MiFID II Understanding and Practical Preparation

AN ACA COMPLIANCE (EUROPE) SERIES

ACA COMPLIANCE (EUROPE)

MiFID II
Primary legislation and implementing acts (updated)

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This paper is part of our MiFID II: understanding and practical preparation – An ACA Compliance (Europe) series of client communications prepared to help our clients understand this significant reform of the European regulatory landscape and work out the direct and indirect implications for their own businesses. In this publication, as the legislative process nears its conclusion, we summarise the main impact areas of the reforms for buy-side firms. This will be supplemented in the coming months by further written guidance notes and verbal presentations on individual areas of focus. Please contact us if you would like to suggest future topics for discussion.

Background

The Markets in Financial Instruments Directive ("MiFID"), which came into force in 2007, represented the European Union's first attempt to regulate its financial markets. It introduced harmonised rules for authorisation, conduct of business and investor protection, competition between new categories of trading venues, and new requirements for transaction reporting in equities. The objective of MiFID II was largely to build upon this work and represents the first comprehensive enhancement to this regime.

How ACA will support you through MiFID II

The main structure of the MiFID II reforms is now in place, even though some of the implementing measures and supporting guidance from the European Commission ("EC"), the FCA and HM Treasury are still awaited. Within an appropriate timeframe prior to implementation day (3 January 2018), we will help our clients through their MiFID II implementation planning, including making necessary revisions to their compliance documentation and monitoring programmes.

Please contact **James Andrews**, **Martin Lovick** or your usual ACA contact with any specific questions or concerns arising from this paper.

The MiFID II process

LEVEL 1

The EC first announced its proposals for the review of MiFID back in 2011. The primary legislation (known as "Level 1") consists of two linked instruments both of which "came into force" in July 2014:

- Directive 2014/65 on markets in financial instruments ("**MiFID II**"); and
- Regulation 600/2014 on markets in financial instruments ("**MiFIR**").

Collectively, these texts are usually referred to as "MiFID II". MiFIR has direct force across the EU and hence does not require separate implementation in each member state. MiFID II – the Directive – must be transposed into each national jurisdiction's laws and regulations.

MiFID II's original timetable has been delayed by one year, with national transposition now required by 3 July 2017, and the go-live date itself now set for 3 January 2018.

LEVEL 2

This contains the often crucial, operational-level detail, which comes in two forms of implementing measures:

- **Delegated acts** – which are drafted by the EC on the basis of advice from the European Securities and Markets Authority ("ESMA"). These are only now being gradually rolled out (originally due mid-2015), broken down into Delegated Directives ("DD") which must be transposed into the law of member states, and Delegated Regulations ("DR") with direct force.
- **Technical standards** – which are drafted by ESMA and approved by the EC. These are further broken down into Regulatory ("RTS") and Implementing ("ITS") Technical Standards. The majority of these were published in September 2015, although the EC initially pushed back on a handful of issues for further consideration by ESMA.

Although both sets of implementation measures are subject to final ratification by the European Parliament and Council, the majority have now cleared this hurdle and further substantive changes to the remainder are now, in our view, unlikely.

LEVEL 3

Given the complexities and inherent possibility of inconsistencies in the implementation process, we expect a further round of guidance from ESMA closer to January 2018, probably supplemented by Q&As.

FCA/HM TREASURY IMPLEMENTATION

The FCA published its first Consultation Paper (CP15/43) in December 2015 on its proposed changes to the Handbook in relation to market structures. It now intends to publish two further consultation papers on conduct issues in July and September 2016. HM Treasury published its consultation on proposed legislative changes back in March 2015.

Does MiFID II affect AIFMD-authorised managers?

Pure Alternative Investment Fund Managers ("AIFMs") – i.e. Collective Portfolio Management ("CPM") firms which act only as AIFMs – and UCITS managers are not subject to MiFID rules. However, Collective Portfolio Management Investment ("CPMI") firms which are also authorised to carry on other investment business (such as managing individual accounts) are subject to MiFID rules with respect to their investment business other than managing an Alternative Investment Fund (an "AIF") and/or managing a UCITS. This will not change under MiFID II. These MiFID rules cover conduct of business as well as organisational (SYSC) requirements. In addition:

- Certain managers carrying out algorithmic trading strategies will require registration with their local competent authority;
- A manager or adviser located in the EU which is not an AIFM will remain subject to MiFID rules. This covers EU sub-managers and advisers of AIFs whether the AIFM is based inside or outside the EU;
- Where a non-EU firm has been delegated portfolio management by an EU manager, the non-EU manager is likely to be subject to MiFID II's new third country rules;
- ESMA has stated the desirability of extending its MiFID II proposals on paying for company research to AIFMs and UCITS managers and we expect the same argument (creating a level playing field) will be applied to other conduct of business rules such as best execution;
- MiFID II will radically change the entire infrastructure of EU financial markets and a high level understanding of these reforms is critical to any manager operating in this universe.

