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FINANCIAL MARKETS LAW COMMITTEE

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EUROPEAN COMMISSION'S REVIEW OF THE MARKETS IN FINANCIAL INSTRUMENTS DIRECTIVE

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Issue 163 – European Commission's Review of the Markets in Financial Instruments Directive

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1. INTRODUCTION

1.1. The remit of the Financial Markets Law Committee (the "FMLC", or the "Committee") is to identify issues of legal uncertainty or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks and to consider how such issues should be addressed.

1.2. In the context of the review being undertaken by the European Commission (the "Commission") of the Markets in Financial Instruments Directive (2004/39/EC) ("MiFID"), the FMLC has reviewed, with interest, the proposed Directive on Markets in Financial Instruments repealing MiFID ("MiFID II"), the Regulation on Markets in Financial Instruments and Amending Regulation [EMIR] on OTC Derivatives, Central Counterparties and Trade Repositories ("MiFIR") and, for the purposes of the sections entitled "The Treatment of Third Country Firms in the Current Drafts of MiFID II and MiFIR" and "Other Provisions in the Current Draft of MiFIR—Product intervention rules" only, the Rapporteur's draft report on MiFID II dated 16 March 2012 (the "Draft MiFID II Report") and the Rapporteur's draft report on MiFIR dated 27 March 2012 (the "Draft MiFIR Report").

1.3. It is not the role of the FMLC to question the policy underlying the proposals. Nonetheless, at this stage, the FMLC would like to draw attention to a number of issues which are indicative of the considerable legal uncertainties posed by the current drafts of MiFID II and MiFIR and which, if left unresolved, could have a negative impact on the financial markets. The FMLC would recommend that such issues are addressed and clarified in subsequent drafts of the legislation.

2. EXECUTIVE SUMMARY

2.1. MiFID came into force on 1 November 2007. It repealed the Investment Services Directive (93/22/EEC) and introduced changes to the regulation of firms conducting investment business throughout the EU.

2.2. MiFID contains high-level provisions governing the organisational and conduct of business requirements that should apply to investment firms. It also aims to harmonise certain conditions governing the operation of regulated markets. On 20 October 2011, four years after it came into force, the Commission adopted a legislative proposal for the revision of MiFID. The legislative proposal takes the form of a Regulation (MiFIR), reflecting the need to achieve a uniform set of rules in some areas, and a Directive (MiFID II), which allows for differences in national markets, legal structures and investor profiles in other areas. In summary, MiFIR establishes uniform requirements in relation to the following: disclosure of trade data to the public; reporting of transactions to the competent authorities; trading of derivatives at organised venues; non-discriminatory access to clearing and trading in benchmarks; product intervention powers of competent authorities and the European Securities and Markets Authority ("ESMA") and powers of ESMA on position management and position limits and provision of investment services or activities without a branch by third country firms. MiFID II deals with the following: authorisation and operating conditions for investment firms; provision of investment services or activities by third country firms with the establishment of a branch; authorisation and operation of regulated markets, authorisation and operation of data reporting service providers; and supervision, cooperation and enforcement by competent authorities.

2.3. Having reviewed the draft texts of MiFID II and MiFIR, the Committee considers that they raise a number of important legal uncertainties. In particular, the current drafts of MiFID II and MiFIR fail to clarify adequately the treatment of third country firms. In addition, the current draft of MiFID II regulates algorithmic trading to a greater extent than indicated in the Recitals and gives rise to uncertainty concerning the treatment of structured deposits, while the current draft of MiFIR includes a very wide definition of Organised Trading Facility, which may be difficult to apply in practice, and provides a framework for the introduction of product intervention rules that is likely, by definition, to generate a degree of uncertainty in financial markets.

2.4. The purpose of this paper is to note these legal uncertainties and, in some cases, to suggest ways in which MiFID II and MiFIR may be amended to remedy them. In light of the prevailing fragility in economies around the globe, legal certainty is of paramount importance in this particular area.

2.5. This paper does not seek to address all of the ambiguities and uncertainties generated by MiFID II and MiFIR, or to identify exhaustively all concerns raised by the aforementioned legal issues. There are a number of other issues, such as the practical application of the proposed regime for systematic internalisers, which are not discussed in this paper but would benefit from greater legal clarity.

