Title: Markets in Financial Instruments Directive II (MiFID II) **IA No:** RPC15-HMT-2309(3) **RPC Reference No:** RPC15-HMT-2309(3) **Lead department or agency:** HM Treasury **Other departments or agencies:**	**Impact Assessment (IA)** **Date:** 06/02/2017 **Stage:** Final **Source of intervention:** EU **Type of measure:** Secondary legislation **Contact for enquiries:** Hugh.McHale-Maughan@HMTreasury.gsi.gov.uk
Summary: Intervention and Options	**RPC Opinion:** GREEN

Cost of Preferred (or more likely) Option				
Total Net Present Value	**Business Net Present Value**	**Net cost to business per year** (EANDCB in 2014 prices)	**One-In, Three-Out**	**Business Impact Target Status**
£-1,302m	£-1,302m	£148.5m	Not in scope	Non qualifying provision

What is the problem under consideration? Why is government intervention necessary?

The UK is required, as a matter of EU law, to transpose the updated Markets in Financial Instruments Directive (MiFID II) by 3 July 2017. The provisions of MiFID II will come into effect on 3 January 2018. The linked Markets in Financial Instruments Regulation (MiFIR) will automatically be binding on the UK on this date. MiFID II will be implemented in the UK through a combination of secondary legislation and FCA rules. The Government consulted on the drafting of the secondary legislation which transposes MiFID II. Prior to the consultation process beginning, the Government produced a consultation stage impact assessment, which received a green rating from the Regulatory Policy Committee on 15 May 2015.

What are the policy objectives and the intended effects?

The policy objective is to implement MiFID II in order to comply with UK requirements under EU law, while completing the transposition with minimum impact upon UK businesses. This includes taking the outcomes of our consultation process into account where appropriate. On 23 June, the EU referendum took place and the people of the United Kingdom voted to leave the European Union. Until exit negotiations are concluded, the UK remains a full member of the European Union and all the rights and obligations of EU membership remain in force. During this period the Government will continue to negotiate, implement and apply EU legislation. The assumptions used in this Impact Assessment have been chosen accordingly.

What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)

In relation to the Statutory Instruments transposing MiFID II three options were considered: 1) do nothing, 2) an intelligent copy out of MiFID II within the structure of existing UK regulation and 3) replacing existing UK regime with direct MiFID II copy out. Option 1 would put the UK in breach of its obligations under EU law and is therefore not considered further. Option 3 would cause significant disruption and uncertainty to industry. The chosen option is option 2, which is justified by providing greater certainty and continuity to UK financial services regulation. In relation to the MiFID II third country regime, the Government consulted on alternatives to the 'do nothing' option, including 'opting into' the MiFID II third country regime. The 'do nothing' option was chosen due the perceived benefits of the current regime. The weight of responses to the consultation also reflected this position.

Will the policy be reviewed? It will be reviewed. **If applicable, set review date:** Month/Year

Does implementation go beyond minimum EU requirements?		No		
Are any of these organisations in scope?	**Micro** Yes	**Small** Yes	**Medium** Yes	**Large** Yes
What is the CO_2 equivalent change in greenhouse gas emissions? (Million tonnes CO_2 equivalent)		**Traded:** N/A	**Non-traded:** N/A	

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

Signed by the responsible Minister: Simon Kirby MP Date: 07.02.17

Summary: Analysis & Evidence

Policy Option 1

Description:

FULL ECONOMIC ASSESSMENT

Price Base Year 2011	PV Base Year 2017	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: Optional	**High:** Optional	**Best Estimate:** -£1,302

COSTS (£m)	**Total Transition** (Constant Price) 1 Year		**Average Annual** (excl. Transition) (Constant Price)	**Total Cost** (Present Value)
Low	Optional		Optional	**Optional**
High	Optional		Optional	**Optional**
Best Estimate	£263,094,367		£120,727,599	**£1,302,279,692**

Description and scale of key monetised costs by 'main affected groups'

MiFID II was estimated by the Commission to impose one-off compliance costs of between €512 and €732 million and ongoing costs of between €312 and €586 million on relevant firms, primarily 'investment firms', across Europe. The government has examined the granular basis for these costs and taken appropriate UK proportions at the granular level, as set out below

Other key non-monetised costs by 'main affected groups'

The full effect of MiFID II on financial markets is difficult to capture given the extent and variety of the changes it imposes. The government believes that the impact assessment primarily captures the direct effects, however.

BENEFITS (£m)	**Total Transition** (Constant Price) Years		**Average Annual** (excl. Transition) (Constant Price)	**Total Benefit** (Present Value)
Low	Optional		Optional	**Optional**
High	Optional		Optional	**Optional**
Best Estimate	0		0	**0**

Description and scale of key monetised benefits by 'main affected groups'

Monetised benefits are difficult to quantify with any precision. It is expected that firms and investors will benefit from a decrease in transaction and execution costs, as spreads across a range of financial instruments tigthen and transparency is increased. Further, increased competition will also provide investors with more widespread and reasonably priced access to trading venues and central counterparty services.

Other key non-monetised benefits by 'main affected groups'

Benefits to the wider economy and society will include the introduction of increased competition, enhanced investor protection and increased transparency in financial markets. MiFID II also permits the passporting of certain investment activities across Europe. There is particular benefit to the introduction of a specific permissive regulatory architecture for SME capital markets.

Key assumptions/sensitivities/risks **Discount rate** 3.5

The government has broken down the granularised costs provided by the Commission by appropriate proportions for the UK, dependent on the UK share of different financial markets, and the estimated number of authorisations of firms by the FCA. There is some risk in this approach, but the government believes that it is the most sensible and accurate approach to take when assessing a directive of this scale.

BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual):			**Score for Business Impact Target (qualifying provisions only) £m:**
Costs: £148.5m	**Benefits:** 0	**Net:** £-148.5m	0

Introduction

1. The Markets in Financial Instruments Directive (MiFID) (Directive 2004/34/EC) and its implementing measures (Directive 2006/73/EC and Commission Regulation 1287/2006) took effect in November 2007. MiFID regulates the buying selling and organised trading of financial instruments and the cross-border provision of such services in the European Union (EU). It was part of the Financial Services Action Plan programme of financial services regulation which sought to complete the European single market in financial services.

2. In 2010 the European Commission (EC) consulted on revisions to MiFID which became the revised MiFID (Directive 2014/65/EU) and Markets in Financial Instruments Regulation (MiFIR) (Regulation 600/2014) referred to collectively below as 'MiFID II'. MiFID II will take effect (in the main) from January 2018.

3. MiFID II updates MiFID in the light of the financial crisis and technological change.

4. MiFID II will create more robust and efficient market structures, and require more trades to be conducted through trading venues in order to promote transparency. It will introduce new safeguards for algorithmic and high frequency trading, and improve competition in essential post-trade services such as clearing. It will provide a stricter framework for commodity derivatives and strengthen investor protection. The aims of the EU legislation are consistent with our overall approach to the regulation of financial markets in the UK.

5. MiFID has been transposed into UK law. Where MiFID II introduces requirements that go beyond those in MiFID or existing domestic law, these changes can be expected to impact upon market participants.

6. We have set out below a description of the regulatory framework of MiFID and the main changes introduced by MiFID II covering:

   - scope;
   - authorisation and operating conditions;
   - investor protection;
   - trading venues;
   - market transparency and integrity;
   - passporting;
   - powers of competent authorities; and
   - new areas covered by MiFID II, not covered by MiFID.

Scope

7. The investment services and activities regulated under MiFID are: the reception and transmission of client orders; execution of client orders; dealing in financial instruments for a firm's own account; investment advice; portfolio management; underwriting and/or placing; and, operation of a Multilateral Trading Facility (MTF).

