The Asset Management Survey: MiFID II and MiFIR
Insights into the latest strategic thinking and implementation plans of asset managers.

MiFID II and the Information Management Challenge
How regulatory reform will have an unprecedented impact on how firms manage data and information across asset classes.

Asset Managers and MiFID II's Investor Protection Requirements
A look at potential strategic and commercial implications for distribution models and product offerings.

Financial Conduct Authority Publish Third MiFID II Implementation Consultation Paper
Focus on conduct of business issues, product governance and perimeter guidance.

Global Trustee and Fiduciary Services News & Views

MiFID II Special Edition 2016

Markets and Securities Services

citi

CONTRIBUTORS

Michael Aldridge
Global Head of Trading Services
IHS Markit
michael.aldridge@ihsmarkit.com
+1 917 441 6344

Peter Bevan
Partner
Linklaters LLP
peter.bevan@linklaters.com
+44 (0) 20 7456 3776

Peter Chapman
Senior Associate
Clifford Chance LLP
peter.chapman@cliffordchance.com
+44 (0) 20 7006 1896

Jeremy Elliott
Senior Professional Support Lawyer
Clifford Chance LLP
jeremy.elliott@cliffordchance.com
+44 (0) 20 7006 3442

Paul Fraser
Senior Manager
Risk Advisory
Deloitte LLP
pfraser@deloitte.co.uk
+44 (0) 20 7007 3843

Amanda Hale
Head of Regulatory Services
Citibank Europe plc
amanda.jayne.hale@citi.com
+44 (0) 20 7508 0178

Andrew Henderson
Financial Institutions Group
Eversheds LLP
andrewhenderson@eversheds.com
+44 (0) 20 7919 0898

Jacqueline Jones
Senior Professional Support Lawyer
Clifford Chance LLP
jacqueline.jones@cliffordchance.com
+44 (0) 20 7006 2457

Sean Kerr
Senior Professional Support Lawyer
Clifford Chance LLP
sean.kerr@cliffordchance.com
+44 (0) 20 7006 2535

Andrew Newson
Senior Fiduciary Technical Analyst
Citibank Europe plc
andrew.c.newson@citi.com
+44 (0) 20 7500 8410

Manmeet Rana
Director
Risk Advisory
Deloitte LLP
mrana@deloitte.co.uk
+44 (0) 20 7303 8624

CONTENTS

Amanda Hale

Head of Regulatory Services, Trustee and Fiduciary Services, Citi

INTRODUCTION

Welcome to our MiFID II Special Edition of *Global Trustee and Fiduciary Services News and Views.*

For Issue 46, we chose to focus on the key aspects and the latest developments of MiFID II and MiFIR.

As a reminder, the current timetable for implementation is…

Transposition by Member States

3 July 2017

Date of application for MiFID II and MiFIR

3 January 2018

As many of our readers will be aware, MIFID II is a significant, multifaceted piece of EU legislation that could have large-scale ramifications for the asset management industry. Many firms are in the process of assessing the new requirements and the impact these will have on their existing operating and distribution models, risk framework, IT infrastructure and financial position. With so much complexity to manage amid a backdrop of continued regulatory uncertainty, we thought it would be an opportune time to undertake an extensive survey of global asset managers to assess industry progress and obtain an insight into the latest thinking on a wide range of MIFID II related areas, including investment research, disclosure requirements and target market rules.

We hope you find the survey's results an interesting snapshot of other firms' thinking on this topic and a useful benchmark for your firm's preparedness against the wider asset management universe. The survey can be found on page 32.

This Special Edition also includes a number of other related articles.

- The MiFID II investor protection requirements
- Commodities
- Algo, high-frequency trading (HFT) and direct electronic access (DEA)
- A view from the UK: which looks at the FCA CPs published in July and September
- MiFID II: the Information Management Challenge, including Clock Synchronisation
- Brexit, third country rights and segregated mandates
- Increased transparency requirements
- And the mandatory trading of derivatives

Of course MiFID II does not just impact asset managers who are MiFID firms: various out-of-scope firms will also be affected – such as UCITS management companies, AIFMs and insurance companies offering life and pensions insurance products.

MiFID II contains various mandates that either require or permit the European and Securities Markets Authority (ESMA) to produce non-binding guidelines on various aspects of the Level I texts. Work is progressing on these Level 3 guidelines in the form of Q&As, most recently with the publication of a Q&A covering certain investor protection measures.

Some jurisdictions are much further ahead in terms of discussing how MiFID II and MiFIR will be implemented into local rules, such as in the UK and France, for example. Here we have seen that the two regulators have differing views on requirements concerning investment research. In the UK specifically, we saw the publication of the Financial Conduct Authority's (FCA's) third consultation paper (CP16/29), which looks at investor protection issues.

We hope that you find this Special Edition helpful for its insights into the Level 2 legislation and for its utility as a useful resource for assisting you in your MiFID II and MiFIR planning.

January 2018 may seem like a long way off. But even just considering the areas touched on in this Special Edition, we think that there is still a lot to be done in a rapidly diminishing timeline.

We would like to thank all the contributors for their time and insights into this complex and very technical legislation, and we are grateful to them for sharing their knowledge and experience with us and our readership.
We hope that you enjoy this MiFID II/MiFIR Special Edition of *Global Trustee and Fiduciary Services News and Views*.

In the meantime, if you have any questions or would like to know more about other regulatory matters not covered in this edition, we invite you to contact our Regulatory Services team (see contact details at the back), who will be happy to help.

REFORMING THE TRADING LANDSCAPE AND IMPROVING INVESTOR PROTECTION

MiFID II and MiFIR, in brief . . .

UNDERSTANDING MiFID II

MiFID II and MiFIR (the Markets in Financial Instruments Directive and Regulation, respectively) will reform how securities are traded in Europe. The European Commission, with the help of ESMA, has now drawn up the necessary technical rules to ensure the requirements under MiFID II/MiFIR are understood and applied in the same way across the EU.

SAFER, MORE EFFICIENT MARKETS

MiFiD II is a comprehensive set of rules determining how securities in the EU – like shares, bonds and derivatives – are traded, especially on trading platforms or stock exchanges. It also sets the standards for investment services and how firms providing such services or operating or acting on trading platforms are set up.

It will bring more trading of securities onto transparent trading platforms that treat investors according to the same high standards, allowing for better and fairer price formation. Loopholes such as dark-pool trading (trading without disclosing prices in real-time) are no longer an option for regular trading. Instead, it will be available where needed to protect investors or those providing liquidity to the markets.

Trading in commodity derivatives will be made more transparent and better organised by limiting how big a position any investor can build up, and authorisation requirements will be broadened.

Requirements to make electronic trading systems more robust and tighter authorisation requirements will be introduced to keep pace with the increasing use of rapid and computerised high-frequency trading. MiFID II should also stimulate competition in trading and related services since the same security can be traded in different places. At the same time, by encouraging the compilation of trading data in one place (consolidated tape), MiFID II will make it easier to get the full picture of where to find the best deal.

BEST INTEREST OF THE CLIENT

When using the services of an investment firm, investors must trust that the service is provided in the best interest of the client and not for other reasons (for example, commissions received by the firm from third parties). So under MiFID II, inducements are not allowed for portfolio management and independent advice and only permitted in other cases where they enhance quality. Reporting to and cooperation between EU supervisors as well as sanctions will be strengthened, and there will be one-stop shop treatment (passport) for non-EU firms that want to access EU markets provided that their home countries have equivalent frameworks.

These new rules should benefit the economy as a whole by improving the way that capital markets work.

ASSET MANAGERS AND MiFID II's INVESTOR PROTECTION REQUIREMENTS

The revised Markets in Financial Instruments Directive (MiFID II) will introduce for EU asset managers a plethora of new requirements that will have a fundamental impact on managers' operating environment and how they interact with their trading counterparties, clients, investors and distributors. While there has been much debate on the effects of MiFID II on the trading landscape, this article focuses on the investor protection requirements and their potential strategic and commercial implications for distribution models and product offerings. Asset managers will face particular challenges when implementing the requirements of MiFID II across areas such as product governance arrangements, costs and charges information, reporting to clients, and applying the new inducements regime. The new rules in these areas may affect not only compliance arrangements and operational processes but also business models and marketing strategies. This article sets out some of the key commercial and strategic challenges asset managers are likely to face over the next 18 months as a result of the forthcoming regulatory changes.