3. THE TREATMENT OF THIRD COUNTRY FIRMS[2] IN THE CURRENT DRAFTS OF MIFID II AND MIFIR

Under MiFID, third country firms providing investment services into the EU are regulated on a state-by-state basis.[3] The current drafts of MiFID II and MiFIR provide for the treatment of such firms to be harmonised across the EU.[4] MiFID II sets out provisions relating to investment services provided by third country firms through a branch and MiFIR sets out provisions relating to investment services provided by third country firms without the establishment of a branch.

Article 41(1) of MiFID II provides that a third country firm intending to provide investment services in the EU through a branch must acquire prior authorisation to do so and Article 41(2) provides that third country firms intending to provide investment services to retail clients must establish a branch in the EU. Article 36 of MiFIR provides that third country firms may provide the services listed in Article 30 of MiFID II to eligible counterparties established in the EU without

2 The term "third country firm" appears in both MiFID II and MiFIR (in each case in the Explanatory Memorandum and the legislative text) to identify the entity subject to regulation but it is not defined. It has been the subject of comment by the Rapporteur who has suggested the alternative "third country financial institution"; see below paragraph 3.5. Readers of this paper who are unfamiliar with the concept of a "third country" may, for all purposes, take it to mean a country outside the European Union.

3 Recital 28, MiFID.

4 Recital 73 and Articles 41 to 46, MiFID II and Article 36, MiFIR.

the establishment of a branch only where such firm is registered in the register of third country firms kept by ESMA.

The FMLC has noted specific areas where the current draft proposals relating to third country firms appear to lack certainty. Details are given below.

3.1. Equivalent Requirements and Reciprocity

A third country firm intending to provide investment services in the EU through a branch must acquire prior authorisation.[5] One of the requirements for prior authorisation is that the Commission has adopted a decision that the third country in question has regulations in place to ensure that firms authorised to act in such third country comply with legally binding requirements which have equivalent effect to the requirements set out in MiFID II, MiFIR and their implementing measures ("Equivalent Requirements") *and* that the third country provides for equivalent reciprocal recognition of the prudential framework applicable to investment firms authorised in accordance with MiFID II ("Reciprocity").[6] Similarly, under Article 36 of MiFIR, a third country firm may only provide services to eligible counterparties established in the EU without the establishment of a branch where that third country firm is registered in the register of third country firms kept by ESMA and one of the requirements for registration by ESMA is that the Commission has adopted a decision regarding Equivalent Requirements and Reciprocity.[7]

These proposals fail to clarify how Equivalent Requirements and Reciprocity decisions might work in practice, the framework under which they will operate and the detailed rules that the Commission will implement in order to achieve Equivalent Requirements and Reciprocity. In light of MiFID II's wide remit, there are various practical difficulties that may arise from attempting to determine the equivalence of certain rules and legislation in any one jurisdiction.

The FMLC also notes that there are concerns in respect of the practical implications of the Equivalent Requirements and Reciprocity test in the context

5 Article 41(1), MiFID II.
6 Article 41(1)(a) and Article 41(3), MiFID II.
7 Article 37 and 37, MiFIR

of a third country's prudential framework, particularly given that it is commonly understood that a number of major third countries with large economies, such as the United States and Japan, do not impose prudential requirements on investment firms which would be considered commensurate with the requirements of the Capital Requirements Directive.[8] Accordingly, it is unclear how the Equivalent Requirements and Reciprocity test will operate in relation to third country investment firms established in certain countries, such as the United States and Japan, where responsibility for the overall prudential supervision of such third country investment firms will remain with the relevant third country.

3.2. The meaning of "own exclusive initiative"

According to Recital 74 of MiFID II and Recital 36 and Article 36(4) of MiFIR, the provisions of MiFID II and MiFIR should not affect the possibility for clients established in the EU of receiving investment services by a third country firm at the "own exclusive initiative" of those clients. Recital 74 of MiFID II and Recital 36 of MiFIR indicate that this exemption will be interpreted narrowly, stating that if a third country firm

> solicits clients or potential clients in the Union or promotes or advertises investment services or activities together with ancillary services in the Union, it should not be deemed as a service provided at the own exclusive initiative of the client.

