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MiFID II for Non-EU Investment Banks, Brokers and Fund Managers

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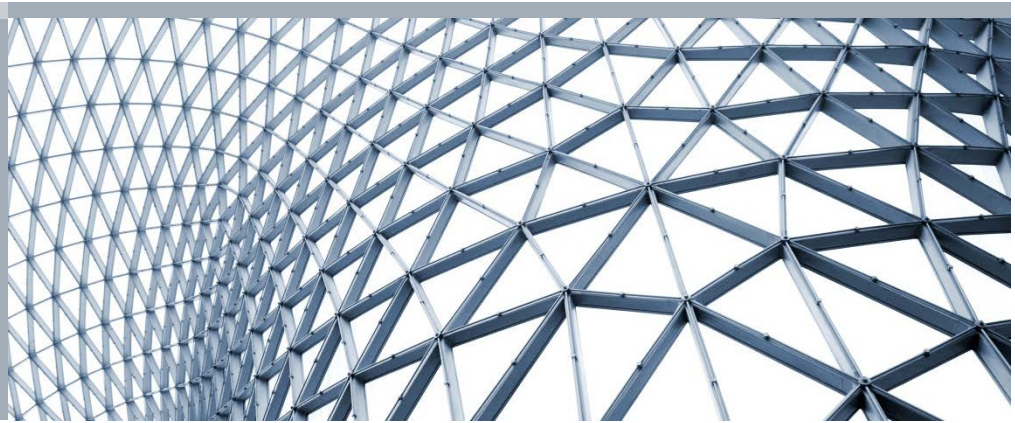


What is MiFID II?

- EU framework for regulating the financial markets
- Not a new framework; it was first developed in circa 1992 and has since evolved over time

Investment Services Directive
Applied from Jan 1, 1996
→
MiFID I
Applied from Nov 1, 2007
→
MiFID II
Applies from Jan 3, 2018

- MiFID II entered into force on July 2, 2014 and is applicable from January 3, 2018, following a delay of one year to allow time for implementation of arrangements
- Requires some EU member state legislation and regulators rules and guidance to implement

Primary legislation + Secondary legislation (circa. 50) + Guidelines and Q&A

Revised Markets in Financial Instruments Directive (requires member state national laws to implement)

New Markets in Financial Instruments Regulation (MiFIR) (directly applicable across the EU)

What is MiFID II?

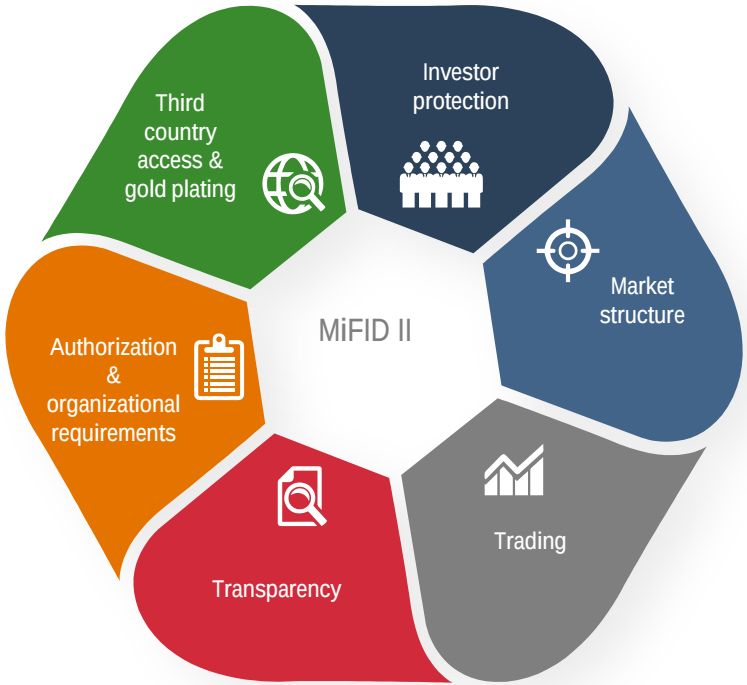
MiFID

- authorization and operating conditions for investment firms
- authorization and operation of regulated markets (exchanges)
- authorization and operation of data reporting services providers
- position limits and position management controls in commodity derivatives and reporting
- supervision, cooperation and enforcement by national regulators
- rules for third-country firms operating through a branch