Impact of the UK's vote to leave the EU

In the UK, MiFID II looks set to stay following the results of the referendum on EU membership on 23 June 2016. The Financial Conduct Authority (FCA) immediately clarified its position, stating that "firms must continue to abide by their obligations under UK law, including those derived from EU law and continue with implementation plans for legislation that is still to come into effect".[1] As MiFID II is due to take effect from 3 January 2018, which is expected to be before the UK leaves the EU, the clear message is that firms should continue with their implementation efforts.

That said, the UK's decision to leave the EU (or "Brexit" as it is called) will naturally cause some asset managers operating in the UK to divert some of their attention away from MiFID II, focusing their efforts on communicating with clients to maintain investor confidence while closely scrutinising investment performance and risks in the wake of market uncertainty and potential illiquidity. Asset managers, in common with other regional and global financial institutions, will no doubt carry out a strategic assessment of the possible impact of Brexit on the evolution of their operating model, product range, client base and distribution networks. From a regulatory perspective, the longer-term impacts of Brexit and what that means for the overall regulatory framework in the UK will depend on the future relationship that the UK ultimately negotiates with the EU. However, firms operating in the UK should consider the impact of Brexit within the context of upcoming regulatory changes, such as MiFID II and Packaged Retail and Insurance-based Investment Products (PRIIPs) Regulation, to identify possible implications for their operating models and business strategies under the various Brexit scenarios.

Product manufacturing and distribution

The enhanced requirements under MiFID II mean that asset managers will have to review their product approval and monitoring processes, and their interaction with distributors. The key areas of impact include: target market assessments, product approval and monitoring processes, and distribution strategy.

Under the new product governance rules asset managers and distributors must conduct target market assessments as part of the approval process for each product they manufacture and distribute. MiFID II does permit the level of detail and the criteria used to define the target market to be proportionate to the complexity of the financial instrument. Setting the target market criteria and level of detail on a fund-by-fund basis could pose a significant challenge to manufacturers and distributors alike. For example, asset managers will need to define the needs, objectives and characteristics of those investors for whom the product is deemed to be compatible and identify types of investors for whom the product is not deemed compatible. Product compatibility should be based on the investor's knowledge of, and past experience with, the product (or similar products) and on the investment strategies and market exposures of that product. Industry bodies across the EU have been working extensively to define exactly what the criteria should be for assessing target markets.

Examples of the criteria under consideration include:

- MiFID classification (retail, professional, eligible counterparty client)
- Client's investment expertise
- Client's ability to bear losses
- Client's needs and objectives
- Firm's intended distribution strategy

Distributors also need to perform their own target market assessments for the products they distribute, based on information obtained from manufacturers, in order to gain the necessary understanding and knowledge of the products. It is possible that the target market assessment conducted by the distributor does not align completely with the assessment performed by the manufacturer. Hence distributors should periodically provide the manufacturer with data on where the product has not reached the target market identified by the product manufacturer. Obtaining information on target market assessments from some asset managers could pose a particular challenge for those distributors marketing products of non-MiFID asset managers (e.g. those outside the EU). That is because those asset managers may not be subject to these new regulations and therefore may not be required to conduct target market assessments at the outset to identify the characteristics, needs and objectives of the target market. Therefore, distributors should ensure that when dealing with manufacturers not subject to the MiFID II requirements, they have appropriate arrangements in place to obtain sufficient information about the product they plan to distribute.

Where distributors offer execution-only services without a need for client appropriateness testing, the FCA stated at the MiFID II Conduct Forum (on 18 April 2016) that the distributor role may be limited to communicating the target market of the manufacturer to the investor rather than imposing any additional point-of-sale assessment requirements onto distributors.[2] How this should be communicated will depend on the distribution model, although it should be set out clearly to the customer as part of any product literature.

The new product monitoring requirements put the onus on distributors to pass sales information (e.g. the types of clients the product has been distributed to and complaints data) to asset managers periodically. Asset managers are expected to use the information to monitor the performance of each product against the needs and objectives of the identified target market identified for it. Under MiFID II, asset managers should regularly review the information provided by their distributors and consider whether their initial target market assessment and distribution strategy remain appropriate. This review should form part of a suite of holistic management information covering sales, comparisons across distributors and also product performance data, so as to ensure that the product is performing as intended. As part of product performance monitoring, asset managers should consider any current stress testing performed, including the implementation of monitoring under PRIIPs. The objective would be to identify whether existing processes cover so called "material events", which could in some way impact the potential risks associated with the product and thereby alter the identified target market.

Overall, the new product manufacturing and distribution requirements will mean significant work for some asset managers, who will need to enhance their product approval and monitoring processes.

Given the increased reliance on distributors for information and data to meet the product monitoring obligations for asset managers under MiFID II, it could well be a challenge for asset managers to analyse and assess the vast amounts of information arising from sometimes complex distribution models. They should therefore use this opportunity to evaluate their current distribution models as well as their marketing strategies, from a cost, commercial and efficiency perspective. Asset managers will need to identify what success looks like for their distribution strategies from a customer-outcomes perspective.

Overall, the new product manufacturing and distribution requirements will mean significant work for some asset managers, who will need to enhance their product approval and monitoring processes. Given the burden of information-sharing between providers and distributors, asset managers with large distribution networks may look to consolidate the number of distributors with whom they deal. Similarly, distributors selling funds from a wide range of asset managers (e.g. large platforms) may look to reduce the number of asset managers with whom they deal. The net effect will likely be further consolidation and concentration around the larger asset managers and distributors.

Investor disclosures: costs and charges

MiFID II introduces new requirements for the disclosure of costs and charges. For example, both manufacturing and distribution costs will have to be disclosed to investors on an aggregated basis together with an analysis of the impact of such costs and charges on the net return of the investment. In addition, firms must provide clients with an itemised breakdown of the aggregated costs and charges on request. There are also disclosure requirements both before and after the sale of the fund. The increased transparency regarding costs and charges should benefit investors. However, the onerous nature of the requirements may lead some asset managers to reconsider their product suites and charging structures.

The MiFID II rules do provide firms with the option of disclosing costs and charges in a less granular fashion when dealing with professional clients and eligible counterparties in some circumstances. However, where the fund is also being marketed to retail clients, asset managers will need to ensure that distributors of the fund have access to the relevant detailed costs and charges information. In addition, even when dealing with professional clients and, in some circumstances, eligible counterparties, funds which embed derivative products will require a more detailed costs and charges breakdown.

The requirements regarding costs and charges will also require firms to aggregate them into different categories. The categories are relatively broad, but even so, retail clients will be able to request a more detailed breakdown for each category. This means that asset managers will need to consider implementing systems and processes to identify, categorise, calculate and report on relevant costs and charges within the funds at a much more detailed level. Asset managers could face significant challenges in making some of these disclosures, for example information needed may not be readily available at the point of the sale of a fund. Thankfully, the rules recognise that on a pre-investment basis costs and charges disclosures can be based on estimates, while post-transaction costs and charges should comprise an aggregate and a percentage amount based on the client's actual investment amount and must be made at least annually.

As mentioned, the disclosures should provide greater transparency and give clients the ability to better compare multiple products. However, where a firm is subject to the PRIIPs Regulation and is relying on making disclosures through the publication of a Key Information Document (KID), clients will have distribution costs disclosed separately. As a result, clients may still struggle to compare charges on a like-for-like basis. The implementation date for PRIIPs is set for 31 December 2016 so before then firms will also need to consider whether they implement a tactical solution for costs and charges disclosure, or whether they opt for a full strategic solution that also covers both PRIIPs and MiFID II requirements. Potentially, this is an even bigger challenge for distributors who deal with end investors and who invest amounts across a range of products and manufacturers. Distributors should consider system solutions to obtain actual costs and charges from manufacturers to be aggregated on a client-specific basis for post-investment reporting purposes. The logistical and system challenges posed by these requirements may be a further catalyst for distributors to assess their current product suites and streamline the number of product manufacturers. In addition, for UCITS managers the UCITS KIID does not contain all the information disclosures required under MiFID II, particularly with regard to the cost of transactions. Consequently, asset managers should conduct a review of their products and disclosure requirements across PRIIPs, UCITS and MiFID II to identify the most cost-effective and -efficient systems and processes to produce and provide these disclosures to clients and distributors.