There is a need for further guidance regarding what will constitute the provision of investment services at the "own exclusive initiative" of a client. For example, how will internet sites and, in particular, an investment company's website be treated for these purposes? Will a third country firm which maintains a website that is accessible in the EU be deemed to be promoting or advertising investment services in the EU? Without further clarity, the Committee is concerned that there will be general uncertainty as to how this principle will:

8 2006/48/EC and 2006/49/EC

a) be implemented at a national level; b) be interpreted on a firm–by-firm basis and c) affect arrangements already in place under existing national regimes.[9]

3.3. Transitional provisions for third country firms

In addition to the foregoing, the FMLC has a number of concerns regarding the application of the transitional provision for third country firms set out in Article 99(1) of MiFID II and Article 45(1) of MiFIR, which provide that

> Existing third country firms shall be able to continue to provide services and activities in Member States, in accordance with national regimes until [4 years after the entry into force of this [directive]/[regulation]].

First, the Commission appears undecided on the length of any transitional period—given that the four-year timeframe is still in brackets. Any shorter transitional period will, in the Committee's view, risk causing unnecessary market disruption and stress. The proposals in the Draft MiFID II Report and the Draft MiFIR Report seek to provide certainty in this area by removing the language in brackets in Article 99(1) of MiFID II and Article 45(1) of MiFIR and replacing it with text which states that the transitional period will last one year from the date of adoption by the Commission of a decision regarding Equivalent Requirements and Reciprocity in relation to the relevant third country.[10] It is essential to provide further clarity on these proposals for the benefit of established firms currently undertaking business in the EU.

Secondly, it is not clear what is meant by, "Existing third country firms" within the text of Article 99(1) of MiFID II and Article 45(1) of MiFIR. Specifically, it is unclear whether this means existing third country firms in general, or just those already operating within the EU. The proposals in the Draft MiFID II Report and the Draft MiFIR Report seek to provide certainty in this area by replacing the text "Existing third country firms" with "Third country financial

[9] The national rules applying to the provision of investment services in situations where there has been no solicitation by the service provider may be more permissive than is implied by the limited concept of services provided at the clients "own exclusive initiative."

[10] Amendment 207, Draft MiFID II Report and Amendment 93, Draft MiFIR Report.

institutions." It is essential to clarify what is intended to be captured here for the benefit of established firms considering whether or not to start to undertake business in the EU.

3.4. The provision of investment services to professional clients

Recital 73 and Article 41(2) of MiFID II only require third country firms intending to provide investment services to *retail clients* in the EU to establish a branch in the EU, while under Article 36 of MiFIR third country firms can only provide *eligible counterparties* with investment services without establishing a branch in the EU. This suggests that third country firms providing investment services exclusively to professional clients who do not also fall under the definition of "eligible counterparties" need to establish a branch in the EU in order to provide these services, but this is not explicitly clear from the current text. In this regard, the Committee acknowledges that the trialogue debate is ongoing and welcomes the suggested additional language for Recital 73 and Article 41)(2) contained in the Draft MiFID II Report, which would clarify the position by requiring third country firms providing investment services to professional clients in the EU to establish a branch in the EU.[11]

3.5. The term "third country firm"

The Rapporteur has commented on the use of the term "third country firm" in MiFID II and MiFIR. The Rapporteur has suggested replacing references to "third country firm" with the term "third country financial institution," stating as follows in the sixth paragraph on page 123 of the Draft MiFID II Report

> In order to have a complete third country regime your rapporteur replaced "third country investment firm" by "third country financial institution." [12]

The Committee assumes this amendment is intended to address any uncertainty owing to the absence of any definition of the term "third country firm" in MiFID

[11] Amendments 20 and 96, Draft MiFID II Report.

[12] In the Rapporteur's mark-up, some references to "third country firm" have not been amended. The Committee assumes, hesitantly and respectfully, that this is an oversight on his part. For example, see Amendment 20, Draft MiFID II Report and Amendment 9, Draft MiFIR Report.

II and MiFIR. In this regard, the Committee notes that the term "third country financial institution" is defined in Article 2(1)(28) of MiFIR as

> an entity, the head office of which is established in a third country, that is authorised or licensed under the law of that third country to carry on any of the activities listed in Directive 2006/48/EC, Directive [new MiFID], Directive 2009/138/EC, Directive 2009/65/EC, Directive 2003/41/EC or Directive 2011/61/EU

and that this concept therefore has the benefit of delimitation. The Committee believes that any ongoing uncertainty relating to the use of the term "third country firm" as opposed to "third country financial institution" in MiFID II and MiFIR is undesirable. However, it expresses no view on the desirability of the solution proposed by the Rapporteur.

