Deutsches Aktieninstitut

MiFID II/MiFIR: Legislation should better reflect financing and hedging practice of the real economy

Use the delay of the implementation period
to fix obvious shortcomings in the level 1 text

Comment of Deutsches Aktieninstitut, 1 March 2016

Summary

A broad political consensus aims for the delay of the implementation of MiFID II/MiFIR. On 10th February 2016 the European Commission released a legislative proposal. The European Parliament and the European Council already expressed their will to extend the implementation time frame. Therefore, an amendment of the legislation is necessary.

The legislator should take this amendment as an oppurtunity to reconsider some details of the legislation already adopted. Some provisions turned out as damaging for the capacity of the real economy to finance their business and to hedge risks stemming from their commercial or treasury financing activities. The adjustment of these unintended consequences would be in line with the European Commission's efforts to establish a Capital Markets Union's in order to retain/restore growth, innovation and employment in the EU.

In relation to the above-mentioned, Deutsches Aktieninstitut[1] proposes the following:

1. Ancillary activity exemption and phase in: Emission allowances held for compliance purposes should be classified as priviliged transactions. The calculation of the tresholds should start at the application date of MiFID II.

2. Pre- and post-transparency on derivative markets: The transparency regime should appropriately take into account the specifics of derivatives used by non-financial companies.

3. Suitability report: Clients receiving investment advice should have the option to waive the documentation requirements.

4. Trading on own account exemption: Corporates using electronic platforms should be regarded as clients and not as members/participants.

[1] Deutsches Aktieninstitut (identification number: 38064081304-25) represents the entire German economy interested in the capital markets. The about 200 members of Deutsches Aktieninstitut are listed corporations, banks, stock exchanges, investors and other important market participants. Deutsches Aktieninstitut keeps offices in Frankfurt, Brussels and in Berlin.

1 Ancillary activity exemption: Treatment of emission allowances and phase in

Art. 2(1)(j) MiFID II determines that non-financial companies using commodity derivatives, emission allowances and derivatives thereof are – inter alia – not required to be licenced under MiFID as investment firm if their trading in these instruments is an ancillary activity. This exemption is of paramount importance as becoming an investment firm would trigger further obligations for the real economy in other regulations, e.g. the clearing obligation under EMIR.

We very much welcome that risk-mitigating derivatives are not considered in the calculation of the ancillary activity thresholds according to Art. 2(4) MiFID II. Nevertheless, this exemption is incomplete due to the treatment of emission allowances. In contrast to commodity derivatives, emission allowances are not acknowledged as "privileged" transactions in the sense mentioned above. This contradicts the rules of the European Emission Allowances System that *require* certain companies to hold/purchase emission allowances. It would be paradox that a law forces companies to buy emission allowances and another law burdens these companies with far-reaching requirements for the ownership of the same instruments.

Companies holding emission allowances for regulatory purposes are at risk to become a licensed firm under MiFID. Therefore, emission allowances held by companies for mere compliance purposes should, as derivatives used for risk mitigation, be privileged. This would also be in line with the exemption under Art. 2(1)(e) MiFID II referring to operators with compliance obligations under Directive 2003/87/EC (i.e. the above mentioned European Emission Allowances System).

Furthermore, the non-financial companies' assessment if they can make use of the ancillary activity exemption should start at the application date of MiFID II/MiFIR at the earliest, i.e. in 2018. The assessment period shall be at least one year. If it turns out at the beginning of 2019 that the application of a MiFID II licence is required, non-financial companies should have another year for the implementation of the respective MiFID II requirements. Therefore, companies should be ready to comply with the licence requirements in 2020.

The proposed phase in period is necessary to provide companies sufficient legal certainty about the rules they have to comply with in order to calculate the thresholds. The data quality of trade repositories is not yet at a level, which makes the transactional data suitable for a reliable and final judgement as to whether a company needs to apply for a MiFID II license. It is not lawful that the calculations are to be conducted based only on data collected during 2016 and 2017 under MiFID I, especially because the definition of commodity derivatives differs substantially between MiFID I and MiFID II.

2 Transparency regime: Clear focus on secondary markets

The transparency requirements for derivatives could seriously interfere with the risk management strategy of non-financial companies using tailor-made or bespoke derivatives. Therefore, the peculiarities of these derivatives should be reasonably reflected by the transparency regime.

In some cases, especially for large orders or orders referring to an illiquid underlying, transparency would have negative impacts on the price formation process. This is e.g. the case in M&A-transactions. To avoid an impact on prices these orders are commonly split into smaller buckets over a longer period in time, in particular since market liquidity has fallen over the last three years. Given that these transactions are immediately turned fully transparent, packages executed at a later stage will become remarkably more expensive. The reason for this is that it is unlikely that various end-users demand a "bespoke" derivative at the same time. The supply side can conclude that the split orders are coming from the same end-user. As a result, prices will increase which makes risk management unnecessarily more costly.