Table 1 All MiFID II costs and associated charges levied for the investment service(s) and/or ancillary services provided to the client that should form part of the amount to be disclosed [3]

Cost items to be disclosed		Examples
One-off charges related to the provision of an investment service.	All costs and charges paid to the investment firm at the beginning or at the end of the provided investment service(s).	Deposit fees, termination fees and switching costs.
Ongoing charges related to the provision of an investment service.	All ongoing costs and charges paid to investment firms for their services provided to the client.	Management fees, advisory fees, custodian fees.
All costs related to transactions initiated in the course of the provision of an investment service.	All costs and charges that are related to transactions performed by the investment firm or other parties.	Broker commissions, entry and exit charges paid to the fund manager, platform fees, mark ups (embedded in the transaction price), stamp duty, transactions tax and foreign exchange costs.
Any charges that are related to ancillary services.	Any costs and charges that are related to ancillary services that are not included in the costs mentioned above.	Research costs. Custody costs.
Incidental costs.		Performance fees.

Table 2 All MiFID II costs and associated charges related to the financial instrument that should form part of the amount to be disclosed [4]

Cost items to be disclosed		Examples
One-off charges.	All costs and charges (included in the price or in addition to the price of the financial instrument) paid to product suppliers at the beginning or at the end of the investment in the financial instrument.	Front-loaded management fee, structuring fee, distribution fee.
Ongoing charges.	All on-going costs and charges related to the management of the financial product that are deducted from the value of the financial instrument during the investment in the financial instrument.	Management fees, service costs, swap fees, securities lending costs and taxes, financing costs.
All costs related to the transactions.	All costs and charges that are incurred as a result of the acquisition and disposal of investments.	Broker commissions, entry and exit charges paid by the fund, mark ups embedded in the transaction price, stamp duty, transactions tax and foreign exchange costs.
Incidental costs.		Performance fees.

Overall, the costs and charges disclosure requirements under MiFID II are likely to pose significant organisational and logistical challenges for most firms. Whether they result in increased competition based on fees within the industry remains to be seen. Nevertheless, the increased transparency should enable investors to make better informed choices, and over time less competitively priced product offerings should become less attractive.

Reporting to investors: quarterly reports

MiFID II will require portfolio managers to report portfolio losses exceeding 10% to clients. This will likely require asset managers to develop and implement systems that can monitor client holdings and trigger such notifications. Naturally firms will want to avoid any potential client panic and/or overreactions arising from such notifications and so firms should consider whether such notifications of portfolio decreases should be accompanied by appropriate explanations of the loss in capital value, including the advantages and disadvantages of holding on to the investments. Asset managers should look to work with their fund administrators to develop solutions for such notifications, which may also require upskilling and additional resources within investor communications functions.

Inducements

Under MiFID II, asset managers will be barred from receiving third-party inducements for their portfolio management services and firms providing independent investment advice will also be prohibited from receiving such inducements. The UK's Retail Distribution Review (RDR) already imposes bans on inducements for firms providing investment advice to retail clients (irrespective of whether this is independent or restricted). However, MiFID II broadens this ban to portfolio management services, irrespective of the type of client. For those UK distributors who do not provide investment advice and are therefore not subject to the UK's RDR regime, MiFID II requires such distributors who can receive inducements from asset managers for the marketing of their funds, to evidence how each inducement would enhance the service provided to their end clients. All inducements that do not pass the quality-of-service enhancement criteria should not be accepted by distributors.

Moreover, the FCA's publication of the key findings from its Inducements and Conflicts of Interest thematic review re-enforces this emphasis on being able to evidence specific enhancements to quality of service and an appropriate assessment of all aspects of non-monetary benefits.[5] The FCA's focus on inducements and hospitality are already having a significant impact on the current hospitality arrangements offered and received by asset managers to and from their distributors. For example, the FCA has stated that sporting and social events (golf, tennis, concerts, etc.) are not conducive to business discussions and such discussions could better take place without these activities. The new MiFID II requirements to assess and evidence quality enhancements relating to any inducements received can only serve to reinforce such higher standards.

In the Netherlands, commission payments are already banned for advised sales, non-advised sales and portfolio management for retail clients. In many other EU countries, where there is no domestic ban on commission payments, the impact of MiFID II will be more significant. In Continental Europe, banks are often the predominant distributors of funds to retail investors, and mainly do so without giving independent advice. Under MiFID II, those banks receiving inducements will need to do more to demonstrate exactly how an enhanced quality of service is provided to their clients as a result of the inducement received.

Investment research is another significant area of focus under MiFID II. Any research consumed by asset managers must be paid for in a transparent way. Rather than receiving research from investment banks for "free" or in return for business, asset managers should pay for the investment research they receive explicitly. Some asset managers may choose to absorb research costs themselves whereas others may increase their management fees to recover them.[6] If asset managers choose to pass on research costs to the funds and end investors, these should be clearly identified, aggregated and disclosed to investors, in accordance with MiFID II's costs and charges requirements. Such arrangements could pose significant challenges for asset managers who choose to pass on the cost of research in terms of allocating the cost fairly and appropriately across all funds.

Overall, the inducements rules could have a significant impact on the pricing models of firms that currently receive commissions for portfolio management or that pay for investment research through dealing commission. The MIFID II rules on inducements will also create pressure on distributors to demonstrate that any commissions they receive enhance the quality of service to their clients.

Conclusions

While most asset managers may perceive these MiFID II requirements as another burdensome regulatory implementation project, they should also seek to identify and take advantage of any potential commercial opportunities by reassessing their product catalogue, charging structures, distribution and marketing strategies. In addition, asset managers may also look to consolidate their distribution channels, and use MiFID II as an opportunity to identify potential cost savings and efficiencies.

Manmeet Rana
Director
Risk Advisory
Deloitte LLP

Paul Fraser
Senior Manager
Risk Advisory
Deloitte LLP

1 Statement on European Union referendum result by the Financial Conduct Authority. See http://www.fca.org.uk/news/european-union-referendum-result-statement, last accessed on 24 June 2016.

2 *MiFID II Conduct Forum*, FCA, April 2016, Point 3.3, Question 8, from https://www.fca.org.uk/static/documents/mifid-ii-conduct-forum-minutes-180416.pdf, last downloaded on 1 September 2016.

3 Annex 2 of the *MiFID II Delegated Regulation*, European Commission, April 2016, from http://ec.europa.eu/transparency/regdoc/rep/3/2016/EN/3-2016-2398-EN-F1-1-ANNEX-1.pdf, last downloaded on 1 September 2016.

4 Annex 2 of the *MiFID II Delegated Regulation*, European Commission, April 2016, from http://ec.europa.eu/transparency/regdoc/rep/3/2016/EN/3-2016-2398-EN-F1-1-ANNEX-1.PDF, last downloaded on 1 September 2016.

5 *Inducements and conflicts of interest thematic review: key findings*, FCA, April 2016, from https://www.fca.org.uk/news/inducements-conflicts-interest-thematic-review-key-findings, last accessed on 1 September 2016.

6 "Woodford publishes all fees paid by savers and removes contentious charge for 'research' altogether", *The Telegraph*, April 2016, from http://www.telegraph.co.uk/investing/funds/woodford-publishes-all-fees-paid-by-savers-and-removes-contentio0/, last accessed on 1 September 2016.

STEP CHANGE: ASSET MANAGERS FACE CHALLENGE FROM NEW RULES ON ALGOs, HFT AND DEA

In June 2016, the EU amended MiFID II and MiFIR to delay their application by one year to 3 January 2018.[1] Part of the reason for the delay was to give EU rule-makers more time to finalise the vast array of implementing Level 2 rules required for the new regime to be able to operate in practice. In this article, we provide a recap of the basic MiFID II/MiFIR requirements on algorithmic trading and high-frequency trading (HFT), and examine the regulatory technical standards adopted by the European Commission (EC) in this area in July 2016.