4. OTHER PROVISIONS IN THE CURRENT DRAFT OF MIFID II

4.1. Algorithmic trading

4.1.1. Article 17 of MiFID II introduces rules regulating investment firms that engage in algorithmic trading. In summary, these rules provide for algorithmic traders to improve their systems and controls, provide information to regulators and operate continually. The definition of algorithmic trading in Article 4(30) of MiFID II is

> 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. This definition does not include any system that is only used for the purpose of

routing orders to one or more trading venues or for the confirmation of orders.

4.1.2. This definition, and therefore the scope of the provisions in Article 17, is too broad. The definition appears to catch all kinds of algorithmic trading, while both one of the Recitals to MiFID II[13] and the Explanatory Memorandum[14] strongly imply that it is *high-frequency* algorithmic trading which exclusively raises regulatory concerns.[15] As a result of the broad definition of algorithmic trading set out in Article 4(30), the Article 17 requirements may catch investment firms engaging in types of trading activity that do not appear to give rise to any particular market-integrity concerns, for example trading based on algorithms designed to: (i) ensure that an index tracker fund continues to track the relevant index or (ii) execute a particular client's trading strategy.

4.2. Structured deposits

4.2.1. MiFID II's treatment of structured deposits lacks certainty. Recital 26 of MiFID II states that "Structured deposits … are not covered under any legislation for the protection of investors at Union level." One can infer from this that that these products are not financial instruments under MiFID. Paragraph 3.4.2 of the Explanatory Memorandum of MiFID II states that the proposals extend MiFID requirements to the advised and non-advised sale of structured deposits by credit institutions and Recital 26 of MiFID II goes on to state that, "it is appropriate to include in the scope of this Directive structured deposits". Given the express intention to extend regulation to structured deposits, one would expect to see draft provisions which reflect this change.

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13 Recital 44, MiFID II.

14 Paragraph 3.4.6, Explanatory Memorandum, MiFID II.

15 In fact, there do not appear to be any obligations in MiFID II that only apply to high-frequency algorithmic trading.

4.2.2. More specifically, given the avowed legislative intent, one might have expected to see the introduction of a definition for the terms, "deposit" and "structured deposit", as well as specific amendments to section C of Annex I.[16] Although the Committee accepts that, on a literal reading, section C of Annex I[17] does already appear to capture some structured deposits—for example it does seem to cover structured deposits in the form of "transferable securities" and some structured deposits might fall under paragraphs (4), (5), (7) or (10)—in the interests of legal certainty it would be preferable if a significant change of this nature were clearly obvious from the operating provisions of MiFID II, rather than being confined to paragraphs in the Explanatory Memorandum and the Recitals.

4.2.3. The lack of a definition for the terms "deposit" and "structured deposit" is regrettable. The text as a whole contains inconsistencies or gives rise to inconsistent inferences. For example, whilst Article 25(6)(b) suggests that only deposits accepted by banks are covered, this is not made clear in Article 3(1) itself and, whilst the wording of Article 1(3) suggests that a zero-interest-paying deposit—for example, a current account at a bank—might be covered by MiFID II, the Committee presumes that this is not the intention. Additionally, some conduct of business and conflicts of interest rules seem to apply to certain types of structured deposit which are not "financial instruments", namely, "deposits other than those with a rate of return which is determined in relation to an interest rate".[18] The legislative intent is unclear.

4.2.4. MiFID II, like MiFID, is concerned with the regulation of investment services and ancillary services. These are the guiding concepts of the legislation. However, as a result of the lacunae noted above, services relating to structured deposits are not among those services listed as investment services and ancillary services. This complicates the

[16] MiFID II.
[17] Ibid.
[18] Article 1(3), MiFID II.

drafting of MiFID II because these types of services need to be referred to specifically each time they are included. As a practical matter, this increases the risk of errors and omissions in the drafting. Although the Committee has not conducted a detailed review of MiFID II with this in mind, it notes that, for example, the effect of Article 1(3) is to make credit institutions subject to a large number of MiFID II requirements in relation to structured deposits—although some of these cross-references appear to be incorrect, which makes it difficult to understand the intended scope of the regulation of these products. On the other hand, these same requirements do not appear to apply to investment firms in relation to structured deposits. This is a significant issue because, although investment firms will not issue these structured deposits themselves, they may advise on them, manage a portfolio that includes them, or execute client orders in relation to them. Similarly, Articles 31(1)(a) and 32(1)(a) of MiFIR (discussed further in "Other Provisions in the Current Draft of MiFIR—Product intervention rules" below) give ESMA and national competent authorities product intervention powers in relation to "financial products", which do not seem to include structured deposits. The legislative intent is unclear.

