold calculation, even though this is not explicitly mentioned in Art 11(1), subpara 4 MiFID. This is so because such shares are acquired by the clients, not the acquirer, regardless of the legal nature of the acquisition (for instance, some firms may provide portfolio administration for clients on a per commission basis where the formal acquirer is the firm rather than the client). More generally, all shares to which client asset segregation requirements apply (cf. → Art 16(8) MiFID) are not shares of the acquirer, but of the clients.

7 Further, Art 11(1), subpara 4 MiFID excludes shares which are formally **shares** of the acquirer, but which are **earmarked for sale** as part of the acquirer's underwriting or placement business if such shares are not for influencing the investment firm and if such shares are sold within a year after the acquisition. As a result, those shares count as being shares of the acquirer after one year.

2. Suitability check re acquirer (Art 11(2) MiFID)

8 While the assessment of the aquirer's suitability is specified in → Art 13 MiFID (cf. comments there), Art 11 MiFID adds two important details: a) the **scope of the suitability assessment**, and b) the **cooperation of the relevant authorities** in providing the information employed for the suitability assessment.

a) Scope (Art 11(2) MiFID)

9 The scope of the suitability check extends to **any regulated financial institution** (lit a) as well as any **parent company and control holder** of any regulated financial institution (lit b, lit c). The reference to "sector" makes clear that it is not relevant whether the respective institution is authorised for the same or different types of financial services. The list of Art 11(2) MiFID has been taken from Directive 2007/44/EC of the European Parliament and of the Council.[1] As this provision was adopted prior to the global financial crisis, it does not include Alternative Investment Funds (AIFMs) and Institutions for Occupational Retirement Provision (IORPs), nor does it include other authorised financial institutions whose authorisation has been established since 2008 (such as Central Securities Depositoris (CSDs)). Apparently, the legislator missed the opportunity to up-

[1] Directive 2007/44/EC of the European Parliament and of the Council of 5 September 2007 amending Council Directive 92/49/EEC and Directives 2002/83/EC, 2004/39/EC, 2005/68/EC and 2006/48/EC as regards procedural rules and evaluation criteria for the prudential assessment of acquisitions and increase of holdings in the financial sector (Text with EEA relevance).

date the list. In our view, which is based on an objective oriented interpretation, the list in Art 11(2) MiFID is not exhaustive, but must be understood *pars pro toto* for all regulated financial institutions. Accordingly, the NCA may request the cooperation of other authorities also in cases where the acquirer is an AIFM, CSD etc. or a parent company or a control holder thereof.

b) Cooperation of NCAs (Art 11(2), second para MiFID)

Art 11(2) MiFID requires **full cooperation and consultation of the respective NCAs**.[2] In particular, it obliges them to provide each other at their own initiative with any information essential for the assessment. The underlying rationale is that in the European System of Financial Supervision, all NCAs together ensure enforcement of the standards of European law. **10**

c) Reliance on NCAs' input

A decision granting authorisation shall reflect any view or concern aired by a NCA consulted in the assessment process if the proposed acquirer is subject to the supervision of that NCA. This is because there are reasonable grounds to assume that this NCA is best equipped to make an informed decision on the acquirer's suitability. Referring to the respective NCA's view is not the same as sharing that view; however, if the difference in the suitability assessment is significant, neutral observers (including ESMA) would wonder how two NCAs could come to entirely different conclusions. This could provide the background for **further inquiries** into the work of the respective NCAs. **11**

3. Disclosures by investment firm (Art 11(3) MiFID)

The **investment firm is required to disclose**, without *undue* delay, if it is informed about **shareholdings exceeding or falling below the thresholds** that prompt a **notification requirement** regarding qualifying holdings (see at → mn 2). **Delays** may be justified if the firm lacks precise information. Rumors do not need to be reported. In a similar vein, the transaction does not need to be reported prior to its signing (investment firms are of course free to inform the NCAs already before the transaction is signed, in particular if the acquirer is of a dubious background). However, the investment firm does not need to have the complete data on the acquirer, its position size, respective parent or subsidiary companies etc. The fact that a shareholding exceeds or falls below the thresholds alone prompts the disclosure requirement. This rigid rule serves to ensure that competent authorities can follow up with the acquirer or seller and enforce the notification requirements of Art 11(1) MiFID. **12**

Further, **investment firms must disclose to the NCA** on a regular basis, at a minimum once per year, **the identity and position of persons with qualifying shareholdings**. MiFID suggests that the shareholders' meeting could provide the background for such a notice, but this will in practice rarely be the case. In listed companies, the notifications subject to disclosures of significant holdings under the → Transparency Directive (see comments there) are most likely to be more topical. Further, in some Member States where the share register is kept up to date and where Member States require the registration of positions of beneficial owners, the information can be taken from the share register. **13**

[2] Depending on the acquirer's or seller's origin and other license holders within the acquirer's or seller's group, multiple NCAs can be involved.

4. Sanctions (Art 11(4) MiFID)

14 In the event of non-compliance, NCAs shall have the same **enforcement mechanisms** at hand as those provided in Art 10(3) MiFID against the harmful influence of shareholders (see comments on → Art 10(3)). Those sanctions supplement those that the NCAs may impose, if the investment firm is a listed company, for non-disclosure of holdings that exceed the thresholds provided by the national law implementing the → Transparency Directive (see comments there), and those sanctions which Member States' laws may provide for non-discloure of significant holdings under the applicable company law.

15 The most effective sanction is **blocking the transaction**. While an injunction using one or multiple powers provided by Art 69 MiFID could stall the transaction for a while, Art 11 MiFID does not authorize the NCA to outright block the transaction. Such an order could conflict with another country's law if the transaction is subject to a law different from the law applicable to the investment firm. For that reason, Art 11(4) MiFID provides a substitute that will **strip the acquirer of voting power** relating to the acquisition by suspending the voting powers associated with its shares or nullifying the votes already cast. An even more efficient tool that strips the acquirer of any dividend is not granted by Art 11(4) MiFID, but could be imposed by legislation of the Member States.

Article 12
Assessment procedures

1. The competent authorities shall, promptly and in any event within two working days following receipt of the notification required under the first subparagraph of Article 11(1), as well as following the possible subsequent receipt of the information referred to in paragraph 2 of this Article, acknowledge receipt thereof in writing to the proposed acquirer.

The competent authorities shall have a maximum of sixty working days as from the date of the written acknowledgement of receipt of the notification and all documents required by the Member State to be attached to the notification on the basis of the list referred to in Article 13(4) (the 'assessment period'), to carry out the assessment.

The competent authorities shall inform the proposed acquirer of the date of the expiry of the assessment period at the time of acknowledging receipt.

2. The competent authorities may, during the assessment period, if necessary, and no later than on the 50th working day of the assessment period, request any further information that is necessary to complete the assessment. Such request shall be made in writing and shall specify the additional information needed.

For the period between the date of request for information by the competent authorities and the receipt of a response thereto by the proposed acquirer, the assessment period shall be interrupted. The interruption shall not exceed 20 working days. Any further requests by the competent authorities for completion or clarification of the information shall be at their discretion but may not result in an interruption of the assessment period.

3. The competent authorities may extend the interruption referred to in the second subparagraph of paragraph 2 up to 30 working days if the proposed acquirer is one of the following:

(a) a natural or legal person situated or regulated outside the Union;
(b) a natural or legal person not subject to supervision under this Directive or Directives 2009/65/EC, 2009/138/EC or 2013/36/EU.

4. If the competent authorities, upon completion of the assessment, decide to oppose the proposed acquisition, they shall, within two working days, and not exceeding the assessment period, inform the proposed acquirer in writing and provide the reasons for that decision. Subject to national law, an appropriate statement of the reasons for the decision may be made accessible to the public at the request of the proposed acquirer. This shall not prevent a Member State from allowing the competent authority to make such disclosure in the absence of a request by the proposed acquirer.

5. If the competent authorities do not oppose the proposed acquisition within the assessment period in writing, it shall be deemed to be approved.

6. The competent authorities may fix a maximum period for concluding the proposed acquisition and extend it where appropriate.

7. Member States may not impose requirements for the notification to and approval by the competent authorities of direct or indirect acquisitions of voting rights or capital that are more stringent than those set out in this Directive.

8. ESMA shall develop draft regulatory technical standards to establish an exhaustive list of information, referred to in Article 13(4) to be included by proposed acquirers in their notification, without prejudice to paragraph 2 of this Article.

ESMA shall submit those draft regulatory technical standards to the Commission by 1 January 2014.

Power is delegated to the Commission to adopt the regulatory technical standards referred to in the first subparagraph in accordance with Articles 10 to 14 of Regulation (EU) No 1095/2010.

9. ESMA shall develop draft implementing technical standards to determine standard forms, templates and procedures for the modalities of the consultation process between the relevant competent authorities as referred to in Article 11(2).

ESMA shall submit those draft implementing technical standards to the Commission by 1 January 2014.

Power is conferred on the Commission to adopt the implementing technical standards referred to in the first subparagraph in accordance with Article 15 of Regulation (EU) No 1095/2010.

I. General features

1. Recitals

Recitals 42, 47, 155 MiFID. 1

2. Implementing acts

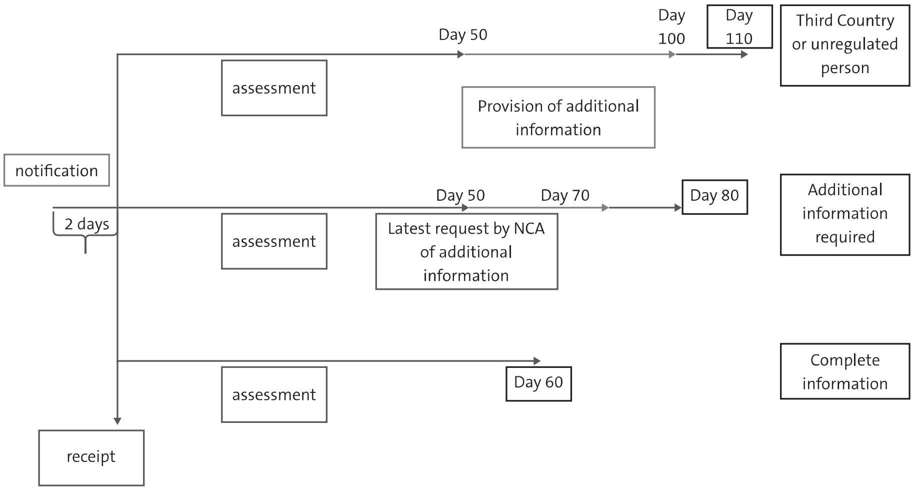
Commission Delegated Regulation (EU) 2017/1946 of 11 July 2017 supplementing Directives 2004/39/EC and 2014/65/EU of the European Parliament and of the Council with regard to regulatory technical standards for an exhaustive list of information to be included by proposed acquirers in the notification of a proposed acquisition of a qualifying holding in an investment firm. 2

II. Commentary

1. Assessment period (Art 12(1)-(3) MiFID)

3 Art 12 (1) to (3) MiFID establishes a **strict time line** for assessing the proposed acquisition (cf. Art 11, 13 MiFID). The strictness is due to the fact that the acquirer needs to keeps the necessary financial means for the transaction at its disposal, which is expensive. Further, the period in which the market suffers from uncertainty regarding the suitability assessment shall be as short as is reasonably possible. The assessment period and procedures of Art 12 MiFID (including the exhaustive list of documents as determined by the implementing legislation) aim at maximum harmonisation, as Art 12(7) MiFID clarifies. Therefore, they may not be deviated from by national law.

The figure below depicts the timeline stipulated by Art 12(1) to (3) MiFID:



2. Assessment decision (Art 12(4)-(5) MiFID)

4 The NCA must communicate a **refusal within two working days** after the decision was made, but at the latest prior to the expiry date of the assessment period. The refusal must be made in writing and be accompanied by the reasons for the decision. If the NCA approves of the acquisition, it has two options: It can either grant approval or wait until the assessment period expires. In the latter case, the acquisition is deemed approved.

3. Maximum closing period (Art 12(7) MiFID)

5 The formation of transactions create uncertainty on all sides and put the sound management of the investment firm at risk where management focuses on the transactions rather than running the firm and their clients. For this reason, the NCA may fix a **maximum period for "concluding" the transaction**. This could be either signing or closing. The NCA is free to choose whether it wants to impose a last signing or closing date. Setting a closing date is more in line with the policy rationale of Art 12 MiFID.

4. Implementing legislation (Art 12(8), (9) MiFID)

ESMA has exercised its implementing powers by developing as RTS, and the Commission by adopting, Commission Delegated Regulation (EU) 2017/1946 of 11 July 2017 supplementing Directives 2004/39/EC and 2014/65/EU of the European Parliament and of the Council with regard to regulatory technical standards for an exhaustive list of information to be included by proposed acquirers in the notification of a proposed acquisition of a qualifying holding in an investment firm. Commission Delegated Regulation (EU) 2017/1946 provides extensive catalogues of information to be provided as well as for exemptions in certain cases. 6

Article 13
Assessment

1. In assessing the notification provided for in Article 11(1) and the information referred to in Article 12(2), the competent authorities shall, in order to ensure the sound and prudent management of the investment firm in which an acquisition is proposed, and having regard to the likely influence of the proposed acquirer on the investment firm, appraise the suitability of the proposed acquirer and the financial soundness of the proposed acquisition against all of the following criteria:

(a) the reputation of the proposed acquirer;

(b) the reputation and experience of any person who will direct the business of the investment firm as a result of the proposed acquisition;

(c) the financial soundness of the proposed acquirer, in particular in relation to the type of business pursued and envisaged in the investment firm in which the acquisition is proposed;

(d) whether the investment firm will be able to comply and continue to comply with the prudential requirements based on this Directive and, where applicable, other Directives, in particular Directives 2002/87/EC and 2013/36/EU, in particular, whether the group of which it will become a part has a structure that makes it possible to exercise effective supervision, effectively exchange information among the competent authorities and determine the allocation of responsibilities among the competent authorities;

(e) whether there are reasonable grounds to suspect that, in connection with the proposed acquisition, money laundering or terrorist financing within the meaning of Article 1 of Directive 2005/60/EC is being or has been committed or attempted, or that the proposed acquisition could increase the risk thereof.

The Commission shall be empowered to adopt delegated acts in accordance with Article 89 which adjust the criteria set out in the first subparagraph of this paragraph.

2. The competent authorities may oppose the proposed acquisition only if there are reasonable grounds for doing so on the basis of the criteria set out in paragraph 1 or if the information provided by the proposed acquirer is incomplete.

3. Member States shall neither impose any prior conditions in respect of the level of holding that must be acquired nor allow their competent authorities to examine the proposed acquisition in terms of the economic needs of the market.

4. Member States shall make publicly available a list specifying the information that is necessary to carry out the assessment and that must be provided to the competent authorities at the time of notification referred to in Article 11(1). The information required shall be proportionate and adapted to the nature of the proposed acquirer

and the proposed acquisition. Member States shall not require information that is not relevant for a prudential assessment.

5. Notwithstanding Article 12(1), (2) and (3), where two or more proposals to acquire or increase qualifying holdings in the same investment firm have been notified to the competent authority, the latter shall treat the proposed acquirers in a non-discriminatory manner.

I. General features

1. Recitals

1 Recitals 42, 47, 155 MiFID.

2. Implementing acts

2 Pursuant to Art 13(1) MiFID, the Commission is empowered to adopt delegated acts in accordance with Article 89, which adjust the criteria set out in the first subparagraph of Art 13 (1) MiFID. As of November 2018, the Commission has not adopted any delegated act with regard to → Art 13 MiFID. However, the RTS adopted under Art 12 (8), (9) MiFID provide comprehensive information as to these matters, and the recital of the RTS make clear that this information shall be used for the objectives laid out in Art 13 (1), first subparagraph MiFID.

II. Commentary

1. Criteria for suitability assessment (Art 13(1) MiFID)

3 Art 13(1) MiFID specifies which **criteria** the NCA may take into account **when assessing the proposed acquisition of a qualifying holding** (see comments on → Art 11 and → Art 12). The guiding rationale is that the acquisition must be in line with the core requirement, which is the sound and prudent management of the investment firm after the acquisition. The guiding rationale is narrowed by two subtests, which refer to the suitability of the proposed acquirer and the financial soundness of the proposed acquisition.

4 Regarding the acquirer, the NCA has to consider:

- the **reputation** of the proposed acquirer;
- the **reputation and experience** of any person who will **direct the business** of the investment firm as a result of the proposed acquisition;
- the **financial soundness** of the proposed acquirer, in particular in relation to the type of business pursued and envisaged in the investment firm.

5 Regarding the **financial soundness** of the proposed acquisition, the NCA has to consider:

- whether the investment firm will be able to comply and continue to comply with the prudential requirements based on MiFID and other financial law, in particular the CRD IV and the Financial Conglomerate Directive (as amended), especially, whether the group of which it will become a part has a structure that makes it possible to exercise effective supervision, effectively exchange information and determine the allocation of responsibilities among the competent authorities;
- whether there are reasonable grounds to suspect that, in connection with the proposed acquisition, money laundering or terrorist financing is being or has been

committed or attempted, or that the proposed acquisition could increase the risk thereof.

Pursuant to Art 13(1), second para MiFID, the Commission is empowered to adopt delegated acts in accordance with Article 89 which adjust the criteria set out in the first subparagraph of Art 13 (1) MiFID. As of March 2018, the Commission has not adopted any delegated act with regard to Art 13 MiFID. However, implementing legislation on the assessment of shareholders and groups has been adopted pursuant to Art 10 MiFID, and extensive disclosure requirements have been laid out pursuant to Article 12 (8), (9) MiFID. Since Art 10 and Art 13 MiFID set out the same requirements as the implementing legislation in Art 10 MiFID applies *mutatis mutandis* to the assessment under Art 13 MiFID, with the disclosures under Article 12 (8), (9) MiFID ensuring that the NCA has the information necessary for that decision. **6**

2. Reasons to oppose acquisition (Art 13(2) MiFID)

Art 13(2), (3) MiFID limits the reasons to oppose an acquisition to those specified in Art 13(1) MiFID or the incomplete provision of materials (see comments on → Art 12). In particular, any **reference to national interests or economic needs of the (national or EU) market is prohibited**. It is not the task of the NCA to second-guess the economic logic of a transaction. Member States are further prohibited from imposing minimum stake requirements. This is without prejudice to the requirements for listed companies contained in the Takeover Directive 2004/25/EC, which asks the acquirer to issue a mandatory bid to all shareholders upon acquiring of control of the target. **7**

3. Information necessary to carry out the assessment (Art 13(3) MiFID)

The information necessary to carry out the assessment is laid down in the RTS and ITS adopted under Art 12(8), (9) MiFiD (see comments on → Art 12). Due to the high degree of harmonisation, the implementing legislation provides the list of information necessary for carrying out the assessment. Since RTS and ITS are published across the EU, it is already made publicy available by the Member State as required by Art 13(4) MiFID. Nevertheless, NCAs tend to publish their version of the lists on their website and thereby ensure publication in the Member State. **8**

4. Discrimination ban (Art 13(4) MiFID)

The sole criteria for assessing suitability are those set out in Art 11-13 MiFID. The NCA is prohibited from preferring any potential acquirer (such as an incumbent or a local favorite) to others. All applicants must be treated equally. Multiple acquirers are to be treated in a non-discriminatory manner, i.e. all applications must be assessed following solely the time line set out in Art 12 MiFID. For instance, assessing a proposed acquisition on a preferred basis, faster or with a more favourable view than the others is strictly forbidden since this would bring that acquirer in an advantageous position. **9**

Article 14
Membership of an authorised investor compensation scheme

The competent authority shall verify that any entity seeking authorisation as an investment firm meets its obligations under Directive 97/9/EC at the time of authorisation.

The obligation laid down in the first paragraph shall be met in relation to structured deposits where the structured deposit is issued by a credit institution which is a member of a deposit guarantee scheme recognised under Directive 2014/49/EU.

I. General features; recitals

1 Recital 42 MiFID.

II. Commentary

2 The NCA must review, prior to authorisation, that the investment firm is a member of an **investment compensation scheme subject to Art 2 Directive 97/9/EC**. Those schemes tend to cover the operational risks of investment firms up to at least 20.000 EUR (see Art 4 Directive 97/9/EC).

3 Since **structured deposits** are somewhere in between financial instruments and deposits, Art 14 second para MiFID allows for risks relating to structured deposits to be deemed as being covered by an investor compensation scheme, if the structured deposit is issued by a credit institution which is a member of a deposit guarantee scheme recognised under Directive 2014/49/EU.

4 We wonder, however, why the same rationale does not apply to **investment firms that do not hold client assets** (see → Art 29 et seq.). In such cases, the client assets are held by credit institutions or other investment firms that are member of the respective schemes. In order to avoid double insurance costs and comply with the principle of proportionality as laid down by Union law, applying the exemption for structured deposits *mutatis mutandis* to investment firms that do not hold client assets where the assets are held by scheme members should be considered.

Article 15
Initial capital endowment

Member States shall ensure that the competent authorities do not grant authorisation unless the investment firm has sufficient initial capital in accordance with the requirements of Regulation (EU) No 575/2013 having regard to the nature of the investment service or activity in question.

I. General features; recitals

1 Recitals 49, 50 MiFID.

2 Art 15 MiFID refers to the CRD IV and the CRR framework for minimum capitalisation of investment firms and credit institutions. Investment firms that are entitled to establish obligations against their own balance sheet by running a trading book or holding client money tend to be treated by EU law similar to credit institutions and are subject to most of the entire CRD IV/CRR framework. The minimum capital endowment of those investment firms amounts to 730,000 EUR (see Art 28 CRD IV). Further, it must consider the requirement to hold eligible capital equivalent to one quarter of their fixed overheads projected in its business plan (see Recital 125 and Art 97 (3) CRR). The initial capital must be provided by the means and instruments specified in Art 26(1)(a) to (e) CRR. The calculation of the requirement to hold eligible capital of at least one quarter of

the fixed overheads of the previous year must meet the requirements set out in EBA guidelines adopted under Art 97 (4) CRR.

Art 29 to 32 CRD IV provides **exemptions** for certain investment firms specified in Art 4 (1) CRR that do not hold client money on their own balance sheet, nor securities, and where the license is limited to certain types of investment services and activities. Recital 49 MiFID emphasises that those firms shall meet the much lower capital requirements requiring between 25,000 and 125,000 EUR in initial capital, as set out by Art 29 to 32 CRD IV. According to Art 31 CRD IV, in certain cases the capital may be provided as initial capital, indemnity insurance, or a combination of both. **3**

In accordance with Recital 50 MiFID, **investment firms that only deal on their own account** in financial instruments other than commodity derivatives, emission allowances or derivatives thereof are **excluded from the MiFID's scope** if they are neither market makers, do not deal on their own account when executing client orders, are not members or participants of a regulated market or MTF, do not have direct electronic access to a trading venue and do not apply a high-frequency algorithmic trading technique. **4**

Article 16
Organisational requirements

1. The home Member State shall require that investment firms comply with the organisational requirements laid down in paragraphs 2 to 10 of this Article and in Article 17.

2. An investment firm shall establish adequate policies and procedures sufficient to ensure compliance of the firm including its managers, employees and tied agents with its obligations under this Directive as well as appropriate rules governing personal transactions by such persons.

3. An investment firm shall maintain and operate effective organisational and administrative arrangements with a view to taking all reasonable steps designed to prevent conflicts of interest as defined in Article 23 from adversely affecting the interests of its clients.

An investment firm which manufactures financial instruments for sale to clients shall maintain, operate and review a process for the approval of each financial instrument and significant adaptations of existing financial instruments before it is marketed or distributed to clients.

The product approval process shall specify an identified target market of end clients within the relevant category of clients for each financial instrument and shall ensure that all relevant risks to such identified target market are assessed and that the intended distribution strategy is consistent with the identified target market.