8. MiFID II adds one new investment service and activity: operation of an Organised Trading Facility (OTF). An OTF is platform for multilateral trading interests to interact leading to transactions in financial instruments. However, in contrast to an MTF where the operator of the platform plays a neutral role in bringing about transactions, the operator of an OTF plays an active role in bringing together buying and selling counterparties and helping them to negotiate the terms of a trade. This will often involve voice trading where the operator contacts counterparties by telephone or electronic communications to develop a transaction.

9. MiFID II also creates a new set of data service activities: Approved Reporting Mechanisms (APAs – firms who make public the details of transactions in financial instruments), Approved Reporting Mechanisms (ARMs – firms who report details of transactions to regulators for the purposes of market abuse surveillance) and Consolidated Tape Providers (CTPs – firms who publish details of all transactions in certain financial instruments so the market can have an overview of trading). APAs, ARMs and CTPs are being introduced to ensure both the market as a whole has high quality

information on which to make trading decisions and regulators have high quality information to use for market abuse surveillance purposes. These organisations will operate on a commercial basis.

10. The financial instruments covered by MiFID were: transferable securities; money market instruments; units in collective investment undertakings; financial derivatives and commodity derivatives. MiFID II also covers emission allowances. Whilst they are not being specified as a financial instrument, advising on and selling structured deposits will also be regulated under MiFID II. Structured deposits are deposits with interest rates derived from or based on a single security, a basket of securities, an index, a commodity, debt insurance or a foreign currency. The interest is paid (or not paid) depending on the performance of the underlying.

11. Commodity and other derivatives will be subject to enhanced regulation under MiFID II. This includes obligations on firms and persons to report the positions they hold in certain derivatives, and powers for regulators to order firms to reduce those positions.

12. There are various exemptions from the authorisation requirement (see below) under MiFID and some of these are being changed under MiFID II.

13. *Financial advisers*. MiFID has an exemption which enables Member States to choose whether to exempt firms providing investment advice and/or receiving and transmitting orders. In the UK, firms who fit into this category can either remain outside of MiFID (but regulated by the FCA) or opt into MiFID gaining the right to provide services outside the UK. Under MiFID II, firms outside of MiFID under this exemption will be required to be subject to analogous requirements to those regulated under MiFID. This will have limited impact in the UK where firms exempt under Article 3 are already subject to very similar regulation to firms regulated under MiFID.

14. *Proprietary trading firms and commodity derivatives firms*. Firms whose sole activity consists of trading against their own capital ('proprietary trading') can in certain circumstances be exempt from MiFID. This exemption is being narrowed under MiFID II to try and ensure in particular that firms using computer algorithms to trade very rapidly (often referred to as 'high-frequency trading firms') will be required to be authorised under MiFID II. MiFID has wider exemptions for firms who specialise in trading commodity derivatives to keep commercial firms using financial markets for purposes of risk management outside its scope. These exemptions are being narrowed under MiFID II.

<u>Authorisation and operating conditions</u>

15. Authorisation under MiFID is reserved to those performing investment services or activities as a regular occupation or business on a professional basis (entities authorised under other EU legislation dealing with collective investment schemes and banks may also perform MiFID services and activities subject to compliance with certain of the standards in MiFID). Firms authorised under MiFID are known as 'investment firms'. This remains unchanged under MiFID II.

16. In order to receive authorisation firms are required to have suitable management and controllers (owners and others able to exert control over the management) and for any changes to management and control to be notified to a firm's regulators. The provisions dealing with management and governance in MiFID II are a significant development on those in MiFID. They specify in much greater detail the requirements of management boards and the way in which theywill operate. This greater detail is broadly consistent with developments in the UK regulation since the financial crisis to increase accountability in financial services firms.

17. To be authorised under MiFID investment firms have to be members of investor compensation schemes and have sufficient regulatory capital as set out in separate EU legislation dealing with capital requirements. This is unchanged under MiFID II.

18. Investment firms under MiFID are required to have adequate organisational structures and arrangements in the following areas:

- compliance;
- management of conflicts of interest;
- systems and controls, including risk management, outsourcing critical functions and business continuity;

- record keeping; and
- safeguarding of clients' assets and funds.

19. These provisions have been updated in MiFID II. For example, requirements on record keeping and client assets have been updated (along the lines of similar developments in the FCA's rules since MiFID came into effect) and new provisions have been added on product governance. The latter are requirements designed to ensure that when manufacturing or distributing financial instruments firms have arrangements in place to understand the products and ensure they are sold to people for whom they are likely to be suitable. Again the FCA already has requirements in this area.

20. MiFID II is introducing additional organisational requirements for algorithmic trading (i.e. trading where computers determine some aspect of the parameter of an order). This builds on, but goes beyond, guidelines on automated trading adopted under the existing directive by the European Securities and Markets Authority ('ESMA'). The requirements seek to ensure that firms have proper governance, testing and continuity arrangements around their algorithmic trading to minimise disruption to trading on financial markets. They also seek to ensure that firms undertaking market making type activities are subjected to market making obligations under the rules of trading venues.

21. There are separate but similar authorisation and organisational requirements for providers of data services (ARMs, APAs and CTPs). In particular, these focus on ensuring the integrity and security of the data that these entities will handle. The UK expects to host the overwhelming majority of European data reporting services providers.

<u>Investor protection</u>

22. MiFID introduced a harmonised framework for investor protection – that is a set of rules designed to ensure that, in their interactions with clients, investment firms act in the best interests of their client.

23. Key aspects of the investor protection measures in MiFID include:
    - general obligations;
    - suitability and appropriateness;
    - best execution; and
    - client categorisation.

24. *General obligations*. Under MiFID, investment firms are required to act honestly, fairly and professionally and in accordance with the best interests of their clients, communicate in a way that is fair, clear and not misleading, and provide clients with appropriate information on the firm, the services it offers and the associated costs and only make or receive payments linked to services provided to clients in limited circumstances.

25. MiFID II makes significant revisions to these obligations. Three of the key changes are as follows. First, firms will be required to inform clients whether the investment advice service they provide is independent. Second, those providing independent investment advice and portfolio management will only be able to receive minor non-monetary benefits from third parties in relation to services they provide to clients. Third, investment firms will need to make much more detailed disclosures of costs and charges.

26. The detail of these changes are included in delegated acts.

27. *Suitability and appropriateness*. Under MiFID, when providing services to a client, firms are required to obtain information from the client to help them determine either the suitability (in the case of investment advice and portfolio management) or appropriateness (in the case of other services) of the services and products for the client. This information can include the client's knowledge and experience in the investment field. The information collected should take into account the nature of the service or product, and the client's retail or professional status. Firms can provide execution services to clients without collecting such information where the client asks for such a service and the instruments involved are 'non-complex'.

28. MiFID II is making revisions to the suitability and appropriateness obligations but not significantly reforming the way they operate.

29. *Best Execution*. "Best execution" in MiFID is an obligation placed on firms to obtain the 'best

possible result for their clients' when executing orders for financial instruments in the absence of specific instructions from the client. In seeking to deliver 'best execution' a firm should take a wide-range of factors into account, such as, price, costs, speed, likelihood of execution and settlement, size, and the nature of the order and other relevant considerations. The obligation on firms requires them to establish a policy to achieve best execution.

30. MiFID II does not change the main aspect of the best execution obligation. However, it seeks to ensure that firms take a more rigorous approach to meeting their obligations including their disclosures to clients. Execution venues will be required to publish standardised information on the quality of order execution and investment firms handling client orders will need to provide information on the execution venues they use and the quality of execution quality they obtain.

