ΕΠΙΤΡΟΠΗ ΚΕΦΑΛΑΙΑΓΟΡΑΣ ΚΥΠΡΟΥ
CYPRUS SECURITIES AND EXCHANGE COMMISSION

ANNOUNCEMENT

The Cyprus Securities and Exchange Commission ('CySEC') would like to notify any interested parties that the Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU ('MiFID II') and Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012 ('MiFIR') will enter into application on 3 January 2018.

In particular, MiFID II must be transposed into national law in Cyprus by 3 July 2017 and will be applicable as of 3 January 2018, whereas MiFIR will be directly applicable on 3 January 2018. Please note that the national law which transposes MiFID II is currently before the House of Representatives.

The current Announcement **aims to highlight the main changes introduced by MiFID II, MiFIR, and the relevant delegated and implementing regulations, which affect the authorisation requirements for investment firms**, including Cyprus Investment Firms ('CIFs'). For a brief overview of all obligations set out in MiFID II and MiFIR please refer to the Practical Guide published by CySEC in October 2014.

The main changes are summarized – non-exhaustively – in the Appendix below.

CySEC would also like to emphasize that all market participants that are affected by the changes introduced by MiFID II and MiFIR must start preparing for the implementation of the new legislative framework and take all steps to comply with it as of 3 January 2018. Such market participants include, but are not limited to,

i. CIFs which will need to extend their authorisation to cover new investment activities and/or financial instruments introduced by MiFID II,
ii. entities that will no longer be exempt from the scope of this legislation,
iii. persons undertaking high frequency algorithmic trading[1] that will now fall within the scope of MiFID II, and
iv. currently unauthorised businesses/entities that will have to be authorised under MiFID II.

[1] As defined in Article 4 (1) (40) of MiFID II.

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In addition to MiFID II and MiFIR and as per CySEC's Announcement dated 13 February 2017, the European Commission is empowered to adopt delegated and implementing acts to specify how competent authorities and market participants shall comply with specific obligations that stem from these legislative acts of the EU. **In relation to the authorisation process, CySEC draws special attention to the**:

i. Commission Delegated Regulation (EU) 2017/565 as regards organisational requirements and operating conditions for investment firms and defined terms, which essentially replaces and enhances numerous of the provisions included in CySEC's Directive for the authorisation and operating conditions of CIFs (DI144-2007-01).
ii. Commission Delegated Regulation with regard to regulatory technical standards on information and requirements for the authorisation of investment firms.
iii. Commission Implementing Regulation laying down implementing technical standards with regard to notifications by and to applicant and authorised investment firms containing, among others, the templates for the new application forms. However, as the latter has not yet been officially adopted by the European Commission, its draft version can be found in ESMA's Final Report MiFID II/MiFIR draft Technical Standards on authorisation, passporting, registration of third country firms and cooperation between competent authorities.

In addition to delegated and implementing acts, the European Securities and Markets Authority (ESMA) has published relevant Guidelines aiming to promote supervisory convergence across EU Member States. To this end, a table containing all ESMA Guidelines, including those relevant to MiFID II and MiFIR implementation, can be accessed here.

Finally, ESMA also uses the Q&A tool, which is a form of guidance on European legislation and the relevant list of Q&As, including those relating to MiFID II and MiFIR, can be accessed here.

CySEC urges CIFs and other businesses/entities to consider whether they fall within the scope of MiFID II and MiFIR and if so to prepare for the implementation of the new legislative framework, which introduces numerous new obligations. All interested parties are strongly advised to carefully consult/study all relevant documents published by the European Commission and ESMA.

CySEC notes that the new application forms are expected to be published within the third semester of 2017.

For any further clarifications **relating to the authorisation process** you may contact CySEC at the following email address mifidii.authorisations@cysec.gov.cy.

Nicosia, 11 April 2017

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APPENDIX

Main changes relating to the authorisation process

1. Scope of investment services and activities

(a) Organised Trading Facility

A new investment service has been added to Annex I, Section A of MiFID II, namely the operation of an Organised Trading Facility (OTF). Therefore, MiFID II is introducing a new trading venue in addition to regulated markets and Multilateral Trading Facilities (MTFs).

An OTF is defined as a multilateral system which is not a regulated market or an MTF and in which multiple third-party buying and selling interests in *bonds, structured finance products, emission allowances or derivatives* are able to interact in the system in a way that results in a contract in accordance with MiFID II.[2] In contrast to regulated markets and MTFs, the operators of OTFs are required to exercise discretion as to how to execute orders, subject though to best execution obligations.

An investment firm operating an OTF will have to comply with the organizational requirements applicable to all investments firms, as well as additional requirements relating to the trading process and finalization of transactions. The majority of these requirements are similar to those for an MTF. For more information see paragraph 10 below.

Please note that CySEC will publish further information on OTFs at a later stage.

(b) Investment advice[3]

The Commission Delegated Regulation (EU) 2017/565 as regards organisational requirements and operating conditions for investment firms and defined terms provides, among others, further information and guidance on the definition of investment advice. For instance, it elaborates on what is considered to be a personal recommendation, whereas it is clarified that a recommendation shall not be considered a personal recommendation if it is issued exclusively to the public (further guidance on this matter is also included in the recitals of the said Delegated Regulation).