MiFID II: The key reforms and their implications

This section splits the reforms into three main areas, and under each issue we summarise the main reforms and also the significant implications for buy-side firms:

1. Market structure
2. Organisational requirements for firms
3. Conduct of business rules for firms

1. Market Structure

(a) Transparency in equities and bonds

KEY REFORMS

MiFID II greatly expands the existing pre- and post-trade transparency requirements into new equity-like and non-equity instruments.

Article 3 of MiFIR extends the pre-trade transparency requirements to equity-like instruments, such as depositary receipts, ETFs, and certificates, and Article 6 does the same for post-trade transparency. Article 4 concerns waivers for certain equity transactions (e.g. large orders and illiquid shares), and Article 7, the deferral of post-trade publication (all similar to the current regime for equities).

Article 5 concerns the Volume Cap Mechanism which limits the volume of transactions dealt in dark pools. Waivers in a given share in each trading venue will be capped at 4% of the volume traded in the previous 12 months, and total trading in each share across all EU venues at 8%.

The above structure is replicated for the non-equity instruments, where Article 8 extends pre-trade transparency to bonds, structured finance products, emission allowances and derivatives traded on a trading venue. Article 9 concerns waivers for these products, Article 10 post-trade transparency, and Article 11 deferred publication.

RTS 1 contains the post-trade requirements for shares and share-related instruments executed on trading venues, with Annex I containing the data fields to be made public, including the list of flags to be attached (e.g. deferred publication) and information about the trading venue (e.g. quote-driven). RTS 3 sets out the technical standards for the volume cap mechanism.

Following the same pattern as above, Draft RTS 92 contains the equivalent for bonds, structured finance products, emission allowances and derivatives. Definitions of liquid markets are critical here as there are waivers for illiquid instruments with Annex III containing the liquidity assessment of each asset class.

Responding to the EC's criticism of its original proposals, ESMA has accepted the recommendation of a four year phase-in both in relation to determining whether a particular bond is "liquid" (as defined by the average number of trades per day) and in the setting of size thresholds for establishing waivers for "large" transactions. ESMA has however proposed that this phase-in be automatic and accompanied by its annual liquidity assessment, with the RTS only being amended to prevent the next stage of automatic phase-in where liquidity has significantly declined.

IMPLICATIONS FOR BUY-SIDE

The new transparency regime has limited direct impact on the buy-side, but potentially major secondary effects to the liquidity of individual instruments and asset classes and, hence, the viability of many investment strategies. Clearly, any impact would be felt most by firms employing strategies which invest heavily in the equity-like and/or non-equity asset classes which are being brought within the transparency regime for the first time.

b) Trading venues

KEY REFORMS

MiFID II refines the existing definitions of Regulated Markets ("RM"), Multilateral Trading Facilities ("MTF"), and introduces a new category of venue, the Organised Trading Facility ("OTF"). OTFs are mainly distinguished from MTFs in that the execution of orders on an OTF can be carried out on a discretionary basis (therefore, certain conduct of business duties to clients will apply) – see Articles 18-20 of MiFID II. Overall there are few differences in the obligations applying to these 3 types of venue.

The definition of a Systematic Internaliser ("SI") is also being overhauled – a "firm which, on an organised, frequent, systematic and substantial basis, deals on its own account when executing client orders".

The RTS specify how financial instruments are admitted to and suspended from trading on regulated markets, and the information to be provided by MTFs and OTFs to competent authorities.

IMPLICATIONS FOR BUY-SIDE

No direct impact but the intention behind the new OTF and amended SI concepts is to bring what were previously off-market broker crossing networks "into the light" with transparency requirements equivalent to other trading venues. Note also that the OTC derivative contracts now falling under the new trading obligation must be traded on an RM, MTF or OTF where there is sufficient liquidity. You should consider how your market counterparties are likely to adapt to the new venue categories.

c) Trading obligation for cleared OTC derivatives

KEY REFORMS

MiFID II builds on the regulatory assault on OTC derivatives markets begun under the European Markets Infrastructure Regulation ("EMIR"). Article 28 of MiFIR establishes that the requirement to trade OTC derivatives on trading venues has equivalent scope to EMIR, namely any contract entered into by financial counterparties, non-financial counterparties above the clearing threshold and equivalent third country entities. Article 32 again mirrors EMIR in applying the trading obligation to classes of OTC derivatives subject to the clearing obligation, but introduces further liquidity criteria that must be satisfied.