31. *Client categorisation*. MiFID graduated its protections for clients depending on whether they were retail, professional or eligible counterparties. Investment firms are able to conduct transactions with entities, such as other financial institutions authorised under domestic or Community law, classified as 'eligible counterparties' without the conduct of business, best execution and part of the client order handling rules applying.

32. MiFID II extends some conduct protections to investment firms' dealings with eligible counterparties, particularly in regard to the provision of information. It also strengthens the protections afforded to professionals.

Trading venues

33. MiFID built on the already established concept in EU legislation of a "regulated market" ("RM") (entities normally referred to as exchanges). An RM is a venue for the multilateral trading of financial instruments under a set of non-discretionary rules set by a market operator.

34. The framework MiFID established for the regulation of RMs has echoes of the regulation of investment firms in respect of the conditions for authorisation and the general operating conditions. There are requirements governing:

- authorisation;
- the suitability of the management;
- the suitability of those who control the management; and
- organisation.

35. The main change MiFID II makes here is to update the provisions dealing with the suitability of the management in the same way as the similar provisions for investment firms.

36. MiFID also has provisions which deal with the specifics of regulated markets. These relate to:

- admission to trading of financial instruments;
- suspension and removal of instruments from trading;
- access to regulated markets;
- compliance with the rules of the market;
- clearing and settlement.

37. These provisions are aimed at investor protection and ensuring that a regulated market is properly run, having clear, transparent and non-discriminatory rules which are properly monitored and enforced. Aside from in relation to the suspension and removal of instruments from trading, MiFID II leaves these provisions largely unchanged.

38. As with investment firms, MiFID II introduces new provisions for regulated markets dealing with algorithmic trading which build on and go beyond those in the ESMA automated trading guidelines. The requirements seek to ensure that regulated markets have proper governance, testing and continuity arrangements around algorithmic trading to minimise disruption to trading on their markets. They also seek to ensure that trading venues encourage market making particularly in stressed market conditions.

39. MiFID also established a second category of trading venues, MTFs. These are defined in the same way as regulated markets but have slightly different obligations to RMs. For those operating MTFs,

whether they are investment firms, credit institutions or operators of regulated markets, MiFID sets out provisions governing how MTFs should operate. These draw on aspects of the regime covering regulated markets. They require that MTFs have:

- transparent criteria for determining the financial instruments that can be traded under their systems;
- non-discriminatory rules for determining access to their systems;
- rules to ensure fair and orderly trading on their systems;
- rules to facilitate efficient settlement of transactions concluded through their systems.

40. MiFID II, as discussed above, creates a new category of trading venue: OTFs. OTFs follow similar organisational requirements to MTFs. However, they are distinct from RMs and MTFs in three key ways. First, again as noted above, the operator of an OTF must play an active role in bringing about transactions on its platform by exercising discretion. Second, following on from the first point, an operator of an OTF is subject to conduct rules such as best execution because of the active role they play in bringing about transactions. Third, OTFs are only allowed to trade bonds and derivatives and not equities and Exchange Traded Funds.

<u>Market transparency and integrity</u>

41. *Trading transparency*. MiFID introduced an extensive framework for market transparency and integrity. These provisions were designed to ensure that the price formation process is as efficient as possible with investors having access to a wide range of pre and post-trade information.

42. The transparency provisions in MiFID relate only to shares. When RMs and MTFs trade shares admitted to trading on RMs they have to make public information about the price and volume at which their members wish to trade ('pre-trade transparency') and the price and volume of transactions ('post-trade transparency'). The provisions in MiFID codified and harmonised what RMs and MTFs were already doing.

43. The regime included waivers from pre-trade transparency. In specified circumstances, trading could occur without trading interest having previously been made public to the market as a whole (sometimes referred to as 'dark trading'). The implementing measures also specified when, and for how long, delays could be granted from the obligation for post-trade transparency to occur within three minutes. These exceptions and delays were intended in particular to assist those providing liquidity to the market by trading against their own capital to be able to manage their risk effectively

44. MiFID II revises the transparency regime on trading venues for shares and introduces a new regime for instruments like shares (such as exchange traded funds) and bonds and derivatives. As with the existing regime there are pre-trade transparency waivers and delays from post trade transparency. For shares the existing waivers have been narrowed to provide for greater transparency and it is likely that post-trade delays will be reduced. In addition to the narrowing of pre-trade transparency waivers for shares, there will be caps on certain forms of dark trading which if exceeded in a particular instrument will lead to the suspension of certain dark trading waivers for a period of six months.

45. MiFID also introduced transparency provisions for investment firms trading the most liquid shares when acting as market makers outside an RM or MTF. Investment firms acting in this capacity on a frequent, systematic and organised basis (something to be assessed on a qualitative basis) had to inform their national regulator that they were 'systematic internalisers' (SIs). In respect of dealings in shares deemed to have a 'liquid market' in sizes up to 'standard market size', SIs have to publish quotes which are visible to the market as a whole. Business can only be done at prices away from these quotes where the transaction being conducted is larger than that customarily undertaken by a retail investor, and where the client they are dealing with is a professional client.

46. MiFID II significantly revises this regime. For trading in shares, the determination of whether an investment firm is an SI will be based on whether a firms trading crosses certain quantitative thresholds. This will increase the number of SIs (there are currently 9 in the UK). Price improvement will also be allowed for dealings with retail clients in justified circumstances. The regime is also being extended to exchange traded funds and other instruments that resemble shares, and bonds and derivatives. In respect of the latter the transparency requirement will apply to dealings in liquid instruments below a Size Specific to the Instrument (SSTI), which will be set in a technical standard,

and the obligation will be to quote in response to a request to a client, with the posted quote being available to other clients of the firm to the extent possible with good risk management when trading on risk in this manner. For bonds and derivatives there will also be quantitative criteria to identify SIs. It is not possible at this stage (the quantitative thresholds have yet to be set) to estimate the number of SIs in the UK who will trade shares and derivatives.

47. MiFID requires that where firms execute transactions away from RMs and MTFs in shares admitted to trading on RMs that they make public the details of the transactions (but can benefit from the same regime for delayed post-trade transparency as applies to transactions carried out on RMs and MTFs). Under MiFID II this is being extended to other instruments, including bonds and derivatives.

48. *Market integrity*. Investment firms are required under MiFID to keep records of the transactions they carry out for at least five years, so that regulators can have access to them if required to ensure the directive and wider obligations, such as those relating to money laundering and market abuse, are adhered to. They also have to report to regulators the transactions they conduct in instruments which are admitted to trading on regulated markets before the close of the following working day. The FCA receives about 12 million such transaction reports a day.

49. MiFID II expands the transaction reporting requirement to a wider range of financial instruments including those admitted to trading on MTFs and OTFs. Provisional estimates suggest this might increase the number of transaction reports sent to the FCA each day to 20 million. It will also increase the number of fields a firm might have to complete for each report in the region of threefold.

50. MiFID II also requires trading venues to keep details of orders sent to their trading systems and harmonises the form in which this information will be held. These records will be made available to regulators upon request.

<u>Passporting</u>

51. A key purpose of MiFID was to facilitate cross-border activity. It provides that firms to have rights to do business outside of the member state in which they are authorised without being subject to additional regulatory requirements (‘passporting’).

52. *Cross-border right to do business*. MiFID provides investment firms with the right to provide services on a cross-border basis (such as by telephone or by the internet) without having additional regulatory requirements relating to matters covered by the directive imposed upon them by the host member state: that is for business with clients in other Member States their home regulator’s requirements apply. They do, however, have to go through a procedure of notifying their home regulator which then passes the information on to the regulator in the Member State in which the investment firm is seeking to do business. Regulated markets and MTFs are also given the right to place trading screens in countries outside that in which they are authorised without the pre-approval of domestic regulatory authorities.