(c) Underwriting and/or placing

The Commission Delegated Regulation (EU) 2017/565 as regards organisational requirements and operating conditions for investment firms and defined terms also provides, among others, further information on additional general requirements in relation to underwriting and/or placing, concerning the obligations of investment firms to identify potential conflicts of interest

[2] Article 4 (1) (23) of MiFID II.
[3] As defined in Article 4 (1) (4) of MiFID II.

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and ensure that adequate controls are in place to manage such conflicts of interest in specific circumstances.

2. Scope of ancillary services

MiFID II does not introduce changes to the scope of ancillary services, set out in Annex I, Section B of MiFID II. The only amendment relates to safekeeping and administration of financial instruments for the account of clients, where it is explicitly states that maintaining securities accounts at the top tier level is excluded from the scope of this service.

MiFID II exempts persons dealing on own account, or providing investment services to clients or suppliers of their main business (other than dealing on own account), in commodity derivatives, emission allowances or derivatives thereof, provided, inter alia, that this is an ancillary activity to their main business on a group basis and the main business is not the provision of investment services or banking activities.

A Commission Delegated Regulation (EU) 2017/592 with regard to regulatory technical standards for the criteria to establish when an activity is considered to be ancillary to the main business has also been published, specifying criteria and setting out tests for determining whether an activity is considered to be ancillary to the main business.

3. Scope of financial instruments

MiFID II introduces the following changes:

- A new financial instrument is introduced in Annex I, Section C of MiFID II, namely emission allowances, consisting of any units recognized for compliance with the requirements of Directive 2003/87/EC establishing a scheme for greenhouse gas emission allowance trading.
- Under Annex I, Section C (6) of MiFID II, commodity derivatives that can be physically settled and that are traded on an OTF are added to the existing commodity derivatives, due to the introduction of the new trading venue, OTF. However, wholesale energy products[4] traded on an OTF that must be physically traded are not considered financial instruments.

The concept of "physically settled" has been clarified in Commission Delegated Regulation (EU) 2017/565 as regards organisational requirements and operating conditions for investment firms and defined terms.

[4] As defined in Regulation (EU) No 1227/2011 on wholesale energy market integrity and transparency.

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The Commission Delegated Regulation (EU) 2017/565 as regards organisational requirements and operating conditions for investment firms and defined terms also provides further important information on:

- Money-market instruments
- Wholesale energy products that must be physically settled
- Energy derivative contracts relating to oil and coal and wholesale energy products
- Other derivative financial instruments
- Derivatives under Section C(10) of Annex I to MiFID II
- Characteristics of other derivative contracts relating to currencies.

4. Structured deposits[5]

Structured deposits also fall within the scope of certain provisions of MiFID II as per the provisions of Article 1(4) of MiFID II. In particular, MiFID II applies to investment firms and credit institutions when selling or advising clients in relation to structured deposits. It is clarified that, since structured deposits are a form of investment product, they do not include deposits linked solely to interest rates, such as Euribor or Libor, regardless of whether or not the interest rates are predetermined, or whether they are fixed or variable. Such deposits are therefore excluded from the scope of MiFID II.

5. Exemptions

The exemptions under the current regime are redefined and certain new exemptions are introduced (Article 2, MiFID II). It is clarified that in the draft law transposing MiFID II, Cyprus has not exercised its discretion under Article 3 to include the additional exemptions which are optional for Member States.

CySEC notes that the exemptions have been revised and we strongly encourage relevant market participants to assess whether they remain outside the scope of MiFID II and, if not, apply for the relevant authorisation in order to remain in operation as of 3 January 2018. For instance, if persons apply a high frequency algorithmic trading technique or have direct electronic access to a trading venue, while dealing on own account, they will fall within the scope of MiFID II. Generally, the exemptions relating to dealing on own account have been amended.

It is noted that in the draft law transposing MiFID II Cyprus has also not exercised its discretion to include in the definition of investment firms, undertakings which are not legal persons. Therefore in the same way as the current Law, a CIF will be defined as a company that is

[5] As defined in Article 4 (1) (43) of MiFID II.

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established in the Republic and is authorised by CySEC pursuant to the applicable Law to provide one or more investment services to third parties or/and perform one or more investment activities.

Moreover, the concept of "incidental manner" (Article 2 (1) (c), MiFID II) has been clarified in Commission Delegated Regulation (EU) 2017/565 as regards organisational requirements and operating conditions for investment firms and defined terms.

6. Systematic Internalisers

MiFID II defines systematic internaliser as an "investment firm which, on an organised, frequent systematic and substantial basis, deals on own account when executing client orders outside a regulated market, an MTF or an OTF without operating a multilateral system. The frequent and systematic basis shall be measured by the number of OTC trades in the financial instrument carried out by the investment firm on own account when executing client orders. The substantial basis shall be measured either by the size of the OTC trading carried out by the investment firm in relation to the total trading of the investment firm in a specific financial instrument or by the size of the OTC trading carried out by the investment firm in relation to the total trading in the EU in a specific financial instrument. The definition of a systematic internaliser shall apply only where the pre-set limits for a frequent and systematic basis and for a substantial basis are both crossed or where an investment firm chooses to opt-in under the systematic internaliser regime".[6]

The new legislative framework amends the existing regime for systematic internalisers, which currently applies only to trading in shares. In particular, certain transparency obligations are imposed by MiFIR (Title III) on investment firms when they are systematic internalisers for one or more equity instruments (shares, depositary receipts, ETFs, certificates and other similar financial instruments) which are traded on a trading venue, requiring such firms to make public firm quotes in respect of the aforementioned financial instruments for which there is a liquid market.