MiFIR

- disclosure of trade data to the public
- reporting of transactions to the competent authorities
- trading of derivatives on organised venues
- non-discriminatory access to clearing and non-discriminatory access to trading in benchmarks
- product intervention powers of national regulators, ESMA and EBA and powers of ESMA on position management controls and position limits
- provision of investment services or activities by third-country firms following an applicable equivalence decision by the Commission with or without a branch

Scope of MiFID II



Investor protection

- Best execution
- Client classification
- Research
- Inducements
- Reporting to clients
- Suitability

Transparency

- Pre-trade & post-trade transparency
- Data consolidation
- Transaction reporting

Market structure

- SME Markets
- Multilateral trading facilities
- Organised trading facilities
- Exchanges
- Systematic Internalisers

Authorization & organizational requirements

- Governance, risk management
- Conflicts of interest
- Telephone / electronic records
- Senior management

Trading

- Trading obligation
- Automated and algorithmic trading
- Commodities

Third country access & gold plating

- Branches and cross-border services
- Additional requirements imposed by member states

Are Non-EU Investment Banks and Brokers In-scope of MiFID II?

Not Generally In Scope

- Non-EU investment banks and brokers without any EU place of business

In Scope

- EU investment firms
- Non-EU investment banks and brokers that no longer fall within an exemption – usually depends on national member state implementation

Indirect Impact for Non-EU Investment Banks and Brokers

- Through their dealings with EU investment firms (broker-dealers)
- If they have an EU investment firm in their group structure

Are Fund Managers In-scope of MiFID II?

Not Generally In Scope

- EU fund managers that provide services only to regulated funds, such as UCITS or AIFs under AIFMD
- Non-EU fund managers without any EU place of business

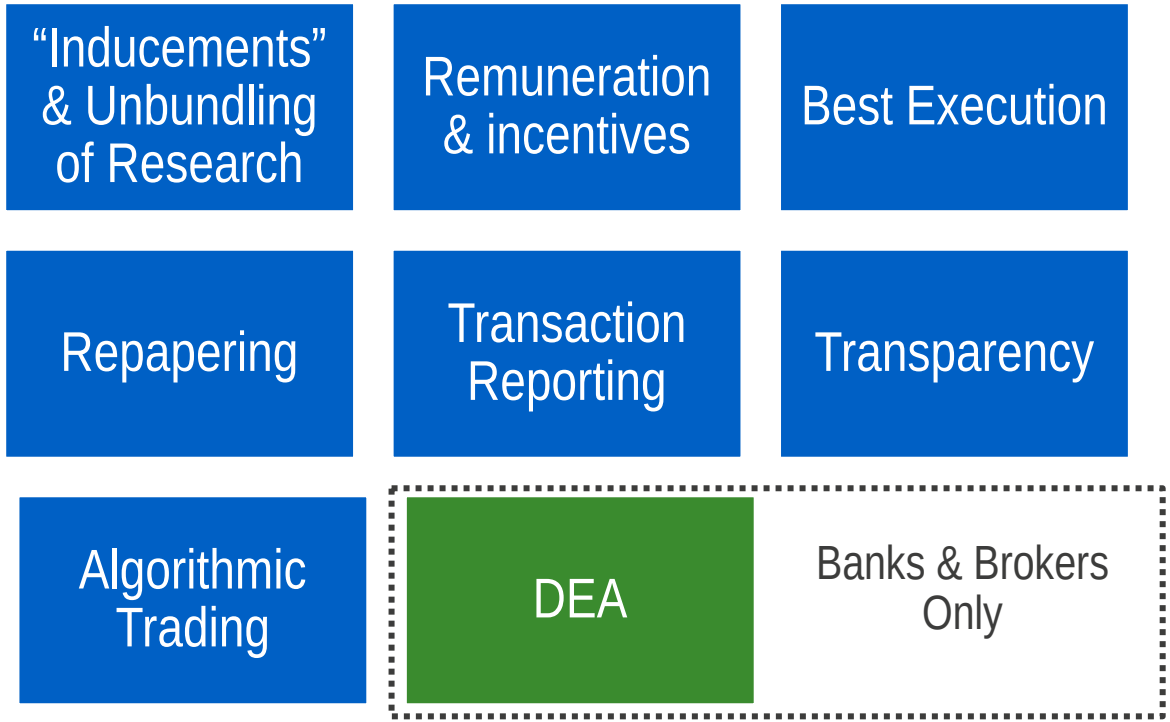
In Scope

- EU fund managers that provide managed account services to particular clients
- Fund managers established in an EU member state that has decided to extend some of the MiFID II requirements to UCITS/AIFMD fund managers in their member state (called “gold plating”). Notably, the UK

