Kern Alexander / Alexandra Schmidt*

The Market in Financial Instruments Directive and Switzerland

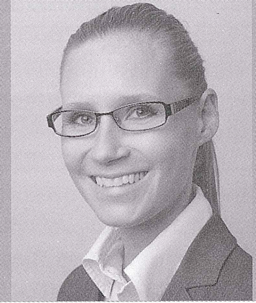

Table of contents

I. Introduction
II. Regulation of cross-border relations
1. The EU perspective
2. The Swiss perspective
III. The scope of prudential supervision
IV. Regulation of exchanges and alternative trading venues
V. Rules governing the relationship between firms and investors
1. Rules of business conduct
2. Organisational requirements
3. Client classification, suitability and appropriateness test
4. «Best Execution»
5. Inducements
VI. MiFID II – Creation of a more transparent and robust European single market
VII. How does MiFID II affect Switzerland?
VIII. Conclusions

I. Introduction

The Market in Financial Instruments Directive (MiFID) has brought sweeping changes to the regulation and operation of securities markets in the European Union. The European Commission has proposed amendments to MiFID – known as MiFID II[1] – which expands its coverage to a broader range of financial instruments and trading facilities and addresses some of the systemic risks that threaten securities markets. Switzerland is not a member of the European Economic Area (EEA) and therefore is not obliged to implement EU legislative requirements such as MiFID. Swiss securities and investment firms, however, are subject to certain MiFID requirements involving their cross-border activities in European Union states. These legal and regulatory pressures are similar to the effect of US and EU banking and regulatory law and the OECD standards[2] restricting bank secrecy and requiring the disclosure of tax information. Since cross-border financial services represent a significant part of the activities of Swiss financial firms, MiFID II will have an important effect on the risk management and compliance strategies of Swiss financial firms. This article analyses and compares the dynamic regulatory processes of MiFID and MiFID II to Switzerland's «made in Switzerland» approach to securities trading regulation. It then reviews and compares MiFID II's proposed amendments that expand the MiFID regime to a broader array of financial instruments and trading facilities and assesses the implications for Swiss financial firms.

II. Regulation of cross-border relations

1. The EU perspective

MiFID creates a single market for securities trading within the European Union. Once an investment firm or bank domiciled in an EU/EEA state has been approved by its *home member state*, it can provide its services through cross-border branches or by cross-border sales in all EU/EEA member states[3]. This so called «European Passport-System» does not apply to branches of Swiss financial institutions offering investment services

* Prof. Dr. Kern Alexander, Professor of Banking and Financial Market Law, University of Zurich, Member of the European Parliament's Expert Panel on Financial Services and Senior Research Fellow in Financial Regulation at the Centre for Financial Analysis and Policy at the University of Cambridge, and lic. iur. Alexandra Schmidt, research assistant at the Institute of Law of the University of Zurich.

1 MiFID II; European Commission proposal for a directive of the European Parliament and of the Council on markets in financial instruments repealing Directive 2004/39/EC of the European parliament and of the Council, Brussels, 20.10.2011 and proposal for a Regulation of the European Parliament and of the Council on Markets in Financial Instruments and amending the draft Regulation on Market Infrastructure (EMIR) on OTC derivatives, central counterparties and trade repositories, Brussels, 20.10.2011; http://ec.europa.eu/internal_market/securities/docs/isd/mifid/COM_2011_652_en.pdf and http://ec.europa.eu/internal_market/securities/docs/isd/mifid/COM_2011_656_en.pdf (visited on: 1.12.2011). The Organisation for Economic Cooperation and Development (OECD) put pressure on Switzerland to loosen its bank secrecy laws and to implement article 26 of the OECD-standards on administrative assistance in tax matters. For more extensive information: Sethe, ZBB 2011, 109/110.

2 The Organisation for Economic Cooperation and Development (OECD) put pressure on Switzerland to loosen its bank secrecy laws and to implement article 26 of the OECD-standards on administrative assistance in tax matters. For more extensive information: Sethe, ZBB 2011, 109/110.

3 cf. Article 31 f. MiFID.

in EU/EEA member states. They have to apply individually for an authorisation from the supervisory authority of the EU/EEA *host country* where they would like to offer investment services or conduct trading activities. Once they are authorised by the host state authority, the branch or subsidiary can expand its business activities into other EU/EEA member states without any further authorisation so long as they comply with MiFID standards and procedures and any other applicable EU legislation that applies to their activities which are passportable to other EU/EEA states.

Swiss firms with EU/EEA[4] domiciled branches or subsidiaries already have to implement the other EU financial services rules. A Swiss financial group might even consider it more efficient to adopt EU standards across the group in order to harmonise their internal compliance and risk management because, pursuant to MiFID, EU seated investment firms have to ensure that every third party firm / venue with whom they might deal abides specifically with MiFID rules, especially MiFID's overarching principle of «best execution»[5]. MiFID's cross-border application raises similar compliance issues as that of other EU laws such as the Lugano-convention, which provides a mandatory forum at the domicile of the client or customer if there is litigation between a Swiss firm and a European retail client[6].

The proposed 2011 amendments to MiFID – known as «MiFID II» – aim to create a harmonised regulatory framework and market access for the provision of cross-border investment services by third country financial firms into the EU. As a condition for granting such market access, MiFID II requires non EU/EEA-based firms which want to transact with EU eligible and professional counterparties to register with the European Securities Markets Authority (ESMA). In order to be registered with ESMA, the third country regulatory regime of the foreign firm would «*have to be deemed to have equivalent effect to EU law*» (the «equivalence-decision») and to have concluded an appropriate cooperation agreement between ESMA and the third country regulatory authority[7]. Until now, wholesale financial services can only be offered to EU-clients, if the non-EU firm maintains an authorised branch or subsidiary in the European Union. Therefore, Swiss financial service providers like banks and investment firms with a registered office in Switzerland generally cannot just offer their services cross-border to EU investors. They have to establish a subsidiary in an EU/EEA state in order to expand their business into other EU/EEA states[8]. UBS adhered to this approach in 2010 by establishing under the MiFID rules a multilateral trading facility (MTF), UBS MTF Ltd., incorporated as a subsidiary under English law with its seat in London[9]. By contrast, under MiFID II, it will still be the case that if a firm intends to provide financial services to *retail clients* the establishment of a branch or subsidiary in an EU member state would be necessary, which then of course is subject to authorisation and supervision in the European Union[10].