The systematic internaliser regime will also apply to non-equity instruments (bonds, structured finance products, emission allowances and derivatives), thus also requiring investment firms to make public firm quotes in respect of these non-equity instruments for which there is a liquid market, when two conditions set out in MiFIR are met.

In the case of an illiquid market for all of the aforementioned financial instruments, systematic internalisers shall disclose quotes to their clients upon request, unless certain conditions are met.

[6] Article 4 (1) (20) of MiFID II.

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Therefore, MiFID II and MiFIR introduce new quantitative criteria for determining an investment firm's status as a systematic internaliser on a specific financial instrument basis.

The Commission Delegated Regulation (EU) 2017/565 as regards organisational requirements and operating conditions for investment firms and defined terms also elaborates on the criteria that systematic internalisers need to meet for specific financial instruments, whereas ESMA has published a questions and answers (Q&A) document on MiFID II and MiFIR transparency topics (accessible here) which clarifies when ESMA will publish the first set of data needed to implement the systematic internaliser regime and the date by when firms must comply with this regime for the first time.

However, it is noted that despite the fact that MiFID II and MiFIR will apply from 3 January 2018, the earliest mandatory deadline on which firms must comply with the systematic internaliser regime is **1 September 2018**. This is because ESMA will publish the necessary data on the total number and the volume of transactions executed in the EU for the first time by 1 August 2018.

Please note that CySEC will publish further information on the systematic internaliser regime at a later stage.

7. Authorisation procedure

MiFID II introduces new requirements on the information to be submitted in the context of granting and refusing requests for authorisation and, to this end, new documentation, such as new application forms will be introduced to reflect these changes.

A Commission Implementing Regulation laying down implementing technical standards with regard to notifications by and to applicant and authorised investment firms will be adopted by the European Commission. However, as aforementioned, since this has not yet been officially published, a draft version can be found in the ESMA Final Report MiFID II/MiFIR draft Technical Standards on authorisation, passporting, registration of third country firms and cooperation between competent authorities.

In the context of the authorisation procedure, an application will need to include information, such as a programme of operations setting out, inter alia, the types of business envisaged and the organisational structure. This information will enable the competent authority to assess, at the time of initial authorisation, whether the applicant has established all the necessary arrangements to meet its obligations under Chapter I, Title II of MiFID II.

One of the main changes at authorisation level is the uniformity and the format of the type of information that Member States will require the applicants to provide, in order to demonstrate that they meet the conditions for authorisation under MiFID II. To this end, the Commission Delegated Regulation with regard to regulatory technical standards on information and requirements for the authorisation of investment firms has been published, which sets out the

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information to be provided, including the content of the programme of operations. It also sets out the requirements applicable to the management of investment firms under Article 9(6) of MiFID II, the information for the notifications under Article 9(5) of MiFID II, the requirements applicable to shareholders and members with qualifying holdings, as well as obstacles which may prevent the effective exercise of the supervisory functions of the competent authority, under Article 10(1) and (2) of MiFID II.

One of the new requirements is the submission of a programme of initial operations for the first three years including information on the geographical distribution and activities to be carried out by the investment firm, the organisational structure and internal control systems of the applicant, a list of the outsourced functions, services or activities along with the contracts concluded or foreseen with external providers and resources and measures to identify and to prevent or manage conflicts of interest and a description of product governance arrangements.

CySEC strongly advises all interested parties to read the relevant documents referred to herein, that also include templates of the new application forms.

8. Corporate Governance rules and management body

MiFID II introduces new corporate governance rules for the management bodies of investment firms. In particular, MiFID II adopts the relevant provisions of the Directive 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, namely Articles 88 and 91. It is noted that the provisions of Articles 88 and 91 are already reflected in Articles 12 and 18A of the Investment Services and Activities and Regulated Markets Law (Law 144(I)/2007).

We also draw your attention to the Consultation Paper, Joint ESMA and EBA Guidelines on the assessment of the suitability of members of the management body and key function holders. The consultation period has ended on 28 January 2017 and it is expected that the Guidelines will be finalized within the following months. The joint Guidelines will apply to Competent Authorities across the EU, as well as to credit institutions and investment firms.

9. New organizational requirements for investment firms

The organizational requirements for investment firms are similar to those set out in Law 144(I)/2007, however they are enhanced by the following new requirements set out in Article 16 of MiFID II:

(a) Product Governance Requirements Arrangements

Requirements on product governance are introduced, covering arrangements for:

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(a) firms to adopt when manufacturing products (product governance obligations for manufacturers); and

(b) firms to adopt when deciding the range of products and services they intend to offer to clients and when offering or recommending such products to clients (product governance obligations for distributors).