Indirect Impact for Non-EU Fund Managers

- Through their dealings with EU broker-dealers
- If they have an EU manager or sub-manager in their group structure

Key Areas of Focus



Non-EU Investment Banks and Brokers: Extraterritorial Impact

	Booking Trades with an EU broker	Local Instrument Execution-only Services to EU Client	Cross-border Trading on an EU Trading Venue
Inducements	Needs attention	Unlikely to be an issue unless the client is regulated in the EU	Unlikely to be an issue
Algorithmic Trading Strategies	Issue for EU counterparty	Unlikely to be an issue	Needs attention
Direct Electronic Access	Needs attention	Needs attention	Needs attention
Repapering by EU Broker or Trading Venue	Needs attention	Unlikely to be an issue unless the client is regulated in the EU	Unlikely to be an issue
Legal Entity Identifier	Needs attention	Needs attention	Needs attention
Best Execution	Issue for EU counterparty	Issue for EU counterparty	Unlikely to be an issue
Transaction Reporting	Issue for EU counterparty	Issue for EU counterparty	Issue for EU counterparty
Transparency	Issue for EU counterparty	Issue for EU counterparty	Issue for EU counterparty

Non-EU Fund Managers: Extraterritorial Impact

	Fund or Firm has EU Manager or Sub-Manager	Trading on EU Market Using Algorithmic Trading	Fund or Firm Uses EU Investment Firm as Broker / Agent
Inducements	Needs attention	See other columns	Needs attention
Best Execution	Needs attention	See other columns	Needs attention
Repapering by EU Broker-Dealers	Needs attention	Needs attention	Needs attention
Repapering by Fund Managers	Needs attention	See other columns	See other columns
Transparency	Needs attention	Needs attention	Issue for investment firm not fund manager
Algorithmic Trading Strategies	See next column	Needs attention	See previous column

Inducements & Unbundling of Research

The Rule

- Commission, fee payments and other non-monetary benefits should not impair a firm's duty to act in the best interests of its client, should enhance the quality of the service provided and must be disclosed to the client
- Research provided by any third party (regardless of where located) will be an inducement unless either:
  1. The research is received in return for either direct payment by the firm from its own resources; or
  2. Payment is made from a separate "Research Payment Account" ("RPA")
- In-scope firms will need to disclose to each client all fees, commissions and non-monetary benefits received by them in connection with any investment service provided by them to that client

Inducements & Unbundling of Research

Exemptions

- Any inducement that is a “minor, non-monetary benefit”
  - Written material commissioned and paid for by an issuer to promote its new issuance,
  - Short term market commentary on the latest economic statistics
  - Company results, information on upcoming releases or events
- Trial periods
  - Firms (a) can only receive trials for up to three months, (b) should not be required to provide any monetary or non-monetary consideration to the research provider for research received during the trial; and (c) should not accept a new trial with the same provider within a 12 month period from the date on which a previous trial, or existing research agreement, ceased
  - Firms should keep adequate records to demonstrate compliance

"**Research** covers research material or services concerning one or more financial instruments or other assets or the issuers or potential issuers of financial instruments or which is closely related to a specific industry or market such that it informs views on financial instruments, assets or issuers within that sector."