53. The rights and regime described above are unchanged under MiFID II. The only real changes are to standardise the forms used for passporting applications and to provide for additional information to be provided to host regulators in certain circumstances when banks are providing investment services and activities.

54. *Right to establish branches*. Investment firms are also given the right in MiFID to establish branches in other Member States without going through a separate authorisation process. As with cross-border business, however, they do have to provide details about their branch to their home regulator for onward transmission to the regulator in the Member State in which they wish to establish a branch. Branches, however, come under the responsibility of the regulators of the Member State in which they are established in respect of their obligations under the Directive concerning conduct of business, best execution, client order handling, transactions reporting and pre- and post-trade transparency.

55. As with doing business cross-border, the rights and regime described above are unchanged under MiFID II. The only real changes are to provide for standardised forms for passporting applications and additional information to be provided to host regulators in certain circumstances when banks are providing investment services and activities.

56. The new passporting forms were discussed in ESMA’s high level cost-benefit analysis of technical standards. This concluded that there would be some very minor costs for regulators and firms but there would be benefits to end consumers from regulators having access to better information about

passporting firms and therefore being better placed to supervise them.

Powers of Competent Authorities

57. MiFID has provisions dealing with the designation of (and co-operation between) ‘competent authorities’ (the Directive’s terminology for regulators) within Member States, the powers of regulators and co-operation between regulators in different Member States.

58. MiFID requires member states to designate competent authorities to carry out each of the duties that fall to competent authorities under the Directive. Where there is more than one competent authority under the Directive in a Member State, they are required to have clearly defined roles and to co-operate closely. This is unchanged under MiFID II.

59. Under MiFID, competent authorities wide-ranging powers to enforce the Directive. These include rights to gain access to documents, to gain access to telephone records, to require trading in financial instruments to be suspended, and to adopt measures to ensure firms comply with their obligations. These powers are expected to be backed up by appropriate sanctions. Such sanctioning powers are, however, balanced by a right of appeal to the courts against regulatory decisions. The rights of individuals are also catered for by a requirements that encourage Member States to establish complaints handling tribunals for the speedy resolution of investor grievances and to safeguard professional secrecy.

60. Under MiFID II the powers of competent authorities are being enhanced. For example, they are being given powers to intervene in positions in commodity derivatives contracts and the selling of certain financial instruments and to remove individual directors from a board. Member States are also required to ensure that the pecuniary sanctions that can be imposed for infringement of MiFID II must at least meet certain thresholds.

61. MiFID II also enhances the role of ESMA. In some areas (like transparency waivers and position limits) it issues an opinion on decisions taken by national regulators. These opinions are not binding but obviously national regulators will take a dissenting opinion from ESMA very seriously. ESMA is also given, in very limited circumstances, the power to reduce individual positions of position holders in commodity derivatives.

62. Regulation cannot operate effectively simply on a Member State by Member State basis. The Directive’s key purpose is to foster cross-border activity. Cross-border activity inevitably requires competent authorities in different Member States to co-operate, both to facilitate the operation of the single market and to protect its integrity. MiFID set out a framework to ensure that regulators in different Member States are obliged to co-operate and have the ability to do so by passing on information. This framework remains in MiFID II.

63. There may, however, be circumstances in which co-operation does not work. MiFID, in common with other financial services directives, provides, in these circumstances, precautionary powers for host-state regulators to take action against firms who are subject to the supervision of other regulatory authorities. These powers, are expected only to be used in extreme circumstances. MiFID II retains these provisions.

64. *UK competent authorities.* The FCA, PRA and Bank of England will all be competent authorities for MiFID II but the main burden of work will fall to the FCA. Implementation will involve significant one-off costs for the authorities.

New aspects of MiFID II

65. There are several key areas where MiFID II does not build on MiFID as such but introduces wholly new requirements. These include:

- position limits and position reporting for commodity derivatives;
- trading obligations for shares and derivatives;
- access to market infrastructure and benchmarks; and
- access of firms from outside the EU providing investment services and activities to clients in the EU.

66. *Position limits and position reporting.* As a result of concerns about possible instances of market abuse and disorderly trading and settlement related to commodity derivatives contracts, there is a

new regulatory regime in MiFID II. This requires limits to be set (by national regulators following a methodology to be set in technical standards) on the size of a position someone can hold in each commodity derivatives contract traded on a trading venue and economically equivalent contracts traded away from a venue (there will be different limits for the month before a contract expires and other maturities).

67. Details of positions will need to be reported to national regulators on a daily basis to support this regime. Information will also need to be sent to ESMA on a weekly basis to enable aggregated weekly reports to be published showing the positions of certain categories of traders in each contract.

68. The EU's two biggest commodity derivative RMs are based in the UK and there are in the region of 1,800 commodity derivative contracts trading on trading venues in the UK.

69. *Trading obligations for shares and derivatives*. To try and protect the price formation process in shares, MiFID II requires investment firms executing transactions in shares trading on RMs and MTFs (and equivalent venues outside the EU) to do so on a trading venue or an SI (subject to certain limited exceptions). The intention is to maximise the amount of trading that takes place inside the framework of MiFID II's pre-trade transparency regime.

70. There is also a trading obligation for derivatives resulting from the 2009 G20 conclusions. G20 members committed themselves to reforms of financial markets including requiring derivatives subject to an obligation to be cleared through a Central Counterparty Clearing House (CCP) to be in most circumstances traded on trading venues within a transparency regime. The trading venues permitted are RMs, MTFs, OTFs and equivalent venues outside the EU. Once a financial instrument is subject to a clearing obligation under EMIR, ESMA will assess its liquidity and, if appropriate, bring forward a technical standard imposing a trading obligation. The purpose of the obligation is to help strengthen the resilience of financial markets by having more trading taking place in a transparent environment on properly regulated trading venues.

71. *Access to market infrastructure and benchmarks*. MiFID helped to stimulate competition between trading venues. MiFID II seeks to push this process further by facilitating access of CCPs to trading venues, trading venues to CCPs and access of CCPs and trading venues to benchmarks.

72. The provisions dealing with access to CCPs require CCPs to clear contracts from trading venues requesting access on a non-discriminatory basis in terms of collateral requirements and cross-margining. Requests for access can only be turned down by CCPs where they would involve significant undue risk (regulators can also prevent them where they would threaten the smooth and orderly functioning of markets).

73. The provisions dealing with access to trading venues require trading venues to provide trade feeds on a non-discriminatory basis to CCPs that wish to clear transactions in financial instruments on that trading venue. Again there are limited grounds on which a trading venue can reject a request for access or a regulator can block a request.

74. *Access of non-EU firms to EU markets*. MiFID effectively leaves it up to individual Member States as to how to regulate access of non-EU firms to clients based in a Member State. MiFID II seeks to introduce a more harmonised regime. Where the EC determines that a country outside the EU has a regulatory regime that is equivalent to that provided for under MiFID, firms regulated in such a country will be able to provide from their home country investment services and activities to professional clients (other than those who have opted up from retail client status) and eligible counterparties based in the EU. In certain circumstances, they might also be permitted to have a branch in an EU country and provide services across the EU from that branch to the same sort of clients as with the arrangements for the cross-border provision of investment services and activities. Member States are given the discretion to determine whether to require non-EU firms to establish a branch in their jurisdiction when dealing with retail clients (and professional clients who have opted up from retail client status). If MSs exercise this option there are harmonised conditions for the operation of branches. In more detail, the primary features of this regime are the following:

- where a non-EEA firm seeks to provide investment services in the UK to a retail or an elective professional client (i.e. a client that has elected to be treated as a professional rather than a retail client) that EEA firm must establish a branch in that Member State before doing so;
- in order to be authorised that branch has to comply with a series of harmonised criteria, such

as having sufficient initial capital, the third country where the non EEA firm is based pays due regard to relevant anti-money laundering regulations and there are cooperation arrangements in place between the third country and the Member State; and

- where a non-EEA firm establishes a branch in a Member State, there is the possibility that it will have the ability to passport across the EU in relation to its wholesale business (where, amongst other things, the EU adopts an equivalence decision in relation to the third country i.e. deeming this country to have a broadly equivalent regulatory architecture).