In particular, amongst others:

- Investment firms which manufacture financial instruments for sale to clients shall maintain, operate and review a **product approval process** for each financial instrument and **significant adaptations of existing financial instruments** before it is marketed or distributed to clients.
- The product approval process shall specify an **identified target market of end clients** within the relevant category of clients for each financial instrument.
- It shall also ensure that **all relevant risks** to such identified target market are assessed and that the intended distribution strategy is consistent with the identified target market.
- An investment firm shall also regularly review the financial instruments it offers or markets, taking into account any event that could materially affect the potential risk to the identified target market, to assess at least whether the financial instrument remains consistent with the needs of the identified target market and whether the intended distribution strategy remains appropriate.
- An investment firm that manufactures financial instruments shall make available to any distributor all appropriate information on the financial instrument and the product approval process, including the identified target market of the financial instrument.
- Where an investment firm **offers or recommends financial instruments which it does not manufacture**, it shall have in place adequate arrangements to obtain such information (i.e. all appropriate information on the financial instrument and the product approval process) and to understand the characteristics and identified target market of each financial instrument.

Moreover, ESMA undertook a consultation on product governance guidelines under MiFID II regarding the target market assessment by manufacturers and distributors of financial products, however, the final report has not yet been published.

Further information in relation to product governance obligations is also included in Commission Delegated Directive (EU) 2017/593 with regard to safeguarding of financial instruments and funds belonging to clients, product governance obligations and the rules applicable to the provision or reception of fees, commissions or any monetary or non-monetary benefits. It is noted that this Directive will be transposed into national law via a CySEC Directive.

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(b) Outsourcing

MiFID II introduces one change in relation to outsourcing of operational functions which are critical for the provision of continuous and satisfactory service to clients and the performance of investment activities on a continuous and satisfactory basis. In particular, in addition to other requirements, the investment firm should also have sound security mechanisms in place to guarantee the security and authentication of the means of transfer of information, minimise the risk of data corruption and unauthorised access and to prevent information leakage maintaining the confidentiality of the data at all times.

The Commission Delegated Regulation (EU) 2017/565 as regards organisational requirements and operating conditions for investment firms and defined terms (Chapter II, Section 2) also focuses on outsourcing. It addresses the scope of outsourcing, the outsourcing of critical and important operational functions and sets out the additional requirements that service providers located in third countries need to meet when the outsourcing involves functions related to the investment service of portfolio management.

(c) Record keeping

MiFID II provides for the record keeping procedure that investment firms need to abide to. In particular, CIFs shall take all reasonable steps to record relevant telephone conversations and electronic communications, made with, sent from or received by equipment provided by the investment firm to an employee or contractor or the use of which by an employee or contractor has been accepted or permitted by the investment firm. Records shall include the recording of telephone conversations or electronic communications relating to, at least, transactions concluded when dealing on own account and the provision of client order services that relate to the reception, transmission and execution of client orders. These record keeping obligations are also applicable even if those conversations or communications do not result in the conclusion of such transactions or in the provision of client order services.

An additional requirement introduced by MiFIR II is that an investment firm shall keep its records for a period of five years and if so requested by the national competent authority for a period of up to for reception and transmissionyears.

The Commission Delegated Regulation (EU) 2017/565 as regards organisational requirements and operating conditions for investment firms and defined terms (Chapter III, Section 8) and its Annex I further elaborates on the record-keeping requirements. For example, this Regulation sets out the conditions to be met for the retention of records, whereas in the Annex the minimum records that investment firms need to keep are set out. It also elaborates further on the recording of telephone conversations or electronic communications.

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ESMA has published a questions and answers (Q&A) document on MiFID II and MiFIR investor protection topics (accessible here) which also addresses issues relating to Recording of telephone conversations and electronic communications.

(d) Safeguarding of client assets and title transfer financial collateral arrangements:

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

Also, Cyprus has exercised the discretion granted by MiFID II and, in the draft law transposing MiFID II to Cyprus law, CySEC is enabled via the issuance of directives to impose additional requirements on investment firms concerning the safeguarding of client assets in exceptional circumstances. Such additional requirements must be objectively justified and proportionate so as to address specific risks to investor protection or to market integrity which are of particular importance in the circumstances of the market structure of that Member State.

(e) Conflicts of interest

MiFID II has elaborated on the obligation of the investment firm to clearly disclose to the client the general nature and/or sources of conflicts of interest and the steps taken to mitigate those risks before undertaking business on its behalf.

It is highlighted that Commission Delegated Regulation (EU) 2017/565 as regards organisational requirements and operating conditions for investment firms and defined terms states that disclosure to clients is a measure of last resort that shall be used only where the effective organisational and administrative arrangements established by the investment firm to prevent or manage its conflicts of interest are not sufficient to ensure, with reasonable confidence, that risks of damage to the interests of the client will be prevented. Moreover, it sets out that over-reliance on disclosure of conflicts of interest shall be considered a deficiency in the investment firm's conflicts of interest policy.

Specifically, such disclosure must be made in a durable medium and it must include sufficient detail to enable that client to take an informed decision with respect to the service in the context of which the conflict of interest arises. For instance, it shall clearly state that the established organisational and administrative arrangements are not sufficient to ensure, with reasonable confidence, that the risks of damage to the interests of the client will be prevented, whereas it shall also include specific description of the conflicts of interest and explaining their general nature and sources, as well as the risks to the client and the steps undertaken to mitigate these risks.