2. The Swiss perspective

The Swiss approach towards the provision of investment services of foreign firms on the domestic market is different from the EU approach. Switzerland has taken a relatively liberal stance towards cross-border activities of foreign financial service providers and basically relies on the principle of *home country control.*

Only if a foreign bank, investment firm or asset manager wants to maintain a physical presence in Swiss territory or if a securities dealer wants to become a remote member of a Swiss exchange[11] a licence would be required from the Swiss regulator – the Financial Markets Supervisory Authority (FINMA) – and the bank or firm in question would then be subject to Swiss regulations[12].

If a Swiss bank or a Swiss securities dealer wants to establish a foreign subsidiary, a branch or a representative office, this must be notified to and approved by FINMA. The banks' or securities dealers' organisation and geographical business scope is then required to be aligned

---

4 Throughout the article, when we refer to «EU» states, we also mean «EEA» states.

5 cf. article 21 (3) MiFID; MiFID II; European Commission; Proposal for a regulation of the European Parliament and of the council on markets in financial instruments and amending regulation [EMIR] on OTC derivatives, central counterparties and trade repositories (Text with EEA relevance); 2011/0296 (COD), Brussels, October 20, 2011, p. 21, http://ec.europa.eu/internal_market/securities/docs/isd/mifid/COM_2011_652_en.pdf (visited on: 15.12.2011) (cited as «MiFID II proposal (regulation)»).

6 Under the Lugano Convention, the applicable law would be the law of the retail client bringing a claim «if the banks provision of service has been designed to be rendered at the domicile of the client». cf. article 15 and 16 of the Lugano-Convention (updated May 2011).

7 MiFID II; European Commission; Proposal for a directive of the European Parliament and of the council on markets in financial instruments repealing Directive 2004/39/EC of the European Parliament and of the council (Recast); 2011/0298 (COD); Brussels, October 20, 2011 http://ec.europa.eu/internal_market/securities/docs/isd/mifid/COM_2011_656_en.pdf (visited on: 15.12.2011) (cited as «MiFID II proposal [directive]»), p. 9; MiFID II proposal (regulation) (FN 5), p. 12.

8 Swiss Confederation; Report of the Federal Assembly answering the postulate Graber; Strategic direction of impact of the Swiss financial market policy; as per December 16, 2009, p. 47 http://www.efd.admin.ch/dokumentation/zahlen/00578/01622/index.html?lang=de (visited on: 15.12.2011) (cited as «Report of the Federal Assembly (2009)»).

9 UBS announced in 2010 that Dr. Robert Barnes, Managing Director of UBS Investment Bank, London, would be the first CEO of UBS MTF.

10 MiFID II proposal (directive) (FN 7), p. 9; MiFID II proposal (regulation) (FN 5), p. 12.

11 i.e. EUREX Zürich AG (the Swiss derivatives exchange partly owned by Deutsche Börse (80 %) and SIX (20 %), Scoach Schweiz AG or SIX Swiss Exchange AG.

12 cf. article 2 (1) BA; article 39 SESTO and article 2 OPFI.

with its *corporate purpose, its financial resources and its internal organisation*. Further, the securities dealer has to notify FINMA if it intends to become a member of a Swiss or a foreign exchange[13]. FINMA's supervision of outbound cross-border activities is based on the two cornerstones (A) the *fit and proper test*[14] and (B) the requirement to implement *an adequate organisation*[15]. Essentially, the bank or the investment firm is required to guarantee that it has an irreproachable business conduct (fit and proper test) and to implement a risk management system (adequate organisation) that enables it to monitor all types of risks like credit, market, settlement, liquidity, reputation risks, as well as operational and *legal risks*[16].

Pursuant to FINMA's recent practice[17] the area of legal risks contains an obligation for the bank or securities dealer to verify its compliance with the rules prevailing in the foreign jurisdictions in which they operate. For that purpose, a conduct of service model compliant with the regulations in the respective host country has to be implemented and documented in a way that it can be reviewed by the auditors or the regulator[18]. If the financial firm does not satisfy these requirements, FINMA will be forced to impose corrective measures or even to withdraw the firm's license[19].

The fact that some domestic financial providers have recently been under suspicion of not complying with rules governing markets where they have cross-border relations has led FINMA to monitor those activities more closely. FINMA has expressed the view that the cross border business of Swiss financial service providers will be under ongoing supervision in the near future and that all related legal and reputation risks shall be appropriately covered, limited and monitored because of their imminent risk potential for single institutions as well as for the economy as a whole[20].

III. The scope of prudential supervision

The main acts of Swiss financial market regulation[21] and supervision are conceptualised as framework laws implemented through various ordinances, enactments, circulars and bulletins issued by FINMA and with self-regulatory rules[22] issued by self-regulation organisations[23]. Similar to MiFID and other EU investment services legislation[24], Swiss law requires that in order to manage or operate an exchange or a bank, or to act as securities dealer or to manage a collective investment scheme, an authorisation by FINMA is required[25]. But contrary to MiFID, investment advice[26] and asset management activities are not subject to public regulatory law and can be provided without prior approval except if these activities are integrated or offered from within a banking or securities dealers' business (which is most often the case). The issue of whether these (few) market participants carrying out investment advice or asset management activities outside of regulated banking institutions or securities dealers shall be equally supervised has attracted much debate but resulted in no change to the law. The current approach clearly is at odds with the regulatory principles of a functional and competitive-neutral financial regulation, investor protection and the aim of creating a level playing field among market participants[27]. Opponents argue, on the other hand, that the existing scheme gives to the financial service provider, as well as to the client, the option to choose the level or extent of supervision they deem sufficient by weighing the benefits of investor protection against the additional costs of further supervisory compliance[28].