RTS 26 contains the detailed methodology for the timely acceptance for clearing of contracts, known as Straight-Through-Processing ("STP").

IMPLICATIONS FOR BUY-SIDE

As well as dealing with the operational aspects of trading cleared derivatives on regulated venues, firms should consider the impact of OTC derivative markets effectively becoming a thing of the past in many asset classes.

2. Organisational requirements on firms

a) Internal functions (compliance, conflicts of interest, risk management and telephone recording)

KEY REFORMS

Article 16 of MiFID II carries forward and refreshes the organisational requirements of the original MiFID which in turn are transcribed in the SYSC sourcebook of the FCA Handbook. The most critical areas are:

- **Compliance**: an independent function with the necessary authority, resources and expertise to monitor and assess the firm's compliance with its regulatory obligations;

- **Risk management**: an independent (at least from portfolio management) function to identify the risks relating to the firm's activities, processes and systems and, where appropriate, set the level of risk tolerated by the firm;
- **Conflicts of interest**: effective arrangements to prevent, manage or disclose (in the last resort) actual or potential conflicts between the firm and its clients or between two or more clients;
- **Product governance**: appropriate controls over financial products that the firm has either "manufactured" or is distributing to ensure that these are consistent with the needs of the identified target market (similar to the FCA's Treating Customers Fairly regime);
- **Record-keeping**: adequate records of all services, activities and transactions undertaken by the firm. These must include the recording of telephones and electronic communications relating both to transactions and conversations "intended to result in a transaction". Note that the previous FCA exemption for discretionary investment managers relying on their brokers to record disappears under MiFID II. All such records must be maintained for five years (or seven, if required by your regulator).

The prescriptive requirements for these and other organisational requirements are set out in Articles 21 to 29 of the relevant DR.

IMPLICATIONS FOR BUY-SIDE

Although there are few substantive changes to the existing SYSC requirements on firms, product governance (particularly for MiFID firms marketing funds on behalf of a third party manager) and record-keeping/telephone recording are both areas where significant changes in arrangements are likely to be necessary. Further guidance in these areas may be expected from the FCA consultations due later in the year.

b) Inducements, dealing commissions and paying for research

KEY REFORMS

Article 24 (8) of MiFID II prohibits investment managers from accepting "fees, commissions or any monetary or non-monetary benefits paid or provided by any third party". This imposes a total ban on inducements other than in relation to "minor non-monetary benefits", and was initially interpreted by many (including the FCA) as ending all dealing commission arrangements to pay for company research. After a protracted period of political debate, the EC finally published its proposals in its DD on "fees, commissions or any monetary or non-monetary benefit" in April 2016.

Article 12 sets out a list of non-monetary benefits that are minor and therefore acceptable. These must be reasonable and proportionate and unlikely to influence the recipient in such a way that is detrimental to the client's interest, including:

- Basic information relating to a financial instrument or investment service (either generic or personalised to an individual client);
- Conferences or training events on the features of a specific financial instrument or investment service;

- **Hospitality of reasonable de *minimis* value, e.g. food provided at a conference.**

Article 13 states that substantive research services can only not be an inducement (and hence allowed) if they have been paid for either:

- **Directly by the firm out of their own resources; or**
- **From a separate Research Payment Account ("RPA") controlled by the firm.**

The RPA must be funded by a specific research charge to each client of the firm. The amount of funding must be determined by a research budget which must be set and regularly re-assessed in line with the perceived need for research. The firm must also make regular formal assessments on the quality of research received and whether it has actually contributed to better investment decisions.

The specific research charge to each client must be based on the research budget as established by the stated need and must not be linked to the value or volume of transactions – in other words, a simple Commission Sharing Arrangement ("CSA") is no longer allowed. However, the text does allow for an operational arrangement whereby a research charge is collected alongside a transaction commission – in other words a "research commission" – but which contains a mechanism to revert to execution-only commission rates once the RPA is fully funded. Sometimes this arrangement is referred to as an "enhanced CSA.