Algorithmic trading and direct electronic access

MiFID II will require firms, including asset managers, engaging in algorithmic trading to put in place internal systems to ensure the resilience of their trading systems and prevent the sending of erroneous orders or the malfunctioning of systems in ways that could cause market disruption. The objective of these rules is to contain the risk in EU markets of events such as the infamous flash crash that seized US stock markets in May 2010.[2] Under the new rules, firms will be required to notify their regulators if they engage in algorithmic trading and also to inform the operators of the exchanges and trading venues where they engage in algorithmic trading.

EU regulators will be able to require firms under their supervision to provide information on their algorithmic trading strategies on a regular or ad hoc basis, including details of trading limits or other parameters to which the system is subject and information on key compliance and risk controls instituted by the firm. Firms engaged in high-frequency trading will also have to keep complete time-sequenced records of all orders (both executed and cancelled) and quotes, and make those records available to the regulator on request.

MiFID II will require firms that give their clients direct electronic access (DEA) to a trading venue to operate effective systems and controls that ensure a proper assessment and review of the suitability of clients using the service, that prevent clients from exceeding appropriate preset trading and credit limits, and that properly monitor clients' activities and control risks that those activities might pose to the firm itself or to wider market stability. Asset managers afforded DEA should expect providers to tighten their controls and do more besides (for which, read on).

Firms that provide DEA will themselves be responsible for ensuring their clients' compliance with the MiFID II rules and the rules of the relevant trading venue. Firms will have to actively and closely monitor their clients' trading activities and report any infringements or cases of suspected market abuse to the regulator. The rules require the firm and its clients to enter into a binding written contract to outline their essential rights and obligations in connection with the provision of DEA.

To fully understand the impact of the new MiFID II rules on firms that engage in HFT and algorithmic trading, it is necessary to refer to a set of regulatory technical standards (RTS) that spell out the requirements in much greater detail than MiFID II itself does. The EC adopted these RTS in July 2016, following consultation on earlier drafts prepared by the European Securities and Markets Authority (ESMA). The following discussion is based on the text of the RTS as adopted by the EC in July 2016, but it is important to note that the RTS themselves are still subject to scrutiny by the European Council and European Parliament, and we may not see final rules until later in Q3 or Q4 of 2016.

Algo traders: governance requirements

Chapter I of the RTS prescribes the following organisation requirements for firms engaged in HFT and algorithmic trading: clear accountability lines, including procedures to approve the development, deployment and updating of algorithms; effective procedures for the communication of information within the firm; the separation of risk and compliance functions from trading desks to ensure that unauthorised trading activity cannot be concealed.

The RTS also require a firm's compliance function to have a general understanding of how the firm's algorithms operate and require continuous contact between compliance staff and the personnel with detailed technical knowledge of a firm's algorithms (including with the person who has access to the algorithm's "kill functionality", a technical safety valve that effectively lets the firm immediately cancel all unexecuted orders in relation to an algo).

The RTS also set out controls that apply when the compliance function (or elements of it) is outsourced to an external provider and requires the firm itself to employ a sufficient number of adequately trained staff to manage the firms' algo systems. These staff members themselves need to understand the systems, how they are monitored, the underlying trading strategies and the firm's legal obligations in connection with algorithmic trading. The RTS require that risk and compliance staff have sufficient authority to challenge the algo trading specialists where trading gives rise to disorderly market conduct or to suspicions of market abuse.

Algo systems: testing and deployment

Chapter II of the RTS sets out detailed and extensive requirements relating to the testing and deployment of algorithmic trading systems. These rules require firms to establish development and testing methodologies to ensure that algorithms function properly (including in stressed market conditions), that they conform with the requirements of the RTS and trading venue rules, and that they do not contribute to disorderly trading conditions.

The rules also stipulate ongoing conformance testing to check that algorithms continue to function correctly and in accordance with the requirements of a trading venue or DEA provider, as and when circumstances and conditions change, for example when there is a material change to trading venue rules or a material change that affects the functionality of a DEA provider. The RTS mandate that all of these testing and development requirements operate in a dedicated testing environment that is separated from the actual trading desks where algorithms operate from day to day.

Before any algorithm is deployed in a "real-world" environment, a firm must also set predefined limits on the number of financial instruments traded by the algo, the price, value and number of orders, the strategy positions, and the number of trading venues to which orders are sent. Once the system is in operation, pretrade controls on order entry require firms to apply price collars and maximum order values and volumes, and maximum message limits to allow the system to reject orders that don't fit within the range of these predefined values. The rules also require the application of automated

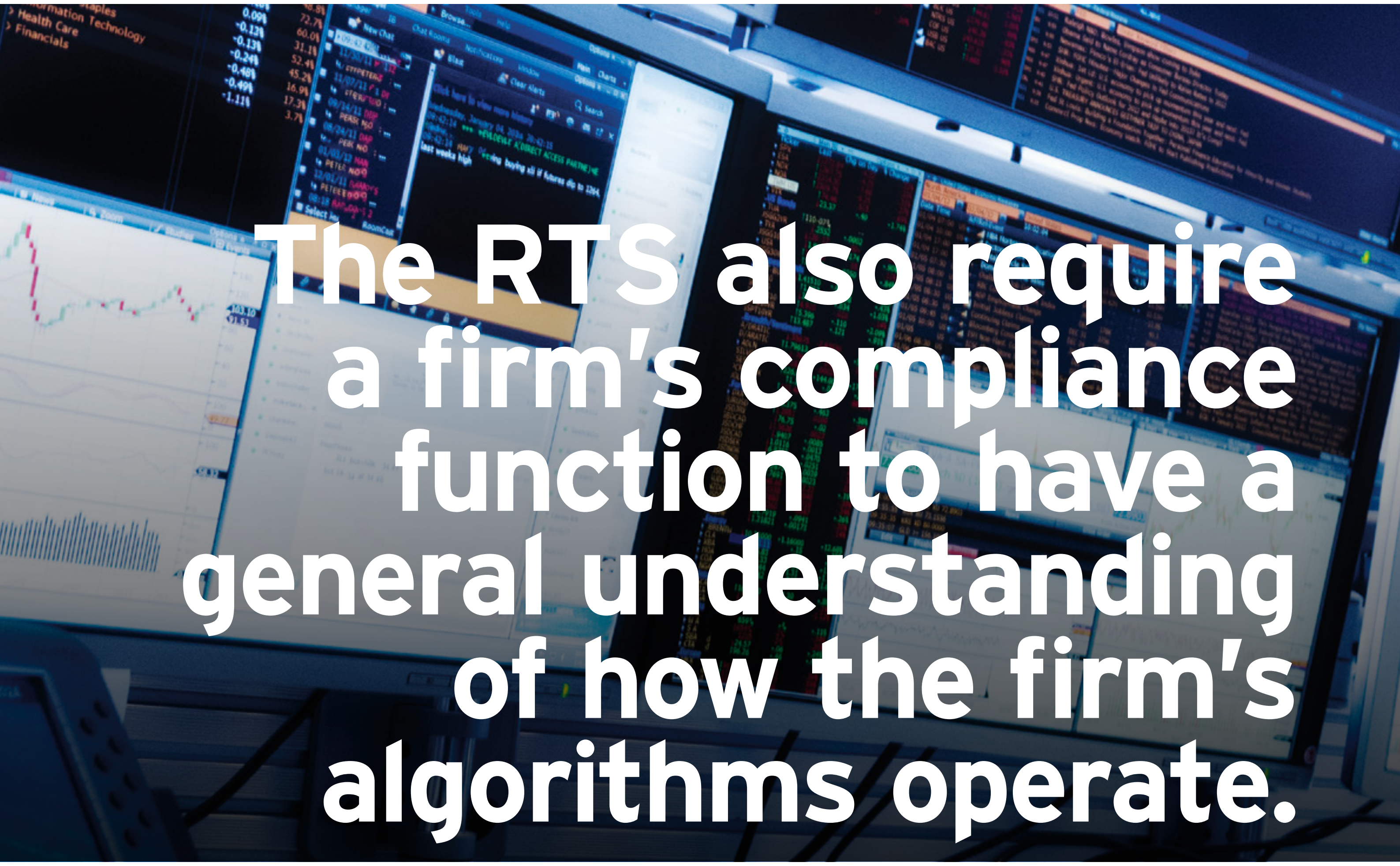
execution "throttles" that can automatically disable new orders in a system once a predefined level has been hit.