---

13 cf. article 3 (2), 7 (3) and 3 (7) BO and article 18 (3,4,5) SESTO.
14 cf. article 3 (2) (c) BA and article 10 (2) (d) SESTA.
15 Shelby R. Du Pasquier/Philipp Fischer; Cross-border financial services in and from Switzerland – Regulatory frameworks and practical considerations, GesKR – Gesellschafts- und Kapitalmarktrecht (2010), p. 450 f., Dike Verlag AG.
16 cf. article 9 (2,3) BO and article 18 (3) and 19 (3) SESTO.
17 cf. FINMA Position Paper on legal and reputational risks in cross-border financial services, 22. Oct. 2010.
18 cf. article 9 (3) BO; and FINMA Position Paper on leagal and reputational risks in cross-border financial services, 22. Oct. 2010.
19 cf. article 37 FINMA Act. Even tough, the Federal Act on the Swiss Financial Market Supervisory Authority (FINMASA) does not state an obligation of Swiss firms to abide foreign regulation when operating cross-border a violation of such provisions could be considered to be contrary to the duty of proper business activities.
20 cf. FINMA Position Paper on risks in cross-border financial services, 22. Oct. 2010.

21 Act on Stock Exchanges and Securities Trading (SESTA), Banking Act (BA), Act on the Swiss Financial Market Supervisory Authority (FINMASA) and Collective Investment Schemes Act (CISA).
22 e.g. listing rules of the SIX exchanges and the Code of Conduct for Securities Dealers of the Swiss banking association.
23 cf. FINMA-circular 2008/10 p. 4 f. (Rules of the Swiss Banking Association).
24 Undertakings for collective investment in transferable securities directive 2001/107/EC and 2001/108/EC.
25 cf. article 3 (1) and 10 (1) SESTA; article 3 (1) BA and article 13 (1) CISA.
26 Especially bank-external investment advisers.
27 IMF; International Monetary Fund; Switzerland: Financial System Stability Assessment, including Reports on the Observance of Standards and Codes on the following topics: Banking Supervision, Securities Regulation, Insurance Regulation, Payment Systems and Monetary and Financial Policy Transparency; IMF Country Reports; Nr. 02/108, 2002; http://www.imf.org/external/pubs/ft/scr/2002/cr02108.pdf (visited on 2.12.2011); (cited as «IWF [2002, p. 9 no. 18]») and Group of Experts on Financial Market Regulation and Supervision, under the chairmanship of the Fribourg Professor Jean-Baptiste Zufferey, Financial Market Regulation and Supervision in Switzerland, Federal Department of Finance FDF; November (2000, p. 14); http://www.efd.admin.ch/dokumentation/zahlen/00578/00854/index.html?lang=de (visited on: 2.12.2011).
28 Group of Experts Zimmerli; III. Partial report of the Groups of Experts appointed by the federal assembly on the Extension of the prudential supervision; Federal Department of Finance; February 2005, p. 14; http://www.efd.admin.ch/dokumentation/zahlen/00578/00891/index.html?lang=it (visited on: 2.12.2011).

Personal, organisational and capital requirements which have to be fulfilled by Swiss financial service providers in order to obtain authorisation are very similar to those demanded under the MiFID regime. But while MiFID implies more extensive organisational requirements on self-dealing and conflicts of interest, the Swiss rules, in addition, contain provisions on accounting standards and risk diversification and require a sounder capital basis[29]. In general, it can be said that the authorisation requirements are more or less the same, even if MiFID's provisions are more detailed than the Swiss requirements containing only general principles which have to be further defined by FINMA or by implementation rules of self-regulation organisations.

IV. Regulation of exchanges and alternative trading venues

FINMA is responsible for issuing operating licences to stock exchanges[30] and bodies similar to stock exchanges[31]. Prudential regulation[32] only contains the basic requirements for authorisation of individual firms, whilst detailed code of conduct provisions are established by the self-regulation rules of the respective exchange or trading facility[33]. In sum, in order to obtain authorisation they must be organised in such a way as to ensure they can provide operational, administrative and monitoring functions that are appropriate to their activities[34]. The Swiss Federal Assembly has delegated substantial discretion to FINMA to decide whether or not a body similar to a stock exchange fulfils certain criteria and should fall under its prudential regulation and supervision[35]. Significantly, the Swiss market has a prudential regulatory rule regarding concentration limits on shares listed and traded on the SIX Exchange; that shares can be traded only *on exchange* during trading hours if the trade does not exceed a value of CHF 200'000[36].

If a stock exchange from another country wants to provide Swiss securities dealers with remote access, it has to be approved by FINMA. In order to achieve this approval the concerned stock exchange has to be authorised and supervised by the foreign competent authority (also here, the Swiss market relies on the home country control of the foreign state). Even with a view to the handling of bodies similar to stock exchanges entering the Swiss market from Europe (e.g. multilateral trading facilities under MiFID) FINMA has been given great flexibility to decide individually if such an entity should fall under Swiss law and supervision wholly or partially especially with a view to issues like investor protection, transparency, equal treatment or protection of the functioning of the market[37].

V. Rules governing the relationship between firms and investors

The most distinctive difference between the Swiss rules governing the contractual relationship between investment firm and client and the MiFID rules is the fact that in Switzerland the law governing the relationship is the private civil law, particularly the principles of the law of mandate[38] of the Code of Obligations, whereas the MiFID legal duties provide regulatory standards, rules and public law principles. Under the Swiss approach, the nature of the legal duties owed and practice customs have been developed through extensive litigation and court practice and by professional standards established by self-regulation organisations[39].