75. Under the UK's current regime third country firms can conduct certain investment activity without the need for authorisation, if they can rely on a specific exclusion. The Government considers that this regime currently works reasonably well both in terms of providing a competitive market place while balancing investor protection. Implementing the MiFID II third country regime may act to increase the regulatory burden on firms and narrow existing exclusions that permit economic activity to take place in the UK. For this reason the UK will maintain its current regime. We consulted on this and the weight of responses reflected this position.

Binary Options

76. Binary options which reference financial instruments are not currently considered to be financial instruments themselves under FSMA and are supervised as bets by the Gambling Commission. On reflection the Government considers that the more accurate approach is that they should be classified as financial instruments under MiFID II and therefore should fall within the FCA's regulatory remit.

77. The Government provided draft secondary legislation on binary options, so that industry could provide comment and feedback in relation to the proposed drafting and the consequences of it. Respondents unanimously agreed that binary options should be treated as financial instruments under MiFID II.

Rationale for intervention

78. As noted above, MiFID II determines the rules of operation for EU financial markets across a range of asset classes (including shares, bonds, derivatives, and structured products). It covers firms that as a regular occupation or business provide investment services and/or perform investment activities on a professional basis.

79. The original MiFID was largely transposed in 2006 through amendments to the Financial Services and Markets Act 2000 and a collection of orders, particularly the FSMA (Regulated Activities) Order 2001.

80. Since then, the financial crisis has exposed flaws in the regulation of increasingly complex products, and there have been significant technological advances. MiFID II therefore contains measures in four distinct areas. It will create more robust and efficient market structures, and require more trades to be conducted through them in order to promote transparency. The new transparency provisions will include requirements for the publication of market data. It will introduce new safeguards for algorithmic and high frequency trading. It will provide a stricter framework for commodity derivatives, and reinforce the power of the regulators in this area. Finally, it will strengthen investor protection in various areas.

Policy Objective

81. To ensure that the UK meets its legal requirements under European law by transposing MiFID II by the Commission deadline of 3rd July 2017, and doing so in a way that where possible minimises impact on UK businesses.

Monetised and non-monetised costs and benefits of each option (including administrative

burden)

Consultation Stage Impact Assessment

82. A consultation stage Impact Assessment was published on 25 March 2015. This estimated that the estimated annual net cost to business would be £105.2 million. The consultation stage impact assessment received a Green Light from the RPC.

83. The figures were drawn from an impact assessment published by the European Commission at the time of the MiFID II proposal. Their impact assessment was composed of three elements. First, an extensive qualitative assessment of the policy options the Commission had chosen against a baseline of no revision to MiFID and looking at some other policy options. This assessment drew on academic literature and a large variety of other sources of information about the EU's financial markets. Second, an attempt to estimate the compliance costs of the Commission's proposals. Third, a discussion of the possible indirect economic effects, in particular considering the potential impacts on liquidity of the transparency proposals.

84. The methodology used for the estimate of the compliance costs was the EU Standard Cost Model. The model is based around identifying the average cost of activities and multiplying that by how many times a year they are performed. The key elements of the approach were as follows:

- identify the main obligations and classify them according to a typology;
- for each type of obligation identify the type of activity performed;
- obtain a picture of the target groups looking at size, type and location;
- identify the frequency of the required actions in the course of a year;
- look at costs based on time spent performing an action, the hourly pay of those performing the action, acquisition costs of equipment and supplies and depreciation period;
- estimate the number of entities in each target group; and
- extrapolate data to EU level.

85. To assist in this approach survey work was done with market participants to understand their current practices and the challenges that implementation would pose. This was supplemented by use of literature, including cost-benefit studies, which could help to provide insight.

86. The Commission Impact Assessment can be found at http://ec.europa.eu/internal_market/securities/docs/isd/mifid/SEC_2011_1226_en.pdf.

Changes for the final stage Impact Assessment

- A number of changes were made in order to update the consultation stage impact assessment:
- The Commission impact assessment was conducted on the draft form of the text in 2011. As such, we have examined and costed the changes from the 2011 to the 2016 text.
- The impact assessment was conducted on the Level 1 Directive and Regulation. We have looked at the appropriateness of costing Level 2 delegated directives and regulations. Where appropriate, we have drawn on the FCA cost-benefit analyses contained within their consultation papers for these costings.
- We have included the direct costs that the FCA will incur while administering MiFID II, as these will be recouped from industry via the levy.
- We have broken down the main areas of cost that the Commission identified. This is to provide a more granular basis for our high level costs. Familiarisation costs are absorbed within these granularised costs, as highlighted
- We have drawn on the industry response to the consultation stage impact assessment, drawn assumptions from the Financial Conduct Authority and evaluated this and wider previous consultations with industry.

UK proportional areas of costs

87. Rather than using the fact that the UK accounts for 36% of wholesale financial market activity in Europe as a heuristic for the proportional cost basis, we have broken down the proportional shares for all of the different markets affected by MiFID II.

- The UK accounts for 45.21% of the European Equity Market. Of this, they currently account for 13 of 102 regulated markets (12.74%); 73 of 150 MTFs (48.67%); and 7 of 11 equity systematic internalisers (63.64%).
- The UK accounts for 82.2% of the EU OTC derivatives market (BIS Triennial Central Bank Survey April 2013); split 65% to 35% bilateral- multilateral, and 85% to 15% voice-electronic.
- The FCA expect to authorise 5-10 APAs, 5-11 ARMs, 0 CTPs, 25-100 firms providing direct electronic access (DEA), 10-20 High Frequency Traders, 40-60 OTFs, and 0-20 Firms trading on commodity derivatives.
- Taking the midpoint of these figures produces the below table:

Type of firm	**Expected number**
RMs	13
SIs	7
APAs	8
ARMs	8
CTPs	0
Firms providing DEA	63
HFTs	15
OTFs	50
MTFs	118
Commodity derivative traders (71% of the EU market)	10
Emission trading allowance traders	150

Granularised Compliance Costs

88. Using these proportions we broke the costs up by the UK share of different financial markets, or multiplied the costs per firm or venue by the UK number of firms. While overall costs on pages 1 and 2 have been converted from 2011 € to 2017 £, the granularised costs have been retained in 2011 € in order to make obvious whereabouts in the Commission's impact assessment this document has drawn its figures from.

89. **OTFs:** the Commission estimated a one-off cost of €400,000 for each firm to be authorised as an OTF, and ongoing costs of 20-30% of that per year €100,000. The costs were associated with the development of tools to monitor trading (such as the purchase of security market surveillance software from independent software vendors and the development of those systems in a bespoke way), and the provision of required information to regulators the purchase of security market surveillance software from independent software vendors, the development of these systems in a bespoke way, and familiarisation costs. With 50 OTFs estimated to be authorised in the UK, the estimated one-off costs are €20,000,000, and ongoing costs are €5,000,000.