5. OTHER PROVISIONS IN THE CURRENT DRAFT OF MIFIR

5.1. Organised Trading Facilities

5.1.1. Article 2(1)(7) of MiFIR introduces the definition of a new type of trading venue, being the Organised Trading Facility ("OTF"), to be regulated by MiFIR. The proposed definition—

> any system or facility, which is not a regulated market or an MTF,[19] operated by an investment firm or a market operator, in which multiple third-party buying and selling interests in financial instruments are able to interact in the system in a way that results in a contract in accordance with the provisions of Title II [of MiFID II]")[20]

—is wide and likely to give rise to legal uncertainty.

5.1.2. First, it will be impossible for firms and other actors to know with certainty what instruments are traded on OTFs, owing to: a) the number and wide distribution of OTFs in the EU; and b) the lack of any central public depositary providing definitive information about instruments traded on these systems. Indeed it is uncertain whether a facility within the meaning of the OTF definition could be one which allowed anyone participating to trade any instrument they wished to propose, so that the instruments admitted to trading in that facility could vary from moment to moment by reference to a participant proposal, rather than operator control. Accordingly, it will be very difficult for market participants to know whether their conduct in relation to instruments traded on OTFs is, or is not, within the market abuse regime as the Commission is proposing separately to

[19] Multilateral trading facility.
[20] See Article 2(1)(7), MiFIR.

extend the scope of the market abuse regime to instruments traded on an OTF (and MTF).[21]

5.1.3. Secondly, the proposed broad definition will leave the perimeter unclear and could lead to legal uncertainty for both market participants and their advisors in determining what types of platforms or facilities will be covered. Uncertainty regarding this definition is particularly undesirable because it is likely to be used in other Directives and is already proposed to be used in the market abuse regime in the future. The Committee would therefore welcome further guidance as to the legislative intent and further express delineation—according to system characteristics—of the concept of an OTF.

5.2. Product intervention rules

The proposals contain a framework under which ESMA[22] and national competent authorities ("NCAs")[23] may introduce rules to prohibit or restrict: a) the marketing, distribution or sale of certain financial instruments or financial instruments with certain features; or b) a type of financial activity or practice (a) and b) together are hereafter referred to as "Relevant Products and Services").

Under Article 31 of MiFIR, ESMA may temporarily prohibit or restrict in the EU Relevant Products and Services where it is satisfied on reasonable grounds that:

a) the proposed action addresses a threat to investor protection or to the orderly functioning and integrity of financial markets or to the stability of the whole or part of the financial system in the EU;

[21] Recital 8 and Article 2(1)(b), proposed Regulation on Insider Dealing and Market Manipulation (Market Abuse).

[22] Article 31, MiFIR.

[23] Article 32, MiFIR.

b) regulatory requirements under EU legislation that are applicable to the relevant financial instrument or activity do not address the threat; and

c) a competent authority or competent authorities have not taken action to address the threat or actions that have been taken do not adequately address the threat.

When taking action under Article 31, ESMA must also take into account the extent to which the action:

a) does not have a detrimental effect on the efficiency of financial markets or on investors that is disproportionate to the benefits of the action; and

b) does not create a risk of regulatory arbitrage.

Under Article 32 of MiFIR, an NCA may prohibit or restrict Relevant Products and Services in or from the relevant Member State if it is satisfied on reasonable grounds that:

a) a financial instrument or activity or practice gives rise to significant investor protection concerns or poses a serious threat to the orderly functioning and integrity of financial markets or the stability of whole or part of the financial system;

b) existing regulatory requirements under EU legislation applicable to the financial instrument or activity or practice do not sufficiently address the risks referred to in paragraph a) above and the issue would not be better addressed by improved supervision or enforcement of existing requirements;

c) the action is proportionate taking into account the nature of the risks identified, the level of sophistication of investors or market participants concerned and the likely effect of the action on investors and market participants who may hold, use or benefit from the financial instrument or activity;

d) it has properly consulted with competent authorities in other Member States that may be significantly affected by the action; and

e) the action does not have a discriminatory effect on services or activities provided from another Member State.