1. Rules of business conduct

The rules of business conduct under MiFID are detailed and generally state that the investment firm has to act honestly, fairly and professionally in accordance with the best interests of its clients. Beyond that, MiFID contains

---

29 Minimal capital requirements: Swiss banks CHF 10 Mio. (art. 4 BA); Swiss securities dealers CHF 1.5 Mio. (art. 22 SESTO); Swiss administrators of collective investment schemes CHF 200'000 (art. 19 CISO). In contrast MiFID resp. CRD 2006/49/EC requires a capital basis of min. EUR 50'000 or an insurance sum up to 1.5 Mio. varying for the different businesses conducted.

30 Three authorised domestic stock exchanges stand under the overall supervision and monitoring of the Swiss financial market authority FINMA (SIX Exchange, Scoach and Eurex the Swiss derivatives and commodity exchange (the last two are joint ventures between the SIX Group and Deutsche Börse AG).

31 So far, FINMA partially regulates the ICMA the International Capital Market Association in Zurich, active in international bond trading and the BX Berne eXchange as «bodies similar to stock exchanges».

32 cf. article 3 ff. SESTA.

33 e.g. listing rules of the SIX exchange.

34 Including adequate organisation for trading, regulating the authorisation of securities firms and the listing of securities, a complaints procedure and direct and efficient trade monitoring (price creation and execution and settlement of trades). Link: http://www.finma.ch/e/finma/taetigkeiten/maerkte/pages/boersenaufsicht.aspx.

35 cf. article 3 (4) SESTA and article 16 SESTO.

36 Since August 2008, the SIX Exchange offers institutional investors the opportunity to trade big blocks of Swiss securities of the SMI-Index away from the public eye over the new electronic trading platform «Swiss Block» (a so-called «dark pool»). The trading venue complies with Article 5 SESTA and with MiFID's reference price pre-trade transparency waiver. Post trade transparency is granted; all executed trades have to be reported to the SIX Exchange. The trading venue is supervised and monitored by SIX Swiss Exchange, which in turn is supervised by FINMA. Link: http://www.parlament.ch/d/suche/seiten/geschaefte.aspx?gesch_id=20093898.

37 http://www.finma.ch/d/finma/taetigkeiten/gb-maerkte/Seiten/boersenaufsicht.aspx (visited on: 28.11.2011).

38 cf. article 394 ff. Code of Obligations (CO).

39 Urs Bertschinger; Sorgfaltspflichten der Bank bei Anlageberatung und Verwaltungsaufträgen; Schweizer Schriften zum Bankenrecht Band 9; Schulthess Polygraphischer Verlag, Zürich (1991, p. 47 ff.) and BGE 132 III 460.

comprehensive information disclosure obligations[40]. In Switzerland the rules of business conduct are framed by the principles outlined in article 11 of SESTA, defining the duties of providing information, diligence and loyalty, and article 398 (2) of the law of mandate of the Code of Obligations, which states that the agent has to act faithfully and diligently. This is complemented by self-regulatory rules that include the Code of Conduct for Securities Dealers, the Agreement on the Swiss banks' code of conduct and the Portfolio Management Guidelines of the Swiss Banking Association[41]. The provisions of MiFID on business conduct are far more detailed than the Swiss provisions but the overall substantive content is more or less the same.

2. Organisational requirements

MiFID requires investment firms to establish adequate policies and procedures sufficient to ensure compliance of the firm including its managers, employees and tied agents with its obligations under the directive to achieve best execution respectively involving third parties and reducing conflicts of interest[42]. The Swiss federal law provisions around organisational requirements constitute a very similar approach. In order to get the authorisation from FINMA, the Swiss securities dealer has to be appropriately organised to achieve a functional separation between trading, asset management and settlement and to implement a proper risk supervisory system especially with respect to risky transactions. Furthermore, as under MiFID, financial intermediaries are obligated to install an *internal control system* which shall facilitate the surveillance of firm compliance with the organisational requirements, the information obligations and the duty of care and loyalty[43].

3. Client classification, suitability and appropriateness test

MiFID states that the bank or investment firm is required to classify its clients[44] and to carry out a suitability and appropriateness tests for each client depending on its categorisation before the provision of any investment services[45]. Therefore, the investment firm has to collect detailed data on the financial circumstances, the knowledge and the investment experience of the client in order to understand which financial products or services would be most appropriate. Based on this evaluation, the firm has to determine whether the product is suitable and appropriate for each type of client. A duty of client classification does not exist in the same form in Switzerland. The Swiss Federal Court has ruled: «*that it is not within the scope of the security dealer's duty of information to assess the financial circumstances of a client and to appraise whether a transaction is suitable for an individual client*»[46]. Still, based on article 11 (2) SESTA, the duty of care of the law of mandate and of the «know your customer rule» of the anti-money laundering regulations, Swiss investment firms are nevertheless bound to take into account the clients' business expertise and professional knowledge and have to establish a client profile which then serves as a benchmark for the diligence required under the law of mandate[47]. So, contrary to MiFID, the Swiss law leaves it to self-regulation rules and court practice to substantiate this duty.

4. «Best Execution»

MiFID contains very detailed requirements concerning best execution, its overarching investor protection principle. Best execution under MiFID means that «investment firms have to take all reasonable steps to obtain, when executing orders, the best possible result for their clients. In doing so, they have to take into account the execution factors, including price, speed, likelihood of execution and settlement, costs, size and nature of the order». On this basis, investment firms are requested to establish a written policy and to build a risk-based model that implements its best execution obligation. The policy and model should provide information to the regulator about the different venues where the investment firm executes its client orders and based on the relevant execution factors determine which venues are most appropriate for particular clients. For example, some clients place a greater importance on executing smaller value but high volume trades on venues which provide the lowest trading costs, whilst other firms place a greater importance on executing larger value but lower volume trades on venues which provide greater liquidity support through market makers. The needs of most clients will vary and therefore the definition of best execution will also vary from client to client based on the application

[40] cf. article 19 MiFID.