Moreover, investment firms will need to not only identify conflicts of interest, but also take all appropriate steps to prevent or manage such conflicts.

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The Commission Delegated Regulation (EU) 2017/565 as regards organisational requirements and operating conditions for investment firms and defined terms (Chapter II, Section 3) also elaborates on matters relating to conflicts of interest. For instance, it sets out the content of the conflicts of interest policy, the conflicts of interest potentially detrimental to a client, additional organisational requirements in relation to investment research or marketing communications, etc.

(f) Additional provisions stemming from the Commission Delegated Regulation (EU) 2017/565 as regards organisational requirements and operating conditions for investment firms and defined terms

The Commission Delegated Regulation (EU) 2017/565 as regards organisational requirements and operating conditions for investment firms and defined terms also elaborates on the provisions of Article 16, MiFID II. As aforementioned, this Regulation will essentially replace CySEC's Directive for the authorisation and operating conditions of CIFs (DI144-2007-01). It sets out provisions relating to:

- General Organisation Requirements
- Compliance
- Risk management
- Internal audit
- Responsibility of senior management
- Complaints handling
- Remuneration policies and practices
- Scope of personal transactions and personal transactions.

10. Additional organizational requirements for MTFs and OTFs

The provisions of Article 18 of MiFID II apply both to MTFs and OTFs. Such additional requirements are similar to those set out in Law 144 (I)/2007; however, these have been enhanced. For instance, MTFs and OTFs should have arrangements for the sound management of the technical operations of the facility, including the establishment of effective contingency arrangements to cope with risks of systems disruption. A minimum number of three materially active members or users each having the opportunity to interact with all the others in respect to price formation is also introduced.

Moreover, MiFID II provides that investment firms and market operators operating an MTF or an OTF have arrangements to identify clearly and manage the potential adverse consequences for the operation of the MTF or OTF, or for the members or participants and users, of any conflict of interest between the MTF, the OTF, their owners or the investment firm or market operator operating the MTF or OTF and the sound functioning of the MTF or OTF.

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The Commission Implementing Regulation (EU) 2016/824 laying down implementing technical standards with regard to the content and format of the description of the functioning of multilateral trading facilities and organised trading facilities and the notification to the European Securities and Markets Authority elaborates on the additional information that competent authorities will need to receive by an investment firm or a market operator in the context of authorizing the operation of an MTF or an OTF, as well as the format for submitting this information. It is noted that this information will also need to be provided on MTFs already in operation.

In addition to this, MiFID II provides that investment firms and market operators operating an MTF or OTF shall also comply with the requirements relating to regulated markets with regards to systems resilience, circuit breakers and electronic trading (Article 48 MiFID II), as well as tick sizes (Article 49 MiFID II).

The following Commission Delegated Regulations have also been published:

- Commission Delegated Regulation (EU) 2017/584 with regard to regulatory technical standards specifying organisational requirements of trading venues
- Commission Delegated Regulation (EU) 2017/578 with regard to regulatory technical standards specifying the requirements on market making agreements and schemes
- Commission Delegated Regulation (EU) 2017/566 with regard to regulatory technical standards for the ratio of unexecuted orders to transactions in order to prevent disorderly trading conditions
- Commission Delegated Regulation (EU) 2017/573 with regard to regulatory technical standards on requirements to ensure fair and non-discriminatory co-location services and fee structures
- Commission Delegated Regulation (EU) 2017/570 with regard to regulatory technical standards for the determination of a material market in terms of liquidity in relation to notifications of a temporary halt in trading
- Commission Delegated Regulation (EU) 2017/588 with regard to regulatory technical standards on the tick size regime for shares, depositary receipts and exchange traded funds.

Moreover, MiFID II sets out further specific requirements for MTFs (Article 19) and OTFs (Article 20).

For example, further to the requirements under Articles 16 and 18, investment firms and market operators operating an MTF will be required to establish and implement non-discretionary rules for the execution of orders in the system, as well as arrangements to manage, identify and mitigate risks, to facilitate the efficient and timely finalisation of the transactions executed under its systems; additionally, adequate financial resources need to be available to facilitate the orderly functioning of an MTF.

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In addition, an investment firm and a market operator operating an OTF should also abide to further requirements, relating to the execution of client orders, matched principal trading in specific financial instruments, dealing on own account etc. It is also explicitly stated that it is not allowed that the operation of an OTF and of a systematic internaliser takes place within the same legal entity.

11. SME Growth Markets

MiFID II (Article 33) introduces the creation within the MTF category of a new sub category of SME growth market. There are specific requirements that need to be satisfied in order for the operator of an MTF to apply to the national competent authority to have the MTF registered as an SME growth. For instance, at least 50% of the issuers whose financial instruments are admitted to trading on the MTF should be SMEs and such assessment should be made on an annual basis and also appropriate criteria are set for initial and ongoing admission to trading of financial instruments of issuers on the market.