A power for ESMA and NCAs to introduce product intervention rules of this nature is likely, by definition, to generate a degree of uncertainty in financial markets. Financial institutions may, by virtue of the introduction of powers of this nature, face the possibility that they will be prevented from proceeding with businesses or practices in which, prior to the exercise of such powers, they were legitimately engaged. While the policy reasons behind the introduction of such powers can be readily understood in the current circumstances and the Committee acknowledges that, for example, the UK Financial Services Authority already has general rule-making powers that would allow it to introduce product intervention rules, the Committee nevertheless believes that it is incumbent on the legislators, in legislating for powers of this nature in a Regulation, to provide the maximum possible clarity and transparency regarding the scope of the powers and the circumstances in which they expect them to be used, bearing in mind that a certain degree of flexibility may be necessary in order to deal with novel issues in the market as they arise and/or are better understood. The Committee does not believe that the provisions of MiFIR,[24] as drafted, are sufficiently clear as to the scope of the powers. The Committee recognises that the Commission intends to address aspects of the new powers in more detail in level 2 measures, but it nonetheless believes it is important for the fundamental provisions contained in MiFIR itself to be sufficiently clear and well thought-through in order that participants in the financial markets can readily understand the types of circumstances in which they might find their businesses disrupted by the exercise of these powers.

[24] Articles 31 to 33, MiFIR.

The FMLC has noted specific areas where the current draft proposals appear to lack clarity. Details are given below.

5.2.1. Use of undefined or unexplained terms

The terms “financial activity or practice”,[25] “threat to investor protection”,[26] “significant investor protection concerns”[27] and “serious threat to the orderly functioning and integrity of financial markets”,:[28] which are used in Articles 31 and 32 to set out the circumstances in which the product intervention powers can be exercised, reflect vague concerns that are inadequately delimited given that regulatory consequences attach to them. In addition, the Draft MiFIR Report recommends adding “investment products, including structured products” to the range of products which can be the subject of ESMA product intervention rules.[29] The categories “investment products” and “structured products” self evidently require further delimitation before the categories of product which are subject to product intervention can be reliably predicted.

5.2.2. Intended duration of interventions

ESMA may only prohibit or restrict Relevant Products and Services “temporarily”,[30] unlike NCAs whose power to prohibit or restrict Relevant Products and Services is not limited in this way. However, ESMA does have the ability to “review” any intervention “at appropriate intervals and at least every three months”.[31] This may result, in practice, in ESMA being able to impose a rolling ban that is, in effect, permanent. If this is the intention, it should be clarified.

25 Article 31(1)(b) and Article 32(1)(b), MiFIR.
26 Article 31(2)(a), MiFIR.
27 Ibid.
28 Article 32(2)(a), MiFIR.
29 Amendment 67, Draft MiFIR Report.
30 Article 31(1), MiFIR.
31 Article 31(6), MiFIR. The Committee notes that Amendment 71 of the Draft MiFIR Report suggests that the minimum review period should be one year in cases where the prohibition was implemented for reasons of investor protection.

5.2.3. Criteria for interventions

There are small, but potentially significant, differences in the wording of the provisions dealing with the circumstances in which ESMA and NCAs may take action. For example, ESMA may intervene to address a "threat to investor protection or to the orderly functioning and integrity of financial markets",[32] whereas competent authorities may only intervene where

> a financial instrument or activity or practice gives rise to significant investor protection concerns or poses a serious threat to the orderly functioning and integrity of financial markets.[33]

It is important to establish whether these differences are intentional and, if so, what the significance of the differences is thought to be.

5.2.4. Relationship between ESMA's powers and those of NCAs

As noted above, the criteria for exercise of ESMA's powers and NCAs' powers appear to be different, but it is provided that ESMA's action will "prevail over any previous action taken by a competent authority".[34] The uncertainties which financial institutions will face will be compounded unless there is absolute clarity as to the circumstances in which actions taken by NCAs might be overturned, or replaced, by actions taken by ESMA.