Following the deployment of a new algorithm, the RTS require ongoing testing of the algorithm through stress-testing, control and review requirements for the introduction of material changes, plus a series of measures to ensure the resilience of the algorithm. Of these, perhaps the most important is a kill functionality that lets the firm running an algo immediately cancel all unexecuted orders in an emergency scenario. This feature is intended to reduce the likelihood and severity of market disruption caused by a malfunctioning algo. Separately, firms are also required to maintain written business continuity plans to enable them to deal with disruption events such as systems unavailability, data centre shut-down, or loss or alteration of critical data and documents.

The RTS require firms to operate automated monitoring and surveillance systems designed to detect market manipulation, and to subject these surveillance systems to annual reviews to ensure that they remain fit for purpose. Post-trade control rules require firms to continually assess and monitor their own market and credit risks in terms of effective exposures. For derivatives, these post-trade controls have to include controls on maximum long and short positions, with trading limits appropriate to the types of financial instruments involved in the strategy.

Finally, for algo operators, the RTS require robust IT security arrangements to minimise the risk of attack against IT systems. These controls have to include identity and access management protocols and impose restrictions on the number of persons with critical user access to relevant systems.

The upshot of all this is that asset managers wishing to continue algo-trading activities will need to meet some heavyweight compliance obligations.



The RTS also require a firm's compliance function to have a general understanding of how the firm's algorithms operate.

Definitions

Algorithmic trading means 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.

High-frequency algorithmic trading technique means an algorithmic trading technique characterised by:

- 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.
- System-determination of order initiation, generation, routing or execution without human intervention for individual trades or orders.
- And high-message intraday rates which constitute orders, quotes or cancellations.

Direct electronic access means 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).

DEA providers

For firms providing DEA to trading venues for their clients (whether on a sponsored or direct-market basis), Chapter III of the RTS imposes a range of detailed requirements. These are designed to ensure that clients' trading complies with venue rules and that the DEA provider itself satisfies the basic obligation under MiFIR, which makes the DEA provider responsible for its clients' activities. Access receivers should expect to see beefed-up representations, warranties and undertakings in DEA services contracts.

The RTS require DEA providers to monitor clients' order flows and to filter orders through pre- and post-trade controls. While the DEA provider may apply order controls provided by a third party or a trading venue, the DEA provider itself must have the exclusive ability to modify the parameters of those controls. At the most fundamental level, these controls should reflect the DEA provider's own credit and risk assessment of its client. The rules explicitly require that the controls applied to DEA clients using sponsored access arrangements are as stringent as those applied to DEA clients with direct market access.

DEA providers must ensure that their systems enable them to monitor client orders and automatically block orders that lack appropriate authority for DEA or breach the risk management thresholds of the DEA provider. Providers are also required to have the ability to stop DEA client order flows and to suspend or withdraw services to any client where the provider thinks that continued access would be inconsistent with its rules and procedures for fair and orderly trading and market integrity.

In terms of client onboarding, the RTS set minimum standards for due diligence assessment by providers of prospective DEA clients. These are detailed and extensive covering, among other things, the client's governance and ownership structure, the strategies the client will undertake, the client's operational set-up, including trading software, historical trading patterns, and the ability of the client to meet its financial obligations to the provider. For existing clients, DEA providers will have to repeat due diligence assessments on an ongoing basis so there's no get-out-of-jail-free card for asset managers who already receive these services.

High-frequency algorithms

Firms engaged in HFT will have to keep written records for five years of all submitted orders (whether executed or cancelled) in accordance with the format prescribed in the tables to the Annexes to the RTS.

UK implementation

UK implementation of MiFID II's rules on algorithmic trading began with a consultation by the Financial Conduct Authority (FCA) in December 2015, followed in March 2016 with proposals from the Prudential Regulation Authority (PRA). Prior to MiFID II, there was no part of the UK regulatory framework that specifically addressed algorithmic trading or HFT, and for PRA firms, new UK rules will be found in a new "Algorithmic Trading" part of the PRA rulebook, while the FCA's transposition of the directive's requirements will be found in a new chapter 7A of the FCA handbook.

For firms subject to supervision by the PRA, the new rules focus predominantly on risks to the firm arising from algorithmic trading activities. By contrast, the FCA rules focus mainly on the prevention of market abuse and disorderly markets. The RTS themselves are directly applicable in the UK and other member states, and both FCA and PRA rules will cross-refer extensively to the RTS.

Conclusion

For asset managers engaged in HFT and algorithmic trading, the new MiFID II regime will mark a step-change in the regulatory environment. DEA providers and asset managers making use of DEA may have to significantly overhaul their internal systems and processes to comply with the new rules. First and foremost, all firms will need to identify where they may be engaged in HFT and algorithmic trading (which is easier said than done) and consider the potential compliance, reporting, disclosure and other obligations to which they will be subject.

Delay to the application of MiFID II until January 2018 may provide firms with a little more breathing room to analyse and implement, but, given the scale of the task, particularly for heavy users of algorithmic strategies or for those firms perhaps inadvertently caught by the rules, every minute of implementation time will be needed, particularly bearing in mind the fact that firms will not properly be able to progress implementation plans unless, and until, the relevant RTS are published in the *Official Journal* and enter into force and relevant member states complete their national transpositions of the directive.

Peter Chapman
Senior Associate
Clifford Chance LLP

Sean Kerr
Senior Professional Support Lawyer
Clifford Chance LLP

[1] European Council Press release, from http://www.consilium.europa.eu/en/press/press-releases/2016/06/17-markets-in-financial-instruments/?utm_source=dsms-auto&utm_medium=email&utm_campaign=Markets+in+financial+instruments%3a+One-year+delay+enacted, last accessed on 25 August 2016.

[2] Findings Regarding the Market Events of 6 May 2010. United States SEC and CFTC Report, from https://www.sec.gov/news/studies/2010/marketevents-report.pdf, last downloaded on 25 August 2016.

COMMODITIES UNDER MIFID II: WHAT ARE THE ISSUES FOR ASSET MANAGERS?

MiFID II marks a significant change in the regulation of commodity derivatives in the EU. Following amending legislation made in June 2016, the application of the new rules is being delayed until January 2018 and, as of Q3 2016, debates among EU rule-makers are continuing on the exact scope of the new rules for commodities, with several important details necessary for implementation still to be finalised.

The main commodity-related developments under MiFID II relate to:

- Instrument scope: MiFID II will bring more commodity derivatives within the regulatory perimeter than is currently the case.
- Exemption scope: although the perimeter of these commodity dealer exemptions has been a focus of continuing debate, they will be of little relevance to asset managers.
- Position controls: the introduction of position limits and position management controls for commodity derivatives presents a significant implementation challenge for asset managers, their clients and their counterparties.

Instrument scope

Currently, under MiFID, contracts traded on a regulated market or multilateral trading facility (MTF) that can be physically settled are within scope as "MiFID instruments". Under MiFID II, this will be expanded to cover physically settled commodity derivatives traded on an organised trading facility (OTF) as well. There will, however, be an exemption for certain energy contracts.

Exemptions for commodities dealers

The existing MiFID exemptions have been narrowed to increase regulatory oversight and transparency. The current exemption for dealers whose main business consists of own-account dealing in commodities or commodity derivatives has been deleted, effectively bringing many commodities dealers who currently rely on this exemption within the regulatory perimeter for the first time. Additionally, the current exemption providing conditional relief for firms who do not provide any investment services apart from own-account dealing has been amended so as not to apply to dealers in commodity derivatives, emissions allowances and derivatives in emissions allowances.

The remaining exemption is retained for "ancillary activities", albeit reduced in scope: the exemption won't be available if executing client orders, market-making, or employing high frequency trading or algorithmic trading strategies for commodities. The latter exemption has been a focus of debate in the genesis of Level 2 rules, with divergent views among EU rule-makers on what proportion of a group's activities could relate to commodities before it ceases to be an "ancillary" activity of the group.