An investment firm shall also regularly review financial instruments it offers or markets, taking into account any event that could materially affect the potential risk to the identified target market, to assess at least whether the financial instrument remains consistent with the needs of the identified target market and whether the intended distribution strategy remains appropriate.

An investment firm which manufactures financial instruments shall make available to any distributor all appropriate information on the financial instrument and the product approval process, including the identified target market of the financial instrument.

Where an investment firm offers or recommends financial instruments which it does not manufacture, it shall have in place adequate arrangements to obtain the information referred to in the fifth subparagraph and to understand the characteristics and identified target market of each financial instrument.

The policies, processes and arrangements referred to in this paragraph shall be without prejudice to all other requirements under this Directive and Regulation (EU) No 600/2014, including those relating to disclosure, suitability or appropriateness, identification and management of conflicts of interests, and inducements.

4. An investment firm shall take reasonable steps to ensure continuity and regularity in the performance of investment services and activities. To that end the investment firm shall employ appropriate and proportionate systems, resources and procedures.

5. An investment firm shall ensure, when relying on a third party for the performance of operational functions which are critical for the provision of continuous and satisfactory service to clients and the performance of investment activities on a continuous and satisfactory basis, that it takes reasonable steps to avoid undue additional operational risk. Outsourcing of important operational functions may not be undertaken in such a way as to impair materially the quality of its internal control and the ability of the supervisor to monitor the firm's compliance with all obligations.

An investment firm shall have sound administrative and accounting procedures, internal control mechanisms, effective procedures for risk assessment, and effective control and safeguard arrangements for information processing systems.

Without prejudice to the ability of competent authorities to require access to communications in accordance with this Directive and Regulation (EU) No 600/2014, an investment firm shall have sound security mechanisms in place to guarantee the security and authentication of the means of transfer of information, minimise the risk of data corruption and unauthorised access and to prevent information leakage maintaining the confidentiality of the data at all times.

6. An investment firm shall arrange for records to be kept of all services, activities and transactions undertaken by it which shall be sufficient to enable the competent authority to fulfil its supervisory tasks and to perform the enforcement actions under this Directive, Regulation (EU) No 600/2014, Directive 2014/57/EU and Regulation (EU) No 596/2014, and in particular to ascertain that the investment firm has complied with all obligations including those with respect to clients or potential clients and to the integrity of the market.

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.

Such telephone conversations and electronic communications shall also include those that are intended to result in transactions concluded when dealing on own account or in the provision of client order services that relate to the reception, transmission and execution of client orders, even if those conversations or communications do not result in the conclusion of such transactions or in the provision of client order services.

For those purposes, an investment firm shall take all reasonable steps to record relevant telephone conversations and electronic communications, made with, sent from or received by equipment provided by the investment firm to an employee or con-

tractor or the use of which by an employee or contractor has been accepted or permitted by the investment firm.

An investment firm shall notify new and existing clients that telephone communications or conversations between the investment firm and its clients that result or may result in transactions will be recorded.

Such a notification may be made once, before the provision of investment services to new and existing clients.

An investment firm shall not provide, by telephone, investment services and activities to clients who have not been notified in advance about the recording of their telephone communications or conversations, where such investment services and activities relate to the reception, transmission and execution of client orders.

Orders may be placed by clients through other channels, however such communications must be made in a durable medium such as mails, faxes, emails or documentation of client orders made at meetings. In particular, the content of relevant face-to-face conversations with a client may be recorded by using written minutes or notes. Such orders shall be considered equivalent to orders received by telephone.

An investment firm shall take all reasonable steps to prevent an employee or contractor from making, sending or receiving relevant telephone conversations and electronic communications on privately-owned equipment which the investment firm is unable to record or copy.

The records kept in accordance with this paragraph shall be provided to the client involved upon request and shall be kept for a period of five years and, where requested by the competent authority, for a period of up to seven years.

8. An investment firm shall, when holding financial instruments belonging to clients, make adequate arrangements so as to safeguard the ownership rights of clients, especially in the event of the investment firm's insolvency, and to prevent the use of a client's financial instruments on own account except with the client's express consent.

9. An investment firm shall, when holding funds belonging to clients, make adequate arrangements to safeguard the rights of clients and, except in the case of credit institutions, prevent the use of client funds for its own account.

10. An investment firm shall not conclude title transfer financial collateral arrangements with retail clients for the purpose of securing or covering present or future, actual or contingent or prospective obligations of clients.

11. In the case of branches of investment firms, the competent authority of the Member State in which the branch is located shall, without prejudice to the possibility of the competent authority of the home Member State of the investment firm to have direct access to those records, enforce the obligation laid down in paragraphs 6 and 7 with regard to transactions undertaken by the branch.

Member States may, in exceptional circumstances, impose requirements on investment firms concerning the safeguarding of client assets additional to the provisions set out in paragraphs 8, 9 and 10 and the respective delegated acts as referred to in paragraph 12. Such requirements must be objectively justified and proportionate so as to address, where investment firms safeguard client assets and client funds, specific risks to investor protection or to market integrity which are of particular importance in the circumstances of the market structure of that Member State.

Member States shall notify, without undue delay, the Commission of any requirement which they intend to impose in accordance with this paragraph and at least two

months before the date appointed for that requirement to come into force. The notification shall include a justification for that requirement. Any such additional requirements shall not restrict or otherwise affect the rights of investment firms under Articles 34 and 35.

The Commission shall within two months of the notification referred to in the third subparagraph provide its opinion on the proportionality of and justification for the additional requirements.

Member States may retain additional requirements provided that they were notified to the Commission in accordance with Article 4 of Directive 2006/73/EC before 2 July 2014 and that the conditions laid down in that Article are met.

The Commission shall communicate to Member States and make public on its website the additional requirements imposed in accordance with this paragraph.

12. The Commission shall be empowered to adopt delegated acts in accordance with Article 89 to specify the concrete organisational requirements laid down in paragraphs 2 to 10 of this Article to be imposed on investment firms and on branches of third-country firms authorised in accordance with Article 41 performing different investment services and/or activities and ancillary services or combinations thereof.

I. General features

1. Recitals

Recitals 56-58 MiFID and recitals of implementing acts. **1**

2. Implementing acts

Commission Delegated Regulation (EU) 2017/565 of 25 April 2016 supplementing **2** 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; Commission Delegated Directive (EU) 2017/593 of 7 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to safeguarding of financial instruments and funds belonging to clients, product governance obligations and the rules applicable to the provision or reception of fees, commissions or any monetary or non-monetary benefits.

3. Other regulatory texts

Questions and Answers on MiFID II and MiFIR investor protection and intermedi- **3** aries topics, 18 November 2017 | ESMA35-43-349 (on Article 16(6) and (7) MiFID); ESMA, Guidelines on certain aspects of the MiFID II suitability requirements, 06/11/2018; ESMA35-43, 1163, p. 7-10, 19-23, 25-28 (on Art 16(2) MiFID and pp. 28-29 (on Art 16(6) MiFID); ESMA MiFID II Supervisory Briefing on Suitability, 13/11/2018, ESMA35-43-1206, p. 12-16, 18-20 (on Art 16(2) MiFID).

II. Commentary

1. Organisational requirements (Art 16(1) MiFID)

a) Single Rulebook

Art 16(2) to (10) MiFID set out the **organisational requirements for authorisation**, **4** with some additional requirements for algorithmic traders in → Art 17 MiFID. The substantial details of the investment firm's organisation, however, are provided in the respective implementing legislation, in Art 21 et seq. of Commission Delegated Regulation (EU) 2017/565 of 25 April 2016. Art 16, 17 MiFID are the best examples for the Union's strategy to strengthen European financial supervision by developing a Single Rulebook for investment firms, and the recitals refer to that purpose explicitly (cf. Recital 58 MiFID) "to help further develop a level playing field for Member States and market participants, to enhance investor protection and to improve supervision and enforcement, the Union is committed to minimising, where appropriate, discretions available to Member States across Union financial services law. In addition to the introduction in this Directive of a common regime for the recording of telephone conversations or electronic communications involving client orders, it is appropriate to reduce the possibility of competent authorities to delegate supervisory tasks in certain cases, to limit discretions in the requirements applicable to tied agents and to the reporting from branches." See also Recital 164 MiFID.

b) Overview

5 Art 16 MiFID is structured as follows:

- Art 16(2) to (3) MiFID, requiring **adequate polices and procedures** as well as an effective organisation and administration of the firm, provide the basic requirements for the authorisation of an investment firm. If the investment firm is engaged in algorithmic trading, additional requirements follow from Art 17 MiFID;
- in Art 16(3), second para to end MiFID concern **product governance and target markets**. See also comments on → Art 24 et seq.;
- Art 16(5) MiFID and Art 30-32 Commission Delegated Regulation (EU) 2017/565 contain the important provisions on **outsourcing**;
- Art 16(5) MiFID provides the crucial rules on the internal control system, including control of IT systems and IT related risks;
- Art 16(6), (7), (11) MiFID deal with **record keeping requirements**, including recording of phone and electronic communications;
- Art 16(8)-(10) MiFID focus on **client protection**.

c) Proportionality

6 The organisational requirements are subject to the **principle of proportionality** established in primary Union law.[1] This principle applies to both Level 1 or Level 2. It is rooted in the objective that non-profitability of the (small) firm does harm the clients potentially to the same extent as an inadequate organisation; further, the MiFID/MiFIR framework must be sufficiently open for assisting innovative small firms to exert competitive pressure on incumbents. Proportionality could be a means for achieving that goal.[2] MiFID and the applicable Level 2 rules try to comply with the proportionality principle by setting a flexible standard: When complying with the requirements, investment firms shall take into account the nature, scale and complexity of the business of the firm, and the nature and range of investment services and activities undertaken in the course of that business (e.g. Art 21(1), 22(2), (4), 34(1), 37(2)(c) Commission Delegated Regulation (EU) 2017/565).

7 The handling of this requirement is a **challenge for regulators**. In hindsight, almost any indicident could have been prevented by imposing additional organisational features, or denying the firm an authorisation altogether. Further, important rule of law concerns arises if applying proportionality results in the disapplication of a requirement set out in MiFID. In addition, the handling of the proportionality principle differs across jurisdictions. Jurisdictions with a greater number of large investment firms will have a natural tendency to understate proportionality, and deem the standards provided for large firms to be adequate for all others as well. Looking at the objective of each requirement could provide a solution to the NCAs' home bias. For instance, in the case of port-

[1] See on proportionality, Zetzsche and Preiner, 'Europäisches Kapitalmarktrecht (Intermediärsrecht)', in Gebauer and Teichmann (eds), *Enzyklopädie Europarecht, Vol. 6: Europäisches Privat- und Unternehmensrecht*, § 7 B (Nomos 2016), p. 178 et seq. The discussion on proportionality in financial law gained traction in the context of CRR-capital requirements for small and medium credit institutions, see EBA, Proportionality in Bank Regulation, A Report by the EBA Banking Stakeholder Group, London (December 2015); Joosen et al., 'Stability, Flexibility and Proportionality: Towards a Two-Tiered European Banking Law?', EBI working paper no 20 (2018); Castro Carvalho et al., 'Proportionality in banking regulation: a cross-country comparison', BIS, FSI Insights No. 1, August 2017; Ferri and Kalmi, 'Only Up: Regulatory Burden and Its Effects on Credit Unions', Filene Research Institute Report, 2014; Hackethal and Inderst, *Auswirkungen der Regulatorik auf kleinere und mittlere Banken am Beispiel der deutschen Genossenschaftsbanken* (2015).

[2] Zetzsche, Buckley, Arner and Barberis, 'Regulating a Revolution: From Regulatory Sandboxes to Smart Regulation', 23:1 *Fordham Journal of Corporate & Financial Law*, 31.

folio management, it is crucial that someone assumes responsibility for the portfolios managed if the key person is sick or permanently absent; hence a proxy solution is indispensable. However, the former does not oblige the firm to create an additional in-house resource, which is expensive to maintain. Under the principle of proportionality, an outsourcing solution could achieve the same objective of investor protection. MiFID does not prohibit solutions harmful to the investment firm if this is the only way to ensure investor protection. For instance, in the example given, the firm could be required to ask a competitor to function as a proxy manager.

2. Organisation of the investment firm (Art 16(2) to (4) MiFID)

Art 16(2) MiFID and Art 21 et seq. of Commission Delegated Regulation (EU) 2017/565 set out the requirements relating to the **general organisation, compliance, responsibility of the senior management, remuneration systems** (see also → Art 23 and → Art 24), and **complaints handling** and **personal transactions** of staff members, while Art 16(3) MiFID provides the basis for the Level 2 provisions on conflicts of interest, with details for each investment service and activity in Art 33 et seq. of Commission Delegated Regulation (EU) 2017/565. Finally, Art 16(4) MiFID sets out **business continuity requirements** designed to maintain the functioning of the investment firm' services and activities. **8**

a) Adequate policies and procedures (Art 16(2) MiFID)

Art 16(2) MiFID uses **general clauses** to describe the polices and procedures of the investment firm. Terms like 'adequate' and 'sufficient to ensure compliance … with its obligations' under MiFID as well as 'appropriate rules' on personal transactions are insufficient to establish a Single Rulebook for investment firms, as is the underlying rationale of MiFID (see Recital 58 MiFID). To fill the gap, **Art 21 et seq. of Commission Delegated Regulation (EU) 2017/565** of 25 April 2016 provides the details on investment firms' policies and procedures. See also ESMA, Guidelines on certain aspects of the MiFID II suitability requirements, 06/11/2018, ESMA35-43-1163, p. 7-10, 19-23, 25-28 (on arrangements necessary to understand clients, arrangements necessary to understand investment products and costs and benefits of swiching investments); ESMA, MiFID II Supervisory Briefing on Suitability, 13/11/2018, ESMA35-43-1206, p. 12-16, 18-20 (on arrangements necessary to ensure the suitability of an investment, qualifications of firm staff and record keeping). **9**

The following table provides an overview of the applicable Level 2 legislation: **10**

Regulation 2017/565	Topic	Content
Art 21	General organisational requirements	1. Investment firms shall comply with the following organisational requirements: (a) establish, implement and maintain decision-making procedures and an organisational structure which clearly and in documented manner specifies reporting lines and allocates functions and responsibilities; (b) ensure that their relevant persons are aware of the procedures which must be followed for the proper discharge of their responsibilities; (c) establish, implement and maintain adequate internal control mechanisms designed to secure compliance

Regulation 2017/565	Topic	Content
		with decisions and procedures at all levels of the investment firm; (d) employ personnel with the skills, knowledge and expertise necessary for the discharge of the responsibilities allocated to them; (e) establish, implement and maintain effective internal reporting and communication of information at all relevant levels of the investment firm; (f) maintain adequate and orderly records of their business and internal organisation; (g) ensure that the performance of multiple functions by their relevant persons does not and is not likely to prevent those persons from discharging any particular function soundly, honestly, and professionally. When complying with the requirements set out in the this paragraph, investment firms shall take into account the nature, scale and complexity of the business of the firm, and the nature and range of investment services and activities undertaken in the course of that business. 2. Investment firms shall establish, implement and maintain systems and procedures that are adequate to safeguard the security, integrity and confidentiality of information, taking into account the nature of the information in question. 3. Investment firms shall establish, implement and maintain an adequate business continuity policy aimed at ensuring, in the case of an interruption to their systems and procedures, the preservation of essential data and functions, and the maintenance of investment services and activities, or, where that is not possible, the timely recovery of such data and functions and the timely resumption of their investment services and activities. 4. Investment firms shall establish, implement and maintain accounting policies and procedures that enable them, at the request of the competent authority, to deliver in a timely manner to the competent authority financial reports which reflect a true and fair view of their financial position and which comply with all applicable accounting standards and rules. 5. Investment firms shall monitor and, on a regular basis, evaluate the adequacy and effectiveness of their systems, internal control mechanisms and arrangements established in accordance with paragraphs 1 to 4, and take appropriate measures to address any deficiencies.
Art 22	Compliance	1. Investment firms shall establish, implement and maintain adequate policies and procedures designed to detect any risk of failure by the firm to comply with its obliga-

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		tions under Directive 2014/65/EU, as well as the associated risks, and put in place adequate measures and procedures designed to minimise such risk and to enable the competent authorities to exercise their powers effectively under that Directive. Investment firms shall take into account the nature, scale and complexity of the business of the firm, and the nature and range of investment services and activities undertaken in the course of that business. 2. Investment firms shall establish and maintain a permanent and effective compliance function which operates independently and which has the following responsibilities: (a) to monitor on a permanent basis and to assess, on a regular basis, the adequacy and effectiveness of the measures, policies and procedures put in place in accordance with the first subparagraph of paragraph 1, and the actions taken to address any deficiencies in the firm's compliance with its obligations; (b) to advise and assist the relevant persons responsible for carrying out investment services and activities to comply with the firm's obligations under Directive 2014/65/EU; (c) to report to the management body, on at least an annual basis, on the implementation and effectiveness of the overall control environment for investment services and activities, on the risks that have been identified and on the complaints-handling reporting as well as remedies undertaken or to be undertaken; (d) to monitor the operations of the complaints-handling process and consider complaints as a source of relevant information in the context of its general monitoring responsibilities. In order to comply with points (a) and (b) of this paragraph, the compliance function shall conduct an assessment on the basis of which it shall establish a risk-based monitoring programme that takes into consideration all areas of the investment firm's investment services, activities and any relevant ancillary services, including relevant information gathered in relation to the monitoring of complaints handling. The monitoring programme shall establish priorities determined by the compliance risk assessment ensuring that compliance risk is comprehensively monitored. 3. In order to enable the compliance function referred to in paragraph 2 to discharge its responsibilities properly and independently, investment firms shall ensure that the following conditions are satisfied:

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		(a) the compliance function has the necessary authority, resources, expertise and access to all relevant information; (b) a compliance officer is appointed and replaced by the management body and is responsible for the compliance function and for any reporting as to compliance required by Directive 2014/65/EU and Article 25(2) Reg 2017/565; (c) the compliance function reports on an ad-hoc basis directly to the management body where it detects a significant risk of failure by the firm to comply with its obligations under Directive 2014/65/EU; (d) the relevant persons involved in the compliance function are not involved in the performance of services or activities they monitor; (e) the method of determining the remuneration of the relevant persons involved in the compliance function does not compromise their objectivity and is not likely to do so. 4. An investment firm shall not be required to comply with point (d) or point (e) of paragraph 3 where it is able to demonstrate that in view of the nature, scale and complexity of its business, and the nature and range of investment services and activities, the requirements under point (d) or (e) are not proportionate and that its compliance function continues to be effective. In that case, the investment firm shall assess whether the effectiveness of the compliance function is compromised. The assessment shall be reviewed on a regular basis.
Art 25	Responsibility of senior management	1. Investment firms shall, when allocating functions internally, ensure that senior management, and, where applicable, the supervisory function, are responsible for ensuring that the firm complies with its obligations under Directive 2014/65/EU. In particular, senior management and, where applicable, the supervisory function shall be required to assess and periodically review the effectiveness of the policies, arrangements and procedures put in place to comply with the obligations under Directive 2014/65/EU and to take appropriate measures to address any deficiencies. The allocation of significant functions among senior managers shall clearly establish who is responsible for overseeing and maintaining the firm's organisational requirements. Records of the allocation of significant functions shall be kept up-to-date. 2. Investment firms shall ensure that their senior management receive on a frequent basis, and at least annually, written reports on the matters covered by Articles 22, 23

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		and 24 indicating in particular whether the appropriate remedial measures have been taken in the event of any deficiencies. 3. Investment firms shall ensure that where there is a supervisory function, it receives written reports on the matters covered by Articles 22, 23 and 24 on a regular basis. 4. For the purposes of this Article, the supervisory function shall be the function within an investment firm responsible for the supervision of its senior management.
Art 26	Complaints handling	1. Investment firms shall establish, implement and maintain effective and transparent complaints management policies and procedures for the prompt handling of clients' or potential clients' complaints. Investment firms shall keep a record of the complaints received and the measures taken for their resolution. The complaints management policy shall provide clear, accurate and up-to-date information about the complaints-handling process. This policy shall be endorsed by the firm's management body. 2. Investment firms shall publish the details of the process to be followed when handling a complaint. Such details shall include information about the complaints management policy and the contact details of the complaints management function. The information shall be provided to clients or potential clients, on request, or when acknowledging a complaint. Investment firms shall enable clients and potential clients to submit complaints free of charge. 3. Investment firms shall establish a complaints management function responsible for the investigation of complaints. This function may be carried out by the compliance function. 4. When handling a complaint, investment firms shall communicate with clients or potential clients clearly, in plain language that is easy to understand and shall reply to the complaint without undue delay. 5. Investment firms shall communicate the firm's position on the complaint to clients or potential clients and inform the clients or potential clients about their options, including that they may be able to refer the complaint to an alternative dispute resolution entity, as defined in Article 4(h) of Directive 2013/11/EU of the European Parliament and the Council on consumer ADR or that the client may be able to take civil action. 6. Investment firms shall provide information on complaints and complaints-handling to the relevant competent

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		authorities and, where applicable under national law, to an alternative dispute resolution (ADR) entity. 7. Investment firms' compliance function shall analyse complaints and complaints-handling data to ensure that they identify and address any risks or issues.
Art 27	Remuneration policies and practices	1. Investment firms shall define and implement remuneration policies and practices under appropriate internal procedures taking into account the interests of all the clients of the firm, with a view to ensuring that clients are treated fairly and their interests are not impaired by the remuneration practices adopted by the firm in the short, medium or long term. Remuneration policies and practices shall be designed in such a way so as not to create a conflict of interest or incentive that may lead relevant persons to favour their own interests or the firm's interests to the potential detriment of any client. 2. Investment firms shall ensure that their remuneration policies and practices apply to all relevant persons with an impact, directly or indirectly, on investment and ancillary services provided by the investment firm or on its corporate behaviour, regardless of the type of clients, to the extent that the remuneration of such persons and similar incentives may create a conflict of interest that encourages them to act against the interests of any of the firm's clients. 3. The management body of the investment firm shall approve, after taking advice from the compliance function, the firm's remuneration policy. The senior management of the investment firm shall be responsible for the day-to-day implementation of the remuneration policy and the monitoring of compliance risks related to the policy. 4. Remuneration and similar incentives shall not be solely or predominantly based on quantitative commercial criteria, and shall take fully into account appropriate qualitative criteria reflecting compliance with the applicable regulations, the fair treatment of clients and the quality of services provided to clients. A balance between fixed and variable components of remuneration shall be maintained at all times, so that the remuneration structure does not favour the interests of the investment firm or its relevant persons against the interests of any client.
Art 28	Scope of Personal transactions	For the purposes of Article 29 and Article 37, a personal transaction shall be a trade in a financial instrument effected by or on behalf of a relevant person, where at least one of the following criteria are met:

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		(a) the relevant person is acting outside the scope of the activities he carries out in his professional capacity; (b) the trade is carried out for the account of any of the following persons: (i) the relevant person; (ii) any person with whom he has a family relationship, or with whom he has close links; (iii) a person in respect of whom the relevant person has a direct or indirect material interest in the outcome of the trade, other than obtaining a fee or commission for the execution of the trade.
Art 29	Personal transactions	1. Investment firms shall establish, implement and maintain adequate arrangements aimed at preventing the activities set out in paragraphs 2, 3 and 4 in the case of any relevant person who is involved in activities that may give rise to a conflict of interest, or who has access to inside information within the meaning of Article 7(1) of Regulation (EU) No 596/2014 or to other confidential information relating to clients or transactions with or for clients by virtue of an activity carried out by him on behalf of the firm. 2. Investment firms shall ensure that relevant persons do not enter into a personal transaction which meets at least one of the following criteria: (a) that person is prohibited from entering into it under Regulation (EU) No 596/2014; (b) it involves the misuse or improper disclosure of that confidential information; (c) it conflicts or is likely to conflict with an obligation of the investment firm under Directive 2014/65/EU. 3. Investment firms shall ensure that relevant persons do not advise or recommend, other than in the proper course of employment or contract for services, any other person to enter into a transaction in financial instruments which, if it were a personal transaction of the relevant person, would be covered by paragraph 2 or Article 37(2)(a) or (b) or Article 67(3). 4. Without prejudice to Article 10(1) of Regulation (EU) No 596/2014, investment firms shall ensure that relevant persons do not disclose, other than in the normal course of his employment or contract for services, any information or opinion to any other person where the relevant person knows, or reasonably ought to know, that as a result of that disclosure that other person will or would be likely to take either of the following steps: (a) to enter into a transaction in financial instruments which, if it were a personal transaction of the relevant

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		person, would be covered by paragraphs 2 or 3 or Article 37(2)(a) or (b) or Article 67(3); (b) to advise or procure another person to enter into such a transaction. 5. The arrangements required under paragraph 1 shall be designed to ensure that: (a) each relevant person covered by paragraphs 1, 2, 3 and 4 is aware of the restrictions on personal transactions, and of the measures established by the investment firm in connection with personal transactions and disclosure, in accordance with paragraphs 1, 2,3 and 4. (b) the firm is informed promptly of any personal transaction entered into by a relevant person, either by notification of that transaction or by other procedures enabling the firm to identify such transactions; (c) a record is kept of the personal transaction notified to the firm or identified by it, including any authorisation or prohibition in connection with such a transaction. In the case of outsourcing arrangements, the investment firm shall ensure that the firm to which the activity is outsourced maintains a record of personal transactions entered into by any relevant person and provides that information to the investment firm promptly on request. 6. Paragraphs 1 to 5 shall not apply to the following personal transactions: (a) personal transactions effected under a discretionary portfolio management service where there is no prior communication in connection with the transaction between the portfolio manager and the relevant person or other person for whose account the transaction is executed; (b) personal transactions in undertakings for collective investments in transferable securities (UCITS) or AIFs that are subject to supervision under the law of a Member State which requires an equivalent level of risk spreading in their assets, where the relevant person and any other person for whose account the transactions are effected are not involved in the management of that undertaking.