5.2.5. Notice of action and ability to challenge

Under Articles 31(4) and 31(5), ESMA is obliged to notify all NCAs of any action it proposes to take pursuant to Article 31 and to publish on its website any decision to take action made pursuant to Article 31. Similarly, under Articles 32(3) and 32(4), a minimum of one month

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32 Article 31(2)(a), MiFIR.
33 Article 32(2)(a), MiFIR.
34 Article 31(7), MiFIR.

before action is taken by an NCA pursuant to Article 32, the relevant NCA must notify ESMA and all other NCAs of, among other things, the precise details of the action to be taken and it must publish on its website any decision to take action pursuant to Article 32. However, the current draft of MiFIR does not provide for any notice of proposed action to the affected market participants, or for any right of challenge by a market participant. These issues will presumably be addressed in the level 2 measures, but it is clearly essential that, unless there exist particular circumstances which make this impracticable, market participants have reasonable warning of the proposed exercise of the powers and the ability to engage with the relevant authority in order to understand and, if appropriate, challenge the use of those powers. This could be further complicated by the Draft MiFIR Report's proposals that could have the effect of speeding up the intervention process, by conferring on ESMA and the NCAs a power to intervene on a precautionary basis before a financial instrument is marketed, [35] and reducing the minimum period in which an NCA must notify ESMA and other NCAs of its plan to impose a restriction from one month to one week.[36]

5.2.6. Basis of ESMA's powers

A separate issue concerns the basis of ESMA's powers. Article 31 of MiFIR confers on ESMA powers, "in accordance with Article 9(5) of Regulation (EU) No. 1095/2010."

However, that Article only appears to confer product intervention powers on ESMA for the purpose of protecting

> the orderly functioning and integrity of financial markets or the stability of the whole or part of the financial system in the Union.

[35] Amendment 69, Draft MiFIR Report.
[36] Amendment 79, Draft MiFIR Report.

It does not go so far as to permit these powers to be used for investor protection purposes, as Article 31 of MiFIR purports to do. The amendments to Article 31 proposed in the Draft MiFIR Report[37] would confer additional powers on ESMA, in accordance with Article 9(2) of Regulation (EU) No. 1095/2010, to monitor the marketing of investment products and financial instruments and proactively to investigate such products. However, Article 9(2) of Regulation (EU) No. 1095/2010 only confers on ESMA a power to provide guidelines and recommendations, "with a view to promoting the safety and soundness of markets and convergence of regulatory practice", not to investigate or take action for investor protection purposes, as the amended Article 31 set out in the Draft MiFIR Report purports to do.[38]

6. CONCLUSION

6.1. The current drafts of MiFID II and MiFIR present a significant number of legal uncertainties. In particular, the current drafts of MiFID II and MiFIR fail to clarify adequately the treatment of third country firms. In addition, the current draft of MiFID II regulates algorithmic trading to a greater extent than indicated in the Recitals and gives rise to uncertainty concerning the treatment of structured deposits, while the current draft of MiFIR includes a very wide definition of Organised Trading Facility, which may be difficult to apply in practice, and provides a framework for the introduction of product intervention rules that is likely, by definition, to generate a degree of uncertainty in financial markets.

6.2. In light of the current economic conditions, it is essential that MiFID II and MiFIR do not increase legal risk for parties to transactions and do not create uncertainty which undermines the objectives of the MiFID regime, namely to

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37 Amendment 66, Draft MiFIR Report.

38 Amendment 66, Draft MiFIR Report introduces a new paragraph 1 to Article 31, as follows: "In accordance with Article 9(2) of Regulation (EU) No 1095/2010, ESMA shall monitor the investment products, including structured deposits and financial instruments which are marketed, distributed or sold in the Union and may proactively investigate new investment products or financial instruments before they are marketed, distributed or sold in the Union in cooperation with the competent authorities."

improve investor protection, eradicate barriers to cross-border trading and enhance competition in the securities industry across the EU. As a result, the FMLC would welcome the Commission turning its attention to the points raised above.

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39 Note that Members act in a purely personal capacity. The names of the institutions that they ordinarily represent are given for information purposes only. Whilst the Bank of England, the Financial Services Authority and HM Treasury participate in the FMLC, the views expressed in this paper are not necessarily those of the three institutions.