Position controls

For asset managers, the position control regime represents the most significant part of the MiFID II commodities reforms. These controls comprise both a position limits regime, whereby national regulators will impose position limits on the maximum net position size that a person can hold in venue-traded commodity derivatives (and "economically equivalent" OTC contracts) and a position reporting regime. Position limits will be set on the basis of all positions held by a person and those held on its behalf at group level.

Under MiFID II, the position limits regime is expressed to apply to "any person." This is extremely broad and, unlike most provisions of the legislation, is not limited in scope to authorised EU investment firms. Indeed, the UK Treasury has indicated that it thinks the scope of the EU position limits regime is strongly extra-territorial, affecting anyone inside and outside the EU.

A group-wide position limit will require complex calculations, which may differ by delivery month. This represents a major implementation challenge for any firm that trades in these markets. Another significant aspect to the legislation relates to the obligation for trading venues to report aggregate positions by class of persons, including daily breakdowns of positions (e.g. by participants, clients, clients of clients) to regulators. Firms have to be able to provide that information to the trading venue and a participant may have to obtain that information from its clients to be able to pass it on, presenting a substantial operational burden and potential confidentiality issues as well.

How will commodity position limits be set?

The complex methodology by which position limits will be set both for the spot month (the spot month being the time period immediately before delivery at expiry – which varies from commodity to commodity and may not necessarily correspond to exactly one month) and for other months depends on the following factors:

- Maturity of the commodity derivative contract.
- Deliverable supply in the underlying commodity.
- Overall open interest in the contract and in other financial instruments with the same underlying commodity.
- Volatility in other relevant markets, including substitute deliverables and underlying commodity markets.
- Number and size of market participants.
- Characteristics of the underlying commodity market including patterns of production, competition and transportation to market.
- And development of new contracts.

The precise methodology by which these different factors determine position limits will be set out in regulatory technical standards

Position controls for commodity derivatives

Position limits

Competent authorities shall impose position limits on:

- Net position that a person can hold at all times.
- In commodity derivatives traded on trading venues and economically equivalent OTC contracts.
- And limits to be set on the basis of all positions held by a person and those held on its behalf at an aggregate group level.

Except that

Limits shall not apply to positions which are held by or on behalf of a non-financial entity and which are objectively measurable as reducing risks directly related to the commercial activity of that non-financial entity.

Other powers for competent authorities

- Temporary additional position limits in exceptional cases (valid for up to 6 months).
- Additional supervisory powers (including power to require a person to provide information on commodity derivatives, to reduce their position or to limit the ability of a person or a class of persons to enter into a commodity derivative).

Position management

Operators of trading venues' trading commodity derivatives must apply position management controls, including powers to:

- Monitor open interest.
- Access information about size and purpose of a position.
- Require a person to terminate or reduce a position.
- And require a person to provide liquidity.

Position reporting

Operators of trading venues' trading commodity derivatives must:

- Make a public report of aggregate positions by class of person weekly.
- Provide a complete breakdown of all positions (participants, clients, clients of clients) to the competent authority daily.
- Require participants to provide them with necessary information to enable them to report.

ESMA powers

- Market monitoring and power to ban products or activities.
- Coordination of national measures.
- And additional position management powers.

(RTS). RTS are also required to describe which contracts will qualify as "economically equivalent" OTC contracts and so factor into the net position limit calculation. These RTS have been the subject of extensive consultation since December 2014.

Following the initial consultations, in September 2015, the European Securities and Markets Authority (ESMA) sent its final draft of the RTS to the European Commission, proposing a limit calculation methodology whereby spot-month limits could vary between 5% and 35% of the deliverable supply underpinning the relevant commodity derivative, with limits for the forward months set in a similar range between 5% and 35% of open interest in the commodity derivative.

These proposals met with some hostility in the European Parliament, which was also critical of ESMA's proposal that contracts should only qualify as "economically equivalent" contracts if they had an identical contractual specification to the venue-traded contract. Some MEPs favoured a slightly more liberal definition of economic equivalence so as to bring more contracts into scope.

After the Commission had written to ESMA indicating that it would only adopt the RTS if certain amendments were made, ESMA published revised RTS, taking into account the Commission's recommended changes in May 2016. The following discussion refers to that version of the RTS, but it is important to note that the RTS themselves are still not technically in final form and have yet to be formally adopted by the Commission or approved by the Parliament or Council.

Under the RTS, the standard baseline position limit will be set at 25% of deliverable supply and open interest, but national regulators will have scope to reduce that limit by 20% (or 22.5% for some agricultural commodity derivatives) and to increase it by a maximum of 10% (or 25% for less liquid commodity derivatives). Compared with ESMA's proposals of September 2015, these limits provide slightly more flexibility to national regulators and are arguably better able to take account of the specificities of the markets in different underlying commodities.

Part of the reason for permitting greater flexibility in changing limits along a sliding scale is to avoid disorderly market conditions as the spot month for a contract approaches. As the RTS observe, in some markets there may be substantial discrepancy between open interest and deliverable supply, for example where there is little derivative trading compared with deliverable supply, or where a particular commodity derivative is used to hedge a wider range of exposure types such that open interest in the contract might exceed deliverable supply. Giving regulators greater control over moving limits upwards or downwards from baseline levels is intended to avoid market disruption that these sorts of discrepancies might otherwise cause.

In terms of the aggregation of positions at group level, the RTS explain that positions should not be aggregated at the level of the parent undertaking if the positions in question are held by collective investment undertakings (i.e. funds) that hold those positions on behalf of their investors rather than on behalf of their parent undertaking in cases where the parent cannot control the use of those positions for its own benefit. This is important because it means that fund managers should not have to aggregate positions held by their funds.

In terms of economically equivalent OTC contracts, the RTS confirm that while the scope of what counts as "equivalent" ought not to be too wide so as to prevent inappropriate netting of potentially dominant positions, small differences in the contractual specification concerning lot size and delivery date should not prevent an OTC contract from being economically equivalent to a venue-traded contract. This softening of the "economically equivalent" definition compared with ESMA's September 2015 draft RTS does not completely resolve the question of exactly which contracts are affected by position limits because the much broader scope question (of general relevance under MiFID II and indeed under other legislation such as the Market Abuse Regulation) as to when a contract can properly be considered to be "traded on a trading venue" currently remains unresolved.

MiFID II establishes a hedging exemption for non-financial entities, which allows them to ignore positions that are objectively measurable as reducing risk directly related to the entity's commercial activities. The RTS explain in greater detail the terms on which this exemption can be used, and confirm that

Part of the reason for permitting greater flexibility in changing limits along a sliding scale is to avoid disorderly market conditions as the spot month for a contract approaches.

a position will count as "risk reducing" for these purposes if (among other things) it qualifies as a hedging contract under International Financial Reporting Standards (IFRS).

Position reporting

The second limb of the position control regime is position reporting, which imposes reporting requirements on trading venues and investment firms as "position holders", obliging them to make both daily and weekly reports of their positions.

Investment firms and market operators operating a trading venue must produce and publish a weekly report showing the aggregate positions held by different categories of persons in the different commodity derivatives traded on their trading venues, once certain thresholds are exceeded. The report must be sent to the competent authority and to ESMA, and ESMA shall proceed to a "centralised publication" of the information included in those reports. There has been some sensitivity about the fact that this is a public report, although it is an aggregate report. So, in theory, it should not be possible to find out a particular counterparty's position, although this might vary, depending on the volume of trading.

The reports will be detailed, as they must specify the number of long and short positions in specified categories, changes since the previous report, the percentage of the total open interest represented by each category and the number of persons holding a position in each category. ESMA submitted to the Commission draft-implementing technical standards (ITS 4 and ITS 5) to determine the format of the reports on 11 December 2015. These are yet to be finalised so it is not yet certain what the final format of the report will be.

In addition to the weekly report, a private, confidential report must be sent to the competent authority "at least daily", showing a complete breakdown of the positions held by all persons, including the members or participants and the clients thereof, on that trading venue.