11 While the numerous articles of Commission Delegated Regulation (EU) 2017/565 leave the impression of an overzealous regulator, a closer look reveals that many of those requirements are the **standard requirements in other EU rules on asset management**. In a way, Art 16 in conjunction with the Level 2 MiFID legislation aligns the MiFID/

MiFIR framework with the UCITSD, AIFMD and the asset management-related parts of CRDIV/CRR, and establishes joint principles on European asset management law.[3]

b) Conflicts of interest (Art 16(3) MiFID)

With Art 16(3) and Level 2 MiFID, demanding the maintenance and operation of **effective organisational and administrative arrangements** to prevent conflicts of interest from adversely affecting the interests of its clients, the European legislature responds to the expanded range of activities simultaneously undertaken by many investment firms, which has increased the potential for synergies between those activities and the clients' interests. In turn, firms "have a duty to take effective steps to identify and prevent or manage conflicts of interest and mitigate the potential impact of those risks as far as possible. Where some residual risk of detriment to the client's interests nonetheless remains, clear disclosure to the client of the general nature and/or sources of conflicts of interest to the client and the steps taken to mitigate those risks should be made before undertaking business on its behalf." (Recital 56 MiFID). **12**

For the **definition** of conflicts of interests see comments on → Art 23. On proportionality supra, at → mn 3. **13**

The following table provides an overview of the applicable Level 2 legislation: **14**

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Art 33	Conflicts of interest potentially detrimental to a client	For the purposes of identifying the types of conflict of interest that arise in the course of providing investment and ancillary services or a combination thereof and whose existence may damage the interests of a client, investment firms shall take into account, by way of minimum criteria, whether the investment firm or a relevant person, or a person directly or indirectly linked by control to the firm, is in any of the following situations, whether as a result of providing investment or ancillary services or investment activities or otherwise: (a) the firm or that person is likely to make a financial gain, or avoid a financial loss, at the expense of the client; (b) the firm or that person has an interest in the outcome of a service provided to the client or of a transaction carried out on behalf of the client, which is distinct from the client's interest in that outcome; (c) the firm or that person has a financial or other incentive to favour the interest of another client or group of clients over the interests of the client; (d) the firm or that person carries on the same business as the client; (e) the firm or that person receives or will receive from a person other than the client an inducement in rela-

[3] See Zetzsche, 'Joint Principles of European Asset Management Law', in Zetzsche (ed), *AIFMD* (2nd ed. 2015) (Ch. 38).

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		tion to a service provided to the client, in the form of monetary or non-monetary benefits or services.
Art 34	Conflicts of interest policy	1. Investment firms shall establish, implement and maintain an effective conflicts of interest policy set out in writing and appropriate to the size and organisation of the firm and the nature, scale and complexity of its business. Where the firm is a member of a group, the policy shall also take into account any circumstances, of which the firm is or should be aware, which may give rise to a conflict of interest arising as a result of the structure and business activities of other members of the group. 2. The conflicts of interest policy established in accordance with paragraph 1 shall include the following content: (a) it must identify, with reference to the specific investment services and activities and ancillary services carried out by or on behalf of the investment firm, the circumstances which constitute or may give rise to a conflict of interest entailing a risk of damage to the interests of one or more clients; (b) it must specify procedures to be followed and measures to be adopted in order to prevent or manage such conflicts. 3. The procedures and measures referred to in paragraph 2(b) shall be designed to ensure that relevant persons engaged in different business activities involving a conflict of interest of the kind specified in paragraph 2(a) carry on those activities at a level of independence appropriate to the size and activities of the investment firm and of the group to which it belongs, and to the risk of damage to the interests of clients. For the purposes of paragraph 2(b), the procedures to be followed and measures to be adopted shall include at least those items in the following list that are necessary for the firm to ensure the requisite degree of independence: (a) effective procedures to prevent or control the exchange of information between relevant persons engaged in activities involving a risk of a conflict of interest where the exchange of that information may harm the interests of one or more clients; (b) the separate supervision of relevant persons whose principal functions involve carrying out activities on behalf of, or providing services to, clients whose interests may conflict, or who otherwise represent dif-

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		ferent interests that may conflict, including those of the firm; (c) the removal of any direct link between the remuneration of relevant persons principally engaged in one activity and the remuneration of, or revenues generated by, different relevant persons principally engaged in another activity, where a conflict of interest may arise in relation to those activities; (d) measures to prevent or limit any person from exercising inappropriate influence over the way in which a relevant person carries out investment or ancillary services or activities; (e) measures to prevent or control the simultaneous or sequential involvement of a relevant person in separate investment or ancillary services or activities where such involvement may impair the proper management of conflicts of interest. 4. Investment firms shall ensure that disclosure to clients, pursuant to Article 23(2) of Directive 2014/65/EU, is a measure of last resort that shall be used only where the effective organisational and administrative arrangements established by the investment firm to prevent or manage its conflicts of interest in accordance with Article 23 of Directive 2014/65/EU are not sufficient to ensure, with reasonable confidence, that risks of damage to the interests of the client will be prevented. The disclosure shall clearly state that the organisational and administrative arrangements established by the investment firm to prevent or manage that conflict are not sufficient to ensure, with reasonable confidence, that the risks of damage to the interests of the client will be prevented. The disclosure shall include specific description of the conflicts of interest that arise in the provision of investment and/or ancillary services, taking into account the nature of the client to whom the disclosure is being made. The description shall explain the general nature and sources of conflicts of interest, as well as the risks to the client that arise as a result of the conflicts of interest and the steps undertaken to mitigate these risks, in sufficient detail to enable that client to take an informed decision with respect to the investment or ancillary service in the context of which the conflicts of interest arise. 5. Investment firms shall assess and periodically review, on an at least annual basis, the conflicts of interest policy established in accordance with paragraphs 1 to 4 and shall take all appropriate measures to address any deficiencies. Over-reliance on disclosure of conflicts of inter-

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		est shall be considered a deficiency in the investment firm's conflicts of interest policy.
Art 35	Record of services or activities giving rise to detrimental conflict of interest	Investment firms shall keep and regularly update a record of the kinds of investment or ancillary service or investment activity carried out by or on behalf of the firm in which a conflict of interest entailing a risk of damage to the interests of one or more clients has arisen or, in the case of an ongoing service or activity, may arise. Senior management shall receive on a frequent basis, and at least annually, written reports on situations referred to in this Article.
Art 37	Additional organisational requirements in relation to investment research or marketing communications	1. Investment firms which produce, or arrange for the production of, investment research that is intended or likely to be subsequently disseminated to clients of the firm or to the public, under their own responsibility or that of a member of their group, shall ensure the implementation of all the measures set out in Article 34(3) in relation to the financial analysts involved in the production of the investment research and other relevant persons whose responsibilities or business interests may conflict with the interests of the persons to whom the investment research is disseminated. The obligations in the first subparagraph shall also apply in relation to recommendations referred to in Article 36(2). 2. Investment firms referred to in the first subparagraph of paragraph 1 shall have in place arrangements designed to ensure that the following conditions are satisfied: (a) financial analysts and other relevant persons do not undertake personal transactions or trade, other than as market makers acting in good faith and in the ordinary course of market making or in the execution of an unsolicited client order, on behalf of any other person, including the investment firm, in financial instruments to which investment research relates, or in any related financial instruments, with knowledge of the likely timing or content of that investment research which is not publicly available or available to clients and cannot readily be inferred from information that is so available, until the recipients of the investment research have had a reasonable opportunity to act on it; (b) in circumstances not covered by point (a), financial analysts and any other relevant persons involved in the production of investment research do not undertake personal transactions in financial instruments

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		to which the investment research relates, or in any related financial instruments, contrary to current recommendations, except in exceptional circumstances and with the prior approval of a member of the firm's legal or compliance function; (c) a physical separation exists between the financial analysts involved in the production of investment research and other relevant persons whose responsibilities or business interests may conflict with the interests of the persons to whom the investment research is disseminated or, when considered not appropriate to the size and organisation of the firm as well as the nature, scale and complexity of its business, the establishment and implementation of appropriate alternative information barriers; (d) the investment firms themselves, financial analysts, and other relevant persons involved in the production of the investment research do not accept inducements from those with a material interest in the subject-matter of the investment research; (e) the investment firms themselves, financial analysts, and other relevant persons involved in the production of the investment research do not promise issuers favourable research coverage; (f) before the dissemination of investment research issuers, relevant persons other than financial analysts, and any other persons are not permitted to review a draft of the investment research for the purpose of verifying the accuracy of factual statements made in that research, or for any purpose other than verifying compliance with the firm's legal obligations, where the draft includes a recommendation or a target price. For the purposes of this paragraph, 'related financial instrument' shall be any financial instrument the price of which is closely affected by price movements in another financial instrument which is the subject of investment research, and includes a derivative on that other financial instrument. 3. Investment firms which disseminate investment research produced by another person to the public or to clients shall be exempt from complying with paragraph 1 if the following criteria are met:

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		(a) the person that produces the investment research is not a member of the group to which the investment firm belongs; (b) the investment firm does not substantially alter the recommendations within the investment research; (c) the investment firm does not present the investment research as having been produced by it; (d) the investment firm verifies that the producer of the research is subject to requirements equivalent to the requirements under this Regulation in relation to the production of that research, or has established a policy setting such requirements.
Art 38	Additional general requirements in relation to underwriting or placing	1. Investment firms which provide advice on corporate finance strategy, as set out in Section B(3) of Annex I, and provide the service of underwriting or placing of financial instruments, shall, before accepting a mandate to manage the offering, have arrangements in place to inform the issuer client of the following: (a) the various financing alternatives available with the firm, and an indication of the amount of transaction fees associated with each alternative; (b) the timing and the process with regard to the corporate finance advice on pricing of the offer; (c) the timing and the process with regard to the corporate finance advice on placing of the offering; (d) details of the targeted investors, to whom the firm intends to offer the financial instruments; (e) the job titles and departments of the relevant individuals involved in the provision of corporate finance advice on the price and allotment of financial instruments; and (f) firm's arrangements to prevent or manage conflicts of interest that may arise where the firm places the relevant financial instruments with its investment clients or with its own proprietary book. 2. Investment firms shall have in place a centralised process to identify all underwriting and placing operations of the firm and record such information, including the date on which the firm was informed of potential underwriting and placing operations. Firms shall identify all potential conflicts of interest arising from other activities of the investment firm, or group, and implement appropriate management procedures. In cases where an investment firm cannot manage a conflict of interest by way of implementing appropriate procedures, the investment firm shall not engage in the operation.

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		3. Investment firms providing execution and research services as well as carrying out underwriting and placing activities shall ensure adequate controls are in place to manage any potential conflicts of interest between these activities and between their different clients receiving those services.
Art 39	Additional requirements in relation to pricing of offerings in relation to issuance of financial instruments	1. Investment firms shall have in place systems, controls and procedures to identify and prevent or manage conflicts of interest that arise in relation to possible underpricing or over-pricing of an issue or involvement of relevant parties in the process. In particular, investment firms shall as a minimum requirement establish, implement and maintain internal arrangements to ensure both of the following: (a) that the pricing of the offer does not promote the interests of other clients or firm's own interests, in a way that may conflict with the issuer client's interests; and (b) the prevention or management of a situation where persons responsible for providing services to the firm's investment clients are directly involved in decisions about corporate finance advice on pricing to the issuer client. 2. Investment firms shall provide clients with information about how the recommendation as to the price of the offering and the timings involved is determined. In particular, the firm shall inform and engage with the issuer client about any hedging or stabilisation strategies it intends to undertake with respect to the offering, including how these strategies may impact the issuer clients' interests. During the offering process, firms shall also take all reasonable steps to keep the issuer client informed about developments with respect to the pricing of the issue.
Art 40	Additional requirements in relation to placing	1. Investment firms placing financial instruments shall establish, implement and maintain effective arrangements to prevent recommendations on placing from being inappropriately influenced by any existing or future relationships. 2. Investment firms shall establish, implement and maintain effective internal arrangements to prevent or manage conflicts of interests that arise where persons responsible for providing services to the firm's investment clients are directly involved in decisions about recommendations to the issuer client on allocation. 3. Investment firms shall not accept any third-party payments or benefits unless such payments or benefits com-

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		ply with the inducements requirements laid down in Article 24 of Directive 2014/65/EU. In particular, the following practices shall be considered not compliant with those requirements and shall therefore be considered not acceptable: (a) an allocation made to incentivise the payment of disproportionately high fees for unrelated services provided by the investment firm ('laddering'), such as disproportionately high fees or commissions paid by an investment client, or disproportionately high volumes of business at normal levels of commission provided by the investment client as a compensation for receiving an allocation of the issue; (b) an allocation made to a senior executive or a corporate officer of an existing or potential issuer client, in consideration for the future or past award of corporate finance business ('spinning'); (c) an allocation that is expressly or implicitly conditional on the receipt of future orders or the purchase of any other service from the investment firm by an investment client, or any entity of which the investor is a corporate officer. 4. Investment firms shall establish, implement and maintain an allocation policy that sets out the process for developing allocation recommendations. The allocation policy shall be provided to the issuer client before agreeing to undertake any placing services. The policy shall set out relevant information that is available at that stage, about the proposed allocation methodology for the issue. 5. Investment firms shall involve the issuer client in discussions about the placing process in order for the firm to be able to understand and take into account the client's interests and objectives. The investment firm shall obtain the issuer client's agreement to its proposed allocation per type of client for the transaction in accordance with the allocation policy.
Art 41	Additional requirements in relation to advice, distribution and self-placement	1. Investment firms shall have in place systems, controls and procedures to identify and manage the conflicts of interest that arise when providing investment service to an investment client to participate in a new issue, where the investment firm receives commissions, fees or any monetary or non-monetary benefits in relation to arranging the issuance. Any commissions, fees or monetary or non-monetary benefits shall comply with the requirements in Article 24(7), 24(8) and 24(9) of Directive 2014/65/EU and be documented in the investment firm's

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		conflicts of interest policies and reflected in the firm's inducements arrangements. 2. Investment firms engaging in the placement of financial instruments issued by themselves or by entities within the same group, to their own clients, including their existing depositor clients in the case of credit institutions, or investment funds managed by entities of their group, shall establish, implement and maintain clear and effective arrangements for the identification, prevention or management of the potential conflicts of interest that arise in relation to this type of activity. Such arrangements shall include consideration of refraining from engaging in the activity, where conflicts of interest cannot be appropriately managed so as to prevent any adverse effects on clients. 3. When disclosure of conflicts of interest is required, investment firms shall comply with the requirements in Article 34(4), including an explanation of the nature and source of the conflicts of interest inherent to this type of activity, providing details about the specific risks related to such practices in order to enable clients to make an informed investment decision. 4. Investment firms which offer financial instruments issued that are by themselves or other group entities to their clients and that are included in the calculation of prudential requirements specified in Regulation (EU) No 575/2013 of the European Parliament and of the Councl, Directive 2013/36/EU of the European Parliament and of the Council or Directive 2014/59/EU of the European Parliament and of the Council, shall provide those clients with additional information explaining the differences between the financial instrument and bank deposits in terms of yield, risk, liquidity and any protection provided in accordance with Directive 2014/49/EU of the European Parliament and of the Council.
Art 42	Additional requirements in relation to lending or provision of credit in the context of underwriting or placement	1. Where any previous lending or credit to the issuer client by an investment firm, or an entity within the same group, may be repaid with the proceeds of an issue, the investment firm shall have arrangements in place to identify and prevent or manage any conflicts of interest that may arise as a result. 2. Where the arrangements taken to manage conflicts of interest prove insufficient to ensure that the risk of damage to the issuer client would be prevented, investment firms shall disclose to the issuer client the specific conflicts of interest that have arisen in relation to their, or

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		group entities', activities in a capacity of credit provider, and their activities related to the securities offering. 3. Investment firms' conflict of interest policy shall require the sharing of information about the issuer's financial situation with group entities acting as credit providers, provided this would not breach information barriers set up by the firm to protect the interests of a client.
Art 43	Record keeping in relation to underwriting or placing	Investment firms shall keep records of the content and timing of instructions received from clients. A record of the allocation decisions taken for each operation shall be kept to provide for a complete audit trail between the movements registered in clients' accounts and the instructions received by the investment firm. In particular, the final allocation made to each investment client shall be clearly justified and recorded. The complete audit trail of the material steps in the underwriting and placing process shall be made available to competent authorities upon request.

c) Continuity and regularity of service (Art 16(4) MiFID)

15 Clients' interests would be put at risk if the investment firm could stop offering its services at any time. For instance, a portfolio management client expects the firm to manage its portfolio continuously in order to be able to respond to market developments. **Service interruptions** can disrupt the effect of portfolio management. For that reason, Art 16(4) MiFID requires the firm to take reasonable steps to ensure service continuity and regularity, by employing appropriate and proportionate systems, resources and procedures. Art 21 (3) Commission Delegated Regulation (EU) 2017/565 requires the firm to write down and update these measures in a business continuity, ensuring, in the case of an interruption to their systems and procedures, the preservation of essential data and functions, and the maintenance of investment services and activities, or, where that is not possible, the timely recovery of such data and functions and the timely resumption of their investment services and activities. Examples include, with regard to **information technology**, automated storage routines on multiple harddrives, back-up routines, multiple mirror servers, protection against server access and manipulaton, firewalls and other black hat hack countermeasures. See on IT risks also comments on → Art 16(5), second para MiFID infra as well as the additional requirements for algorithmic trading in → Art 17.

16 From an **organisational perspective**, the firm must double up on the expertise of key personnel, or at least require regular documentation of material knowledge, write down a business organisation plan that leaves no gap even if one of the key people is sick or permanently absent, etc. These are the usual features of "adequate policies and procedures" set out in the Level 2 legislation to Art 16(2) MiFID.

3. Product governance, target market (Art 16(3), second para to end MiFID)

a) Objective

Art 16(3), second para to end MiFID stipulates the **target market requirement** on the side of the investment firm that manufactures, i.e. creates the financial product for sale to clients (for firms distributing products, see the requirements set out in → Art 24 et seq.).[4] Manufacturing firms shall "operate and review a process for the approval of each financial instrument and significant adaptations of existing financial instruments before it is marketed or distributed to clients." The objective of Art 16(3) MiFID is **investor protection**; investors shall be protected from risks resulting from information asymmetry and lack of sophistication necessary to understand the characteristics of a financial product in all market environments. For instance, a new product often responds to an investor's obvious need at the time of manufacturing, for example a yield product responding to a low interest environment. While investors may be delighted to find higher yields, they may disregard the risks they bear due to the underlying exposures in case of changing expectations, such as when the interest rates suddenly raise again. They may also disregard the fees they incur while hunting the (expected) yield. These behavioural errors shall be avoided by **product governance requirements**. **17**

Where the **investment firm holds the underlying assets on their own account**, investors are exposed to a "pump-and-down" risk, i.e. an undue marketing of a financial product that could enable the investment firm to dispose of its assets at unfair prices or in disregard of the acquirers' interests.[5] In this variant, the product approval requirement is a qualification of the general requirements to make the **client's interest paramount** when pursuing investment services. This is the rationale and justification of Art 16(3) MiFID. But the target market and product approval are not limited to the firm's own clients. It must also consider a potential mismarketing of the distributing investment firm's clients. In this regard, the rationale exceeds that of Art 16(3), first para MiFID. But the product approval process goes even beyond any client protection in that it must consider the **orderly functioning of markets as such**. This relates in particular to cases that may not clearly qualify as market abuse, since market abuse is prohibited anyway via the MAR and MAD. This could concern, for instance, privileged knowledge on who holds the counter position on any financial instruments offered to investors. **18**

In order to meet these various policy objectives, a **product manufacturer** must identify for each product a target market of end clients within the relevant category of clients. When identifiying the target market, the manufacturer needs to consider all relevant risks for investors of that group, as well as how that group would usually understand the marketing of characteristics associated with the product. In turn, the firm must adopt a distribution strategy for that product which is consistent with the identified target market. For example, a product targeted at sophisticated investors shall not be marketed to risk averses retail clients. **19**

The **manufacturer must make the information** about the target market and the product approval process **available to all distributors**, and distributors are mandated to acquire the respective information before distributing a product (see Art 16(3) para 4 and 5 MiFID). It follows from that requirement that the target market and product governance requirements are aiming at **restricting undue marketing**, but it falls short of a marketing ban to clients that are outside the identified group. If a client wants, at its own **20**

[4] See on target markets the literature cited in the comments on → Art 24.
[5] See Art 9(2), (3) of Commission Delegated Directive (EU) 2017/593.

initiative, to acquire the product, the investment firm is in principle allowed to sell it to the client.

Example:

Professional investor A wants to purchase a product targeted at retail investors. Of course, the investor may purchase such a product. An exception to the principle that the target market requirement does not affect the freedom of distribution is, however, the restriction which Art 25(4) MiFID imposes on sales of financial instruments on an execution only basis (see comments on → Art 25(4) MiFID).

b) Scope

21 The target market requirement covers all investment services and activities pursued by the investment firm. **Manufacturing** means any creation, development, issue and/or design of financial instruments, "including when advising corporate issuers on the launch of new financial instruments."[6] The target market requirement shall also apply to firms authorised to **perform investment services without being subject to MiFID**,[7] such as entities providing services to intra-group entities only or the managers of collective investment schemes (for further examples, see comments on → Art 2 and 3). If a firm engages in both manufacturing and distribution, it shall comply with the requirements set out in Art 16 MiFID and Art 24 et seq. MiFID.[8]

22 Although used very often in MiFID, neither "**sale** to clients" nor "**marketing**" or "**distribution**" to clients is defined in MiFID Level 1 and 2. This is unusual when compared to other EU financial law acts, such as the AIFMD. In our opinion, the aforementioned activities require an active step on the side of the manufacturing firm in the direction of the client. If, by contrast, the client approaches the firm and asks it to set up a certain product (e.g. a certain derivative or fund product) on demand, then Art 16(3) MiFID does not apply.

c) Minimum content

23 Level 2 implementing legislation sets out a number of factors to consider when defining the target market.[9] In particular, it requires that the target market definition be **sufficiently detailed** so that the definition can function effectively.[10] In light of this requirement, defining the target market for "all retail investors" would for example be insufficient. A more precise qualification is necessary, such as "ready to bear a certain [defined] degree of volatility", "ready to bear the risks of a changing interest rate environment", etc.