The Commission Delegated Regulation (EU) 2017/565 as regards organisational requirements and operating conditions for investment firms and defined terms (Chapter III, Section 9) further elaborates on the registration and the deregistration as an SME growth market, in particular as to the determination of whether at least 50% of the issuers admitted to trading on an MTF are SMEs. Moreover, it sets out conditions that the investment firm or a market operator should satisfy in order to register an MTF as an SME growth market, such as rules for objective and transparent criteria for the initial and ongoing admission to trading of issuers on its venue, an appropriate operating model, publication of an appropriate admission document if applicable. It also sets out that notwithstanding the remaining conditions set out in MiFID II, an SME growth market shall only be deregistered where the proportion of SMEs falls below 50 % for three consecutive calendar years.

The Commission Implementing Regulation (EU) 2016/824 laying down implementing technical standards with regard to the content and format of the description of the functioning of multilateral trading facilities and organised trading facilities and the notification to the European Securities and Markets Authority also refers to additional information that an investment firm or a market operator which is applying for registration of an MTF as an SME growth market should provide.

12. Algorithmic trading

MiFID II (Article 17) introduces regulation and monitoring of algorithmic trading through the introduction of requirements on algorithmic traders and the trading venues on which they trade (regulated markets, MTFs and OTFs).

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Algorithmic trading is defined as trading in financial instruments where a computer algorithm automatically determines individual parameters of orders such as whether to initiate the order, the timing, price or quantity of the order or how to manage the order after its submission, with limited or no human intervention, and does not include any system that is only used for the purpose of routing orders to one or more trading venues or for the processing of orders involving no determination of any trading parameters or for the confirmation of orders or the post-trade processing of executed transactions.[7]

The Commission Delegated Regulation (EU) 2017/565 as regards organisational requirements and operating conditions for investment firms and defined terms further specifies the definition by providing that a system shall be considered as having *no or limited human intervention* where, for any order or quote generation process or any process to optimise order-execution, an automated system makes decisions at any of the stages of initiating, generating, routing or executing orders or quotes according to pre-determined parameters. The recitals of this Delegated Regulation state that algorithmic trading should also refer to the optimisation of order execution processes by automated means, whereas it should also encompass smart order routers (SORs) but not automated order routers (AOR).

ESMA has published a questions and answers (Q&A) document on MiFID II and MiFIR market structures topics (accessible here), which also includes a section on algorithmic trading.

(a) Requirements for an investment firm that engages in algorithmic trading

An investment firm that engages in algorithmic trading shall have in place:

- effective systems and risk controls suitable to the business it operates to ensure that its trading systems are resilient and have sufficient capacity, are subject to appropriate trading thresholds and limits and prevent the sending of erroneous orders or the systems otherwise functioning in a way that may create or contribute to a disorderly market.
- effective systems and risk controls to ensure the trading systems cannot be used for any purpose that is contrary to Regulation (EU) No 596/2014 on market abuse or to the rules of a trading venue to which it is connected.
- effective business continuity arrangements to deal with any failure of its trading systems and shall ensure its systems are fully tested and properly monitored to ensure that they meet the aforementioned requirements.

According to MiFID II, an investment firm that engages in algorithmic trading (including high frequency traders) shall notify the national competent authority, i.e. CySEC, and the relevant trading venue that the investment firm engages in algorithmic trading as a member or participant of the trading venue.

[7] Article 4 (1) (39) of MiFID II.

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CySEC, as the national competent authority, may require the investment firm to provide, on a regular or ad-hoc basis:

- a description of the nature of its algorithmic trading strategies,
- details of the trading parameters or limits to which the system is subject,
- the key compliance and risk controls that it has in place to ensure the aforementioned are satisfied,
- details of the testing of its systems.

The national competent authority may, at any time, request further information from an investment firm about its algorithmic trading and the systems used for that trading and may, upon request of a competent authority of a trading venue at which the investment firm as a member or participant of the trading venue is engaged in algorithmic trading, communicate this information.

All investment firms must keep records in relation to the above and such records should be sufficient to enable its competent authority to monitor compliance with MiFID II requirements.

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

- carry out this market making continuously during a specified proportion of the trading venue's trading hours, except under exceptional circumstances, with the result of providing liquidity on a regular and predictable basis to the trading venue;
- enter into a binding written agreement with the trading venue which shall at least specify the aforementioned obligations of the investment firm; and
- have in place effective systems and controls to ensure that it fulfils its obligations under such agreement at all times.

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

We also draw your attention to Commission Delegated Regulation (EU) 2017/578 on markets in financial instruments with regard to regulatory technical standards specifying the requirements on market making agreements and schemes, which further elaborates on the abovementioned requirements, such as the circumstances under which an investment firm performing a market

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making strategy should enter into a market making agreement, the content and scope of such agreements, the exceptional circumstances under which the obligation of investment firms to provide liquidity on a regular and predictable basis to the trading venue is not required.

(b) High-frequency algorithmic trading

MiFID II also encapsulates high frequency algorithmic trading, which is considered to be a subset of algorithmic trading and hence is subject to the requirements and controls that apply to algorithmic trading, as well as the additional requirements set out in MiFID II and the relevant delegated regulations. Therefore, as already mentioned, persons dealing on own account and applying a high-frequency algorithmic trading technique fall within the scope of MiFID II and need to apply for the relevant authorisation in order to remain in operation as of 3 January 2018.