To ensure compliance with the position limits and position management controls regime imposed by Article 57, firms have to report to the trading venue on "at least a daily basis" details of their own positions in commodity derivatives and economically equivalent OTC contracts and, notably, "those of their clients and the clients of those clients until the end client is reached".

Finally, there are additional reporting requirements for transactions that take place outside a trading venue. Investment firms must submit to the competent authority a report "at least daily" of trades undertaken outside a trading venue, showing a complete breakdown of their positions in commodity derivatives traded on a trading venue as well as economically equivalent OTC contracts. Similar to the requirement to report to the trading venue, the requirements apply to firms' own positions as well as of those of "their clients and the clients of those clients until the end-client is reached".

The position reporting requirements raise a number of significant issues for asset managers, notably the practical issues of obtaining position information along the chain to the "end-client" and the issues of data protection and confidentiality. As yet, these have not been fully resolved. In ESMA's Final Report and Draft ITS issued in December 2015, the confidentiality issues raised by the market were noted, although they were not addressed in the ITS because the empowerment in the Level 1 text is limited in scope and does not extend to confidentiality. ESMA intends further work in this area and to provide additional guidance. However, this has not yet been issued. So the questions on how to obtain consents or waivers of confidentiality, if they are available and whether they can they be relied on, remain.

We may see more guidance from ESMA in this important area in the autumn, which will be welcome as firms will face a real challenge obtaining information from end-clients on positions when the firm and end-client could be separated by several intermediaries.

Peter Chapman
Senior Associate
Clifford Chance LLP

Jeremy Elliot
Senior Professional Support Lawyer
Clifford Chance LLP

MIFID II: KEY ISSUES FOR ASSET MANAGERS CONCERNING MANDATORY TRADING OF DERIVATIVES

The introduction of a so-called mandatory trading obligation for certain derivative contracts is a significant new requirement under the Markets in Financial Instruments Regulation (Regulation 600/2014) (MiFIR). In particular, Article 28 imposes an obligation on a wide range of counterparties, including asset managers, to trade certain derivative contracts only on specified trading venues such as regulated markets (RMs), multilateral trading facilities (MTFs) and organised trading facilities (OTFs), or an equivalent third country market. The mandatory trading obligation complements the existing mandatory clearing obligation introduced by the European Regulation on OTC derivative transactions, central counterparties and trade repositories (Regulation 648/2012) (EMIR) and implements the G20 commitments from 2009 to trade all standardised derivative contracts on trading venues.

When will a class or sub-class of derivatives become subject to mandatory trading?

Unlike the mandatory trading obligation for equities and equity-like instruments under Article 23 of MiFIR, derivatives are not automatically subject to a mandatory trading requirement. There are two possible routes for a class or sub-class of derivatives to become subject to mandatory trading – the so-called "bottom-up" and "top-down" approaches. Once a class or sub-class of derivatives has been declared subject to mandatory trading, it will be included in a register published and maintained by the European Securities and Markets Authority (ESMA). The register will specify the class of derivatives and the venues on which the relevant derivatives are admitted to trading or are traded.

The top-down approach

ESMA is tasked under Article 32(4) of MiFIR with monitoring those classes of derivatives for which no CCP has been authorised to clear under EMIR and which have also not been declared subject to mandatory trading. If determined necessary, ESMA can dictate that such classes or sub-classes of derivatives should be subject to mandatory trading. Before it could use its powers in this way, however, ESMA is required to conduct a public consultation and would need to notify the Commission.

The bottom-up approach

A number of tests are applied to determine whether a class or sub-class of derivatives should be made subject to the mandatory trading obligation. The initial question is whether the relevant class or sub-class has been made subject to the clearing obligation under EMIR. If not, that is the end of the assessment. The class or sub-class will not be subject to mandatory trading under the bottom-up approach, albeit the top-down approach would still be available to ESMA.

Assuming the class or sub-class of derivatives is subject to mandatory clearing under EMIR, however, two further tests are applied to determine whether it is appropriate for transactions in that class or sub-class to be restricted to trading venues only: the venue test and the liquidity test.

The venue test

This requires an assessment of whether the relevant class or sub-class of derivatives has been admitted to trading on or traded on a RM, MTF, OTF or equivalent third country market.[1] If the class or sub-class of derivatives fails the venue test, then there is no need to consider the liquidity test. The rationale for this is obvious: if there is no venue on which a particular class or sub-class of derivatives can currently be traded, then a mandatory requirement to trade such class or sub-class would be inappropriate.

The liquidity test

The final test is to determine whether there is sufficient third-party buying and selling interest in a particular class or sub-class of derivatives so that such class or sub-class is considered sufficiently liquid to trade only on trading venues. ESMA was tasked under MiFIR with developing technical standards specifying the criteria for determining liquidity. These standards have subsequently been adopted by the Commission by way of a Delegated Regulation that sets out a two-step process for determining whether a class or sub-class is sufficiently liquid.

As a first step, ESMA sets certain thresholds for four different criteria indicative of liquidity. The liquidity criteria and the relevant factors that ESMA takes into account for establishing the thresholds for each of the four liquidity criteria are as shown in the table below.

Having established the relevant liquidity thresholds for a particular class or sub-class of derivatives, the second step of the liquidity test is an assessment by ESMA of the liquidity of that particular class or sub-class as against the relevant liquidity thresholds.

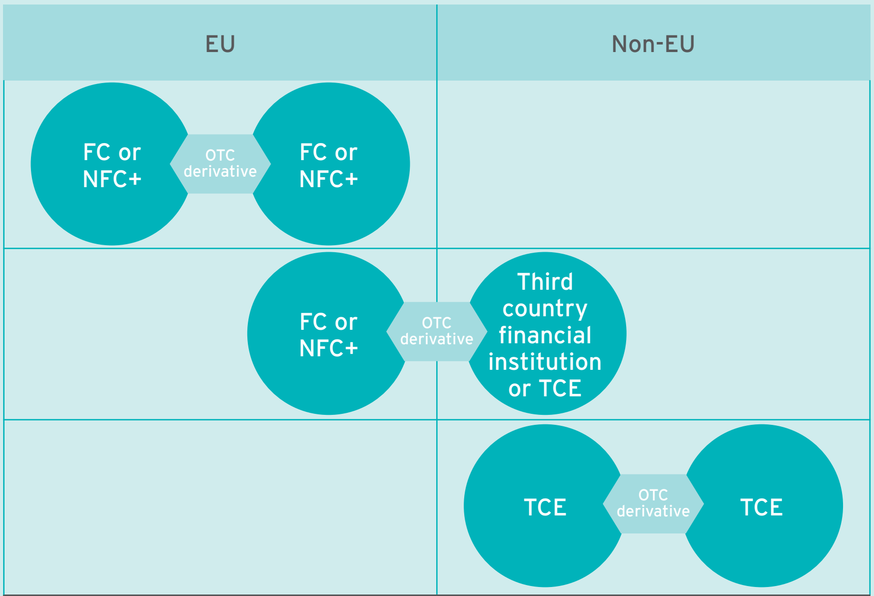
What sort of counterparties will be subject to mandatory trading?

The trading obligation is not restricted to investment firms. It applies to financial counterparties (as defined in EMIR) (FCs), which includes asset managers, AIFs, UCITS, etc., when they deal with other financial counterparties or with non-financial

Liquidity criteria	Relevant factors
Average frequency of trades	• Minimum number of transactions per day and minimum number of trading days. • Whether the liquidity of the class or sub-class is subject to seasonal or structural factors.
Average size of trades	• Average daily turnover: being the notional size of all trades combined divided by number of trading days. • Average value of trades: being the notional size of all trades combined divided by number of trades.
Number and type of active market participants	• Total number of market participants trading in that class or sub-class is not lower than two. • Number of trading venues that have admitted to trading the relevant class or sub-class. • Number of market participants under a binding obligation to provide liquidity.
Average size of spreads	• Average size of weighted spreads over different time periods • Spreads at different times during trading sessions.

Who is subject to mandatory trading?