90. **Trading obligation for derivatives:** The Commission estimates that the costs for the trading obligation for derivatives for all market participants range from €47.6 million to €94.9 million, and

on-going range from €37.5 million to €74.9 million. Taking the UK's share of the OTC derivatives market 82.2% as a proxy for the proportion of the market participants, we estimate the one-off costs to be €58.5675 million and the ongoing costs to be €46.1964 million. The majority of this cost comes from market participants linking up to electronic trading platforms.

91. **HFT firms:** The Commission have estimated an ongoing cost of €36,000 per HFT firm. This is a cost associated with both increased capital provision and maintaining fit and proper systems in order to comply with the authorisation process, as well as familiarisation with the authorisation process. Given that the FCA is expecting to authorise 15 HFT firms, the total ongoing cost will be €540,000.

92. **Algorithmic trading:** The Commission have estimated that it will take each firm involved in algorithmic trading two man-weeks in order to construct a document setting out an explanation of the firm's algorithm's design, purpose and functioning which would satisfy the notification requirements. This would entail a cost of €4000 per firm. The FCA estimates that around 1500 firms will notify them, leading to total costs of €6,000,000.

93. **Direct Electronic Access:** The Commission interviewed firms who provided sponsored access to venues. The firms estimates that 4–6 working weeks would be required in order to develop, and familiarise staff with, a new system that complied with the robustness and risk requirements.. At an estimated annual cost of €100,000 per IT professional this works out at about €8,888–€13,333 per firm. An on-going cost below this level, at 1–2 working weeks per firm per annum equates to €2,222–€4,444 per firm. Taking the midpoint of these figures, and with an estimated 63 firms to be authorised to provide DEA, the aggregate cost implication of these proposals would be one-off costs of €699,961.50 and on-going costs of approximately €209,979.

94. **Equities trading transparency:** Concerning the costs and benefits associated with the preferred options in the area of equity pre-trade transparency, the proposals mainly clarify the status quo and seek to ensure uniform application of the waivers via a reinforced process involving ESMA. No incremental costs are thus expected. The costs of extending the equities-transparency regime to shares traded only on MTFs or organised trading facilities is not expected to generate significant costs as MTFs are already expected to possess and disclose this information. As a prudent estimate, the Commission derived the possible cost impact from the overall one-off implementation costs of the equity transparency regime when MiFID was first introduced. The one-off cost of the IT and systems necessary to support transparency requirements for the Europe-wide financial services industry in respect of equity trading under MiFID was an estimated €100 million. The volume of trading of shares only admitted to trading on MTFs is substantially below one percent of the existing volume of equities traded. As a result, the Commission considered a further Europe-wide one-off cost of around €2 million to be a reasonable estimate (2% of the one-off costs of the introduction of the initial equity regime). The incremental ongoing cost is estimated at about €0.4 million (being 20 per cent of the one-off cost). The UK accounts for 45.21% of the European Equity Market; as such, we estimate that the one-off UK cost will be €905,000 and the ongoing costs to be €180,000.

95. **Non-equity transparency: T**he introduction of a wholly new pre- and post-trade transparency regime for non-equities would generate one-off costs for per MTF of €26,000 with yearly ongoing costs of €10,000. This figure is produced by taking the midpoint of the figure estimated by the Commission for the cost of the regime for all MTFs, and then dividing it by the then Commission estimate for the number of MTFs (46). With 118 MTFs expected to be operating in the UK after new authorisations, this implies overall one-off costs of €3,068,000 and ongoing costs of €1,140,000. The figure is based on the cost of extending data publication systems to meet the new requirements. The Commission estimated that the cost of the new post-trade transparency regime to market participants trading derivatives would be €2,174,000 in one-off costs, and €1,872,000 in ongoing costs. The UK accounts for 82.2% of the derivatives market, leading to one-off costs for UK market participants of €2,522,000 and on-going costs of €1,538,784. The Commission

estimated that the cost of the new post-trade transparency regime to market participants trading bonds would be €1,578,000 in one-off costs, and €1,903,000 in ongoing costs. Given that the UK accounts for 70% of secondary markets trading in the global bonds market, it would be prudent to estimate that the UK would account for nearly all of this cost. Taking a conservative estimate of 90% of the Commission's estimates of total cost for pre-trade transparency (halfway between the bonds and the derivatives estimates) leads to estimates of one-off costs of €725,000, and on-going costs of €4.2 million for all market participants. The majority of costs are located in familiarisation with the new procedures, and the development and maintenance of IT systems.

96. **Data Reporting Services Providers:** The Commission estimates that the costs to Data Reporting Services Providers, who operate on a commercial basis, of conforming with and providing a fully standardised reporting format and content for post-trade data should not exceed one quarter of the original investment in transparency systems when MiFID was implemented and are estimated at €30 million. Maintenance may be €3–€4.5 million per year, or 10-15% of this. The UK is expected to host up to 100% of DRSPs, and thus it is prudent to expect this entire cost to fall on UK firms. There is a potential aggregate saving from requiring venues and vendors to sell data in unbundled form, though this is difficult to quantify or fully predict.

97. **Reinforce position oversight:** The Commission estimated that the Europe-wide one off costs would be €10.55 million, and ongoing costs would be €14.9 million, taking midpoints as best estimates. Given that the UK accounts for 82.2% of the derivatives market, this leads to figures of €8.651 million and €12.25 million respectively for the UK. The Commission modelled the current cost based upon three components: an internal systems cost; labour costs and data cleaning cost.

98. **Extending transaction reporting:** The Commission broke down the costs for this change by the extension to MTFs (one-off costs of €0.9 million, ongoing costs of €0.1 million), the extension to OTC derivatives (one-off costs of €55.1 million, ongoing costs of €0.75 million), the extension to commodity derivatives (one-off costs of €17.95 million, ongoing costs of €0.55 million), and the extension to depositary receipts (one-off costs of €0.9 million, on-going costs of €0.9 million). It is reasonable to assume with authorisations that the proportion of MTFs located in the UK will be around 50%, leading to one off costs of €0.45 million, and ongoing costs of €0.05 million for UK MTFs from the extension. The UK accounts for 82.2% of the OTC derivatives market, which implies one-off costs of €45.3 million, and ongoing costs of €0.6165 million. The UK's 71% share of the commodity derivatives market leads to one-off costs of €12.7445 million, and ongoing costs of €390,500. Taking 36% as an approximation of the UK proportion of the depositary receipt market yields one-off costs of €324,000, and ongoing costs of the same. The Commission estimated that about 20 per cent of this cost related to on-going IT expenditure (including the cost of a requirement to store order data for five years), and about 55 per cent being the labour input (put another way, they believe that about 300–390 FTEs work on transaction reporting activity across the EU at present). The remaining costs relate to data cleaning, payments to ARMs and other associated costs, including familiarisation.

99. **Commodity regime:** The Commission estimated that position reporting would entail costs for both the trading venues and the market participants at between €0.8 and €1.0 million for one-off costs and between €3.3 and €3.8 million as yearly ongoing costs. Taking 71% of the midpoints of these figures (the UK accounts for 71% of the Commodity Derivative market) yields one off costs of €0.639 million and annual ongoing costs of €3.55 million. This is a prudent estimate as, while degree of trading and position oversight, including position reporting, among MTFs, is less clear, the main UK commodity derivative regulated markets (*ICE Futures Europe Energy, the London Metal Exchange,* and *NYSE Euronext Liffe London*) already have members regularly submitting position reports, and responding to requests for information, including on their positions. For those exchanges who already operate position reporting, the only cost that would be incurred would be in compiling a COT report, estimated at about a quarter of a fulltime equivalent employee per year. Using cost information provided by exchanges in the UK, the one-off cost of developing systems to receive and collate position reports for those MTFs who do not already do so would be between

of between €10,000 and €15,000 (many MTFs will not be required to make this investment as they either do not trade commodity derivatives or already have systems in place). On-going costs will be greater, given the staff costs required to collate and analyse position information as well as on-going IT maintenance costs. Regarding the review of the exemptions, the number of firms benefiting from the MiFID exemptions under Articles 2(1)(i) and 2(1)(k) is usually not known to regulators because they are not usually required to be authorised. However, in the UK the boundaries of regulation are wider than those under MiFID. Therefore some of the MiFID exempt firms in the UK - essentially trading arms of commercial firms who are acting as agent for the group - are authorised by the FSA and subject to a national regulatory regime. The administration of the MiFID II position management regime is accounted for in the FCA costs.