High-frequency algorithmic trading technique is defined[8] as an algorithmic trading technique characterised by:

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

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

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

The Commission Delegated Regulation (EU) 2017/565 as regards organisational requirements and operating conditions for investment firms and defined terms further clarifies the definition of high frequency algorithmic trading through the establishment of criteria to define "high message intraday rates".

Investment firms that engage in a high-frequency algorithmic trading technique must comply with the additional requirement to store in an approved form accurate and time sequenced records of all its placed orders, including cancellations of orders, executed orders and quotations on trading venues and shall make such records available to the national competent authority, upon request.

Moreover, the Commission Delegated Regulation (EU) 2017/589 with regard to regulatory technical standards specifying the organisational requirements of investment firms engaged in algorithmic trading provides for the content and format of order records of an investment firm that engages in a high-frequency algorithmic trading technique. The format is set out in tables 2 and 3 of Annex II of the Delegated Regulation.

[8] Article 4 (1) (40) of MiFID II.

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(c) Organisational requirements of investment firms engaged in algorithmic trading

We would like to draw your attention to the Commission Delegated Regulation (EU) 2017/589 with regard to regulatory technical standards specifying the organisational requirements of investment firms engaged in algorithmic trading and Commission Delegated Regulation (EU) 2017/584 with regard to regulatory technical standards specifying organisational requirements of trading venues.

In particular the Commission Delegated Regulation (EU) 2017/589 with regard to regulatory technical standards specifying the organisational requirements of investment firms engaged in algorithmic trading sets out specific requirements (the below is indicative and not exhaustive of the requirements of the relevant Delegated Regulation) such as:

- **General organization requirements:** The investment firm shall establish and monitor its trading systems and trading algorithms through a clear and formalised governance arrangement. This should be done taking into account the nature, scale and complexity of its business. It should also set out, inter alia, clear lines of accountability, as well as separation of tasks and responsibilities of trading desks and supporting functions in order to ensure that unauthorised trading activity cannot be concealed.

- **Role of the compliance function:** The investment firm must ensure that its compliance staff has at least a general understanding of how the algorithmic trading systems and trading algorithms of the investment firm operate. Therefore, the compliance staff shall be in continuous contact with persons within the firm who have detailed technical knowledge of the firm's algorithmic trading systems and algorithms. It must also be ensured that compliance staff have, at all times, contact with the person or persons within the investment firm who have access to the 'kill functionality'[9] or direct access to that 'kill functionality' and to those who are responsible for each trading system or algorithm.

- **Staffing**: Investment firms shall employ a sufficient number of staff with the necessary skills to manage its algorithmic trading systems and trading algorithms and with sufficient technical knowledge of:

  (a) the relevant trading systems and algorithms;

  (b) the monitoring and testing of such systems and algorithms;

  (c) the trading strategies that the investment firm deploys through its algorithmic trading systems and trading algorithms;

  (d) the investment firm's legal obligations.

[9] An investment firm shall be able to cancel immediately, as an emergency measure, any or all of its unexecuted orders submitted to any or all trading venues to which the investment firm is connected ('kill functionality').

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The investment firm shall ensure that those staff's skills remain up-to-date through continuous and extensive training and shall evaluate their skills on a regular basis. Specific reference is also made to the skills of the staff responsible for the risk and compliance functions of algorithmic trading.

- **IT strategy:** Investment firms shall implement an IT strategy with defined objectives and measures which:

  (a) is in compliance with the business and risk strategy of the investment firm and is adapted to its operational activities and the risks to which it is exposed;

  (b) is based on a reliable IT organisation, including service, production, and development;

  (c) complies with an effective IT security management.

  There are further requirements that are imposed on investment firms such as an annual obligation to undertake penetration tests and vulnerability scans to simulate cyber-attacks, as well as setting up and maintaining appropriate arrangements for physical and electronic security that minimise the risks of attacks against its information systems.

- **Resilience of trading systems:** Chapter II of the Delegated Regulation provides for the resilience of trading systems in relation to

  - the testing and deployment of trading algorithms systems and strategies (general methodology; conformance testing; testing environments; controlled deployment of algorithms),
  - the post-deployment management (annual self-assessment and validation, e.g. of its algorithmic trading systems and strategies, trading algorithms, governance, accountability and approval framework; stress testing; management of material changes), and
  - the means to ensure resilience (kill functionality; automated surveillance system to detect market manipulation (implementation of Regulation (EU) No 596/2014 on market abuse); business continuity arrangements; pre-trade controls on order entry; real-time monitoring; post-trade controls, security and limits to access).

As stated in the aforementioned Commission Delegated Regulation (EU) 2017/589 with regard to regulatory technical standards specifying the organisational requirements of investment firms engaged in algorithmic trading, compliance with the specific organisational requirements for an investment firm should be determined according to a self-assessment which includes an assessment of compliance with the criteria set out in Annex I. That self-assessment should furthermore include all other circumstances that may have an impact on the organisation of that investment firm.

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(d) Organisational requirements for trading venues:

MiFID II provides that Member States shall require trading venues (regulated markets, MTFs, OTFs) to have in place effective systems, procedures and arrangements, including requiring members or participants to carry out appropriate testing of algorithms and providing environments to facilitate such testing. This is necessary, in order to ensure that algorithmic trading systems cannot create or contribute to disorderly trading conditions on the market and to manage any disorderly trading conditions which do arise from such algorithmic trading systems. .