According Art. 8(1) MiFIR the pre-trade transparency regime already adequately reflects these particularities of derivatives used by non-financial companies. The respective pre-trade transparency on venues does not apply for hedging derivative transactions of non-financial counterparties.

Furthermore, recital 15 MiFIR clearly state that the transparency requirements should "help the valuation of products as well as the efficiency of price formation". This clearly indicates that the transparency regime should improve investor's decisions in secondary market transactions. Derivatives used by non-financial companies for risk-mitigating purposes are largely not fully fungible, standardized instruments. They are contracts bilaterally agreed with their banking partners. If the corporate customer wants to get out of the position, it is closed out. Secondary markets with "active" investors do not exist for the derivatives described above.

Therefore, the legislator should clarify that those derivatives, which are not traded on a secondary market and, hence, do not involve any (retail) investor, are excluded from the transparency requirements.

3 Suitability report: Waiver for experienced retail investors

According to Art. 25(6) MiFID II the investment firm shall provide the client with a statement on suitability („suitability report“) before the transaction is entered into. In Germany, a corresponding obligation exists with the so-called “Beratungsprotokoll” (investment advice minutes) enacted in 2010.

Experience with the “Beratungsprotokoll” shows that the formalized procedure to record the investment advice is very time-consuming. Especially those retail clients frequently advised by banks have difficulties to see the benefit of the documentation process. They complain about the additional time consumed and would prefer to waive this obligation individually – unfortunately, they are not allowed to do so.

In addition, due to the documentation requirement banks have to spend a huge amount of resources to implement the respective processes. As unintended side effect, many (especially smaller) banks abandoned its investment advice in shares completely and others reduced their investment advice in shares significantly. A survey conducted by Deutsches Aktieninstitut among German banks in July 2014 provides evidence. Regulation is also a main reason why banks retreat from investment advice in other securities like bonds and investment funds.

The development that banks refrain from share recommendations will further harm equity culture among retail investors, which is already underdeveloped in the EU compared to other jurisdictions like the US. The result is a severe damage for the private wealth building by equity instruments especially at a time when investments in fixed income instruments hardly yield above the inflation rate. Finally yet importantly, financing SMEs by issuance of shares purchased by retail investors will become more difficult as banks are increasingly reluctant to provide information regarding share investments. This contradicts the approach of the Commission to improve the access to capital markets especially for SMEs as an essential part of the Capital Markets Union.

The legislator should consider these negative developments. Experienced retail clients should have the option to waive the reporting requirement when receiving periodic suitability assessments/reports and when receiving single investment advices frequently in Art. 25(6) MiFID II. Recently, German market participants and politics are discussion this “waiver” which could e.g. be applied for retail clients having received an investment advice (including a suitability assessment and its documentation) five times during the last two years from different investment firms.

4 Own account exemption: Member of/participant in regulated markets/MTFs

According to Art. 2(1)(d) MiFID II persons trading on own account in financial instruments other than commodity derivatives or emission allowances or derivatives thereof are not required to apply for a licence as investment firm. For the reasons mentioned above this exemption is also very important for the real economy (see section 1 of this paper).

This exemption is not available for persons who are members of or participants in a regulated market or an MTF or have direct electronic access (DEA) to a trading venue. So far, it is not clear whether this restriction would impair the use electronic platforms like Currenex or 360T by non-financial companies in order to conclude derivative transactions for risk-mitigating purposes.

Some providers of electronic platforms announced that they would aim for a MTF status regarding certain instruments. Therefore, corporates using these platforms are endangered to be classified as members of/participants in these trading venues for a lack of a clear definition. In addition, companies access these platforms via electronic interfaces which could be mixed up with an electronic access in the meaning of Art. 2(1)(d). Both would render the own-account-exemption useless for corporates. Consequently, these companies would refrain from trading on the respective venues, which would undermine efficiency of corporate risk management.

Therefore, the legislator should clarify that non-financial companies are only users / clients of these platforms in order to enter efficiently into derivative contracts for risk management purposes. In this regard, ESMA's analysis released in its final report "Technical advice on MiFID II and MiFIR" is very helpful. ESMA clarifies under which circumstances an electronic transmission of an order should be regarded as DEA (e.g. the possibility to determine the fraction of a second an order is posted). If these conditions are not met, market participants access the electronic platform as "client" without bearing the risk of not benefiting from the exemption according to Art. 2(1)(d) MiFID II. That clarification (i.e. non-financial companies are using electronic platforms as clients, and not as members/participants or via DEA) should be part of the legislation.

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