[41] Code of Conduct for Securities Dealers 2008, Swiss Bankers Association; Agreement on the Swiss banks' code of conduct with regard to the exercise of due diligence (CDB 08); http://www.swissbanking.org/en/20080410-vsb-cwe.pdf (visited on: 2.12.2011), Swiss Bankers Association; Portfolio Management Guidelines 2010; http://www.swissbanking.org/en/20100504-3200-all-rl_vermoegenswervaltungsauftrage_web-cwe.pdf (visited on: 2.12.2011).

[42] cf. article 13 (1-10) and 18 MiFID.

[43] cf. article 19 and 20 SESTO.

[44] Into the three categories of eligible counterparties, professional clients and retail clients.

[45] cf. article 19 (4, 5) MiFID.

[46] Han-Lin Chou/Martin Hess; MiFID – Challenge for Swiss investment firms as well?; sponsored editorial by Wenger & Vieli attorneys at law, and BGE 133 III 97.

[47] Rolf Watter/Nedim Peter Vogt (ed.); Commentary on the Stock Exchange Act and the Financial Market Authority Act (FINMA-Act); Helbling & Lichthahn, Basel (2011, article 11 no. 44 et seq.).

of execution factors that determine which venue is most appropriate for the client[48]. As a result, the obligation to provide best execution will vary from firm to firm and depend on the nature of the firm's business and its trading needs. The firm is required to build a model containing data regarding its trading costs – or probable trading costs – on different venues and to weigh its assessment of trading costs with other relevant execution factors such as the speed by which it can execute trades and the venue's liquidity capacity and ability to absorb high value trades without substantial impact on prices. These are all relevant factors which must be taken into account in each firm's model, and the model must be approved by the home state regulator.

In contrast, the Swiss requirements regarding the execution of client orders are simpler and worded in a more general manner as follows:

> *The securities dealer must execute the securities transaction on a generally recognised execution venue where proper handling in terms of execution is ensured. In general, the best execution principle provides that the securities dealer must execute client transactions without delay, completely and at the best possible market price, taking into account any limits, special instructions and reservations specified by the client. In the absence of any particular client instructions the securities dealer is deemed to have satisfied the duty of diligence by executing the securities transactions on the local stock exchange (or the local OTC market) on which the securities dealer usually transacts, or on the domestic stock exchange (or the domestic OTC market) for the respective security, or on another market with the appropriate liquidity. Securities transactions may also be executed on Multilateral Trading Facilities or via other authorized brokers and other liquidity providers if a proper order execution is warranted and the required liquidity exists*[49].

The investment service provider, therefore, does not necessarily have to search for the venue with the best possible results. Only if the financial intermediary systematically and deliberately chooses trading venues which do not offer the best possible result, its actions would be considered contrary to the duty of loyalty under the law of the mandates.

The rules around best execution in MiFID furthermore contain comprehensive reporting requirements and information duties which are unfamiliar to the Swiss Code of Conduct. Also, the MiFID II obligation to publish annual data on execution quality will increase disclosure requirements when it is implemented by member states[50].

5. Inducements

Both MiFID and Swiss rules have the requirement that the *inducement system* shall be conceptualised in a way that it does not hinder the financial service provider from acting in the best interest of the client. Beyond that, MiFID requires that the firm's inducement system should be primarily aimed at enhancing the service provided to the client. Firm incentive payments, such as bonus programmes for employees, do not fall within the MiFID rules (pursuant to CESR practice), nor do the Swiss provisions cover bonus programmes. Otherwise, some Swiss banks with their rather extensive bonus programmes might have a problem with regard to their MiFID compliance[51].

VI. MiFID II – Creation of a more transparent and robust European single market

The European Commission has proposed amendments to MiFID (MiFID II) that are part of a comprehensive overhaul of the EU regulation of securities, derivatives and retail financial products. The MiFID II rules have the objectives of increasing market liquidity, creating orderly pricing and settlement conditions for the trading of securities, derivatives and commodities, and preventing market abuse. Whilst MiFID II mainly focuses on enhancing the regulation of trading of securities and derivatives on exchanges, multilateral trading facilities (MTFs) and other alternative trading venues, other EU legislative initiatives are developing in parallel by addressing the clearing and settlement of securities and derivatives in EU markets and additional restrictions on market abuse. Indeed, some of these initiatives overlap with MiFID II in certain areas. For example, the proposed draft Regulation on Market Infrastructure (EMIR) that requires the clearing of standardised over-the-counter derivatives contracts in clearing houses or central counterparties (CCPs), and which requires that those transactions are recorded in trade repositories. Other initiatives include: the proposed Directive on Packaged Retail Investment Products PRIPS; the review of the Directive on Undertakings for Collective Investment in Transferable Securities (UCITS) or the on-going review of the Market Abuse Directive (MAD II). The main focus of these

48 cf. article 21 MiFID.

49 Relevant to the order execution are article 11 SESTA, article 398 CO and article 5 Code of Conduct for Securities Dealers; Swiss Bankers Association; Code of Conduct for Securities Dealers 2008; http://www.swissbanking.org/en/801908_e.pdf (visited on: 2.12.2011).

50 MiFID II proposal (directive) (FN 7), p. 8.

51 CESR; Committee of European Securities Regulators; Inducements under MiFID – Recommendations; CESR/07-228b; Mai 2007, p. 4 http://www.cmvm.pt/CMVM/Cooperacao%20Internacional/Docs_ESMA_Cesr/Documents/07_228b.pdf (visited on: 2.12.2011).

initiatives lies in enhancing *market transparency* which is believed to reduce systemic risk and market abuse, and to increase market confidence by clients, customers and investors with more relevant information.