100. **Extend MiFID to cover the secondary spot trading of emission allowances:** Emission trading allowance traders currently not holding a MiFID authorisation for investment firms would be required to ensure compliance with applicable organizational and operational requirements of the MiFID and to obtain such authorisation in order to pursue activity in secondary spot market for emission allowances. The Treasury believes that the overwhelming majority of these authorisations will be undertaken by smaller firms, for whom the Commission estimated that the cost would be €100,000 for one-off cost and €30,000 for on-going cost per year. If we take the midpoint of the upper costs as a prudent estimate, the FCA expect to authorise 150 emission trading allowance firms, yielding one costs of €15 million, and on-going costs of €4.5 million.

101. **Structured Deposits:** The UK has a relatively small market in structured deposits, accounting for just 7.08% of total amounts invested in the EU. The Commission estimated that the one-off impact would be €31-€44m with ongoing costs of €9-€15m on a yearly basis. This was drawn from ongoing work on PRIIPS, and based on familiarisation and authorisation costs for firms rather than any substantive spend. The UK proportion of the mid-point would therefore be €2.665 million of one off costs and €0.8496 ongoing costs.

102. **Strengthening conduct of business rules for the provision of investment advice:** The Commission calculated this based on the number of high net worth or mass affluent individuals in the EU, of whom around 25% are domiciled in the UK, with an incremental increase of 3-5 minutes per client associated with the completion of a more extensive suitability report. Four separate costs were specified. Firstly, the Commission also stated that the UK's existing situation was sufficiently close to the requirements under MiFID II that the time required for advice would not need to be extended in any way. HMT concur with this analysis. Secondly, additional training would be required for bank-based advisers. The Commission applied the industry standard of 150 clients per adviser and anticipated 1-2 hours per adviser. As such, the incremental one-off training cost would be €6–€12 million across the EU, or €2.25 million as a sensible estimate for the UK. Thirdly, requiring financial intermediaries to provide bi-annual updates (as a minimum frequency) to inform investors on the fair market value of their investments and on whether there has been any material modifications would give an incremental cost of accessing and delivering the valuation information, which is likely to be €1–€1.5 per client. This implies an on-going cost of €40–€67.5 million per annum for the EU as a whole, or €13.4375 million for the UK. Finally, a requirement to annually request information updates from clients would have several costs associated with it: the initiation of contact as well as the updating of the investment adviser's records. Generally, independent intermediaries send an information request pack (costing €1–€2 per client) whereas non-independent ones (typically banks) send a more generic request (e.g. for the customer to contact the local branch) at a lower cost of €0.5–€1 per client. This gives a cost impact across the EU of €23.5–€52.5 million, or €9.5 million for the UK. However, in the event of a reply the investment adviser would potentially be required to re-work his or her estimates of suitability. We assume that only a relatively small proportion of clients — interviews carried out by Commission with bank-based and independent advisers, and also a consumer representative group indicated that 5–10 per cent would be a reasonable response rate to expect. An association of independent advisers indicated to the Commission that the necessary review of circumstances would take at least 90–120 minutes per client. However, in some proportion of cases it would be recommended by the adviser that some re-balancing of the investments should be done. Assuming that this was agreed

to by the client and was executed by the adviser then this would generate revenue for the adviser and would pay for the time spent in reviewing the on-going suitability of the investments. Taking into account these two factors, we believe that the proportion of total clients requesting a review (by identifying a change in circumstances) but not requiring a change in the investments made (i.e. the net effect of the changes was not significant) may be 2.5–4 per cent. The implied on-going cost would then be €42–€100 million for the whole of the EU, or €17.75 million for the UK.

103. **Excluding municipalities and local public authorities from list of eligible counterparties and professional clients per se:** In the UK, municipalities are already restricted from trade in OTC derivatives. Moreover, local authorities are able to request treatment as a professional client subject to certain criteria. The Treasury does not expect any costs to be accrued from this action, and is working closely with representatives of local government and the Financial Conduct Authority in order to make sure that this is the case.

104. **Reinforce information obligations when providing investment services in complex products and strengthen periodic reporting obligations for different categories of products, including when eligible counterparties are involved:** The Commission assumed that the community of investor relevant to this policy option were largely "high net worth" investors. The UK accounts for roughly 25% of the European population. The Commission estimated that the one-off cost would be €114.5 million, and ongoing costs would be €24.1 million. Along with familiarisation costs, this would be based on the development of risk-gain profiles and the related marketing materials costs. The Commission assumed that the time required for this would be less than a day per product for a compliance official. Taking 25% of these costs leads to one-off costs to UK firms of €28.625 million, and €6.025 million of ongoing costs.

105. **Ban inducements in the case of investment advice provided on an independent basis and in the case of portfolio management:** MiFID II changes the existing inducement provisions in two key ways. Firstly, it will extend current restrictions on inducements from investment advisors to include portfolio managers. This will prohibit, for example, individual broker-dealers, who provide access to markets, from inducing investment managers to use their firm's services to execute trading orders. Secondly, it will more tightly define what constitutes quality enhancement which enables an inducement to be accepted. The FCA, consistent with its current approach, will continue to prohibit firms from accepting and rebating inducements to retail clients, as well as prohibiting accepting and retention. However, the Commission expected all costs to the UK to have already been triggered by the 2010 Retail Distribution Review, so the increase in costs to the UK to be negligible. HMT concur with this analysis.

106. **Require trading venues to publish information on execution quality and improve information provided by firms on best execution:** An obligation on trading venues to publish data regarding execution quality would require labour costs to create systems or to at the trading venue concerned which the Commission estimated as amounting to €150,000 per venue one-off and as €50,000 per venue on an on-going basis. This was based on direct conversations with trading venues. The UK has 118 MTF and 13 Regulated Markets. This implies €19,650,000 one off costs, and €6,550,000 ongoing costs. Firms' execution policies are already required to be reviewed on an annual basis, and common market practice is to review them more frequently.

107. **Reinforce the functioning of internal control functions when launching new products and services:** The Commission estimated that this universal requirement would impose a requirement for each firm to allocate two working days of a compliance office for the re-assessment of protocols for the launch of new products resulting in an incremental one-off cost of €5m. It is appropriate for the proportion of the wholesale financial market to be used to granularise this cost, leading to a cost to UK firms of €1.8 million.

108. **Require specific organisational requirements and procedures for the provision of portfolio**

management services: The Commission anticipated that firms providing these services would need to carry out a review of existing client handling protocols that would likely take two or three days translating into a one-off EU wide cost of €2.8-4.2m. The European Fund and Asset Management Association (EFAMA) estimates that the UK accounts for 37% of the European portfolio management industry, which suggests estimated one-off costs for the UK of €1.295 million.

109. Require specific organisational requirements and procedures for the provision of underwriting services: Insurance Europe estimate that the UK accounts for 21.2% of the EU insurance market. The Commission estimated one-off costs of €9–€22 million, resulting from the necessary review of existing procedures by firms' personnel. This implies a one-off UK cost of €3.286 million.