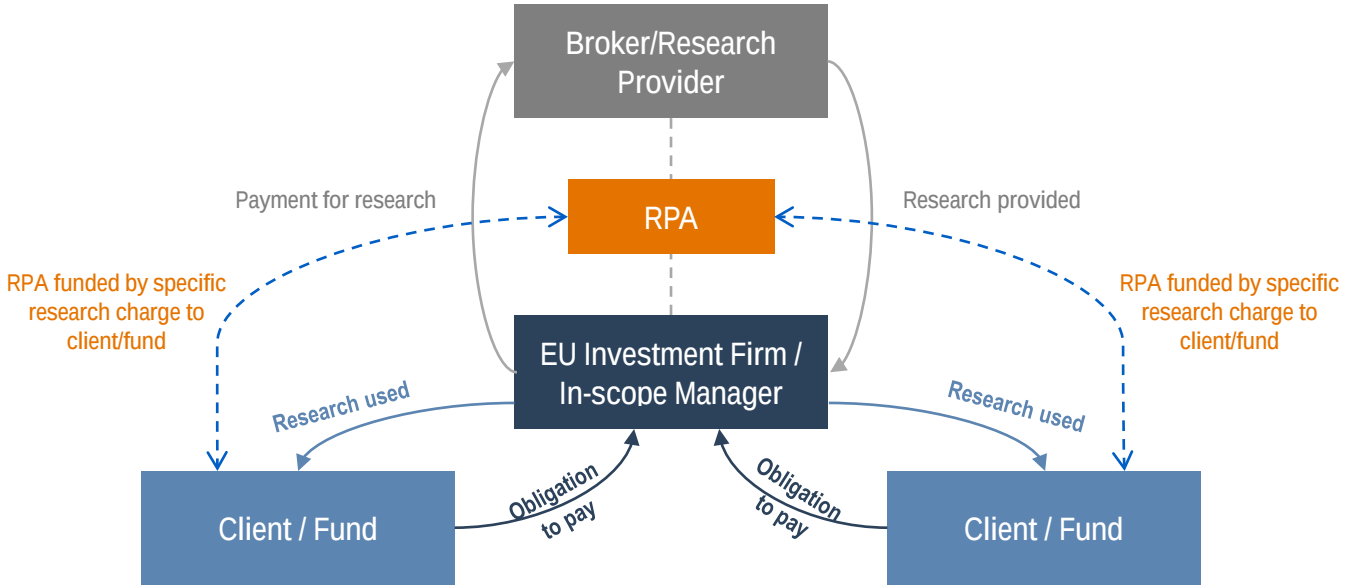
Recital 28, Commission Delegated Regulation 2017/593

Inducements & Unbundling of Research

Scope – fund managers

- In-scope fund managers are EU fund managers:
  - That provide **managed account services** to clients; or
  - That are **established in an EU member state** that has opted to extend some of the MiFID II requirements to the EU fund managers in their country
- UK is extending the MiFID II rules on inducements / unbundling of research to most UK authorized firms that carry out investment management of collective investment schemes, including UK AIFMs, UK branches of EEA AIFMs and managers of UCITS funds
  - Exceptions for private equity:
    - "Funds where the investment policy does not generally involve investing in financial instruments that can be registered in a financial instruments account opened in the books of a depository or physically delivered to the depository"
    - Funds that generally invests in issuers or non-listed companies to acquire control over such companies
  - The FCA expects in-scope fund managers to push the research and unbundling requirements down onto sub-managers

Research Payment Account Structure



An RPA is an account of the EU investment firm or manager with a broker/research provider that is used by the manager to pay for research on the part of a fund or client

Inducements & Unbundling of Research

Research Payment Account ("RPA") ("soft dollars")

- RPA to be funded by a specific research charge to the client/fund
- Research charge cannot be linked to the volume and/or value of transactions executed on behalf of the client/fund
- Firm must regularly set and assess a research budget, based on its reasonable assessment of the need for third party research
- Research charge cannot exceed the research budget
- Allocation of the research budget must be subject to appropriate controls and senior management oversight
- Any surplus in the RPA must be returned to the client/fund
- Audit trail of payments made to research providers is required
- Delegation of administration of RPA possible provided that:
  - Research is still purchased in the name of the firm; and
  - Payments to research providers are in the name of the firm and made without delay

Inducements & Unbundling of Research

RPA - “soft dollars”

- Research policy required
  - Used by investment firm/fund manager to assess the quality of research
  - Assessment must be part of pricing
  - Sets out extent to which research may benefit clients’/funds’ portfolios taking into account investment strategies applicable to various types of portfolios and how the costs will be allocated fairly to the various clients’/funds’ portfolios
  - Must be provided to clients, funds and portfolio clients under management
- Disclosure to clients and funds:
  - Information about the budgeted amount for research
  - Estimated research charge for each client/fund
  - Information on total costs incurred by each client/fund (annual disclosure)
  - Any proposed increase in costs (before the increase takes effect)

Inducements & Unbundling of Research

RPA - “soft dollars”

- RPAs differ from Commission Sharing Agreements because a budget must be set, there is greater selection over research and any excess in the account must be return to the fund
- Firms using CSAs will need to implement changes to ensure compliance with the new RPA rules

Inducements & Unbundling of Research

Direct Payment ("hard dollars")

- In-scope firms that adopt a direct payment structure (payment in "hard dollars") may present issues if a US broker-dealer is providing the research because the payment for research using hard dollars may mean that the research provider would need to become regulated as an investment adviser
  - US broker-dealers usually try to avoid being classified as an "investment adviser" because of the fiduciary duties and related rules that entails

Combination of hard and soft dollar systems?