24 At the same time, as all financial regulation, the target market definition is subject to the **principle of proportionality**.[11] If the product is of a plain vanilla type, such as a simple share or bond, and comprehensive information on the product is readily available, the target market definition can be "relatively simple for certain simple products distributed on an execution-only basis where such products would be compatible with the needs and characteristics of the mass retail market."[12] On the other hand, for complex products a detailed description of the target client profile is of the essence, including definitions of clients who shall not be the target of marketing efforts. "The level of granularity of the target market and the criteria used to define the target market and determine

[6] Cf. Recital 15 of Commission Delegated Directive (EU) 2017/593.
[7] Cf. Recital 16 of Commission Delegated Directive (EU) 2017/593.
[8] Cf. Recital 17 of Commission Delegated Directive (EU) 2017/593.
[9] Art 9(8) et seq. of Commission Delegated Directive (EU) 2017/593.
[10] Cf. Recital 17 of Commission Delegated Directive (EU) 2017/593.
[11] Art 9(1) of Commission Delegated Directive (EU) 2017/593.
[12] Cf. Recital 18 of Commission Delegated Directive (EU) 2017/593.

the appropriate distribution strategy should be relevant for the product and should make it possible to assess which clients fall within the target market".[13]

d) Policy, review

The target market and product approval process must be laid down in a **product approval policy**. Key staff must be involved in the product approval to ensure compliance with the policy. If Third Country entities are involved, compliance with Art 16(3) MiFID must be ensured by contractual means.[14] This policy could be part of the investment firm's general organisation or programme of operations. However, since the distributors are required to ask for information on the former, it is advisable to lay down those requirements in a separate policy document. **25**

The target market definition is up for a **regular review**, "taking into account any event that could materially affect the potential risk to the identified target market" (Art 16(3) MiFID).[15] This review shall include insights based on communication between the manufacturer and the distributors. Distributors are to "periodically inform the manufacturers about their experience with the products. While distributors should not be required to report every sale to manufacturers, they should provide the data that is necessary for the manufacturer to review the product and check that it remains consistent with the needs, characteristics and objectives of the target market defined by the manufacturer. Relevant information could include data about the amount of sales outside the manufacturer's target market, summary information of the types of clients, a summary of complaints received or by posing questions suggested by the manufacturer to a sample of clients for feedback."[16] **26**

e) Level 2 legislation

Details are laid down in **Art 9, 10 Commission Delegated Directive (EU) 2017/593** of 7 April 2016. The following table provides an overview of the applicable Level 2 legislation: **27**

Directive 2017/593	**Topic**	**Content**
Art 9	Product governance obligations for investment firms manufacturing financial instruments	1. Member States shall require investment firms to comply with this Article when manufacturing financial instruments, which encompasses the creation, development, issuance and/or design of financial instruments. Member States shall require investment firms manufacturing financial instruments to comply, in a way that is appropriate and proportionate, with the relevant requirements in paragraphs 2 to 15, taking into account the nature of the financial instrument, the investment service and the target market for the product. 2. Member States shall require investment firms to establish, implement and maintain procedures and measures to ensure the manufacturing of financial instruments complies with the requirements on proper management of con-

[13] Cf. Recital 19 of Commission Delegated Directive (EU) 2017/593.
[14] Art 9(6) to (8) of Commission Delegated Directive (EU) 2017/593.
[15] For details see Art 9(15) of Commission Delegated Directive (EU) 2017/593.
[16] Cf. Recital 20 of Commission Delegated Directive (EU) 2017/593.

Directive 2017/593	Topic	Content
		flicts of interest, including remuneration. In particular, investment firms manufacturing financial instruments shall ensure that the design of the financial instrument, including its features, does not adversely affect end clients or does not lead to problems with market integrity by enabling the firm to mitigate and/or dispose of its own risks or exposure to the underlying assets of the product, where the investment firm already holds the underlying assets on own account. 3. Member States shall require investment firms to analyse potential conflicts of interests each time a financial instrument is manufactured. In particular, firms shall assess whether the financial instrument creates a situation where end clients may be adversely affected if they take: (a) an exposure opposite to the one previously held by the firm itself; or (b) an exposure opposite to the one that the firm wants to hold after the sale of the product. 4. Member States shall ensure that investment firms consider whether the financial instrument may represent a threat to the orderly functioning or to the stability of financial markets before deciding to proceed with the launch of the product. 5. Member States shall require investment firms to ensure that relevant staff involved in the manufacturing of financial instruments possess the necessary expertise to understand the characteristics and risks of the financial instruments they intend to manufacture. 6. Member States shall require investment firms to ensure that the management body has effective control over the firm's product governance process. Investment firms shall ensure that the compliance reports to the management body systematically include information about the financial instruments manufactured by the firm, including information on the distribution strategy. Investment firms shall make the reports available to their competent authority on request. 7. Member States shall require investment firms to ensure that the compliance function monitors the development and periodic review of product governance arrangements in order to detect any risk of failure by the firm to comply with the obligations set out in this Article. 8. Member States shall require investment firms, where they collaborate, including with entities which are not authorised and supervised in accordance with Directive 2014/65/EU or third-country firms, to create, develop, issue and/or design a product, to outline their mutual responsibilities in a written agreement.

Directive 2017/593	Topic	Content
		9. Member States shall require investment firms to identify at a sufficiently granular level the potential target market for each financial instrument and specify the type(s) of client for whose needs, characteristics and objectives the financial instrument is compatible. As part of this process, the firm shall identify any group(s) of clients for whose needs, characteristics and objectives the financial instrument is not compatible. Where investment firms collaborate to manufacture a financial instrument, only one target market needs to be identified. Investment firms manufacturing financial instruments that are distributed through other investment firms shall determine the needs and characteristics of clients for whom the product is compatible based on their theoretical knowledge of and past experience with the financial instrument or similar financial instruments, the financial markets and the needs, characteristics and objectives of potential end clients. 10. Member States shall require investment firms to undertake a scenario analysis of their financial instruments which shall assess the risks of poor outcomes for end clients posed by the product and in which circumstances these outcomes may occur. Investment firms shall assess the financial instrument under negative conditions covering what would happen if, for example: (a) the market environment deteriorated; (b) the manufacturer or a third party involved in manufacturing and or functioning of the financial instrument experiences financial difficulties or other counterparty risk materialises; (c) the financial instrument fails to become commercially viable; or (d) demand for the financial instrument is much higher than anticipated, putting a strain on the firm's resources and/or on the market of the underlying instrument. 11. Member States shall require investment firms to determine whether a financial instrument meets the identified needs, characteristics and objectives of the target market, including by examining the following elements: (a) the financial instrument's risk/reward profile is consistent with the target market; and (b) financial instrument design is driven by features that benefit the client and not by a business model that relies on poor client outcomes to be profitable. 12. Member States shall ensure that investment firms consider the charging structure proposed for the financial instrument, including by examining the following:

Directive 2017/593	**Topic**	**Content**
		(a) financial instrument's costs and charges are compatible with the needs, objectives and characteristics of the target market; (b) charges do not undermine the financial instrument's return expectations, such as where the costs or charges equal, exceed or remove almost all the expected tax advantages linked to a financial instrument; and (c) the charging structure of the financial instrument is appropriately transparent for the target market, such as that it does not disguise charges or is too complex to understand. 13. Member States shall require investment firms to ensure that the provision of information about a financial instrument to distributors includes information about the appropriate channels for distribution of the financial instrument, the product approval process and the target market assessment and is of an adequate standard to enable distributors to understand and recommend or sell the financial instrument properly. 14. Member States shall require investment firms to review the financial instruments they manufacture on a regular basis, taking into account any event that could materially affect the potential risk to the identified target market. Investment firms shall consider if the financial instrument remains consistent with the needs, characteristics and objectives of the target market and if it is being distributed to the target market, or is reaching clients for whose needs, characteristics and objectives the financial instrument is not compatible. 15. Member States shall require investment firms to review financial instruments prior to any further issue or re-launch, if they are aware of any event that could materially affect the potential risk to investors and at regular intervals to assess whether the financial instruments function as intended. Investment firms shall determine how regularly to review their financial instruments based on relevant factors, including factors linked to the complexity or the innovative nature of the investment strategies pursued. Firms shall also identify crucial events that would affect the potential risk or return expectations of the financial instrument, such as: (a) the crossing of a threshold that will affect the return profile of the financial instrument; or (b) the solvency of certain issuers whose securities or guarantees may impact the performance of the financial instrument.

Directive 2017/593	Topic	Content
		Member States shall ensure that, when such events occur, investment firms take appropriate action which may consist of: (a) the provision of any relevant information on the event and its consequences on the financial instrument to the clients or the distributors of the financial instrument if the investment firm does not offer or sell the financial instrument directly to the clients; (b) changing the product approval process; (c) stopping further issuance of the financial instrument; (d) changing the financial instrument to avoid unfair contract terms; (e) considering whether the sales channels through which the financial instruments are sold are appropriate where firms become aware that the financial instrument is not being sold as envisaged; (f) contacting the distributor to discuss a modification of the distribution process; (g) terminating the relationship with the distributor; or (h) informing the relevant competent authority.
Art 10	Product governance obligations for distributors	1. Member States shall require investment firms, when deciding the range of financial instruments issued by themselves or other firms and services they intend to offer or recommend to clients, to comply, in a way that is appropriate and proportionate, with the relevant requirements laid down in paragraphs 2 to 10, taking into account the nature of the financial instrument, the investment service and the target market for the product. Member States shall ensure that investment firms also comply with the requirements of Directive 2014/65/EU when offering or recommending financial instruments manufactured by entities that are not subject to Directive 2014/65/EU. As part of this process, such investment firms shall have in place effective arrangements to ensure that they obtain sufficient information about these financial instruments from these manufacturers. Investment firms shall determine the target market for the respective financial instrument, even if the target market was not defined by the manufacturer. 2. Member States shall require investment firms to have in place adequate product governance arrangements to ensure that products and services they intend to offer or recommend are compatible with the needs, characteristics, and objectives of an identified target market and that the intended distribution strategy is consistent with the identified target market. Investment firms shall appropriately identify and assess the circumstances and needs of the

Directive 2017/593	Topic	Content
		clients they intend to focus on, so as to ensure that clients' interests are not compromised as a result of commercial or funding pressures. As part of this process, firms shall identify any groups of clients for whose needs, characteristics and objectives the product or service is not compatible. Member States shall ensure that investment firms obtain from manufactures that are subject to Directive 2014/65/EU information to gain the necessary understanding and knowledge of the products they intend to recommend or sell in order to ensure that these products will be distributed in accordance with the needs, characteristics and objectives of the identified target market, Member States shall require investment firms to take all reasonable steps to ensure they also obtain adequate and reliable information from manufacturers not subject to Directive 2014/65/EU to ensure that products will be distributed in accordance with the characteristics, objectives and needs of the target market. Where relevant information is not publicly available, the distributor shall take all reasonable steps to obtain such relevant information from the manufacturer or its agent. Acceptable publicly available information is information which is clear, reliable and produced to meet regulatory requirements, such as disclosure requirements under Directive 2003/71/EC (8) or 2004/109/EC (9) of the European Parliament and of the Council. This obligation is relevant for products sold on primary and secondary markets and shall apply in a proportionate manner, depending on the degree to which publicly available information is obtainable and the complexity of the product. Investment firms shall use the information obtained from manufacturers and information on their own clients to identify the target market and distribution strategy. When an investment firm acts both as a manufacturer and a distributor, only one target market assessment shall be required. 3. Member States shall require investment firms, when deciding the range of financial instrument and services that they offer or recommend and the respective target markets, to maintain procedures and measures to ensure compliance with all applicable requirements under Directive 2014/65/EU including those relating to disclosure, assessment of suitability or appropriateness, inducements and proper management of conflicts of interest. In this context, particular care shall be taken when distributors intend to offer or recommend new products or there are variations to the services they provide.

Directive 2017/593	**Topic**	**Content**
		4. Member States shall require investment firms to periodically review and update their product governance arrangements in order to ensure that they remain robust and fit for their purpose, and take appropriate actions where necessary. 5. Member States shall require investment firms to review the investment products they offer or recommend and the services they provide on a regular basis, taking into account any event that could materially affect the potential risk to the identified target market. Firms shall assess at least whether the product or service remains consistent with the needs, characteristics and objectives of the identified target market and whether the intended distribution strategy remains appropriate. Firms shall reconsider the target market and/or update the product governance arrangements if they become aware that they have wrongly identified the target market for a specific product or service or that the product or service no longer meets the circumstances of the identified target market, such as where the product becomes illiquid or very volatile due to market changes. 6. Member States shall require investment firms to ensure their compliance function oversee the development and periodic review of product governance arrangements in order to detect any risk of failure to comply with the obligations set out in this Article. 7. Member States shall require investment firms to ensure that relevant staff possess the necessary expertise to understand the characteristics and risks of the products that intend to offer or recommend and the services provided as well as the needs, characteristics and objectives of the identified target market. 8. Member States shall require investment firms to ensure that the management body has effective control over the firm's product governance process to determine the range of investment products that they offer or recommend and the services provided to the respective target markets. Investment firms shall ensure that the compliance reports to the management body systematically include information about the products they offer or recommend and the services provided. The compliance reports shall be made available to competent authorities on request. 9. Member States shall ensure distributors provide manufacturers with information on sales and, where appropriate, information on the above reviews to support product reviews carried out by manufacturers. 10. Where different firms work together in the distribution of a product or service, Member States shall ensure the in-

Directive 2017/593	Topic	Content
		vestment firm with the direct client relationship has ultimate responsibility to meet the product governance obligations set out in this Article. However, intermediary investment firms shall: (a) ensure that relevant product information is passed from the manufacturer to the final distributor in the chain; (b) if the manufacturer requires information on product sales in order to comply with their own product governance obligations, enable them to obtain it; and (c) apply the product governance obligations for manufacturers, as relevant, in relation to the service they provide.

4. Outsourcing (Art 16(5) MiFID)

28 Art 16(5) MiFID deals with the outsourcing of **critical services or functions** "for the provision of continuous and satisfactory service to clients and the performance of investment activities on a continuous and satisfactory basis". As a general matter, services that can be easily acquired at standard terms on the market are not critical in this regard.[17] All non-material services or functions may be outsourced in line with the general requirements, particularly the requirements to ensure compliance with MiFID and to ensure business continuity.

29 If the firm outsources critical functions and services, it must take steps to **avoid undue operational risk**, i.e. risk stemming from the disruption of performance of such functions and services. Further, the outsourcing must not materially impair the quality of its internal control and the ability of the supervisor to monitor the firm's compliance with all obligations (cf. → Art 16(5)).[18] Particular risks with regard to non-compliance with MiFID stem from the operations of Third Country providers, which are not subject to MiFID.[19]

30 A crucial factor, in particular, but not only with regard to outsourcing to Third Country entities is the ability of the investment firm to maintain its head office functions, which is a crucial condition for authorisation, but also for protection of clients' interests.[20] This **prohibition of letter-box entities** is material for investor protection and enforcement of Union financial law: if an investment firm cannot make decision, cannot control risks, or cannot perform operations on its own, then it cannot serve clients with sufficient controls to ensure compliance with MiFID in the absence of the outsourcing provider. Therefore, the latter gains control over the EU firm as an outsourcing company, which materially weakens enforcement of Union financial law. In light of the prohibition of letter-box entities, MiFID only partially acknowledges the **interests of a group of companies** to run the group efficiently and smoothly, with as little overlap of functions as possible.

[17] See the definition in Art 30 Commission Delegated Regulation (EU) 2017/565.
[18] For details, see Art 31 Commission Delegated Regulation (EU) 2017/565.
[19] See Art 32 Commission Delegated Regulation (EU) 2017/565.
[20] See in particular Art 31 (1)(a) and (d) as well as (2)(e), (g) of Commission Delegated Regulation (EU) 2017/565.

Details are laid down in Art 30-32 Commission Delegated Regulation (EU) 2017/565. The following table provides an overview of the applicable Level 2 legislation: **31**

Regulation 2017/565	**Topic**	**Content**
Art 30	Scope of critical and important operational functions	1. For the purposes of the first subparagraph of Article 16(5) of Directive 2014/65/EU, an operational function shall be regarded as critical or important where a defect or failure in its performance would materially impair the continuing compliance of an investment firm with the conditions and obligations of its authorisation or its other obligations under Directive 2014/65/EU, or its financial performance, or the soundness or the continuity of its investment services and activities. 2. Without prejudice to the status of any other function, the following functions shall not be considered as critical or important for the purposes of paragraph 1: (a) the provision to the firm of advisory services, and other services which do not form part of the investment business of the firm, including the provision of legal advice to the firm, the training of personnel of the firm, billing services and the security of the firm's premises and personnel; (b) the purchase of standardised services, including market information services and the provision of price feeds.
Art 31	Outsourcing critical or important operational functions	1. Investment firms outsourcing critical or important operational functions shall remain fully responsible for discharging all of their obligations under Directive 2014/65/EU and shall comply with the following conditions: (a) the outsourcing does not result in the delegation by senior management of its responsibility; (b) the relationship and obligations of the investment firm towards its clients under the terms of Directive 2014/65/EU is not altered; (c) the conditions with which the investment firm must comply in order to be authorised in accordance with Article 5 of Directive 2014/65/EU, and to remain so, are not undermined; (d) none of the other conditions subject to which the firm's authorisation was granted is removed or modified. 2. Investment firms shall exercise due skill, care and diligence when entering into, managing or terminating any arrangement for the outsourcing to a service provider of critical or important operational functions and shall take the necessary steps to ensure that the following conditions are satisfied:

Regulation 2017/565	Topic	Content
		(a) the service provider has the ability, capacity, sufficient resources, appropriate organisational structure supporting the performance of the outsourced functions, and any authorisation required by law to perform the outsourced functions, reliably and professionally; (b) the service provider carries out the outsourced services effectively and in compliance with applicable law and regulatory requirements, and to this end the firm has established methods and procedures for assessing the standard of performance of the service provider and for reviewing on an ongoing basis the services provided by the service provider; (c) the service provider properly supervises the carrying out of the outsourced functions, and adequately manage the risks associated with the outsourcing; (d) appropriate action is taken where it appears that the service provider may not be carrying out the functions effectively or in compliance with applicable laws and regulatory requirements; (e) the investment firm effectively supervises the outsourced functions or services and manage the risks associated with the outsourcing and to this end the firm retains the necessary expertise and resources to supervise the outsourced functions effectively and manage those risks; (f) the service provider has disclosed to the investment firm any development that may have a material impact on its ability to carry out the outsourced functions effectively and in compliance with applicable laws and regulatory requirements; (g) the investment firm is able to terminate the arrangement for outsourcing where necessary, with immediate effect when this is in the interests of its clients, without detriment to the continuity and quality of its provision of services to clients; (h) the service provider cooperates with the competent authorities of the investment firm in connection with the outsourced functions; (i) the investment firm, its auditors and the relevant competent authorities have effective access to data related to the outsourced functions, as well as to the relevant business premises of the service provider, where necessary for the purpose of effective oversight in accordance with this article, and the competent authorities are able to exercise those rights of access; (j) the service provider protects any confidential information relating to the investment firm and its clients;

Regulation 2017/565	**Topic**	**Content**
		(k) the investment firm and the service provider have established, implemented and maintained a contingency plan for disaster recovery and periodic testing of backup facilities, where that is necessary having regard to the function, service or activity that has been outsourced; (l) the investment firm has ensured that the continuity and quality of the outsourced functions or services are maintained also in the event of termination of the outsourcing either by transferring the outsourced functions or services to another third party or by performing them itself. 3. The respective rights and obligations of the investment firms and of the service provider shall be clearly allocated and set out in a written agreement. In particular, the investment firm shall keep its instruction and termination rights, its rights of information, and its right to inspections and access to books and premises. The agreement shall ensure that outsourcing by the service provider only takes place with the consent, in writing, of the investment firm. 4. Where the investment firm and the service provider are members of the same group, the investment firm may, for the purposes of complying with this Article and Article 32, take into account the extent to which the firm controls the service provider or has the ability to influence its actions. 5. Investment firms shall make available on request to the competent authority all information necessary to enable the authority to supervise the compliance of the performance of the outsourced functions with the requirements of Directive 2014/65/EU and its implementing measures.
Art 32	Service providers located in third countries	1. In addition to the requirements set out in Article 31, where an investment firm outsources functions related to the investment service of portfolio management provided to clients to a service provider located in a third country, that investment firm ensures that the following conditions are satisfied: (a) the service provider is authorised or registered in its home country to provide that service and is effectively supervised by a competent authority in that third country; (b) there is an appropriate cooperation agreement between the competent authority of the investment firm and the supervisory authority of the service provider. 2. The cooperation agreement referred to in point (b) of paragraph 1 shall ensure that the competent authorities of the investment firm are able, at least, to:

Regulation 2017/565	Topic	Content
		(a) obtain on request the information necessary to carry out their supervisory tasks pursuant to Directive 2014/65/EU and Regulation (EU) No 600/2014; (b) obtain access to the documents relevant for the performance of their supervisory duties maintained in the third country; (c) receive information from the supervisory authority in the third country as soon as possible for the purpose of investigating apparent breaches of the requirements of Directive 2014/65/EU and its implementing measures and Regulation (EU) No 600/2014; (d) cooperate with regard to enforcement, in accordance with the national and international law applicable to the supervisory authority of the third country and the competent authorities in the Union in cases of breach of the requirements of Directive 2014/65/EU and its implementing measures and relevant national law. 3. Competent authorities shall publish on their website a list of the supervisory authorities in third countries with which they have a cooperation agreement referred to in point (b) of paragraph 1. Competent authorities shall update cooperation agreements concluded before the date of entry into application of this Regulation within six months from that date.

5. Risk management, internal controls, IT systems (Art 16(5), second para MiFID)

32 The **internal control system** of an investment firm consists of the risk management, compliance and internal audit functions. Art 16(5) second para MiFID refers to these functions collectively and adds the "arrangements for information processing systems." This addition is crucial in times where many investment services rely on information technology and algorithms.[21]

33 The details on **risk management and audit** are set out in Art 23 and 24 of Commission Delegated Regulation 2017/565. These requirements are similar to the principles underlying Art 15 and 16 AIFMD (for risk management) and Art 12, 14, 18 AIFMD (for organisational requirements). The following table provides an overview of the applicable Level 2 legislation:

Regulation 2017/565	Topic	Content
Art 23	Risk management	1. Investment firms shall take the following actions relating to risk management: (a) establish, implement and maintain adequate risk management policies and procedures which identify

[21] See also the additional requirements in the case of algorithmic trading in Art 17 MiFID as well as the comments on the business continuity requirements set out in → Art 16(4) above.