MiFID II also aims to improve market integrity and to grant equal rights to trading venues (exchanges or regulated markets, multilateral trading facilities and organised trading facilities) and market participants *which provide the same service to investors* through abolishing differences in their existing organisational regulation and market surveillance. Significantly, MiFID II extends the reporting and disclosure requirements, including pre-trade transparency, of regulated markets and most multilateral trading facilities (MTFs) to all organised trading platforms or trading facilities which offer trade execution services to most third party buying and selling interests. The expanded scope of MiFID II's reporting and disclosure requirements and liquidity support measures is designed to address the differential scope and intensity of regulation that applies to exchanges and MTFs. The European Commission concluded in its consultation on MiFID II that this had a detrimental effect on investor protection, market abuse and competitive regulatory neutrality between trading venues. However, the Commission's review of MiFID and proposed MiFID II has not resulted in regulatory requirements that apply equally to all three types of trading venues. The Commission's long awaited proposal to amend the Market Abuse Directive (MAD II) addresses these gaps somewhat by expanding the scope of market abuse reporting to all three types of trading venues. This has led to further Commission efforts in MiFID II to reduce the differential application of regulatory requirements for different types of trading venues[52].

Furthermore, activities which involve high frequency trading shall be subject to MiFID II and its surveillance system without any exemptions. They shall be obliged to comply with extensive disclosure requirements and to fulfil certain organisational requirements like the establishment of a robust risk control system (e.g. circuit breakers) in order to reduce the imminent threat that their activities could pose to market stability and safety[53]. HFT traders often use strategies which could be very disruptive for the orderly functioning of the market. For example the strategy of quote stuffing, a stock market technique whereby large trades are placed before being promptly cancelled in an attempt to flood the market with quotes that competitors have to process causing them to lose their competitive edge.

MiFID II contains enhanced transparency requirements that are designed to apply uniformly across EU states, so as to strengthen market confidence[54]. In order to achieve the goal of more transparent and robust markets, MiFID II will have a broader scope that will apply to a wider range of market participants and investment products, which were not within the scope of the MiFID regime. Therefore, the scope of MiFID II's transparency regime shall be increased from the present application to only equity products («shares admitted to trading on regulated markets») to include non-equity products like derivatives, bonds, depositary receipts, exchange-traded funds, certificates and similar financial instruments[55]. Existing transparency requirements shall be enhanced and loopholes fostered previously by exemptions shall be closed, thereby capturing under the regulation market participants and investment products *whose activity or features could have a detrimental effect on price discovery and market stability*.

In addition, there are many MTFs operating under the current pre-trade transparency exemptions of MiFID, as dark pools, and have become an important competitive challenge for exchanges. For example, the UBS MTF (domiciled in London) has been among the fastest-growing non-displayed MTFs and broker-operated platforms conducting off-exchange share trading within the last year. Dark Pools do not publish prices in the sense of pre-trade transparency; they are only visible to traders who participate in the system. The advantages of dark pools for institutional investors are that they can trade anonymously, quickly, at low cost and without the risk that the market moves against them. The growth of proprietary algorithmic trading and the fragmentation of the order flow also contributed to the desire to rebuild liquidity pools in areas formerly held by exchanges which serve the needs of institutional/professional investors or even retail investors, while regulators are concerned about fair and equal treatment of investors and the orderly functioning of the market[56]. In fact, under MiFID II, broad discretion is allocated to ESMA to decide whether or not a market participant (i.e., brokerage or trader) or a certain product could still make use of any pre-trade transparency exemptions[57].

Through the creation of the new trading venue category of organised trading facilities (OTFs), MiFID II intends to refine and expand the definition of trading venues that are subject to its regulatory requirements, including bro-

---

52 MAD II; European Commission; Proposal for a regulation of the European Parliament and of the council on insider dealing and market manipulation (market abuse); 2011/0295 (COD), Brussels, October 20, 2011, p. 4 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2011:0651:FIN:EN:PDF (visited on: 15.12.2011) (cited as «MAD II proposal [regulation]»).

53 MiFID II proposal (directive) (FN 7), p. 25.

54 MiFID II proposal (regulation) (FN 5), p. 15.

55 MiFID II proposal (regulation) (FN 5), p. 16.

56 Francis A. Lees; Financial Exchanges – A Comparative Approach; Routledge Taylor & Francis Group, New York and London (2012), p. 42.

57 MiFID II proposal (regulation) (FN 5), p. 17.

ker crossing networks which also act as dark pools. The aim is that all trading on such organised venues (regulated markets, MTFs, and OTFs) shall be fully pre- and post- trade transparent according to consistent requirements. Taking into account the different types of investment products, transparency requirements shall be individually calibrated for each asset class (e.g. equity, bonds and derivatives) and will depend on the type of trading strategies or market models (e.g. order book trading vs. quote driven systems) used, and shall only apply below specific thresholds in order to avoid market impact[58].

The fact that trading on dark pools increased 78 % between August 2010 and August 2011 suggests that investors are worried about the detrimental effects of transparency especially regarding market impact, order size[59] and/or high frequency traders who – in a transparent market – can cause great harm with price distorting strategies[60].

One of the most famous changes in the name of transparency is the implementation of the G-20 proposal *to relocate all organised trading of standardised financial products (namely derivatives)*[61], which until now were traded mainly in off-exchange OTC markets, to regulated trading venues like regulated markets, multilateral trading facilities and organised trading facilities and to clear them in so called central counterparties (CCPs)[62]. The CCP – essentially a clearing house – acts as a buyer for every seller and as a seller for every buyer of securities or other financial instruments. The interposition of the CCP between the counterparties is intended to reduce counterparty credits risks in the financial system and ultimately to control and reduce systemic risk, which can occur by the default of a systemically important counterparty. This aims to bring a large portion of the fast growing non-transparent derivatives market under MiFID II's transparency requirements.