110. Introduce a common regime for telephone and electronic recording: The UK already has relatively stringent taping requirements for financial firms. In order to bring the standards up to the level required by MiFID II, the FCA estimated in their consultation paper CP16-29 that there would be one off costs ranging from £5.7 million to £8.6 million, and ongoing costs ranging from £5.4 million to £8.2 million. Taking the midpoints of these estimates yields £7.15 million for one-off costs, and £6.8 million for ongoing costs.

Delegated directives and regulations

111. The Commission impact assessment was conducted only on the main directive and regulation, rather than any delegated directives or regulations. It was subsequently augmented with two delegated regulations and one delegated directive. As the delegated regulations apply directly in the UK, HM Treasury will not cost them. Similarly, as the delegated directive will be transposed into FCA rules rather than into secondary legislation, this will be costed by the FCA rather than in this impact assessment.

Changes between the 2011 and 2016 text

112. The Commission impact assessment was conducted only on the 2011 version of the text. There were some changes between the 2011 and 2016 versions of the text. The Treasury is satisfied that there were no material cost changes associated with these drafting changes, given how the Commission produced their impact assessment, and that there is no need to update the impact assessment in light of this.

FCA direct costs

113. The FCA are implementing MiFID II, MiFIR and the Market Abuse Regulation (MAR) through a combined programme. As with all FCA expenditure, the costs of this programme will be funded via industry levy, so the costs will fall on firms. Internal FCA estimates- as reported in the minutes of the discussion of the outline business case for the MiFIDII/MAR programme at the March 2016 FCA Board– suggest that they will spend between £47.8 million and £60.6 million on implementation costs, £28 million of which will be spent externally. Taking the midpoint of the two bounds gives a figure of £54.2 million. Given the overlap between the enforcement of MiFID and MAR, the FCA have not broken down the relative costs between the two. However, with MiFID II and MiFIR being far more extensive in scope than MAR, a prudent estimate would suggest that at least 90% of this expenditure would exist without MAR. As such, we estimate that there is **£48.8 million** FCA spend associated with MiFID II implementation.

Assumptions

114. The following cost assumptions were used by the European Commission. These were tested with

industry by the European Commission, and the Treasury believe that the figures are reasonable. The initial 2011 cost in € has been converted into 2017 cost in sterling, adjusting for the exchange rate and inflation.

Cost type	**2011 Costs, €, Annual**	**2017 Costs, £, Annual**
IT worker	100,000	**97,965**
Compliance and back office worker (mid-ranking)	60,000	**58,779**
Compliance and back office worker (senior)	100,000	**97,965**
Portfolio managers	125,000	**122,457**
Transaction Reporting (low)	100,000	**97,965**
Transaction Reporting (high)	125,000	**122,457**

Testing with stakeholders

115. The Commission engaged extensively with stakeholders during the production of the impact assessment, through several ad hoc and organised meetings with representatives of market participants, public authorities, and others. Six targeted roundtables were organised and a large and well-attended public hearing was held over two days. The public consultation received over 4200 contributions.

116. Amongst others, the Commission consulted with the following market participants, organisations or trade associations in the production of the Impact Assessment:

The Association for Financial Markets in Europe; European Federation of Energy Traders; the European Fund and Asset Management Association; EuroPEX; Tradeweb; London Energy Brokers' Association; Thomson Reuters; ICE Futures Europe; the Alternative Investment Management Association; the London International Financial Futures and Options Exchange (NYSE Euronext); Committee of European Securities Regulators; Euroinvestors; Markit; International Emissions Trading Association; International Capital Market Association; European Climate Exchange; European Banking Federation; European Regulators' Group for Electricity and Gas; London Stock Exchange Group; Morgan Stanley; ICAP; Bloomberg; FESE; Getco; Optiver; Federation of European Securities Exchanges; International Algorithmic Trading; BATS-Chi-X; European Association of Co-operative Banks; and Liquidnet.

117. The Government also engaged extensively with stakeholders during the transposition of MiFID II. The Treasury ran a public consultation on the transposition of MiFID II which opened on 27 March 2015 and closed on 18 June 2015. In particular, this invited feedback on its consultation impact assessment. Over 30 market participants and trade associations responded to the document. No respondent objected to the methodology or the costs estimated by the impact assessment.

118. The government also engaged with the Financial Conduct Authority in order to draw on their knowledge and assumptions about the estimated number of firms currently operating in the UK, and expected to be authorised under MiFID II.

Benefits

119. The benefits of MiFID II can be considered to predominately accrue indirectly to market participants. Three key areas of benefits are set out below.

120. *Market structure and transparency*. Increased trade transparency in non-equity markets should, if appropriately calibrated under the Level 2 measures currently under development, support more efficient price formation, increased competition amongst liquidity providers and more information for investors. Increased trade transparency may have the benefit of reducing transaction costs (as set through bid/offer spreads). For example, studies of the introduction of post-trade transparency requirements in the US through the Trade Reporting and Compliance Engine (TRACE) have found

evidence of reduced transaction costs post-implementation. Given differences in market structure, we have not attempted to use such studies to provide estimates of monetised benefits for the UK.

121. The introduction of a consolidated tape in both equities and non-equities should support this outcome.

122. The trading obligation in respect of derivatives may provide scope for operational efficiencies where there are currently traded bilaterally (or over-the-counter) and will in future trade on trading venues, where efficiencies of scale may be realised.

123. The introduction of a specific regulatory architecture for SME markets would be likely be an increased access to financial markets for SMEs leading to a reduction of their cost for capital.

124. *Investor protection.* These requirements include placing information obligations on investment firms when offering investment services in complex products, enhanced information to be published by trading venues on execution quality and information given to clients by firms on best execution.

125. The European Securities and Markets Authority (ESMA)'s qualitative CBA stated that improved best execution could have significant benefits to investors in terms of reduced costs of trading. It also suggested that the data required under MiFID II come at a low cost to trading venues and brokers where based on data they already have access to.

Authorisation and Operating Conditions

126. ESMA's high-level cost-benefit analysis of the draft technical standards mentions as potential benefits from these type of organisational requirements greater market resilience and integrity. This may in turn lead to greater confidence in financial markets and a greater willingness to trade – enhancing liquidity and possibly reducing the costs of capital.

Direct costs and benefits to business calculations (following OIOO methodology)

127. As this measure involves the implementation of an EU Directive, it does not need to be counted as part of one-in, two-out. However in line with the Government's objectives, it is seeking to minimise the impact on industry where possible.

Wider impacts

Equalities Impact

128. The Government has considered its obligations under the Equality Act 2010 and does not believe these measures will impact upon discrimination, equality of opportunity or good relations towards people who share relevant protected characteristics under that Act.

Impact on small firms and micro-businesses

129. MiFID II will have an effect on small firms and micro-business's to the extent that they are investment firms or otherwise caught. These firms will be required to comply with the authorisation and regulatory requirements as prescribed by MiFID II. However, this burden is in many instances mitigated by the ability to apply the regulatory requirements in a proportionate manner to the business conducted.

Impact on competition

130. MiFID II seeks to increase and deepen competition in a number of financial markets. It will seek to increase economic efficiency gains and drive lower transaction and execution costs for investors. In particular, it will increase transparency in the equity and non-equity markets and drive competition amongst providers of clearing and settlement infrastructure.

Environmental, social and development impacts Impact

131. The Government does not anticipate any impact upon greenhouse gases, wider environmental issues, health and well-being, human rights, the justice system, rural proofing and sustainable development.

Conclusion

132. The UK achieved its key objectives in the negotiations of MiFID II, and, while it has costs to business as set out in this impact assessment, the Treasury believe that it is necessary for the effective functioning of financial markets. The government will transpose MiFID II as part of its obligations under membership of the European Union.