Regulation 2017/565	Topic	Content
		the risks relating to the firm's activities, processes and systems, and where appropriate, set the level of risk tolerated by the firm; (b) adopt effective arrangements, processes and mechanisms to manage the risks relating to the firm's activities, processes and systems, in light of that level of risk tolerance; (c) monitor the following: (i) the adequacy and effectiveness of the investment firm's risk management policies and procedures; (ii) the level of compliance by the investment firm and its relevant persons with the arrangements, processes and mechanisms adopted in accordance with point (b); (iii) the adequacy and effectiveness of measures taken to address any deficiencies in those policies, procedures, arrangements, processes and mechanisms, including failures by the relevant persons to comply with such arrangements, processes and mechanisms or follow such policies and procedures. 2. Investment firms shall, where appropriate and proportionate in view of the nature, scale and complexity of their business and the nature and range of the investment services and activities undertaken in the course of that business, establish and maintain a risk management function that operates independently and carries out the following tasks: (a) implementation of the policy and procedures referred to in paragraph 1; (b) provision of reports and advice to senior management in accordance with Article 25(2). Where an investment firm does not establish and maintain a risk management function under the first sub-paragraph, it shall be able to demonstrate upon request that the policies and procedures which it is has adopted in accordance with paragraph 1 satisfy the requirements therein.
Art 24	Internal audit	Investment firms shall, where appropriate and proportionate in view of the nature, scale and complexity of their business and the nature and range of investment services and activities undertaken in the course of that business, establish and maintain an internal audit function which is separate and independent from the other functions and activities of the investment firm and which has the following responsibilities:

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		(a) establish, implement and maintain an audit plan to examine and evaluate the adequacy and effectiveness of the investment firm's systems, internal control mechanisms and arrangements; (b) issue recommendations based on the result of work carried out in accordance with point (a) and verify compliance with those recommendations; (c) report in relation to internal audit matters in accordance with Article 25(2).

34 As to **information systems**, see the **business continuity requirements** set out in Art 21(3), (4) of Commission Delegated Regulation 2017/565 and comments on → Art 16(4) MiFID. In addition, Art 16(5) MiFID requires the implementation of "sound security mechanisms" sufficiently able "to guarantee the security and authentication of the means of transfer of information, minimise the risk of data corruption and unauthorised access and to prevent information leakage maintaining the confidentiality of the data at all times." While the requirement itself is sound, it is difficult to comply with such a requirement where data security is a function of effort invested. With hackers having multiple resources around the world at their disposal, it is always possible that they will attack an investment firm's server security structure. The provision must thus be read as a best efforts-requirement designed to ensure that sufficient funds are devoted to this task. Art 16(5) MiFID does not require the firm to spend enough funds to achieve 100% security, in line with the old Latin adage *impossibilium nulla est obligatio*.

6. Record keeping, recording phone conversation, communications

a) Record keeping (Art 16(6), (11) MiFID)

35 MiFID and relating Level 2 legislation provides for **extensive record keeping requirements** (see the overview provided infra). The objective is to ensure full monitoring of compliance by the respective NCAs. At the same time, the record keeping shall ensure effective internal controls to avoid more frequent interference by the supervisory authority. See for further details ESMA, Guidelines on certain aspects of the MiFID II suitability requirements, 06/11/2018, ESMA35-43-1163, pp. 28-29.

36 The same record keeping requirements apply to **branches of investment firms**. Enforcment is concentrated in the hands of the NCA responsible for supervising the branch (Art 16(11) MiFID).

b) Recording phone conversations and electronic communications (Art 16(7) MiFID)

37 As a qualified way of record keeping, Art 16 (7) MiFID requires the investment firm to record phone conversation and electronic communications in certain cases. The rule seeks to prevent circumvention of record keeping requirements, and thus to strengthen the enforcement of Union financial law. However, the record keeping requirement reduces questions about what has been said and what has not been said about the characteristics of a financial instrument. While those concerns are to be understood in the context of retail client protection, there is little evidence for the necessity to protect professional clients in the same manner. For those clients, the prime rationale underpinning the recording obligation is the prevention of market abuse.

The Preamble to MiFID, in Recital 57, sets out the rationale in the following way: "Such records should ensure that there is evidence to prove the terms of any orders given by clients and its correspondence with transactions executed by the investment firms, as well as to detect any behaviour that may have relevance in terms of market abuse, including when firms deal on own account." Recital 57 MiFID also states that recording phone conversations is "compatible with the Charter of Fundamental Rights of the European Union (the Charter) and is justified in order to strengthen investor protection, to improve market surveillance and increase legal certainty in the interest of investment firms and their clients." Yet the Commission as well as the other legislative bodies of the EU have no power to construe the Charter in a binding manner. This privilege is granted only to the Court of Justice of the European Union and the European Court of Human Rights. We are not aware of decisions specifically on the MiFID recording requirements. The question of the telephone recording requirements' compatibility with the Charter of Fundamental Rights is – in fact – open and not settled. **38**

Records shall include at least **all communications relating to transactions** concluded when dealing on own account as well as client orders, including communications *aimed at* concluding a transaction. The recording requirement covers all communications, made with, sent from or received by equipment provided by the investment firm to an employee or contractor or the use of which by an employee or contractor has been accepted or permitted by the investment firm. These could be, for instance, cell phones provided by the investment firm or private phones that the investment firm has authorised to be used for contacting clients. Investment firms need to set up communication policies detailing which communication devices may be used for communication with clients. They shall take all reasonable steps to prevent an employee or contractor from making, sending or receiving relevant telephone conversations and electronic communications on privately-owned equipment which the investment firm is unable to record or copy. **39**

The record keeping requirement extends to **face-to-face conversations**, but for this particular situation Art 16(6) MiFID allows *ex post* recording by use of written minutes or notes. Orders recorded in this way shall be considered equivalent to orders received by telephone. Pursuant to Recital 57 MiFID, Member States must "ensure that appropriate safeguards are in place to ensure that the client does not lose out as a result of the minutes inaccurately recording the communication between the parties. Such safeguards should not imply any assumption of liability by the client." **40**

Clients may be concerned about the **invasion of their privacy** by the recording of the communication. For this reason, the firm must **inform the client** about the recording before the services or activities are performed. However, MiFID is silent on the consequences of the client's rejection of the recording. There may be very valid reasons for such a rejection, for instance the danger of abuse of the client's voice in a subsequent IT hacker attack. While this position is not shared by the respective NCAs, the correct opinion in our view is that in this situation the rules for face-to-face conversation applies *mutatis mutandis*. As a conseqence, the conversation can take place and will be recorded via written minutes or notes. The overarching protection the joint constitutional traditions of Member States grant to personality rights sets aside the NCAs' interest in having a full digital recording of voice conversations. **41**

The records kept in accordance with Art 16(6) MiFID shall be provided upon request to the client involved and shall be kept for a period of five years and, where requested by the competent authority, for a **period of up to seven years**. **42** *c) Level 2 legislation*

43 Details are laid down in **Art 35, 43, 72 et seq. of Commission Delegated Regulation (EU) 2017/565**. Annex IV of that Directive contains a list of record keeping requirements for client orders and decision to deal and of transactions and order processing. The following table specifies the applicable Level 2 legislation:

Regulation 2017/565	**Topic**	**Content**
Art 35	Record of services or activities giving rise to detrimental conflict of interest	Investment firms shall keep and regularly update a record of the kinds of investment or ancillary service or investment activity carried out by or on behalf of the firm in which a conflict of interest entailing a risk of damage to the interests of one or more clients has arisen or, in the case of an ongoing service or activity, may arise. Senior management shall receive on a frequent basis, and at least annually, written reports on situations referred to in this Article.
Art 43	Record keeping in relation to underwriting or placing	Investment firms shall keep records of the content and timing of instructions received from clients. A record of the allocation decisions taken for each operation shall be kept to provide for a complete audit trail between the movements registered in clients' accounts and the instructions received by the investment firm. In particular, the final allocation made to each investment client shall be clearly justified and recorded. The complete audit trail of the material steps in the underwriting and placing process shall be made available to competent authorities upon request.
Art 72	Retention of records	1. The records shall be retained in a medium that allows the storage of information in a way accessible for future reference by the competent authority, and in such a form and manner that the following conditions are met: (a) the competent authority is able to access them readily and to reconstitute each key stage of the processing of each transaction; (b) it is possible for any corrections or other amendments, and the contents of the records prior to such corrections or amendments, to be easily ascertained; (c) it is not possible for the records otherwise to be manipulated or altered; (d) it allows IT or any other efficient exploitation when the analysis of the data cannot be easily carried out due to the volume and the nature of the data; and (e) the firm's arrangements comply with the record keeping requirements irrespective of the technology used. 2. Investment firms shall keep at least the records identified in Annex I to this Regulation depending upon the nature of their activities.

Regulation 2017/565	Topic	Content
		The list of records identified in Annex I to this Regulation is without prejudice to any other record-keeping obligations arising from other legislation. 3. Investment firms shall also keep records of any policies and procedures they are required to maintain pursuant to Directive 2014/65/EU, Regulation (EU) No 600/2014, Directive 2014/57/EU and Regulation (EU) No 596/2014 and their respective implementing measures in writing. Competent authorities may require investment firms to keep additional records to the list identified in Annex I to this Regulation.
Art 73	Record keeping of rights and obligations of the investment firm and the client	Records which set out the respective rights and obligations of the investment firm and the client under an agreement to provide services, or the terms on which the firm provides services to the client, shall be retained for at least the duration of the relationship with the client.
Art 74	Record keeping of client orders and decision to deal	An investment firm shall, in relation to every initial order received from a client and in relation to every initial decision to deal taken, immediately record and keep at the disposal of the competent authority at least the details set out in Section 1 of Annex IV to this Regulation to the extent they are applicable to the order or decision to deal in question. Where the details set out in Section 1 of Annex IV to this Regulation are also prescribed under Articles 25 and 26 of Regulation (EU) No 600/2014, these details should be maintained in a consistent way and according to the same standards prescribed under Articles 25 and 26 of Regulation (EU) No 600/2014.
Art 75	Record keeping of transactions and order processing	Investment firms shall, immediately after receiving a client order or making a decision to deal to the extent they are applicable to the order or decision to deal in question, record and keep at the disposal of the competent authority at least the details set out in Section 2 of Annex IV. Where the details set out in Section 2 of Annex IV are also prescribed under Articles 25 and 26 of Regulation (EU) No 600/2014, they shall be maintained in a consistent way and according to the same standards prescribed under Articles 25 and 26 of Regulation (EU) No 600/2014.
Art 76	Recording of telephone conversations or electronic	1. Investment firms shall establish, implement and maintain an effective recording of telephone conversations and electronic communications policy, set out in writing, and appropriate to the size and organisation of the firm, and

Regulation 2017/565	Topic	Content
	communications	the nature, scale and complexity of its business. The policy shall include the following content: (a) the identification of the telephone conversations and electronic communications, including relevant internal telephone conversations and electronic communications, that are subject to the recording requirements in accordance with Article 16(7) of Directive 2014/65/EU; and (b) the specification of the procedures to be followed and measures to be adopted to ensure the firm's compliance with the third and eighth subparagraphs of Article 16(7) of Directive 2014/65/EU where exceptional circumstances arise and the firm is unable to record the conversation/communication on devices issued, accepted or permitted by the firm. Evidence of such circumstances shall be retained and shall be accessible to competent authorities. 2. Investment firms shall ensure that the management body has effective oversight and control over the policies and procedures relating to the firm's recording of telephone conversations and electronic communications. 3. Investment firms shall ensure that the arrangements to comply with recording requirements are technology-neutral. Firms shall periodically evaluate the effectiveness of the firm's policies and procedures and adopt any such alternative or additional measures and procedures as are necessary and appropriate. At a minimum, such adoption of alternative or additional measures shall occur when a new medium of communication is accepted or permitted for use by the firm. 4. Investment firms shall keep and regularly update a record of those individuals who have firm devices or privately owned devices that have been approved for use by the firm. 5. Investment firms shall educate and train employees in procedures governing the requirements in Article 16(7) of Directive 2014/65/EU. 6. To monitor compliance with the recording and record-keeping requirements in accordance with Article 16(7) of Directive 2014/65/EU, investment firms shall periodically monitor the records of transactions and orders subject to these requirements, including relevant conversations. Such monitoring shall be risk based and proportionate. 7. Investment firms shall demonstrate the policies, procedures and management oversight of the recording rules to the relevant competent authorities upon request. 8. Before investment firms provide investment services and activities relating to the reception, transmission and

Regulation 2017/565	Topic	Content
		execution of orders to new and existing clients, firms shall inform the client of the following: (a) that the conversations and communications are being recorded; and (b) that a copy of the recording of such conversations with the client and communications with the client will be available on request for a period of five years and, where requested by the competent authority, for a period of up to seven years. The information referred to in the first sub-paragraph shall be presented in the same language(s) as that used to provide investment services to clients. 9. Investment firms shall record in a durable medium all relevant information related to relevant face-to-face conversations with clients. The information recorded shall include at least the following: (a) date and time of meetings; (b) location of meetings; (c) identity of the attendees; (d) initiator of the meetings; and (e) relevant information about the client order including the price, volume, type of order and when it shall be transmitted or executed. 10. Records shall be stored in a durable medium, which allows them to be replayed or copied and must be retained in a format that does not allow the original record to be altered or deleted. Records shall be stored in a medium so that they are readily accessible and available to clients on request. Firms shall ensure the quality, accuracy and completeness of the records of all telephone recordings and electronic communications. 11. The period of time for the retention of a record shall begin on the date when the record is created.

d) Minimum list of records to be kept by the investment firm

Annex I to Commission Delegated Regulation (EU) 2017/565 provides a list of minimum records to be kept by investment firms depending on the nature of their activities: **44**

Nature of obligation	Type of record	Summary of content	Legislative reference
Client assessment			
	Information to clients	Content as provided for under Art 24(4) of Directive 2014/65/EU and Arts 39 to 45 Reg 2017/565	Art 24(4) MiFID II Arts 39 to 45 Reg 2017/565

Nature of obligation	**Type of record**	**Summary of content**	**Legislative reference**
	Client agreements	Records as provided for under Art 25(5) of Directive 2014/65/EU	Art 25(5) MiFID II Art 53 Reg 2017/565
	Assessment of suitability and appropriateness	Content as provided for under Art 25(2) and (3) of Directive 2014/65/EU and Art 50 Reg 2017/565	Art 25(2) and (3) of Directive 2014/65/EU Arts 35, 36 and 37 Reg 2017/565
Order handling			
	Client order-handling — Aggregated transactions	Records as provided for under Arts 63 to 66 Reg 2017/565	Arts 24(1) and 28(1) of Directive 2014/65/EU Arts 63 to 66 Reg 2017/565
	Aggregation and allocation of transactions for own account	Records as provided for under Art 65 Reg 2017/565	Arts 28(1) and 24(1) of Directive 2014/65/EU Art 65 Reg 2017/565
Client Orders and transactions			
	Record keeping of client orders or decision to deal	Records as provided for under Art 69 Reg 2017/565	Art 16(6) of Directive 2014/65/EU Art 69 Reg 2017/565
	Record keeping of transactions and order processing	Records as provided for under Art 70 Reg 2017/565	Art 16(6) of Directive 2014/65/EU Art 70 Reg 2017/565
Reporting to clients			
	Obligation in respect of services provided to clients	Contents as provided for under Arts 53 to 58 Reg 2017/565	Art 24(1) and (6) and Art 25(1) and (6) of Directive 2014/65/EU Arts 53 to 58 Reg 2017/565
Safeguarding of client assets			
	Client financial instruments held by an investment firm	Records as provided for under Art 16(8) of Directive 2014/65/EU and under Art 2 of Commission Delegated Directive (EU) 2017/593	Art 16(8) of Directive 2014/65/EU Art 2 of Delegated Directive (EU) 2017/593
	Client funds held by an investment firm	Records as provided for under Art 16(9) of Directive 2014/65/EU and under Art 2 of	Art 16(9) of

Nature of obligation	**Type of record**	**Summary of content**	**Legislative reference**
		Delegated Directive (EU) 2017/593	Directive 2014/65/EU Art 2 of Delegated Directive (EU) 2017/593
	Use of client financial instruments	Records provided for under Art 5 of Delegated Directive (EU) 2017/593	Art 16(8) to (10) of Directive 2014/65/EU Art 5 of Delegated Directive (EU) 2017/593
Communication with clients			
	Information about Costs and associated charges	Contents as provided for under Art 45 Reg 2017/565	Art 24(4)(c) of Directive 2014/65/EU Art 45 Reg 2017/565
	Information about the investment firm and its services, financial instruments and safe-guarding of client assets	Content as provided for under Arts 45 and 46 Reg 2017/565	Art 24(4) of Directive 2014/65/EU Arts 45 and 46 Reg 2017/565
	Information to clients	Records of communication	Art 24(3) of Directive 2014/65/EU Art 39 Reg 2017/565
	Marketing communications (except in oral form)	Each marketing communication issued by the investment firm (except in oral form) as provided under Arts 36 and 37 Reg 2017/565	Art 24(3) of Directive 2014/65/EU Arts 36 and 37 Reg 2017/565
	Investment advice to retail clients	(i) The fact, time and date that investment advice was rendered and (ii) the financial instrument that was recommended (iii) the suitability report provided to the client	Art 25(6) of Directive 2014/65/EU Art 54 Reg 2017/565
	Investment research	Each item of investment research issued by the investment firm in a durable medium	Art 24(3) of Directive 2014/65/EU Arts 36 and 37 Reg 2017/565
Organisational requirements			
	The firm's business and internal organisation	Records as provided for under Art 21(1)(h) Reg 2017/565	Art 16(2) to (10) of Directive 2014/65/EU Art 21(1)(h) Reg 2017/565

Nature of obligation	Type of record	Summary of content	Legislative reference
	Compliance reports	Each compliance report to management body	Art 16(2) of Directive 2014/65/EU Art 22(2)(b) and Art 25(2) Reg 2017/565
	Conflict of Interest record	Records as provided for under Art 35 Reg 2017/565	Art 16(3) of Directive 2014/65/EU Art 35 Reg 2017/565
	Inducements	The information dis-closed to clients under Art 24(9) of Directive 2014/65/EU	Art 24(9) of Directive 2014/65/EU Art 11 of Delegated Directive (EU) 2017/593
	Risk management reports	Each risk management report to senior management	Art 16(5) of Directive 2014/65/EU Art 23(1)(b) and Art 25(2) Reg 2017/565
	Internal audit reports	Each internal audit report to senior management	Art 16(5) of Directive 2014/65/EU Art 24 and Art 25(2) Reg 2017/565
	Complaints-handling records	Each complaint and the complaint handling measures taken to address the complaint	Art 16(2) of Directive 2014/65/EU Art 26 Reg 2017/565
	Records of personal transactions	Records as provided for under Art 29(2)(c) Reg 2017/565	Art 16(2) of Directive 2014/65/EU Art 29(2)(c) Reg 2017/565

7. Client protection (Art 16(8)-(11) MiFID)

45 Art 16(8) to (11) MiFID provide the rules on client protection measures to be adopted by the investment firm. These rules encompass

- the **asset segregation requirements** (Art 16(8) MiFID and Art 2 to 4 of Commission Delegated Directive (EU) 2017/593);
- the **prohibition to use clients' assets** (Art 16(9) MiFID and Art 5 of Commission Delegated Directive (EU) 2017/593);

- the **prohibition to engage in certain title transfer arrangements with retail clients** (Art 16(10) MiFID and Art 6 of Commission Delegated Directive (EU) 2017/593); and
- the rules on **safeguarding client assets in exceptional cases** (Art 16(11) MiFID and Art 7 of Commission Delegated Directive (EU) 2017/593).

The client protection rules provide the **fundamentals of the European investor protection framework**. In order to reach this goal, the external auditor shall report at least annually to the competent authority of the firm's home NCA on the adequacy of the firm's arrangements under Article 16(8) to (10) MiFID and the respective implementing legislation (cf. Art 8 Commission Delegated Directive (EU) 2017/593). This is an instance of indirect enforcement of EU financial law. **46**

Fund management firms regulated under the UCITSD and the AIFMD, credit institutions and structured deposits are subject to the same requirements referred to in Article 1(3) and (4) of Directive when engaging in investment services (Art 1(1), (2) Commission Delegated Directive (EU) 2017/593). **47**

Since the steps to be taken for allowing the disentangling the assets during insolvency vary depending on each Member State's private law, the implementing legislation is laid down in the form of a Directive. **48**

a) Safeguarding clients' rights and asset segregation (Art 16(8) MiFID)

Protecting the clients' assets in insolvency is crucial. They must be kept **separate and earmarked**, and **must not be used** for the investment firm's own account except where the client expressly consents. **49**

Art 16(8) MiFID calls for **adequate safeguards**, a policy to that extent and the responsibility of the firm's key people.[22] The required conduct differs depending on whether financial instruments[23] or client funds in the form of cash are concerned.[24] In principle, financial instruments can be segregated by keeping them in an account held by the investment firm or a third party in the name of the client. Due care must be exercised when accounts are opened with third party investment firms so as to ensure that the third party offers the same level of protection as the investment firm. Investment firms, as part of their due diligence, must "also take into account the expertise and market reputation of the other third parties to which the initial third-party, with whom they might deposit financial instruments, may have delegated functions concerning the holding and safekeeping of financial instruments." (Recital 12 of Commission Delegated Directive (EU) 2017/593). **50**

In the case of funds in the form of cash, it may meet the requirement to deposit it with public institutions, credit institutions or invest it in a qualifying money market fund (i.e. by turning cash into financial instruments)[25]. A particular worry concerns deposits with **intra-group credit institutions**, given that the credit rating of the group may impair the value of clients' funds. Art 2(3) Commission Delegated Directive (EU) 2017/593 therefore sets a specific 20% limit on the percentage of client funds that can be deposited at an intra-group credit institution. This limit "should significantly reduce any potential conflicts with due diligence requirements and address the contagion risk inherent in depositing all client funds with a credit institution in the same group as the investment firm. While in certain circumstances it may be proportionate and appropriate for invest- **51**

[22] Art 2 Commission Delegated Directive (EU) 2017/593.
[23] Art 3 Commission Delegated Directive (EU) 2017/593.
[24] Art 4 Commission Delegated Directive (EU) 2017/593.
[25] Cf. Art 1(4) and Recital 4 of Commission Delegated Directive (EU) 2017/593.

ment firms to deposit, after proper consideration, client funds with entities within their own group, national authorities should closely monitor the reasons for not diversifying client funds outside of the investment firm's group in order to avoid creating loopholes where the general intragroup limit is applied."[26]

52 As a further part of the safeguards, investment firms are prohibited from agreeing to security interests, liens or rights of set-off over client assets, unless required by the applicable law in a non-EU/EEA country. [27] Even then, sufficiently tailored risk disclosures must be made to clients in order to alert them to the specific risks they face in such cases.[28] These limitations aim at protecting the client's financial instruments or funds from appropriation by third parties seeking to recover debts or charges that are not the clients.

53 In terms of **organisation**, a single officer with sufficient skills and authority for that task shall bear responsibility for safeguarding the clients' assets. Such an officer can have additional roles where this does not prevent the officer from discharging the duties for safeguarding client financial instruments and funds effectively.[29]

54 Details are laid down in Art 2 to 4 of Commission Delegated Directive (EU) 2017/593. The following table sets out the rules of the applicable Level 2 legislation:

Directive 2017/593	**Topic**	**Content**
Art 2	Safeguarding of client financial instruments and funds	1. Member States shall require that investment firms comply with the following requirements: (a) they must keep records and accounts enabling them at any time and without delay to distinguish assets held for one client from assets held for any other client and from their own assets; (b) they must maintain their records and accounts in a way that ensures their accuracy, and in particular their correspondence to the financial instruments and funds held for clients and that they may be used as an audit trail; (c) they must conduct, on a regular basis, reconciliations between their internal accounts and records and those of any third parties by whom those assets are held; (d) they must take the necessary steps to ensure that any client financial instruments deposited with a third party, in accordance with Article 3, are identifiable separately from the financial instruments belonging to the investment firm and from financial instruments belonging to that third party, by means of differently titled accounts on the books of the third party or other equivalent measures that achieve the same level of protection; (e) they must take the necessary steps to ensure that client funds deposited, in accordance with Article 4, in a central bank, a credit institution or a bank authorised in a third country or a qualifying money market fund

[26] Cf. Recital 13 of Commission Delegated Directive (EU) 2017/593.
[27] Cf. Recital 14 of Commission Delegated Directive (EU) 2017/593.
[28] Cf. Art 2(4) of Commission Delegated Directive (EU) 2017/593.
[29] Cf. Recital 5 and Art 7 of Commission Delegated Directive (EU) 2017/593.