IMPLICATIONS FOR THE BUY-SIDE

These reforms for inducements and paying for research amount to a radical break from past practice. Alongside a rule on sell-side firms requiring them to split out execution commissions from "other benefits or service", they amount to an effective unbundling of receiving research "free" in exchange for commissions paid. Going forward, paying for research without some sort of "arrangement" in place between investment manager and broker would appear to be problematic. RPA's will also need to be set up in such a way that they do not amount to buy-side firms "holding client money" which would require a separate permission and an additional layer of compliance – a potential problem that may point towards a delegation solution.

c) Algorithmic and high frequency trading, and direct market access

KEY REFORMS

MiFID II attempts to address concerns arising from the rapid pace of technology in financial markets and, in particular, the market integrity issues stemming from algorithmic and high frequency trading. Definitions are important in determining who is caught by the new requirements (Article 4 of MiFID II):

- **Algorithmic trading: "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";**
- **High frequency algorithmic trading ("HFAT"): "an algorithmic trading technique characterised by... infrastructure intended to minimise network and other types of latencies... system-determination of order initiation, generation,**

routing or execution without human intervention... or high message intraday rates (at least two per second for an individual instrument, or four per second across all instruments traded on a trading venue)".

Article 17 of MiFID II requires all firms undertaking such activities to be registered with their home competent authority and that of the trading venue of which they are a member. Organisational requirements include systems and risk controls to prevent the transmission of erroneous orders or causing a disorderly market. These controls include non-live testing of algorithms prior to roll out (and periodically thereafter) and detailed systems requirements in relation to risk management, business continuity and outsourcing. The firm's home competent authority may, at any time, require the firm to provide details of the systems and controls it has in place and, in relation to algorithmic trading, a description of the nature of its strategies.

HFAT firms (a sub-set of algorithmic traders) are subject to additional requirements including retaining detailed records of their trading systems for at least five years and making these available to regulators upon request. HFAT firms using market making strategies may be caught by the requirement to participate in market making schemes with trading venues.

Article 17 also introduces a new layer of regulation for investment firms providing direct market access ("DMA"), requiring them to supervise their clients' activity to prevent disorderly trading and market abuse.

RTS 13 specifies the detailed organisational requirements for firms engaged in algorithmic trading, and RTS 14 does the same for MTFs and OTFs. RTS 15 determines that a firm making continuous quotes for at least 30% of the trading day will be considered to be pursuing a market making strategy, and establishes the requirements for market makers and market making schemes.

IMPLICATIONS FOR THE BUY-SIDE

The proposals amount to a shift in the burden of proof between regulator and firms, with the latter having to present positive evidence of their systems meeting integrity and resilience standards. Those caught by the new definitions face a significant additional layer of obligations and compliance monitoring. Firms using DMA providers are also likely to face significant changes to legal agreements, reflecting the greater responsibilities falling on DMA's to monitor the trading of their clients.

d) Third country firms

KEY REFORMS

Although MiFID enabled EU investment firms to passport their services across the EU, it did not extend this treatment to non-EU firms, with each country left to apply its own rules to such entities. MiFID II introduced a harmonised framework of regulation for non-EU firms for the first time.

Article 39 of MiFID II establishes rules for third country firms providing services to retail or elective professional clients, requiring them to do so through an EU branch.

Article 46 of MiFIR introduces a regime for third country firms providing services to per se professional clients and eligible counterparties which allows them to passport these services across the EU. Such firms will, however, be required to register with ESMA who will assent to passporting subject to the fulfilment of three conditions:

i **The firm must already be authorised and subject to effective supervision in a third country;**

ii **The EC must have adopted an equivalence determination for that third country;**

iii **Cooperation arrangements must be in place between the EU and the third country.**

ESMA will maintain a publically available register of all such registered third country firms (this is expected to be known as the Article 48 register).

IMPLICATIONS FOR THE BUY-SIDE

The new rules for third country firms potentially amount to a significant opening up of EU financial markets particularly at the wholesale end. In practice, as we have seen with the AIFMD marketing passport, much will depend on how effectively the equivalence assessment process works in respect of third country regimes.

3. Conduct of business rules for firms

a) Best execution

KEY REFORMS

Article 27 contains the best execution obligation, including changing the requirement to take "all *reasonable* steps" to "all *sufficient* steps". As subtle as that re-wording would seem, this represents an enhancement to the position under the original MiFID, and will underpin the importance of looking to the relative importance given to the execution factors ('price', 'costs', 'speed' and 'likelihood of execution') as part of a firm's monitoring processes. It is likely that being able to demonstrate that best execution has been consistently achieved will become a significantly more burdensome exercise for firms, involving the recording and analysis of a greater volume of comparison data across markets and trading venues. Also, firms must summarise and publish annually their top five execution venues in terms of volume and information on the quality of execution actually obtained, and enhance their execution policies and client disclosure, with a view to increasing transparency to investors.

Not much has changed in respect of the enhanced best execution obligations from the text of the Delegated Acts over and above the Level 1 text and RTS. There is more emphasis placed on best execution obligations in respect of Securities Financing Transactions ("SFT"), making it expressly clear that, whether the order under contemplation will involve entering into an SFT is one of the criteria that firms should assess in determining the relative importance to be given to the execution factors.