A lot of such OTC derivative products are currently traded over so called systematic internalisers (SIs) because the transparency requirements for them are much lower than those for exchanges and MTFs. Systematic Internalisers are investment firms which execute client orders against their own proprietary capital. The MiFID II proposal provides a *much tightened transparency scheme for SIs especially with view to pre-trade transparency*, which does not only cover shares and equity-like products but also bonds and structured products with a prospectus or which are traded on organised trading venues, emission allowances[63] and – last but not least – *clearing-eligible standardised derivatives* which could also be traded on one of MiFID's organised trading venues. While considering the specialities of every product, *pre-* and post-trade transparency of such OTC trades executed over SIs shall be on a comparable level as if they would be carried out on-venue, thereby promoting price formation and discovery. The SI does not have to declare firm quotes for trades above the standard market size. Only highly specialised and OTC tradable products, which are not eligible to be traded on an organised level because they're traded ad hoc, irregular and/or are above standard market size, shall stay outside this new scheme[64].

The aim of MIFID II is to provide for a suitable range of eligible venues on which these remaining OTC financial products can be traded. Those venues shall also be obliged to fulfil the same organisational and operational requirements that intend to reduce conflicts of interest, monitor trading activity, and ensure pre- and post-trade transparency[65]. Moreover, to minimise the risk of the manipulative use of OTC instruments (especially of credit default swaps (CDS)) the review of MAD intends to state a clear prohibition of market manipulation through such OTC financial products so that *«prohibitions of insider dealing and market manipulation would also apply to any financial instrument not admitted on a regulated market or an MTF or an OTF, but whose value depends on a financial instrument»*[66].

Furthermore, MiFID II intends to capture investment firms and banks which sell their own securities (even if they are not providing any investment advice) and the existing exemptions for market participants which are dealing on their own account shall be restricted to activities which are primarily proprietary or commercial in nature or which do not involve high frequency trading. Moreover, in order to improve transparency and investor protection and to eliminate the detrimental effects of the fragmentation of the market the review aims to enhance the current transaction reporting and data consolidation scheme. Every trade execution will be required to be reported except those with instruments which are not traded in an organised way and whose value does not depend on or cannot have an impact on a financial instrument traded on-venue and therefore cannot be abused for manipulative behaviour. The reported data is required to be stored for a period of five years for

58 MiFID II proposal (directive) (FN 7), p. 7/8.

59 In many lit automated markets, big orders (parent orders) are sliced into smaller sizes by computer algorithms (child orders).

60 http://www.efinancialnews.com/story/2011-09-26/dark-pool-equities-trading-doubles (visited on: 19.12.2011).

61 The difficult decision which derivatives shall be considered to be standardised and clearing-eligible has to be taken by ESMA or the European Commission.

62 MiFID II proposal (regulation) (FN 5), p. 7.

63 In the trading of emission allowances a range of fraudulent practices have occurred. Bringing their trading within the scope of MiFID II would not only enhance the trust in this trading scheme but also help achieving their initial environmental aim: emissions reduction.

64 MiFID II proposal (regulation) (FN 5), p. 17.

65 MiFID II proposal (regulation) (FN 5), p. 19.

66 MAD II proposal (regulation) (FN 52), p. 6/7.

use by supervisory authorities. The stored information must include the identification of the client and of the person responsible for the transaction (or the computer algorithm)[67]. This means that the investment firm has to transmit such information to the venue over which the order shall be executed. The harmonisation and comparability of the gathered data shall be improved through so-called Approved Publication Arrangements (APAs) signed by the market participants and approved by the competent authority. The APA contains binding instructions to the contracting party on which and how market data will be published. This unification of data consolidation is also believed to further facilitate the monitoring of abuses under the Market Abuse Directive (MAD). The creation of a European trade reporting and data consolidation system which would make it possible that the data reported by firms goes directly to ESMA is being considered for the near future[68].

MiFID II also gives the competent authorities of the member states the competence, to temporarily or permanently ban a financial product, a practice or a service, to restrict the trading, advertising or distribution of a financial product or to set up position limits if it is likely to have a detrimental effect on the orderly functioning of the market (market abuse risk), on investor protection or if it is believed to cause systemic risk. In every case the member state has to get an approval for the measure from ESMA, which is responsible for the coordination of the actions taken on national level[69].

Commodities derivatives markets

MiFID II also contains important changes to the regulation of commodity derivatives markets. OTC commodity derivatives were one of the two highest growth categories within the period from 2001 to 2007[70]. If traded on trading venues, such contracts attract a wide array of market players because their price often serves as a benchmark for the underlying natural resource[71]. In order to protect the commodity market from extreme volatilities it is proposed that all trading venues adopt appropriate trading limits and that they provide regulators with information on positions by different types of financial and commercial traders and market participants[72].

MiFID II's proposals imposing trading limits on the commodity markets are strongly opposed by trading firms that claim that such limits could reduce market liquidity and reduce the ability of firms to hedge risk. Others observe that MiFID II may lead to a significant increase in trading costs that could have the effect of eliminating some of the markets for illiquid derivatives products. Lobbying organisations for commodity derivatives groups argue that the rules are designed mainly to appease political pressures to control commodity prices amid concerns that unrestrained speculation has resulted in commodity price inflation, especially with respect to food products and energy.

Trading firms that are at their maximum position limits on the futures exchanges are likely to seek alternative hedges in the exchange-traded fund market that offers exposure to a variety of underlying asset classes, including physical commodities. It is likely that MiFID II's rules that limit a firm's ability to take speculative positions in commodities futures markets will lead some firms to move their trading activities to other jurisdictions where the position limits do not apply. Some trading firms have increased their lobbying efforts to influence ESMA to require that firms report enhanced quality data and to use powers that require firms to establish position management rules with the capacity, under exceptional circumstances, such as market dislocation to set temporary position limits. Under this approach, position limits would be applied only within a position management regime, that is, a rules-based process establish by the individual firm that is approved by the member state supervisor based on ESMA guidelines. This would allow firms to use their own data and risk positions to determine position limits according to a set of principles and guidelines set by ESMA and approved at the firm level by the member state supervisor[73].