Directive 2017/593	Topic	Content
		are held in an account or accounts identified separately from any accounts used to hold funds belonging to the investment firm; (f) they must introduce adequate organisational arrangements to minimise the risk of the loss or diminution of client assets, or of rights in connection with those assets, as a result of misuse of the assets, fraud, poor administration, inadequate record-keeping or negligence. 2. If, for reasons of the applicable law, including in particular the law relating to property or insolvency, investment firms cannot comply with paragraph 1 of this Article to safeguard clients' rights to satisfy the requirements of Article 16(8) and (9) of Directive 2014/65/EU, Member States shall require that investment firms put in place arrangements to ensure that clients' assets are safeguarded to meet the objectives of paragraph 1 of this Article. 3. If the applicable law of the jurisdiction in which the client funds or financial instruments are held prevents investment firms from complying with points (d) or (e) of paragraph 1, Member States shall prescribe requirements which have an equivalent effect in terms of safeguarding clients' rights. When relying on such equivalent requirements under Article 2(1)(d) or (e), Member States shall ensure that investment firms inform clients that in such instances they do not benefit from the provisions envisaged under Directive 2014/65/EU and this Directive. 4. Member States shall ensure that security interests, liens or rights of set-off over client financial instruments or funds enabling a third party to dispose of client's financial instruments or funds in order to recover debts that do not relate to the client or provision of services to the client are not permitted except where this is required by applicable law in a third country jurisdiction in which the client funds or financial instruments are held Member States shall require investment firms, where the firm is obliged to enter into agreements that create such security interests, liens or rights of set-off, to disclose that information to clients indicating to them the risks associated with those arrangements. Where security interests, liens or rights of set-off are granted by the firm over client financial instruments or funds, or where the firm has been informed that they are granted, they shall be recorded in client contracts and the firm's own accounts to make the ownership status of client assets clear, such as in the event of an insolvency.

Directive 2017/593	Topic	Content
		5. Member States shall require that investment firms make information pertaining to clients' financial instruments and funds readily available to the following entities: competent authorities, appointed insolvency practitioners and those responsible for the resolution of failed institutions. The information to be made available shall include the following: (a) related internal accounts and records that readily identify the balances of funds and financial instruments held for each client; (b) where client funds are held by investment firms in accordance with Article 4, details on the accounts in which client funds are held and on the relevant agreements with those firms; (c) where financial instruments are held by investment firms in accordance with Article 3, details on the accounts opened with third parties and on the relevant agreements with those third parties, as well as details on the relevant agreements with those investment firms; (d) details of third parties carrying out any related (outsourced) tasks and details of any outsourced tasks (e) key individuals of the firm involved in related processes, including those responsible for oversight of the firm's requirements in relation to the safeguarding of client assets; and (f) agreements relevant to establish client ownership over assets.
Art 3	Depositing client financial instruments	1. Member States shall allow investment firms to deposit financial instruments held by them on behalf of their clients into an account or accounts opened with a third party provided that the firms exercise all due skill, care and diligence in the selection, appointment and periodic review of the third party and of the arrangements for the holding and safekeeping of those financial instruments. In particular, Member States shall require investment firms to take into account the expertise and market reputation of the third party as well as any legal requirements related to the holding of those financial instruments that could adversely affect clients' rights. 2. Where an investment firm proposes to deposit client financial instruments with a third party, Member States shall ensure that this investment firm only deposits financial instruments with a third party in a jurisdiction where the safekeeping of financial instruments for the account of another person is subject to specific regulation and supervi-

Directive 2017/593	**Topic**	**Content**
		sion and that third party is subject to this specific regulation and supervision. 3. Member States shall ensure that investment firms do not deposit financial instruments held on behalf of clients with a third party in a third country that does not regulate the holding and safekeeping of financial instruments for the account of another person unless one of the following conditions is met: (a) the nature of the financial instruments or of the investment services connected with those instruments requires them to be deposited with a third party in that third country; (b) where the financial instruments are held on behalf of a professional client, that client requests the firm in writing to deposit them with a third party in that third country. 4. Member States shall ensure the requirements under paragraph 2 and 3 shall also apply when the third-party has delegated any of its functions concerning the holding and safekeeping of financial instruments to another third-party.
Art 4	Depositing client funds	1. Member States shall require investment firms, on receiving any client funds, promptly to place those funds into one or more accounts opened with any of the following: (a) a central bank; (b) a credit institution authorised in accordance with Directive 2013/36/EU of the European Parliament and of the Council; (c) a bank authorised in a third country; (d) a qualifying money market fund. The first subparagraph shall not apply to a credit institution authorised under Directive 2013/36/EU in relation to deposits within the meaning of that Directive held by that institution. 2. Member States shall require that, where investment firms do not deposit client funds with a central bank, they exercise all due skill, care and diligence in the selection, appointment and periodic review of the credit institution, bank or money market fund where the funds are placed and the arrangements for the holding of those funds and they consider the need for diversification of these funds as part of their due diligence. Member States shall ensure, in particular, that investment firms take into account the expertise and market reputation of such institutions or money market funds with a view to ensuring the protection of clients' rights, as well as any legal or regulatory requirements or market practices

Directive 2017/593	Topic	Content
		related to the holding of client funds that could adversely affect clients' rights. Member States shall require that investment firms ensure that clients give their explicit consent to the placement of their funds in a qualifying money market fund. In order to ensure this right to consent is effective, investment firms shall inform clients that funds placed with a qualifying money market fund will not be held in accordance with the requirements for safeguarding client funds set out in this Directive. 3. Member States shall require that, where investment firms deposit client funds with a credit institution, bank or money market fund of the same group as the investment firm, they limit the funds that they deposit with any such group entity or combination of any such group entities so that funds do not exceed 20 % of all such funds. An investment firm may not comply with this limit where it is able to demonstrate that, in view of the nature, scale and complexity of its business, and also the safety offered by the third parties considered in the previous subparagraph, and including in any case the small balance of client funds the investment firm holds the requirement under the previous paragraph is not proportionate. Investment firms shall periodically review the assessment made in accordance with this subparagraph and shall notify their initial and reviewed assessments to NCAs.
Art 7	Governance arrangements concerning the safeguarding of client assets	Member States shall ensure that investment firms appoint a single officer of sufficient skill and authority with specific responsibility for matters relating to the compliance by firms with their obligations regarding the safeguarding of client financial instruments and funds. Member States shall allow investment firms to decide, ensuring full compliance with this Directive, whether the appointed officer is to be dedicated solely to this task or whether the officer can discharge responsibilities effectively whilst having additional responsibilities.

b) Prohibition to use clients' assets (Art 16(9) MiFID)

55 Beyond asset segregation, investment firms are prohibited from using clients' assets for their own accounts. The only exception from this rule is where the client has given **prior express consent and the use is restricted to the specified terms to which the client consents**.[30] MiFID is silent as to the form in which consent may be given. It merely specifies that "A record should be understood as any evidence permissible under national law. Client's consent may be given once at the start of the commercial relationship, as long as it is sufficiently clear that the client has consented to the use of their securities.

[30] Cf. Art 5(1) of Commission Delegated Directive (EU) 2017/593.

Where an investment firm is acting on a client instruction to lend financial instruments and where this constitutes consent to entering into the transaction, the investment firms should hold evidence to demonstrate this."[31]

Special provisions apply to **securities financing transactions**.[32] In particular, the investment firm must take precautions to guarantee that the borrowed financial instruments will be returned. Investment firms must also make specific arrangements to ensure that the borrower of a client's assets provides the appropriate collateral and must monitor the continued appropriateness of such collateral. The investment firms' duty to monitor collateral applies where they are party to a securities financing transaction (SFT), including when acting as an agent for the conclusion of a SFT or in cases of a tripartite agreement between the external borrower, the client and the investment firm.[33] **56**

c) *Prohibition of title transfer financial collateral arrangements with retail clients (Art 16(10) MiFID)*

Investment firms are prevented from **concluding title transfer financial collateral arrangements** (TTCA), a special case of SFT, with retail clients for the purpose of securing or covering their present or future, actual or contingent or prospective obligations. **57**

Investment firms are not, however, prohibited from concluding **TTCAs with non-retail clients**. Recital 6 of Commission Delegated Directive (EU) 2017/593 sees "a risk that without further guidance investment firms could use TTCA more often than reasonably justified when dealing with non-retail clients, undermining the overall regime put in place to protect client assets. Therefore, in light of the effects of TTCAs on firms' duties towards clients and in order to ensure the safeguarding and segregation rules pursuant to Directive 2014/65/EU are not undermined, investment firms should consider the appropriateness of title transfer collateral arrangements used with non-retail clients by means of the relationship between the client's obligations to the firm and the client assets subject to TTCA." **58**

When concluding TTCAs with non-retail clients, investment firms are to properly consider, and to demonstrate that they have done so, the use of title transfer collateral arrangements in the context of the relationship between the client's obligation to the firm and the client's assets subjected to title transfer collateral arrangements by the firm. When considering and documenting the appropriateness of the use of title transfer collateral arrangements, investment firms shall take into account a limited set of the three factors laid down in Art 16(10) MiFID. Where using title transfer collateral arrangements, investment firms shall highlight to professional clients and eligible counterparties the risks involved and the effect of any title transfer collateral arrangement on the client's financial instruments and funds.[34] **59**

Further requirements are set out in Recitals 7 to 8 of Commission Delegated Directive (EU) 2017/593: "(7) Demonstrating a robust link between collateral transferred under a TTCA and client's liability should not preclude taking appropriate security against a client's obligation. Investment firms could thus continue to require a sufficient collateral and where appropriate, to do so by a TTCA. That obligation should not prevent com- **60**

[31] Recital 10 of Commission Delegated Directive (EU) 2017/593 of 7 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to safeguarding of financial instruments and funds belonging to clients, product governance obligations and the rules applicable to the provision or reception of fees, commissions or any monetary or non-monetary benefits.

[32] Cf. Art 5(2) to (5) of Commission Delegated Directive (EU) 2017/593. See the definition in Art 1(3) of Commission Delegated Directive (EU) 2017/593.

[33] Cf. Recital 9 of Commission Delegated Directive (EU) 2017/593.

[34] See Art 6 of Commission Delegated Directive (EU) 2017/593.

pliance with requirements under [EMIR] and should not prohibit the appropriate use of TTCAs in the context of contingent liability transactions or repos for non-retail clients. (8) While some securities financing transactions may require the transfer of title of clients' assets, in that context investment firms should not be able to effect arrangements prohibited under Article 16(10) of Directive 2014/65/EU."

d) Safeguarding client assets in exceptional cases (Art 16 (11) MiFID)

61 If Member States believe that in addition to Art 16 (8) to (10) MiFID, further safeguards are necessary to ensure the safeguarding of client assets they may, in deviation from the Single Rulebook approach, impose **additional requirements on investment firms**, but must send a notice to the Commission 2 months before the additional requirements comes into force. The notice will prompt a review by the Commission, which will be carried out with a view to the Single Rulebook approach (cf. Recital 58 MiFID).

62 Art 16(11) MiFID grandfathers certain old investor protection measures.

8. Implementing legislation

63 The Commission has exercised its implementing powers by issuing Commission Delegated Regulation (EU) 2017/565 of 25 April 2016 … in regards to organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive and Commission Delegated Directive (EU) 2017/593 of 7 April 2016 … with regard to safeguarding of financial instruments and funds belonging to clients, product governance obligations and the rules applicable to the provision or reception of fees, commissions or any monetary or non-monetary benefits.

9. Sanctioning

64 See comments on → Art 69 MiFID for sanctions. The provision in Art 69(2) para 3 MiFID, according to which "Member States shall ensure that mechanisms are in place to ensure that compensation may be paid or other remedial action be taken in accordance with national law for any financial loss or damage suffered as a result of an infringement of this Directive or of Regulation (EU) No 600/2014" is particularly meaningful for infringements of Art 16 MiFID. This provision is justified in light of the fact that many MiFID services are off-balance services, i.e the results of a deficient organisation immediately impacts the value of the investors' portfolio. This is contrary to the stereotypical banking business where the damage is felt, primarily, on the bank's balance sheet and only on a secondary level in the bank clients' portfolio.

Article 17
Algorithmic trading

1. An investment firm that engages in algorithmic trading shall have in place effective systems and risk controls suitable to the business it operates to ensure that its trading systems are resilient and have sufficient capacity, are subject to appropriate trading thresholds and limits and prevent the sending of erroneous orders or the systems otherwise functioning in a way that may create or contribute to a disorderly market. Such a firm shall also have in place effective systems and risk controls to ensure the trading systems cannot be used for any purpose that is contrary to Regulation (EU) No 596/2014 or to the rules of a trading venue to which it is connected.

The investment firm shall have in place effective business continuity arrangements to deal with any failure of its trading systems and shall ensure its systems are fully tested and properly monitored to ensure that they meet the requirements laid down in this paragraph.

2. An investment firm that engages in algorithmic trading in a Member State shall notify this to the competent authorities of its home Member State and of the trading venue at which the investment firm engages in algorithmic trading as a member or participant of the trading venue.

The competent authority of the home Member State of the investment firm may require the investment firm to provide, on a regular or ad-hoc basis, a description of the nature of its algorithmic trading strategies, details of the trading parameters or limits to which the system is subject, the key compliance and risk controls that it has in place to ensure the conditions laid down in paragraph 1 are satisfied and details of the testing of its systems. The competent authority of the home Member State of the investment firm may, at any time, request further information from an investment firm about its algorithmic trading and the systems used for that trading.

The competent authority of the home Member State of the investment firm shall, on the request of a competent authority of a trading venue at which the investment firm as a member or participant of the trading venue is engaged in algorithmic trading and without undue delay, communicate the information referred to in the second subparagraph that it receives from the investment firm that engages in algorithmic trading.

The investment firm shall arrange for records to be kept in relation to the matters referred to in this paragraph and shall ensure that those records be sufficient to enable its competent authority to monitor compliance with the requirements of this Directive.

An investment firm that engages in a high-frequency algorithmic trading technique shall store in an approved form accurate and time sequenced records of all its placed orders, including cancellations of orders, executed orders and quotations on trading venues and shall make them available to the competent authority upon request.

3. An investment firm that engages in algorithmic trading to pursue a market making strategy shall, taking into account the liquidity, scale and nature of the specific market and the characteristics of the instrument traded:

(a) carry out this market making continuously during a specified proportion of the trading venue's trading hours, except under exceptional circumstances, with the result of providing liquidity on a regular and predictable basis to the trading venue;

(b) enter into a binding written agreement with the trading venue which shall at least specify the obligations of the investment firm in accordance with point (a); and

(c) have in place effective systems and controls to ensure that it fulfils its obligations under the agreement referred to in point (b) at all times.

4. For the purposes of this Article and of Article 48 of this Directive, an investment firm that engages in algorithmic trading shall be considered to be pursuing a market making strategy when, as a member or participant of one or more trading venues, its strategy, when dealing on own account, involves posting firm, simultaneous two-way quotes of comparable size and at competitive prices relating to one or more financial instruments on a single trading venue or across different trading venues, with the result of providing liquidity on a regular and frequent basis to the overall market.

5. An investment firm that provides direct electronic access to a trading venue shall have in place effective systems and controls which ensure a proper assessment and review of the suitability of clients using the service, that clients using the service are prevented from exceeding appropriate pre-set trading and credit thresholds, that trading by clients using the service is properly monitored and that appropriate risk controls prevent trading that may create risks to the investment firm itself or that could create or contribute to a disorderly market or could be contrary to Regulation (EU) No 596/2014 or the rules of the trading venue. Direct electronic access without such controls is prohibited.

An investment firm that provides direct electronic access shall be responsible for ensuring that clients using that service comply with the requirements of this Directive and the rules of the trading venue. The investment firm shall monitor the transactions in order to identify infringements of those rules, disorderly trading conditions or conduct that may involve market abuse and that is to be reported to the competent authority. The investment firm shall ensure that there is a binding written agreement between the investment firm and the client regarding the essential rights and obligations arising from the provision of the service and that under the agreement the investment firm retains responsibility under this Directive.

An investment firm that provides direct electronic access to a trading venue shall notify the competent authorities of its home Member State and of the trading venue at which the investment firm provides direct electronic access accordingly.

The competent authority of the home Member State of the investment firm may require the investment firm to provide, on a regular or ad-hoc basis, a description of the systems and controls referred to in first subparagraph and evidence that those have been applied.

The competent authority of the home Member State of the investment firm shall, on the request of a competent authority of a trading venue in relation to which the investment firm provides direct electronic access, communicate without undue delay the information referred to in the fourth subparagraph that it receives from the investment firm.

The investment firm shall arrange for records to be kept in relation to the matters referred to in this paragraph and shall ensure that those records be sufficient to enable its competent authority to monitor compliance with the requirements of this Directive.

6. An investment firm that acts as a general clearing member for other persons shall have in place effective systems and controls to ensure clearing services are only applied to persons who are suitable and meet clear criteria and that appropriate requirements are imposed on those persons to reduce risks to the investment firm and to the market. The investment firm shall ensure that there is a binding written agreement between the investment firm and the person regarding the essential rights and obligations arising from the provision of that service.

7. ESMA shall develop draft regulatory technical standards to specify the following:

(a) the details of organisational requirements laid down in paragraphs 1 to 6 to be imposed on investment firms providing different investment services and/or activities and ancillary services or combinations thereof, whereby the specifications in relation to the organisational requirements laid down in paragraph 5 shall set out specific requirements for direct market access and for sponsored access in such a way as to ensure that the controls applied to sponsored access are at least equivalent to those applied to direct market access;

(b) the circumstances in which an investment firm would be obliged to enter into the market making agreement referred to in point (b) of paragraph 3 and the content of such agreements, including the proportion of the trading venue's trading hours laid down in paragraph 3;

(c) the situations constituting exceptional circumstances referred to in paragraph 3, including circumstances of extreme volatility, political and macroeconomic issues, system and operational matters, and circumstances which contradict the investment firm's ability to maintain prudent risk management practices as laid down in paragraph 1;

(d) the content and format of the approved form referred to in the fifth subparagraph of paragraph 2 and the length of time for which such records must be kept by the investment firm.

ESMA shall submit those draft regulatory technical standards to the Commission by 3 July 2015.

Power is delegated to the Commission to adopt the regulatory technical standards referred to in the first subparagraph in accordance with Articles 10 to 14 of Regulation (EU) No 1095/2010.

Bibliography: Conac PH, 'Algorithmic Trading and High Frequency Trading' in Ferrarini G and Busch D (eds), *Regulation of EU Financial Markets*, margin no 17.01, 22 et seq.; Kindermann J and Coridaß B, 'Der rechtliche Rahmen des algorithmischen Handels inklusive des Hochfrequenzhandels', *ZBB* 2014, 178; Lerch MP, 'Algorithmic Trading and High-Frequency Trading', in Veil (ed), *European Capital Markets Law* (2nd edn, Hart Publishing 2017); Moloney N, *EU Securities and Financial Markets Regulation* (2nd edn 2014), 525 et seq.; Stötzel M, 'High Frequency Trading – Einordnung in das Börsen- und Kapitalmarktrecht', *RdF* 2011, 156.

I. General features

1. Recitals

Recitals 59-68 MiFID. 1

2. Implementing acts

Commission Delegated Regulation (EU) 2017/589 of 19 July 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to regu- 2 latory technical standards specifying the organisational requirements of investment firms engaged in algorithmic trading.

3. Other regulatory texts

3 ESMA guidelines on systems and controls in an automated trading environment for trading platforms, investment firms and competent authorities (ESMA/2012/122)

4 ESMA, Questions and Answers on MiFID II and MiFIR market structures topics, 29 May 2018, ESMA70-872942901-38, in particular on the scope of Art 17 (p. 18), on Art 17(2) (p. 21, 23-24), on Art 17(4) (p. 24, 50), on Art 17(4) (p. 16, 24), on Art 17(5) (p. 25, 26).

II. Commentary

1. Fundamentals on algorithmic trading

5 The use of computer support and even full reliance on algorithms for the selection, weighting and execution of investment decisions is widespread. Art 17 MiFID shall address the **risks stemming from the market participants' extensive use of trading technology**, in particular algorithmic trading. Pursuant to Art 4(1)(39 MiIFD, 'algorithmic trading' means trading in financial instruments where a computer algorithm automatically determines individual parameters of orders such as whether to initiate the order, the timing, price or quantity of the order or how to manage the order after its submission, with limited or no human intervention. Order routing systems used for the purpose of directing orders to one or more trading venues, the processing of orders involving no determination of any trading parameters, or the confirmation of orders or the post-trade processing of executed transactions are not covered by the definition of algorithmic trading.

6 While clients of investment firms often benefit from algorithmic strategies, other market participants may be **disadvantaged due to a lack of access to information** at the same speed as algorithmic traders, or a **lack of equal access** to the market when responding to new information. Art 17 MiFID addresses these risks by imposing additional requirements on investment firms with a view toward ensuring orderly markets and preventing market abuse (cf. Recital 64 MiFID); investor protection is not the focus of regulatory activity. The same concern justifies additional requirements for trading venues, such as those provided in Art 18 to 20 MiFID, particularly relating to the fee structure of trading venues (cf. Recital 65 MiFID).

7 Art 17 MiFID distinguishes between **different types of software and computers** in the context of trading decisions. These include:

– '**algorithmic trading**', i.e. trading in financial instruments where a computer algorithm automatically determines individual parameters of orders; Art 17(1) and (2) MiFID contain general provisions focusing on algorithm-based trading decisions; for the most part those provisions and extensive implementing legislation are more detailed requirements adopted with a view on computer and software risks. Those general rules apply to many trading decisions at the modern capital markets; in fact, almost any asset manager that relies on some type of technical support while identifying investment opportunities qualifies as algorithmic trader under the broad definition provided by Art 4(1)(39) MiFID.
– '**high-frequency algorithmic trading technique**' (cf. Art 4(1)(40) MiFID) refers to trading where infrastructure intended to *minimise network and other types of latencies* is employed (including at least one of the following facilities for algorithmic or-

der entry: co-location, proximity hosting or high-speed direct electronic access); further, the trading involves system-determination of order initiation, generation, routing or execution without human intervention for individual trades or orders, as well as reliance on high message intraday rates which constitute orders, quotes or cancellations. These are the types of traders referred to in the literature that seek advantages from first access to information and trading.[1] Art 17 (2) fifth para MiFID imposes (only) one additional record keeping requirement on those high-frequency traders.

- An 'investment firm that pursues a **market making strategy'** is defined in Art 17(4) MiFID as investment firm whose strategy, as a member or participant of one or more trading venues, when dealing on own account, involves posting firm, simultaneous two-way quotes of comparable size and at competitive prices relating to one or more financial instruments on a single trading venue or across different trading venues, with the result of providing liquidity on a regular and frequent basis to the overall market. This provision responds to the fact that modern market making relies to a large extent on algorithms. Those market maker firms must apply the general requirements specified in Art 17(1), (2) MiFID and in addition the organisational requirements for those firms in Art 17(3) MiFID.
- An investment firm that provides **direct electronic access** (cf. Art 4(1)(41) MiFID) to a trading venue (cf. Art 4(1)(24)) must apply, in addition to the general requirements in Art 17(1), (2) MiFID, the requirements set out in Art 17(5) MiFID and the implementing legislation.