IMPLICATIONS FOR THE BUY-SIDE

The enhanced best execution obligation represents a major strengthening of a regime which, outside of the equities sphere, some firms have only just started to get to grips with. Compliance teams will need to engage with their front office to expand upon the detail contained within their order execution policies, outlining their execution strategy and approach across all relevant asset classes traded. Additionally, firms will need to reconsider the mechanics of their current trade surveillance process, to ensure that they encompass a sufficient breadth of currently available (and soon to be available) data for market / pricing comparison to facilitate monitoring of execution quality and the public disclosure element.

b) Transaction reporting

KEY REFORMS

MiFIR broadens the scope of financial instruments caught by transaction reporting beyond equity instruments, and greatly increases the number of data fields to be reported.

Under Article 26, transaction reporting will apply to all financial instruments admitted to trading on a trading venue, or whose underlying is such a financial instrument, or financial instruments based on a basket where at least one component of the basket is such a financial instrument. The currently exempted bond, interest rate, commodity and FX derivatives thus all come into scope, as do all instruments traded on MTFs and OTFs.

Trading venues also become responsible for all transactions executed through their systems by non-MiFID firms.

Although Article 26 sets out the high level requirements, the details of the new data fields are set out in RTS 22. These include Legal Entity Identifier ("LEI") codes, any applicable waivers under which the transaction has taken place, short sales and the ID's of the individual trader or algorithm responsible for the decision to trade. Annex I of this RTS contains the table of fields, amounting to 65 fields in total.

The original MiFID carried an exemption for firms relying on a third party to make reports on their behalf which was interpreted broadly by the FCA to mean that discretionary investment managers can rely on their brokers (assuming they are MiFID investment firms) to transaction report. This exemption is only partially carried forward under MiFID II, introducing the concept of an investment manager "transmitting" an order to a broker for execution. Where this occurs, the transmitting firm may still rely on the "receiving" firm (the broker), but only where two conditions are fulfilled:

- **A prior written transmission agreement between the transmitting and receiving firms; and**
- **The sending of certain specified details about the order to the receiving firm, including identifying the client or clients for whom the transaction has been made (if across a number of funds/accounts), the identification of the individual or algorithm who make the decision to trade, and execute it, and a designation to identify short sales.**

IMPLICATIONS FOR BUY-SIDE

Importantly for UK AIFMs, the FCA proposes to apply the new transaction reporting rules only to MiFID investment firms, and not extend them to managers of collective investment undertakings (including AIFMs and UCITS managers) or pension managers. The impact of this, should it carry through the FCA's consultation process, would be that UK AIFMs would not be subject to the transaction reporting regime under MiFID II.

For MiFID firms, transaction reporting becomes much more onerous, and the delegation of reporting to your executing broker more complicated.

c) Commodity derivatives reporting

KEY REFORMS

Although commodities traded on spot markets remain outside the financial instrument definition, the scope of commodity derivatives is now very broad (see Annex I section C of MiFID II), including all contracts that are cash settle-able and all physically settle-able contracts traded on a trading venue. Emission allowances also now come into the MiFID definition. Existing exemptions for commodity firms narrow to non-financial firms whose trading activity is "ancillary" to their main business.

Article 57 of MiFID II establishes position limits (to be set by national competent authorities) for firms trading commodities and commodity derivatives, in order to support orderly pricing and prevent market abuse. Article 58 establishes the details of daily position reports that firms must make to trading venues on a daily basis. Trading venues are required to send this data to ESMA on a weekly basis and they in turn will publish aggregated data which distinguishes between commercial and financial firms.

In response to ESMA's RTS 21, the EC proposed lower position limits in some agricultural commodities to take account of the high volatility of such instruments. It also proposed greater flexibility in the use of open interest as a parameter to set limits in contract months other than the one closest to expiry and an expansion of the definition of Economically Equivalent OTC contracts which must also be subject to position limits. ESMA has responded to each of these issues with proposals to: lower position limits on commodities with foodstuffs as underlying to 2.5%; adjust position limits for other contract months where deliverable supply and open interest diverge significantly; and by widening the definition of contracts traded "OTC only" to prevent this being used as a means to circumvent the position limits regime.

IMPLICATIONS FOR BUY-SIDE

Daily position reporting will become a fact of life for any buy-side firm pursuing commodity-based investment strategies. The intention is that the integrity of commodity trading should improve as market squeezes and other forms of manipulation become harder to effect without detection.

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