- The FCA recently confirmed that firms can pay for research using both methods
- However, "hard dollars" cannot be charged to the fund or client (i.e. no passing on cash without an RPA)

Inducements & Unbundling of Research

Combination on in-scope and out of scope funds - apportionment

- Managers of multiple funds can split research costs across funds – a research budget could be set at a desk or investment strategy level if portfolios have sufficiently similar mandates and investment objectives
  - Pro rata allocation therefore possible in such circumstances
- An in-scope manager within a firm's structure could mean that some business is covered by the provisions while other aspects may not be

Inducements & Unbundling of Research

U.S.-registered broker-dealers receipt of “hard dollars” for research

- Under the U.S. Investment Advisers Act, an investment adviser is someone who, for compensation, provides advice as to the value of securities
- Securities research is generally considered to be advice for these purposes
- The U.S. Investment Advisers Act provides that broker-dealers are not considered to be investment advisers if and to the extent they provide advice that is “incidental” to brokerage services, and receive “no special compensation” for providing the advice. *See* Investment Advisers Act of 1940, Section 202(a)(11)(C)
- Historically, broker-dealers have relied on this provision to provide research without charge. Broker-dealers are compensated for this research through the receipt of trading flow, and the resultant commissions
- The receipt of hard dollars, however, calls into question whether the broker-dealer can rely on this traditional exemption
- To the extent that MIFID II requires fund managers to pay hard dollars in exchange for research, broker-dealers may find themselves required to register as investment advisers
- The industry is currently consulting the SEC regarding this issue, but no guidance or relief has to date been forthcoming from the SEC

Inducements & Unbundling of Research

Practicalities

- Non-EU investment banks, brokers and fund managers may find that their research costs are unbundled and separately invoiced through an RPA by their EU broker-dealers
- EU clients and counterparties may not be able to receive inducements unless these qualify as “minor, non-monetary benefits”
- EU clients and funds may expect non-EU investment banks, brokers and fund managers to unbundle as a matter of market practice
- Some investment banks, brokers and fund manager firms may wish to apply the same standards globally while others will apply different compliance policies to different parts of their group
- Some clients and funds may not be ready or able to pay for research in hard dollars
- Unrequested research: Systems required to ensure that a firm stops receiving or ceases benefiting from research that is not requested and is not wanted

Remuneration & Incentives

Requirements

- Firms must not remunerate or assess the performance of their own staff in a way that conflicts with their duty to act in the best interest of their client or provides an incentive for recommending or selling a particular financial instrument when another product may better meet the client's needs
  - Design compliant remuneration policies and practices
  - Remuneration policy must be approved by management body
- Relevant staff:
  - all relevant persons with an impact, **directly or indirectly**, on investment and ancillary services provided by the investment firm, or on its corporate behavior, regardless of the type of clients

Scope

- Applies to non-EEA firms only in relation to activities carried on from an establishment in the United Kingdom

Best Execution

Requirements

- Obtain the best possible results on a consistent basis when executing client orders
  - Slightly amended text vs. MiFID I
- Disclosure to clients of commissions, execution costs and research-related expenses
- Reporting requirements
  - Annual publication on the firm's website about the top five execution venues in terms of trading volume where client or fund orders have been executed and information on the quality of execution
  - Not client-specific or fund-specific
- Execution policy
  - Stating how orders will be executed
  - Fund/client consent required
  - Most MiFID I policies need amending and repapering by in-scope firms to comply with MiFID II

Best Execution

Scope – fund managers

- In-scope fund managers are EU fund managers:
  - That provide managed account services to clients; or
  - That are established in an EU member state that has opted to extend some of the MiFID II requirements to the EU fund managers in their country
- UK is extending the MiFID II rules on best execution to all UK authorized UCITS management companies, with some modifications
- UK AIFMs and incoming EEA AIFM branches are already subject to best execution provisions under AIFMD which will remain the case; the FCA has decided not to extend the MiFID II reporting requirements to these firms
- The extension of the MiFID II best execution rules to small authorized UK AIFMs and residual CIS operators has been delayed by the FCA
- The FCA expects in-scope fund managers to push the applicable best execution rules down onto its sub-managers