Art 17 MiFID and the accompanying implementing legislation are built on **ESMA guidelines on systems and controls** in an automated trading environment for trading platforms, investment firms and competent authorities (ESMA/2012/122). The approach of these guidelines is that the "risks from increased use of technology are best mitigated by a combination of measures and specific risk controls directed at firms that engage in algorithmic trading or high-frequency algorithmic trading techniques, those that provide direct electronic access, and other measures directed at operators of trading venues that are accessed by such firms" (Recital 62 MiFID). 8

MiFID requires high-frequency algorithmic trading firms to be **authorized and to meet the respective organisational requirements,** in particular those set out in Art 17(1) and (2) MiFID and the respective implementing legislation. At the same time, there may be some high-frequency algorithmic trading firms authorised and supervised under other parts of EU financial law, for instance under the AIFMD. AIFMs are not required to obtain an authorisation under MiFID and are only subject to the measures and controls aiming to tackle the specific risk arising from the type of trading specified under the AIFMD, such as the requirement of orderly processes and controls laid down in Art 12, 14, 18 AIFMD. ESMA is encouraged to ensure orderly markets at EU level, for instance by defining the appropriate tick sizes[2] for such traders across the respective EU legislation (cf. Recital 63 MiFID). Further, ESMA is encouraged to regularly seek input from national experts on developments relating to trading technology, including high-frequency trading and new practices which could constitute market abuse, so as to identify and promote effective strategies for preventing and addressing such abuse (cf. Recital 68 MiFID). 9

[1] See Lewis, *Flash Boys* (A Wall Street Revolution) (Norton & Company 2015).
[2] See on tick sizes → Art 48(6), → 49 MiFID and comments thereon.

2. Effective systems and controls (Art 17(1) MiFID)

10 Art 17(1) MiFID sets out the requirements applicable to all investments firms involved in algorithmic trading (cf. Art 4(1)(39) MiFID and supra, → mn 3). It aims to encourage **robust measures** for investment firms in order to ensure that algorithmic trading or high-frequency algorithmic trading techniques do not create a **disorderly market and cannot be used for abusive purposes (cf. Recital 64 MiFID)**.

11 Pursuant to Art 17(1) MiFID the respective firm shall have in place **effective systems and risk controls suitable to the business it operates** to ensure that its trading systems:

– are resilient and have sufficient capacity;
– are subject to appropriate trading thresholds and limits that prevent both the sending of erroneous orders and the systems otherwise functioning in a way that may create or contribute to a disorderly market;
– cannot be used for any purpose that is contrary to Regulation (EU) No 596/2014 [MAR] or to the rules of a trading venue to which it is connected.

The investment firm shall also have in place effective business continuity arrangements to deal with any failure of its trading systems and shall ensure its systems are fully tested and properly monitored to ensure that they meet the requirements laid down in this paragraph.

12 The details are set out in the **Commission Regulation (EU) 2017/589** as follows:

Regulation 2017/589	**Topic**	**Content**
Art 1	General organisational requirements	General organisational requirements
Art 2	Role of the compliance function	General organisational requirements
Art 3	Staffing	General organisational requirements
Art 4	IT outsourcing and procurement	General organisational requirements
Art 5	General methodology	Testing and deployment of trading algorithms systems and strategies
Art 6	Conformance testing	Testing and deployment of trading algorithms systems and strategies
Art 7	Testing environments	Testing and deployment of trading algorithms systems and strategies
Art 8	Controlled deployment of algorithms	Testing and deployment of trading algorithms systems and strategies
Art 9	Annual self-assessment and validation	Post-deployment management
Art 10	Stress testing	Post-deployment management
Art 11	Management of material changes	Post-deployment management
Art 12	Kill functionality	Means to ensure resilience
Art 13	Automated surveillance system to detect market manipulation	Means to ensure resilience

Regulation 2017/589	**Topic**	**Content**
Art 14	Business continuity arrangements	Means to ensure resilience
Art 15	Pre-trade controls on order entry	Means to ensure resilience
Art 16	Real-time monitoring	Means to ensure resilience
Art 17	Post-trade controls	Means to ensure resilience
Art 18	Security and limits to access	Means to ensure resilience

3. Reporting and record keeping (Art 17(2) MiFID)

a) Notification of algorithmic trading (Art 17(2) MiFID)

Algorithimic trading prompts an **additional notification requirement**. This requirement applies to the NCA that supervises the investment firm engaging in algorithmic trading as well as the trading venue where the trading occurs. Both the NCA and the trading venue must follow up and identify the respective algorithm in case of unexpected market events. MiFID goes even further and requires flagging of all orders generated by algorithmic trading on the side of the trading venue (cf. Recital 67 and Art 18-20 MiFID). This shall ensure effective supervision and enable the NCAs to take appropriate measures against defective or rogue algorithmic strategies in due time. By means of flagging, NCAs can identify and distinguish orders originating from different algorithms as well as efficiently reconstruct and evaluate the strategies that algorithmic traders employ. This should mitigate the risk that orders are not unambiguously attributed to an algorithmic strategy and a trader. **13**

b) Reporting on algorithmic trading (Art 17(2), second, third para MiFID)

Further, investment firms engaged in algorithmic trading need to respond to the NCA's request to **report**, either regularly or ad-hoc, the nature of its algorithmic trading strategies, details of the trading parameters or limits to which the system is subject, the key compliance and risk controls that it has in place (cf. Art 17(1) MiFID) and details regarding the testing of its systems. Said information may be forwarded, upon request, to the trading venue where the investment firm is engaged in algorithmic trading. **14**

c) Record keeping (Art 17(2), fourth para MiFID)

The reports, as well as the algorithms used for trading and the data on trading orders, or their cancellations, must be held on record by the investment firm for further review by the NCA. **15**

d) Record keeping in case of high-frequency trading (Art 17(2), fifth para MiFID)

In addition to the technical definition in Art 4(1)(40) MiFID, high-frequency trading is comprehensively described in **Recital 61 MiFID,** which may be used to apply the **technical definition**: "A specific subset of algorithmic trading is high-frequency algorithmic trading where a trading system analyses data or signals from the market at high speed and then sends or updates large numbers of orders within a very short time period in response to that analysis. In particular, high-frequency algorithmic trading may contain elements such as order initiation, generating, routing and execution which are determined by the system without human intervention for each individual trade or order, **16** short time-frame for establishing and liquidating positions, high daily portfolio turnover, high order-to-trade ratio intraday and ending the trading day at or close to a flat position. High-frequency algorithmic trading is characterised, among others, by high message intra-day rates which constitute orders, quotes or cancellations. In determining what constitutes high message intra-day rates, the identity of the client ultimately behind the activity, the length of the observation period, the comparison with the overall market activity during that period and the relative concentration or fragmentation of activity should be taken into account. High-frequency algorithmic trading is typically done by the traders using their own capital to trade and rather than being a strategy in itself is usually the use of sophisticated technology to implement more traditional trading strategies such as market making or arbitrage."

17 Art 17(2) fifth para MiFID imposes **additional record keeping requirements** in case an investment firm engages in high-frequency trading. Such a firm shall store, in an approved form, accurate and time sequenced records of all its placed orders, including order cancellations, executed orders and quotations on trading venues. The firm shall make these records available to the competent authority upon request. Art 28 Commission Delegated Regulation (EU) 2017/589) stipulates the content and format of order records: An investment firm that engages in a high-frequency algorithmic trading technique shall, immediately following the submission of an order, record the details of each submission using the format set out in tables 2 and 3 of Annex II, and update the information in the standards and formats specified in the fourth column of tables 2 and 3 of Annex II of Commission Delegated Regulation (EU) 2017/589). In line with Art 25(1) MiFIR, the records must be kept for five years from the date the order is submitted.

18 Although Art 17(2) MiFID (together with Art 28 Commission Delegated Regulation (EU) 2017/589) is the only provision specifically addressing high-frequency trading,[3] the **proportionality principle** of Union law suggests that the general requirements set out in Art 17(1) MiFID, as well as the reporting and record keeping requirements of Art 17(2) MiFID, must be read while at the same time considering the additional risks created by high-frequency (algorithmic) trading of that investment firm. As a result, the limitation of the aforementioned provisions to high-frequency trading must be read strictly to avoid any extension of the principles to other trading techniques.

19 This construction of Art 17 MiFID is supported by the **extensive descriptions of risks relating to high-frequency trading** in Recital 62 MiFID: "(62) Technical advances have enabled high-frequency trading and an evolution of business models. High-frequency trading is facilitated by the co-location of market participants' facilities in close physical proximity to a trading venue's matching engine. In order to ensure orderly and fair trading conditions, it is essential to require trading venues to provide such co-location services on a non-discriminatory, fair and transparent basis. The use of trading technology has increased the speed, capacity and complexity of how investors trade. It has also enabled market participants to facilitate direct electronic access by their clients to markets through the use of their trading facilities, through direct market access or sponsored access. Trading technology has provided benefits to the market and market participants generally such as wider participation in markets, increased liquidity, narrower spreads, reduced short term volatility and the means to obtain better execution of orders for clients. Yet that trading technology also gives rise to a number of potential risks such as an increased risk of the overloading of the systems of trading venues due to large volumes of orders, risks of algorithmic trading generating duplicative or erroneous

[3] HFT is mentioned in the context of exemptions (see → Art 2 MiFID) and definitions (see Art 4(1)(40) MiFID).

orders or otherwise malfunctioning in a way that may create a disorderly market. In addition, there is the risk of algorithmic trading systems overreacting to other market events which can exacerbate volatility if there is a pre-existing market problem. Finally, algorithmic trading or high-frequency algorithmic trading techniques can, like any other form of trading, lend themselves to certain forms of behaviour which is prohibited under Regulation (EU) No 596/2014. High-frequency trading may also, because of the information advantage provided to high-frequency traders, prompt investors to choose to execute trades in venues where they can avoid interaction with high-frequency traders. It is appropriate to subject high-frequency algorithmic trading techniques which rely on certain specified characteristics to particular regulatory scrutiny. While those are predominantly techniques which rely on trading on own account such scrutiny should also apply where the execution of the technique is structured in such a way as to avoid the execution taking place on own account."

4. Algotraders pursuing market making strategies (Art 17(3), (4) MiFID)

Art 17(3) MiFID imposes **additional requirements on algorithmic traders that pursue market making strategies** (see the definition in Art 17(4) MiFID, which is different and independent from that of 'market making activities' in Regulation (EU) No 236/2012, see Recital 60 MiFID). Such an investment firm must have in place appropriate systems and controls for that activity and must hold themselves out for business continuously. In particular, they must "carry out that market making continuously during a specified proportion of the trading venue's trading hours. Regulatory technical standards should clarify what constitutes specified proportion of the trading venue's trading hours by ensuring that such specified proportion is significant in comparison to the total trading hours, taking into account the liquidity, scale and nature of the specific market and the characteristics of the financial instrument traded" (Recital 59 MiFID). Further, they shall enter into a binding written agreement with the trading venue specifying both parties' obligations in line with Art 17(3) MiFID. **20**

5. Provision of direct electronic access to trading venue (Art 17(5) MiFID)

Direct electronic access of one investment firm to a trading venue can put **market fairness at risk**. For that purpose, MiFID pursues a four-pronged approach. First, it requires trading venues to be **transparent and considerate of the risk** and provide **access on a non-discriminatory basis** (cf. Recital 51 and → MiFIR Art 3 et seq.). **21**

Second, it imposes a **ban on the provision of direct electronic access** to markets by investment firms for their clients where such access is not subject to proper systems and controls. Such systems and controls include (cf. Art 17(5), first para MiFID and Art 19 to 21 Commission Regulation (EU) 2017/589): **22**

– a proper assessment and review of the suitability of clients using the service;
– that clients using the service are prevented from exceeding appropriate pre-set trading and credit thresholds;
– that trading by clients using the service is properly monitored and
– that appropriate risk controls prevent trading that may create risks to the investment firm itself or that could create or contribute to a disorderly market or could be contrary to Regulation (EU) No 596/2014 or the rules of the trading venue.

Third, irrespective of the form of the direct electronic access provided, firms providing such access must **assess and review the suitability of clients** using that service and **23** ensure that risk controls are imposed on the use of the service and that those firms retain responsibility for trading.[4]

24 Fourth, in order to ensure effective supervision, **reporting is itensified**. The firm that provides direct electronic access to a trading venue must notify the NCA of its home Member State and of the trading venue. The NCA of the home Member State may require additional information on the systems and controls the investment firm employs, and will subsequently exchange those with the NCA of the trading venue. The investment firm is subject to intensified reporting requirements so that the NCA of its home Member State can monitor compliance with the requirements of Art 17(5) MiFID.

25 The details are set out in the Commission Regulation (EU) 2017/589 as follows:

Regulation 2017/589	**Topic**	**Content**
Art 19	General provisions for DEA	A DEA provider shall establish policies and procedures to ensure that trading of its DEA clients complies with the trading venue's rules so as to ensure that the DEA provider meets the requirements in accordance with Art 17(5) MiFID.
Art 20	Controls of DEA providers	1. A DEA provider shall apply the controls and the real-time monitoring (cf. Art 17(1) to the order flow of each of its DEA clients. Those controls and that monitoring shall be separate and distinct from the controls and monitoring applied by DEA clients. In particular, the orders of a DEA client shall always pass through the pre-trade controls that are set and controlled by the DEA provider. 2. A DEA provider may use its own pre-trade and post-trade controls, controls provided by a third party or controls offered by the trading venue and real time monitoring. In all circumstances, the DEA provider shall remain responsible for the effectiveness of those controls. The DEA provider shall also ensure that it is solely entitled to set or modify the parameters or limits of those pre-trade and post-trade controls and real time monitoring. The DEA provider shall monitor the performance of the pre-trade and post-trade controls on an on-going basis. 3. The limits of the pre-trade controls on order submission shall be based on the credit and risk limits which the DEA provider applies to the trading activity of its DEA clients. Those limits shall be based on the initial due diligence and periodic review of the DEA client by the DEA provider. 4. The parameters and limits of the controls applied to DEA clients using sponsored access shall be as stringent as those imposed on DEA clients using DMA.

[4] For details, see Art 17(5), second para MiFID and Art 22, 23 Commission Regulation (EU) 2017/589.

Regulation 2017/589	Topic	Content
Art 21	Specifications for the systems of DEA providers	1. A DEA provider shall ensure that its trading systems enable it to: (a) monitor orders submitted by a DEA client using the trading code of the DEA provider; (b) automatically block or cancel orders from individuals which operate trading systems that submit orders related to algorithmic trading and which lack authorisation to send orders through DEA; (c) automatically block or cancel orders from a DEA client for financial instruments which that client is not authorised to trade, using an internal flagging system to identify and block single DEA clients or a group of DEA clients; (d) automatically block or cancel orders from a DEA client that breach the risk management thresholds of the DEA provider, applying controls to exposures of individual DEA clients, financial instruments or groups of DEA clients; (e) stop order flows transmitted by its DEA clients; (f) suspend or withdraw DEA services to any DEA client where the DEA provider is not satisfied that continued access would be consistent with its rules and procedures for fair and orderly trading and market integrity; (g) carry out, whenever necessary, a review of the internal risk control systems of DEA clients. 2. A DEA provider shall have procedures to evaluate, manage and mitigate market disruption and firm-specific risks. The DEA provider shall be able to identify the persons to be notified in the event of an error resulting in violations of the risk profile or in potential violations of the trading venue's rules. 3. A DEA provider shall at all times be able to identify its different DEA clients and the trading desks and traders of those DEA clients, who submit orders through the DEA provider's systems, by assigning a unique identification code to them. 4. A DEA provider allowing a DEA client to provide its DEA access to its own clients ('sub-delegation') shall be able to identify the different order flows from the beneficiaries of such sub-delegation without being required to know the identity of the beneficiaries of such arrangement. 5. A DEA provider shall record data relating to the orders submitted by its DEA clients, including modifications and cancellations, the alerts generated by its monitoring systems and the modifications made to its filtering process.

Regulation 2017/589	**Topic**	**Content**
Art 22	Due diligence assessment of prospective DEA clients	1. A DEA provider shall conduct a due diligence assessment of its prospective DEA clients to ensure that they meet the requirements set out in this Regulation and the rules of the trading venue to which it offers access. 2. The due diligence assessment referred to in paragraph 1 shall cover: (a) the governance and ownership structure of the prospective DEA client; (b) the types of strategies to be undertaken by the prospective DEA client; (c) the operational set-up, the systems, the pre-trade and post-trade controls and the real time monitoring of the prospective DEA client. The investment firm offering DEA allowing DEA clients to use third-party trading software for accessing trading venues shall ensure that the software includes pre-trade controls that are equivalent to the pre-trade controls set out in this Regulation. (d) the responsibilities within the prospective DEA client for dealing with actions and errors; (e) the historical trading pattern and behaviour of the prospective DEA client; (f) the level of expected trading and order volume of the prospective DEA client; (g) the ability of the prospective DEA client to meet its financial obligations to the DEA provider; (h) the disciplinary history of the prospective DEA client, where available. 3. A DEA provider allowing sub-delegation shall ensure that a prospective DEA client, before granting that client access, has a due diligence framework in place that is at least equivalent to the one described in paragraphs 1 and 2.
Art 23	Periodic review of DEA clients	1. A DEA provider shall review its due diligence assessment processes annually. 2. A DEA provider shall carry out an annual risk-based reassessment of the adequacy of its clients' systems and controls, in particular taking into account changes to the scale, nature or complexity of their trading activities or strategies, changes to their staffing, ownership structure, trading or bank account, regulatory status, financial position and whether a DEA client has expressed an intention to sub-delegate the access it receives from the DEA provider.

6. General clearing member (Art 17(6) MiFID)

Art 17(6) MiFID imposes additional requirements on investment firms that act as a general clearing member for other persons. These requirements are designed to ensure **clearing services are only applied to persons who are suitable and meet clear criteria**. The appropriate requirements shall reduce risks created by those investment firms to the market and their clients. 26

The details are set out in the Commission Regulation (EU) 2017/589 as follows: 27

Regulation 2017/589	Topic	Content
Art 24	Systems and controls of investment firms acting as general clearing members	Any systems used by an investment firm acting as a general clearing member ('clearing firm') to support the provision of its clearing services to its clients shall be subject to appropriate due diligence assessments, controls and monitoring.
Art 25	Due diligence assessments of prospective clearing clients	1. A clearing firm shall make an initial assessment of a prospective clearing client, taking into account the nature, scale and complexity of the prospective clearing client's business. Each prospective clearing client shall be assessed against the following criteria: – credit strength, including any guarantees given; – internal risk control systems; – intended trading strategy; – payment systems and arrangements that enable the prospective clearing client to ensure a timely transfer of assets or cash as margin, as required by the clearing firm in relation to the clearing services it provides; – systems settings and access to information that helps the prospective clearing client to respect any maximum trading limit agreed with the clearing firm; – any collateral provided to the clearing firm by the prospective clearing client; – operational resources, including technological interfaces and connectivity; – any involvement of the prospective clearing client in a breach of the rules ensuring the integrity of the financial markets, including involvement in market abuse, financial crime or money laundering activities. 2. A clearing firm shall annually review the on-going performance of its clearing clients against the criteria listed in paragraph 1. The binding written agreement referred to in Article 17(6) of Directive 2014/65/EU shall contain those criteria and set out the frequency at which the clearing firm shall review its clearing clients' performance against those criteria, where this review is to be conducted more than once a year. The binding written agreement shall set

Regulation 2017/589	Topic	Content
		out the consequences for clearing clients that do not comply with those criteria.
Art 26	Position limits	1. A clearing firm shall set out and communicate to its clearing clients appropriate trading and position limits to mitigate and manage its own counterparty, liquidity, operational and other risks. 2. A clearing firm shall monitor its clearing clients' positions against the limits referred to in paragraph 1 as close to real-time as possible and have appropriate pre-trade and post-trade procedures for managing the risk of breaches of the position limits, by way of appropriate margining practice and other appropriate means. 3. A clearing firm shall document in writing the procedures referred to in paragraph 2 and record whether the clearing clients comply with those procedures.
Art 27	Disclosure of information about the services provided	1. A clearing firm shall publish the conditions under which it offers its clearing services. It shall offer those services on reasonable commercial terms. 2. A clearing firm shall inform its prospective and existing clearing clients of the levels of protection and of the costs associated with the different levels of segregation it provides. Information on the different levels of segregation shall include a description of the main legal effects of the respective levels of segregation offered, including information on the insolvency law applicable in the relevant jurisdiction.

7. Implementing legislation (Art 17(7) MiFID)

28 ESMA has proposed, and the Commission has adopted as RTS, Commission Delegated Regulation (EU) 2017/589 of 19 July 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to regulatory technical standards specifying the organisational requirements of investment firms engaged in algorithmic trading.

Article 18
Trading process and finalisation of transactions in an MTF and an OTF

1. **Member States shall require that investment firms and market operators operating an MTF or an OTF, in addition to meeting the organisational requirements laid down in Article 16, establish transparent rules and procedures for fair and orderly trading and establish objective criteria for the efficient execution of orders. They shall have arrangements for the sound management of the technical operations of the facility, including the establishment of effective contingency arrangements to cope with risks of systems disruption.**

2. Member States shall require that investment firms and market operators operating an MTF or an OTF establish transparent rules regarding the criteria for determining the financial instruments that can be traded under its systems.

Member States shall require that, where applicable, investment firms and market operators operating an MTF or an OTF provide, or are satisfied that there is access to, sufficient publicly available information to enable its users to form an investment judgement, taking into account both the nature of the users and the types of instruments traded.

3. Member States shall require that investment firms and market operators operating an MTF or an OTF establish, publish and maintain and implement transparent and non-discriminatory rules, based on objective criteria, governing access to its facility.

4. Member States shall require that investment firms and market operators operating an MTF or an OTF have arrangements to identify clearly and manage the potential adverse consequences for the operation of the MTF or OTF, or for the members or participants and users, of any conflict of interest between the interest of the MTF, the OTF, their owners or the investment firm or market operator operating the MTF or OTF and the sound functioning of the MTF or OTF.

5. Member States shall require that investment firms and market operators operating an MTF or OTF comply with Articles 48 and 49 and have in place all the necessary effective systems, procedures and arrangements to do so.

6. Member States shall require that investment firms and market operators operating an MTF or an OTF clearly inform its members or participants of their respective responsibilities for the settlement of the transactions executed in that facility. Member States shall require that investment firms and market operators operating an MTF or an OTF have put in place the necessary arrangements to facilitate the efficient settlement of the transactions concluded under the systems of that MTF or OTF.

7. Member States shall require that MTFs and OTFs have at least three materially active members or users, each having the opportunity to interact with all the others in respect to price formation.

8. Where a transferable security that has been admitted to trading on a regulated market is also traded on an MTF or an OTF without the consent of the issuer, the issuer shall not be subject to any obligation relating to initial, ongoing or ad hoc financial disclosure with regard to that MTF or an OTF.

9. Member States shall require that any investment firm and market operator operating an MTF or an OTF comply immediately with any instruction from its competent authority pursuant to Article 69(2) to suspend or remove a financial instrument from trading.

10. Member States shall require that investment firms and market operators operating an MTF or an OTF provide the competent authority with a detailed description of the functioning of the MTF or OTF, including, without prejudice to Article 20(1), (4) and (5), any links to or participation by a regulated market, an MTF, an OTF or a systematic internaliser owned by the same investment firm or market operator, and a list of their members, participants and/or users. Competent authorities shall make that information available to ESMA on request. Every authorisation to an investment firm or market operator as an MTF and an OTF shall be notified to ESMA. ESMA shall establish a list of all MTFs and OTFs in the Union. The list shall contain information on the services an MTF or an OTF provides and entail the unique code identifying the MTF and the OTF for

use in reports in accordance with Articles 6, 10 and 26 of Regulation (EU) No 600/2014. It shall be updated on a regular basis. ESMA shall publish and keep up-to-date that list on its website.