All trading venues should ensure that its rules on co-location services are transparent, fair and non-discriminatory. Moreover its fee structures including execution fees, ancillary fees and any rebates should be transparent, fair and non-discriminatory and that they do not create incentives to place, modify or cancel orders or to execute transactions in a way which contributes to disorderly trading conditions or market abuse.

We draw your attention to Commission Delegated Regulation (EU) 2017/573 on markets in financial instruments with regard to regulatory technical standards on requirements to ensure fair and non-discriminatory co-location services and fee structures. Such a Delegated Regulation was published on the basis of Article 48(12) of MiFID II, which empowers ESMA to further specify the organisational requirements of regulated markets, MTFs and OTFs enabling or allowing algorithmic trading through their systems, in order to ensure that the trading systems of those venues are resilient and have adequate capacity.

(e) Direct electronic access

Direct electronic access is defined as an arrangement where a member or participant or client of a trading venue permits a person to use its trading code so that the person can electronically transmit orders relating to a financial instrument directly to the trading venue. It includes arrangements which involve the use by a person of the infrastructure of the member or participant or client, or any connecting system provided by the member or participant or client, to transmit the orders (direct market access) and arrangements where such an infrastructure is not used by a person (sponsored access).[10]

The Commission Delegated Regulation (EU) 2017/565 as regards organisational requirements and operating conditions for investment firms and defined terms further clarifies the definition of direct electronic access.

Direct electronic access will be is prohibited unless the investment firm has in place effective systems and controls to ensure:

- a proper assessment and review of the suitability of clients using the service,

[10] Article 40 (1) (41) of MiFID II.

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- that clients using the service are prevented from exceeding appropriate pre-set trading and credit thresholds,
- that trading by clients using the service is properly monitored and
- that appropriate risk controls prevent trading that may create risks to the investment firm itself or that could create or contribute to a disorderly market or could be contrary to Regulation (EU) No 596/2014 on market abuse or the rules of the trading venue.

An investment firm that provides direct electronic access shall be responsible for ensuring that clients using that service comply with the requirements of MiFID II and the rules of the trading venue. It must monitor the transactions in order to identify infringements of those rules, disorderly trading conditions or conduct that may involve market abuse and that is to be reported to the competent authority.

Moreover, the investment firm must ensure that there is a binding written agreement between the investment firm and the client regarding the essential rights and obligations arising from the provision of the service and that, under the agreement, the investment firm retains responsibility under MiFID II.

According to MiFID II, an investment firm that provides direct electronic access to a trading venue shall notify the national competent authority and the trading venue at which the investment firm provides direct electronic access accordingly.

CySEC, as the national competent authority, may require that a CIF provides, on a regular or ad-hoc basis, a description of the abovementioned systems and controls and evidence that those have been applied.

Moreover, CySEC shall, on the request of a competent authority of a trading venue in relation to which a CIF provides direct electronic access, communicate without undue delay the information that it receives from the CIF with regards to the relevant systems and controls.

Investment firms must keep records in relation to the above and such records should be sufficient to enable its competent authority to monitor compliance with MiFID II requirements.

Moreover, Chapter III of the Commission Delegated Regulation (EU) 2017/589 with regard to regulatory technical standards specifying the organisational requirements of investment firms engaged in algorithmic trading further elaborates on these requirements. An investment firm that provides direct electronic access shall establish policies and procedures to ensure that trading of its direct electronic access clients complies with the trading venue's rules so as to ensure that the direct electronic access provider meets the requirements in accordance with MiFID II. Moreover, the Delegated Regulation provides for specific controls that need to be applied by a direct electronic access provider , sets out specifications for the systems of direct

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electronic access providers and includes aspects to be covered by the due diligence assessment of prospective clients of direct electronic access providers.

ESMA has published a questions and answers (Q&A) document on MiFID II and MiFIR market structures topics (accessible here), which also includes a section on algorithmic trading.

(f) General clearing member

An investment firm that acts as a general clearing member for other persons shall have in place effective systems and controls to ensure clearing services are only applied to persons who are suitable and meet clear criteria and that appropriate requirements are imposed on those persons to reduce risks to the investment firm and to the market.

The investment firm shall ensure that there is a binding written agreement between the investment firm and the person regarding the essential rights and obligations arising from the provision of that service.

The Commission Delegated Regulation (EU) 2017/589 with regard to regulatory technical standards specifying the organisational requirements of investment firms engaged in algorithmic trading also sets out requirements for the systems and controls of investment firms acting as general clearing members, in relation to the due diligence assessments of prospective clearing, the position limits and disclosure of information about the services provided.

13. Authorisation of Data Reporting Service Providers (DRSPs)

Please note that CySEC will publish further information, on the authorisation of DRSPs, which include Approved Publication Arrangements (APAs), Consolidated Tape Providers (CTPs) and Approved Reporting Mechanisms (ARMs) at a later stage.

14. Passporting Issues and Provision of investment services and activities by third country firms

Please note that CySEC will publish further information concerning the amendments introduced in relation to passporting and the provision of investment services and activities by third country firms at a later stage.

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