Best Execution

Practicalities

- Non-EU investment banks, brokers and fund managers using an EU broker-dealer for trade execution will likely be repapered by the EU broker-dealer because the broker-dealer will need to provide its clients with appropriate information on their execution policy, including how orders will be executed
- Non-EU investment banks, brokers and fund managers may need legal advice as to the revised terms of their brokerage agreements
- Non-EU investment banks and brokers may find that they are at a competitive disadvantage if they do not adopt similar information disclosure practices

Repapering Generally

- MiFID II includes revised frameworks for many of the existing national rules for conduct of business, including conflicts of interest, suitability and appropriateness, inducements and best execution
- Non-EU investment banks, brokers and fund managers that use an EU broker may find that the EU broker needs to repaper them with new terms of business and may want to change certain elections or client categorizations
- Structures involving in-scope investment banks, brokers and fund managers will need to consider whether any aspects require them to repaper their funds or investors

Transparency and Transaction Reporting

- No specific requirements imposed on non-EU persons
- Pre-trade: trading venues must make public on a continuous basis during normal trading hours current bid and offer prices and the depth of trading interests in those prices which are advertised through their systems
- Post-trade: details of actual transactions must be made public by EU brokers as close to real time as possible – for equities, within one minute of trading, and for non-equities, within 15 minutes (reducing to five minutes in 2020)
- Anonymized information to be published about all transactions on EU trading venues and in certain products
  - Covers equity and non-equity products
  - Traded on EU exchanges, multilateral trading facilities and organised trading facilities
  - Exemptions for larger-in-size trades and illiquid instruments
- EU firms subject to MiFID II transaction reporting obligations will need LEI data for all of their counterparties to report to transactions to regulators
- Intended to help users and the buy-side by making more information available
- However, trading strategies may be impacted

Algorithmic trading is the "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."

MiFID, Article 4(39)

Excludes any system that is only used for the purpose of routing orders to one or more trading venues, processing of orders involving no determination of trading parameters, confirmation of orders or post-trade processing of executed transactions

Algorithmic Trading Strategies

Requirement

- General requirements for the regulation of firms engaging in algorithmic trading and prevention of unregulated firms, including those outside of the EU, from engaging in such trading on EU trading venues

Scope

- Application to non-EU investment banks, brokers and fund managers depends on the laws of the relevant EU member state
- Perimeter issues vary by member state

Algorithmic Trading Strategies

Practicalities

- Non-EU investment banks, brokers and fund managers using an algorithmic trading strategy may need to cease accessing some continental EU trading venues or obtain a local license in the relevant member state

Direct Electronic Access

DEA is "an arrangement where a member or participant or client of a trading venue permits a person to use its trading code so the person can electronically transmit orders relating to a financial instrument directly to the trading venue and 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)."MiFID, Article 4(41)

DEA is **not** where a non-member user "cannot exercise discretion regarding the exact fraction of a second of order entry and the lifetime of the order within that timeframe"

ESMA Guidance clarifies that the issue is whether the DEA user can exercise discretion as to the exact fraction of a second in sending an order, not the exact timing of an order reaching the matching engine

Direct Electronic Access

Requirement

Providers of DEA must:

1. Have systems and controls in place to review the suitability of clients using the service to:
   - Ensure users are prevented from exceeding pre-set trading and credit thresholds
   - Monitor trading by clients
2. Ensure that clients using their DEA services comply with the relevant requirements of MiFID II and with the rules of relevant trading venue
3. Enter into binding written agreements with their DEA clients

Direct Electronic Access

Scope

- The ability of non-EU entities to use DEA services to access EU trading venues depends on the laws of the relevant EU member state
- UK: Overseas persons exclusion preserved: no regulation of entities not established in the UK that want to use or provide DEA services to access UK trading venues
- For most other EU member states: entities will need to be locally licensed as a condition to accessing a trading venue using DEA and those entities will need to comply with various systems and control requirements
- However, exemptions are available: Netherlands has a limited equivalence regime and Germany has a six-month transitional regime for firms newly subject to local licencing requirements

Direct Electronic Access

Practicalities

Non-EU investment banks, brokers and fund managers using DEA services:

- Will need to cease accessing or being a member of some continental EU trading venues or obtain a local license in the relevant member state
- Will need to comply with the relevant requirements of MiFID II and with the rules of relevant trading venue
- Will need to enter written agreements with the DEA service provider

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