11. ESMA shall develop draft implementing technical standards to determine the content and format of the description and notification referred to in paragraph 10.

ESMA shall submit those draft implementing technical standards to the Commission by 3 January 2016.

Power is conferred on the Commission to adopt the implementing technical standards referred to in the first subparagraph in accordance with Article 15 of Regulation (EU) No 1095/2010.

Bibliography: Clausen NJ and Sørensen KE, 'Reforming the Regulation of Trading Venues in the EU under the Proposed MiFID II – levelling the playing field and overcoming market fragmentation?', *ECFR* 2012, 275-306; Ferrarini GA, 'Best execution and competition between trading venues – MiFID's likely impact', (2007) 2 *CMLJ* 404-413; Ferrarini, GA and Saguato P, 'Regulating Financial Market Infrastructures', *ECGI Law Working Paper* 259/2014; Gobbo G, 'MiFID's Systematic Internalisation: the Efficiency Debate and the Future of the European Financial Markets', *EBLR* 2009, 63-99; Güllner M, 'MiFID II: Die neue Handelsplatzarchitektur in der EU', *WM* 2017, p. 938-945 (cited as "Güllner, *WM* 2017"); Kumpan Ch, 'Market-based financing in the Capital Markets Union: The European Commission's Proposals to Foster Financial Innovation in the EU', *ECFR* 2017, p. 336-363; Kumpan Ch, *Die Regulierung außerboerslicher Wertpapierhandelssysteme im deutschen, europaeischen und US-amerikanischen Recht* (de Gruyter Recht, Berlin 2006); Kumpan Ch, 'Börsen und außerbörsliche Handelssysteme – Die kollisionsrechltiche Behandlung von grenzüberschreitenden Wertpapierdienstleistungen', in Zetzsche D and Lehmann M (eds), *Grenzüberschreitende Finanzdienstleistungen* (Mohr 2018), p. 281; Kumpan Ch and Leyens PC, 'Conflicts of Interest of Financial Intermediaries – Towards a Global Common Core in Conflicts of Interest Regulation', *European Company and Financial Law Review (ECFR)* 2008, p. 72-100; Kumpan Ch and Müller-Lankow H, 'The multilateral single-dealer system – an oxymoron under MiFID II?': https://ssrn.com/abstract=3034984 (15.6.2018); Lucantoni P, 'Trading equity financial instruments under MiFID II and MiFIR', (2016) 31 *JIBLR* 207; Moloney N, *EU securities and financial markets regulation* (3rd edn, Oxford University Press 2014); Rusen G, 'Financial Collateral Arrangements' (2007) 2 *Journal of International Commercial Law and Technology* 250-258.

I. General features

1. Purpose

1 Article 18 MiFID II forms the basis for all organisational arrangements needed to operate a multilateral trading system (MTF) or an organised trading facility (OTF). The provision provides for rules for MTF and OTF operators regarding the trading process,

provision of information, access to a system, avoidance of conflicts of interest, billing and information exchange with public authorities.[1]

2. Legislative history

Article 18(2) MiFID II is equivalent to Art 14(2) MiFID I of 2004. Article 18(6) MiFID II is equivalent to Art 14(5) MiFID I. Article 18(8) MiFID II is equivalent to Art 14(6) MiFID I Article 18(9) MiFID II is equivalent to Art 14(7) MiFID I. **2**

3. Recitals; level 2 and 3 measures

Recital 7 MiFIR is relevant to the definitions of an MTF and an OTF. **3**

Level 2:
Commission Implementing Regulation (EU) 2016/824.[2]

Level 3:
ESMA, Q&As on MiFID II and MiFIR market structures topics, 18 Dec 2017, ESMA70-872942901-38.

II. Commentary

1. Multilateral system

Article 18 MiFID II concerns multilateral trading systems (MTFs) and organised trading facilities (OTFs). Both MTFs and OTFs are multilateral systems, as defined in Art 4(1)(19) MiFID II. Pursuant to Art 4(1)(19) MiFID II, a **multilateral system** is a system or facility in which multiple third-party buying and selling trading interests in financial instruments are able to interact in the system. The essential conditions are, thus, that (a) the trading arrangements in place have the characteristics of a system and (b) trading is conducted on a multilateral basis. **4**

Point (a) above, regarding trading arrangements having the characteristics of a system, means that an MTF or OTF must utilise a system for trading. A **system** can be composed of a set of rules and a trading platform or only a set of rules.[3] Hence, “system” refers to automated systems, non-automated systems or repeatable arrangements that achieve a similar outcome as a computerised system.[4] MTFs, regulated markets and OTFs are not obliged to operate a ‘technical’ system for matching orders and should be able to operate other trading protocols including systems where users are able to trade against quotes they request from multiple providers.[5] Although the source of that interpretation, recital 7 MiFIR, expressly mentions only MTFs and regulated markets, but not OTFs, it appears that this is merely an oversight and there is no intent or legal basis to **5**

[1] Lutter, Bayer, Schmidt, *Europäisches Unternehmens- und Kapitalmarktrecht* (6th edn 2018), § 32 Rn. 32.46 et seq.; Moloney, *EU Securities and Financial Markets Regulation* (3rd edn 2014), V.8, p. 475 et seq.

[2] Commission Implementing Regulation (EU) 2016/824 of 25 May 2016 laying down implementing technical standards with regard to the content and format of the description of the functioning of multilateral trading facilities and organized trading facilities and the notification to the European Securities and Markets Authority according to Directive 2014/65/EU of the European Parliament and of the Council on markets in financial instruments (OJ EU L 137/10).

[3] Recital 7 subpara 1 sent 4 MiFIR.

[4] Recital 7 subpara 1 sent 4 MiFIR.

[5] Recital 7 subpara 1 sent 5 MiFIR.

exclude OTFs from the rule.[6] Moreover, a regulated market, MTF or OTF may operate a system that is composed only of a set of rules that governs aspects related to membership, admission of instruments to trading, trading between members, reporting and, where applicable, transparency obligations.[7]

6 Executing orders would be considered to be under the rules of a system if, once the trade price, volume and terms have been agreed, the counterparties' names are disclosed and the system operator steps away from the transaction which is then legally formalised between the counterparties outside of the respective trading venue.[8] However, if orders to buy or sell are executed internally by coincidence or accidentally, that would not be deemed operating a system.[9] Any trade to which no rules of any system apply would not be considered trading under the rules of the system. If an investment firm arranges transactions on one system and provides for execution of the transactions on another system to avoid regulation, the disconnection between arranging and executing would not waive the obligation for the investment firm operating those systems to be authorised as an OTF operator.[10]

7 "On a **multilateral** basis", under point (b) above, means that interactions with a view to trading in a financial instrument are conducted in such a way that a trading interest in a system may potentially interact with other, opposite, trading interests of other market participants.[11] This criterion is meant to **exclude bilateral systems** where an investment firm enters into every trade on own account.[12] Under Art 18(7) MiFID II, MTFs and OTFs are required to "have at least three materially active members or users, each having the opportunity to interact with all the others in respect to price formation". Therefore, an MTF/OTF user's trading interests must be able to, potentially, interact with the trading interests of at least two other users. The interaction between the trading interests of users on an MTF/OTF can occur in different ways, including through matched-principal trading (with regard to OTFs) or market-making, within the limits set out in Arts 20(2) and 20(5) MiFID II.[13]

2. Multilateral trading facility

8 A multilateral trading facility (MTF) is a specific multilateral system. According to Art 4(1)(22) MiFID II, an MTF is a multilateral system operated by an investment firm or a market operator which brings together multiple third-party buying and selling interests in financial instruments in the system – in accordance with non-discretionary rules – in a way that results in a contract in accordance with Title II of MiFID II. Operating an MTF is an investment activity that requires prior authorisation in accordance with Annex I, Section A(8) MiFID II.

[6] Recital 7 MiFIR is the successor of recital 6 MiFID I and it seems that it was forgotten to adapt it to the new regime, after OTFs had been introduced.

[7] Recital 7 subpara 1 sent 6 MiFIR.

[8] ESMA, Q&As on MiFID II and MiFIR market structures topics, 18 Dec 2017, ESMA70-872942901-38, p. 37.

[9] ESMA, Q&As on MiFID II and MiFIR market structures topics, 18 Dec 2017, ESMA70-872942901-38, p. 37.

[10] ESMA, Q&As on MiFID II and MiFIR market structures topics, 18 Dec 2017, ESMA70-872942901-38, p. 37.

[11] In regard of the criterion "multilateral" see Kumpan and Mueller-Lankow, *The multilateral single-dealer system – an oxymoron under MiFID II?*, p. 15.

[12] Recital 7 subpara 1 sent 2 MiFIR.

[13] ESMA, Q&As on MiFID II and MiFIR market structures topics, 18 Dec 2017, ESMA70-872942901-38, p. 37.

The requirement regarding **non-discretionary rules** means that orders are brought together in accordance with a system's rules or by means of the system's protocols or internal operating procedures, including procedures embodied in computer software.[14] Hence, when matching orders in an MTF, the predetermined priority-rules determine whether an order is matched without any discretion of the market operator.[15] **9**

3. Organised trading facility

According to Art 4(1)(23) MiFID II, an OTF is a multilateral system which is not a regulated market or an MTF and in which multiple third-party buying and selling interests in bonds, structured finance products, emission allowances or derivatives are able to interact in the system in a way that results in a contract in accordance with Title II of MiFID II. Operating an OTF is an investment activity that requires prior authorisation in accordance with Annex I, Section A(9) MiFID II. **10**

In contrast to MTFs, **orders** placed through OTFs can be **executed on a discretionary basis**[16] through a system or under the rules of a system.[17] This condition, and the OTFs' limitation to certain financial instruments, differentiates OTFs and MTFs. Otherwise, MTFs and OTFs are similar. **11**

Moreover, ESMA highlights that a trading interest in an OTF may not be executed against an opposite order or quote on another execution venue. It is necessary that both trading interests be placed in the same execution venue. However, this does not prevent the investment firm or the market operator operating an OTF from retracting the order from the OTF and sending it to another OTF, a systematic internaliser, an MTF or a regulated market, where doing so is consistent with the policy and discretion of the investment firm or the market operator.[18] **12**

4. Rules for MTFs and OTFs

Article 18(1) MiFID II requires that, beyond the organisational requirements laid down in Art 16 MiFID II, MTF/OTF operators establish **transparent and fair trading rules and procedures** and objective criteria for the effective execution of client orders. Similarly, an MTF/OTF operator shall take appropriate precautions in the event of a system failure. Moreover, Art 18(5) extends the obligations of Arts 48 and 49 MiFID II to MTFs and OTFs.[19] This means that both the MTF and OTF operators have to comply with the rules governing regulated markets regarding system security arrangements, exceptional market conditions and tick sizes.[20] The result is that MTFs and OTFs are regulated in similar fashion as regulated markets. However, since not all provisions relating to regulated markets apply to MTFs and OTFs, they are only subject to "light" regulation. **13**

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[14] Recital 7 subpara 2 sent 2 MiFIR.
[15] Güllner, *WM* 2017, p. 938 (944).
[16] In this context, discretionary basis means when and how an order is executed may be determined by the system operator and not by predetermined rules.
[17] ESMA, Q&As on MiFID II and MiFIR market structures topics, 18 Dec 2017, ESMA70-872942901-38, p. 36.
[18] ESMA, Q&As on MiFID II and MiFIR market structures topics, 18 Dec 2017, ESMA70-872942901-38, p. 41.
[19] ESMA, Final Report – Draft Regulatory and Implementing Technical Standards MiFID II/MiFIR, 2015/1464, p. 227.
[20] Güllner, *WM* 2017, 938 (943).

14 MTF/OTF operators should set clear rules regarding which financial instruments may be traded within their systems.[21] Moreover, operators have to enable investors to make comprehensive judgments on investment opportunities. This may be accomplished through rules on making information publicly available. If a transferable security is traded on an MTF/OTF without the issuer's consent, the issuer is not subject to any obligations relating to initial, ongoing or ad hoc financial disclosure with regard to the MTF/OTF.[22]

15 MTF and OTF operators have to establish transparent, non-discriminatory and objective **criteria regarding access** to their systems.[23] In principle, trading venues should not unreasonably restrict access by market participants. In particular, discrimination exists when trading venues require that their members are direct clearing members of a CCP; instead, a member of the trading venue may only be obligated to make an agreement with a clearing system if the trade is settled centrally.[24] When trades are centrally cleared, however, it would be discriminatory if trading participants require other trading participants to be authorised by the central clearing party or CCP before they are allowed to trade with each other.[25] All mechanisms in centrally cleared markets whereby existing members or participants of a trading venue can decide whether their trading interests may interact with a new participant's trading interest are, therefore, considered to restrict competition and be discriminatory.[26] Moreover, establishing a minimum threshold for trading activities is also considered discriminatory because it would limit access for smaller participants.[27] Additionally, restrictions regarding the number of participants that a participant may trade or interact with are considered discriminatory.[28] This may be distinguished from the situation in which a firm, in a request for quote system, wants to limit the number of participants it requests quotes from in order to minimise the risk of unduly exposing its trading interests, which could result in obtaining a worse price. In such case, a trading venue should not intervene because smaller firms may benefit from requesting a quote from a large number of market makers and liquidity providers.[29]

16 The operator of an MTF or OTF must have arrangements in place to clearly identify and manage the potential adverse consequences of any **conflicts of interest** resulting from operating an MTF/OTF.[30] Because MTF/OTF operators are investment firms, it is likely that they engage in other investment services and, thus, may have conflicting interests when operating an MTF/OTF. The general rule is further specified by, among others, Art 20(4) MiFID II, which prohibits an operator from simultaneously operating an OTF and acting as a systematic internaliser because doing so might lead to a conflict of interest due to the different standards (for example, regarding investor protection) that apply to the systems.

[21] Art 18(2) MiFID II.
[22] Art 18(8) MiFID II.
[23] Art 18(3) MiFID II.
[24] ESMA, Q&As on MiFID II and MiFIR market structures topics, 18 Dec 2017, ESMA70-872942901-38, p. 34 litera a.
[25] ESMA, Q&As on MiFID II and MiFIR market structures topics, 18 Dec 2017, ESMA70-872942901-38, p. 34 litera b.
[26] ESMA, Q&As on MiFID II and MiFIR market structures topics, 18 Dec 2017, ESMA70-872942901-38, p. 34.
[27] ESMA, Q&As on MiFID II and MiFIR market structures topics, 18 Dec 2017, ESMA70-872942901-38, p. 34 litera c.
[28] ESMA, Q&As on MiFID II and MiFIR market structures topics, 18 Dec 2017, ESMA70-872942901-38, p. 34 litera d.
[29] ESMA, Q&As on MiFID II and MiFIR market structures topics, 18 Dec 2017, ESMA70-872942901-38, p. 34 et seq.
[30] Art 18(4) MiFID II.

Operators of an OTF/MTF must ensure that their subscribers are informed of their respective responsibilities in regard to settlements in the facility. At the same time, operators must also ensure that effective settlement of transactions concluded within the system is facilitated.[31] **17**

To qualify as a multilateral system, MTFs and OTFs need to have **at least three materially active members or users**.[32] A participant's trading interest must be able to potentially interact with those of at least two other participants in respect of price formation.[33] **18**

Article 18(9) MiFID II makes an important connection by obligating MTF/OTF operators to comply with any instruction from a competent authority[34] made regarding suspensions and removals in Arts 32 and 52 MiFID II. **19**

Article 18(10) MiFID II requires MTF/OTF operators to provide a detailed description of the functioning of the trading venue to the relevant competent authority. To that end, the information must be as complete as possible and contain all the necessary information. The MTF/OTF operator should describe in detail any links to or participation by a regulated market, an MTF/OTF or a systematic internaliser owned by the same investment firm or market operator, and a list of their members, participants and/or users. The transmission of the detailed information to supervisors should help to ensure the efficient and orderly functioning of financial markets.[35] **20**

The technical **specifications of the information** which must be submitted to the relevant competent authority are stipulated in the Commission Implementing Regulation (EU) 2016/824. The regulation lists all the information an MTF or OTF operator must provide to the competent authority. Accordingly, operators of an MTF/OTF have to provide general information such as, for example, the asset classes of financial instruments traded on the system, the rules and procedures for making financial instruments available for trading, the rules and provisions to ensure objective and non-discriminatory access to the system, any arrangements to facilitate liquidity and arrangements and procedures to monitor transactions.[36] Moreover, the required information includes a detailed description of the functioning of the MTF/OTF,[37] information on how and in what instances possible conflicts of interest may arise due to the operation of the MTF/OTF,[38] information on outsourcing arrangements[39] and information on any links to or participation by a regulated market, MTF, OTF or systematic internaliser owned by the same operator.[40] **21**

Articles 3 through 5 of the Commission Implementing Regulation (EU) 2016/824 set out **additional information** that must be provided only by operators of an **MTF**. The information includes a description of the arrangements and systems implemented to manage risks, facilitate the finalisation of transactions and a description of the financial resources considered sufficient to facilitate the orderly functioning of the market.[41] Operators of MTFs already in operation have to ensure that the information they provide to, and which is held by, a competent authority is always correct and that they comply **22**

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[31] Art 18(6) MiFID II.

[32] Art 18(7) MiFID II.

[33] Moloney, *EU Securities and Financial Markets Regulation* (3rd edn 2014), V.8, p. 477).

[34] These are the authorities designated by each Member State in accordance with Art 67 MiFID II. See Art 4(1)(26) MiFID II.

[35] Recital 1 of the Commission Implementing Regulation (EU) 2016/824.

[36] Art 2(1) of the Commission Implementing Regulation (EU) 2016/824.

[37] Art 2(2) of the Commission Implementing Regulation (EU) 2016/824.

[38] Art 2(3) of the Commission Implementing Regulation (EU) 2016/824.

[39] Art. 2(4) of the Commission Implementing Regulation (EU) 2016/824.

[40] Art 2(5) of the Commission Implementing Regulation (EU) 2016/824.

[41] Art 3 of the Commission Implementing Regulation (EU) 2016/824.

with the obligations under MiFID II and MiFIR.[42] When an MTF operator applies to have its MTF registered as an SME growth market, it has to identify which functionalities or arrangements are applicable to the SME growth market.[43]

23 Operators of **OTFs** must submit **additional information,** such as whether another firm carries out market making activities on the OTF, how the OTF operator exercises discretion in regard to executing trades, the rules, procedures and protocols to route the trading interests of a member or participant to external trading facilities, a description of the use of matched principal trading and the rules and procedures to ensure compliance with Arts 24, 25, 27 and 28 MiFID II. The obligations of Arts 24, 25, 27(1), (2), (4) through (10) and 28 MiFID II, regarding the market-client duties, are not applicable to transactions concluded under the rules governing an MTF between its members and participants, in accordance with Art 19(4) MiFID II.[44]

24 If a change occurs that results in any information previously submitted to a competent authority being incorrect, the MTF/OTF operator must immediately inform the competent authority.[45] However, if information is provided to correct, update or explain information previously given, the operator need not submit any minor or purely technical information which is not relevant to its compliance with MiFID II and MiFIR.[46] In addition, MTFs that have already been approved under MiFID I should inform the relevant competent authority about all information that they have submitted under MiFID I.[47]

25 To transmit information to a competent authority, operators should use the formats provided in Table 1 of the Annex of the Commission Implementing Regulation (EU) 2016/824.[48] Moreover, information should be sent in a uniform manner and in an electronic format to the competent authority.[49] Competent authorities must notify ESMA of the authorisation of an MTF or OTF using the format specified in Table 2 of the Annex of the Commission Implementing Regulation (EU) 2016/824.[50]

Article 19
Specific requirements for MTFs

1. **Member States shall require that investment firms and market operators operating an MTF, in addition to meeting the requirements laid down in Articles 16 and 18, shall establish and implement non-discretionary rules for the execution of orders in the system.**
2. **Member States shall require that the rules referred to in Article 18(3) governing access to an MTF comply with the conditions established in Article 53(3).**
3. **Member States shall require that investment firms and market operators operating an MTF to have arrangements:**
   (a) **to be adequately equipped to manage the risks to which it is exposed, to implement appropriate arrangements and systems to identify all significant**

[42] Art 4 of the Commission Implementing Regulation (EU) 2016/824.
[43] Art 5 of the Commission Implementing Regulation (EU) 2016/824.
[44] Moloney, *EU Securities and Financial Markets Regulation* (3rd edn 2014), V.8, p. 477).
[45] Art 8(1) of the Commission Implementing Regulation (EU) 2016/824.
[46] Art 8(2) of the Commission Implementing Regulation (EU) 2016/824.
[47] Art 8(3) of the Commission Implementing Regulation (EU) 2016/824.
[48] Art 9 (1) of the Commission Implementing Regulation (EU) 2016/824.
[49] Recitals 3, 6 and Article 9 (3) of the Commission Implementing Regulation (EU) 2016/824.
[50] Art 10 of the Commission Implementing Regulation (EU) 2016/824.

risks to its operation, and to put in place effective measures to mitigate those risks;

(b) to have effective arrangements to facilitate the efficient and timely finalisation of the transactions executed under its systems; and

(c) to have available, at the time of authorisation and on an ongoing basis, sufficient financial resources to facilitate its orderly functioning, having regard to the nature and extent of the transactions concluded on the market and the range and degree of the risks to which it is exposed.

4. Member States shall ensure that Articles 24, 25, Article 27(1), (2) and (4) to (10) and Article 28 are not applicable to the transactions concluded under the rules governing an MTF between its members or participants or between the MTF and its members or participants in relation to the use of the MTF. However, the members of or participants in the MTF shall comply with the obligations provided for in Articles 24, 25, 27 and 28 with respect to their clients when, acting on behalf of their clients, they execute their orders through the systems of an MTF.

5. Member States shall not allow investment firms or market operators operating an MTF to execute client orders against proprietary capital, or to engage in matched principal trading.

I. General features

1. Purpose

As the operation of an MTF is an **investment service** (see Annex I, Section A (8) MiFID II) it may be carried out alongside other investment services. Moreover, there are ample opportunities to profit from additional activities and it is expected that investment firms will offer other services. Ensuring that this does not lead to conflicts of interest is, thus, an important purpose of Art 19 MiFID II. Hence, Art 19 MiFID II sets out **special requirements** for investment firms and market operators that operate a **multilateral trading facility** (MTF), as defined in Art 4(22) MiFID II. 1

2. Legislative history

Article 19 MiFID II corresponds to Art 14 MiFID I of 2004: Article 19(1) MiFID II is equivalent to Art 14(1) MiFID I. Article 19(2) MiFID II is equivalent to Art 14(4) MiFID I. Article 19(3) MiFID II is equivalent to Art 14(5) MiFID I. Article 19(4) MiFID II is equivalent to Art 14(3) MiFID I. 2

When the predecessor of Article 19 MiFID II, Art 14 MiFID I, was introduced in 2004, newly created trading facilities such as MTFs had made it necessary for the EU regulators to enact new rules targeting these systems.[1] Specifically, efficient and orderly functioning of financial markets was one of the main reasons for new rules related to new investment services, which remains the purpose of the rules set out in Art 19 MiFID II.[2] 3

[1] See Gomber and Nassauer, 'Neuordnung der Finanzmärkte in Europa durch MiFID II/MiFIR' *Zeitschrift für Bank und Bankwirtschaft (ZBB)*, vol. 26 issue 4 (2014), p. 250 (251).

[2] Recital 5 MiFID I (Directive 2004/39/EC).