In addition, carbon emission allowances have been increasingly abused for fraudulent practices in the recent past and shall therefore be brought within both the scope of MiFID by classifying them as financial instruments and within the new Market Abuse Directive[74] in order to enhance transparency and provide for effective sanctions in the case of a breach of contracts[75].

---

[67] Of course the so gathered data will be subject to strict data protection rules.

[68] MiFID II proposal (directive) (FN 7), p. 9; MiFID II proposal (regulation) (FN 5), p. 10.

[69] MiFID II proposal (regulation) (FN 5), p. 12, 19.

[70] Lees (FN 56), p. 162 f.

[71] Market abuse is also an issue in commodity derivatives markets, especially with respect to spot markets of commodity derivatives. Therefore, MAD II proposes a new definition of inside information for those markets because the current version of MAD may allow information asymmetries connected to those spot markets from which a market participant could benefit by trading on a related derivative market. MAD II proposal (regulation), (FN 52), p. 7.

[72] MiFID II proposal (regulation) (FN 5), p. 3.

[73] For instance, the Futures and Options Association (FOA), the International Swaps and Derivatives Associations (ISDA) have expressed concern at the extent of the position limits set forth in the MiFID rules.

[74] MiFID II proposal (regulation) (FN 5), p. 22.

[75] MAD II proposal (regulation), (FN 52), p. 8.

VII. How does MiFID II affect Switzerland?

What might be the Swiss attitude towards the European approach of creating more stable and safe financial markets through enhanced transparency and product standardisation? In its report on «strategic direction of impact of the Swiss financial market policy» the Federal Assembly observes that there is a demand for action to regulate the OTC derivatives market because of the systemic risk that became apparent with the collapse Lehman Brothers in September 2008. Whilst Switzerland does also strive for improved regulatory transparency and enhanced risk control systems in the OTC markets, Swiss regulators are worried that the regulatory changes in the EU clearing market and the obligation to clear standardised OTC (or ex-OTC) products in so called CCPs may contribute to systemic risk because of the concentration of risks in, and inter-linkages between, CCPs. The Swiss derivatives market shall be reviewed mainly through a new set of reporting obligations and through a reinforced collaboration between FINMA and the Swiss National Bank (SNB) that also involves the relevant financial market infrastructure entities (SIX Group, x-clear) and the large Swiss banking institutions. The Federal Assembly also wants to consider how regulations and requirements could help to achieve a higher level of standardisation in derivatives contracts. It was agreed that those trades which are still bilaterally executed shall be subject to improved capital requirements so that OTC trading gets more expensive and therefore more unattractive to market participants[76]. The G20 global recommendations that seek to migrate standardised OTC derivative contracts (i.e., credit default swaps) onto exchanges is regarded critically because it would apply not only to speculative traders but also to non-speculative commercial traders for whom the clearing requirement would significantly increase the costs of non-standardised hedging risks which may lead to less effective risk management[77].

Also Switzerland's exchanges have lost market share to multilateral trading facilities in an intensive competition created through the deregulatory spirit of MiFID. MTFs have been successful in attracting away from exchanges the lucrative trading of blue chip shares by taking advantage of their comparatively lower operational and regulatory compliance costs. Accordingly, the Federal Assembly considers it an important objective for the SIX Swiss Exchange not to lose its status as the main reference market for the trading of Swiss blue chips. Besides, the ongoing fragmentation of the markets aggravates the political and regulatory aim to reduce transaction costs for end-investors through high liquidity and transparency. As a consequence, Swiss policymakers generally approve of the European Commission's MiFID II objective of harmonising and aligning the requirements for all trading venues and bodies similar to stock exchanges such as MTFs[78].

VIII. Conclusions

The article analyses and compares the dynamic regulatory processes of MiFID and MiFID II to Switzerland's regulation of trading in securities and derivatives and the operation of exchanges. It reviews and compares MiFID II's proposed amendments that expand the MiFID regime to cover a broader range of financial instruments and trading facilities and assesses the implications for Swiss financial firms. Although Switzerland is not legally bound by European directives, the MiFID II rules will presumably become a new European benchmark and most Swiss securities firms and financial intermediaries will likely aim to comply with MiFID II rules in order to obtain direct access to EU/EEA markets. The limited scope of the Swiss home market for Swiss financial service providers means that it is necessary for Switzerland to have open access to EU markets in order to achieve the scale and scope required for a profitable financial services industry. Indeed, the recent financial crisis has resulted in many countries increasingly resorting to protectionist measures for their financial services sectors. In light of this, the Swiss Federal Assembly concluded in its Report on *Strategic direction of impact of the Swiss financial market policy* that Switzerland should strive to achieve a high-quality regulation that should be based on international best practice standards[79]. Switzerland will continue to examine potential measures which could help facilitate market access to the EU – especially under the MiFID regime – while removing market access restrictions on a bilateral and multilateral level[80].

[76] Report of the Federal Assembly (2009), (FN 8) p. 17, 53/54. As a member of several international financial standard setting bodies, Switzerland plays an important role in promoting financial stability by supporting the development of international financial standards and implementing recommendations that are viewed as necessary for enhancing financial stability.

[77] Financial Stability Board (FSB), Bank for International Settlement (BIS), OTC Derivatives Supervisors Group and Senior Supervisors Group, OTC Derivatives Regulators Forum, CPSS-IOSCO Working Group and Basel Committee on Banking Supervision.

[78] Report of the Federal Assembly (2009) (FN 8), p. 30/31.

[79] Report of the Federal Assembly (2009) (FN 8), p. 21.

[80] Report of the Federal Assembly (2009) (FN 8), p. 47.