- **FC** – Financial counterparty
- **NFC+** – Non-financial counterparty over the EMIR clearing threshold
- **TCE** – Non-EU entity that would have been subject to the clearing obligation if established in the EU
- **Third country financial institution** – Non-EU entity authorised to carry on any of the activities listed in BCD, MiFID II, Solvency II, UCITS, IORPS, and the AIFMD



Only if transaction has a direct, substantial and forseeable effect in the EU or if necessary or appropriate to prevent evasion.

ESMA's proposed RTS are aligned with EMIR.

counterparties whose derivatives trading activity is above the clearing threshold set under EMIR (NFC+s). It also applies to NFC+s when they deal with FCs or other NFC+s.

The mandatory trading obligation also applies to FCs and NFC+s when they enter into a derivatives transaction with third country financial institutions or other third country entities that would be subject to the EMIR clearing obligation if they were established in the EU (TCEs) – for example, where a UK asset manager deals with a US-based investment bank.

What will this mean for counterparties in practice?

The mandatory trading obligation for derivatives is a significant new requirement that asset managers will need to grapple with – it will potentially require structural change to booking practices and models (moving from OTC to venue trading), which, in turn, may mean new trading terms and other knock-on impacts for other MiFID obligations, such as transaction reporting, transparency, etc.

How many and which classes of derivatives ESMA may declare subject to mandatory trading has yet to be seen. However, the mandatory trading provisions in MiFIR rely to a considerable extent on relevant provisions under EMIR (in particular, the triggering of the mandatory clearing obligation). So this is likely to provide a clear line of sight as to the classes or sub-classes of derivatives that may become subject to mandatory trading.

Peter Chapman
Senior Associate
Clifford Chance LLP

Jacqueline Jones
Senior Professional Support Lawyer
Clifford Chance LLP

[1] The Commission may determine that a third country is equivalent where the legal and supervisory framework of that third country fulfils the following:

(a) trading venues in that third country are subject to authorisation and to effective supervision and enforcement on an ongoing basis;

(b) trading venues have clear and transparent rules regarding admission of financial instruments to trading so that such financial instruments are capable of being traded in a fair, orderly and efficient manner, and are freely negotiable;

(c) issuers of financial instruments are subject to periodic and ongoing information requirements ensuring a high level of investor protection; and

(d) it ensures market transparency and integrity via rules addressing market abuse in the form of insider dealing and market manipulation.

MiFID II AND THE INFORMATION MANAGEMENT CHALLENGE

Regulatory reform will have an unprecedented impact on how financial services stakeholders manage data and information across asset classes. Updated approaches to collecting, analysing, structuring and evaluating data will be required for compliance with trade execution, investor protection, reporting and settlement standards.

The catalyst for this change is both the requirements of the Markets in Financial Instruments Directive (MiFID II)[1] and Regulation (MiFIR)[2] and the other security-specific regulations coming into force in the next two years. The wider implications, however, are much more far-reaching, as firms consider other regional and global reforms that will revamp the reporting and transparency landscape.

Analysis of the technical rules reveals that the scope and depth of new requirements will require data sets that are too large and complex for existing in-house technology to manage effectively. The ability to evaluate rapid changes in these data sets is a key requirement for efficient information management in the new environment.

This makes it a strategic priority for firms to develop a centralised data platform to manage the integration of extensive data sets with different specialised trading systems and diverse reference data.

Information management in a new age

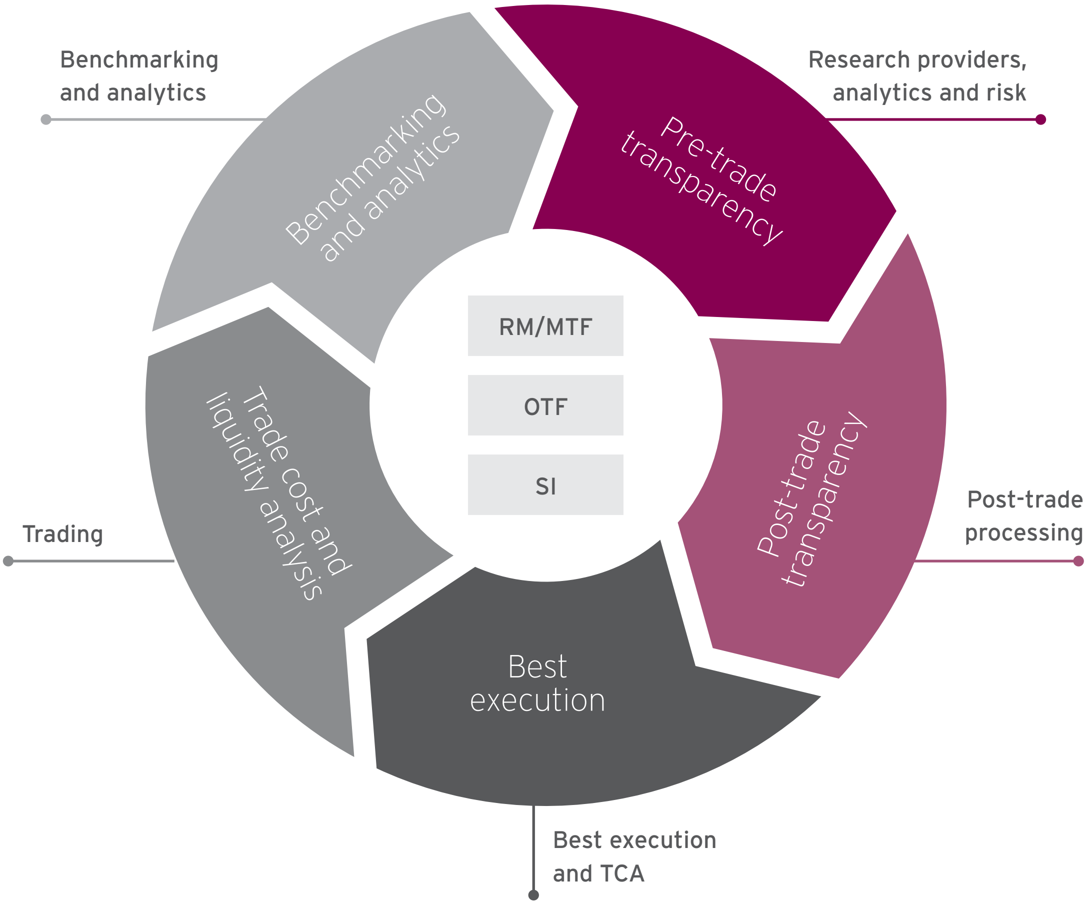
The January 2018 implementation of sweeping transparency, trade reporting and best-execution requirements under MiFID II will require wholesale end-to-end changes to the way firms process and manage trade data. The publication of regulatory technical standards by the European Securities and Markets Association (ESMA) and the European Commission (EC) have given the roadmap for compliance. New standards covering trade execution, investor protection, trade reporting, settlement, best execution, and systems governance and controls will have an unprecedented impact on all financial services stakeholders across asset classes.

In some instances, such as post-trade reporting, the increase in the range of information required will necessitate an overhaul of data systems and the automation of the reporting and settlement process. In traditionally over-the-counter (OTC) markets, that will mean electronic adoption in the trade negotiation process — a shift from the predominantly manual workflow to date.

Complying with MiFID II

Many financial services firms previously complied with regulation by simply reworking existing technology and information repositories, placing more strain on often-overloaded IT departments. However, the scope and depth of MiFID II requirements necessitate data sets that maybe too large and complex for these systems to handle. In addition, market information can change too quickly to evaluate at the trade-by-trade execution level. Financial firms will need to capture, combine, analyse, store and disseminate information in ways not previously contemplated. This presents a major challenge for existing systems at many firms.

A reason for this is the need to centralise data sets from a large number of different subsystems into a normalised and coherent data framework that supports validation, enrichment, analysis and distribution. Accordingly, for most firms, implementing MiFID II requires new information architecture, software processing, analytics calculation and data-distribution capabilities. There are several key areas where this should translate into a more effective decision-making and performance-management benchmark that makes firms more efficient.



Transaction capture and measurement

To achieve compliance with MiFID II's pre-trade, at-trade and post-trade requirements, financial firms will need a comprehensive transaction management platform. This requires harmonising data from different parts of the firm and external sources and redeploying that data in new ways.

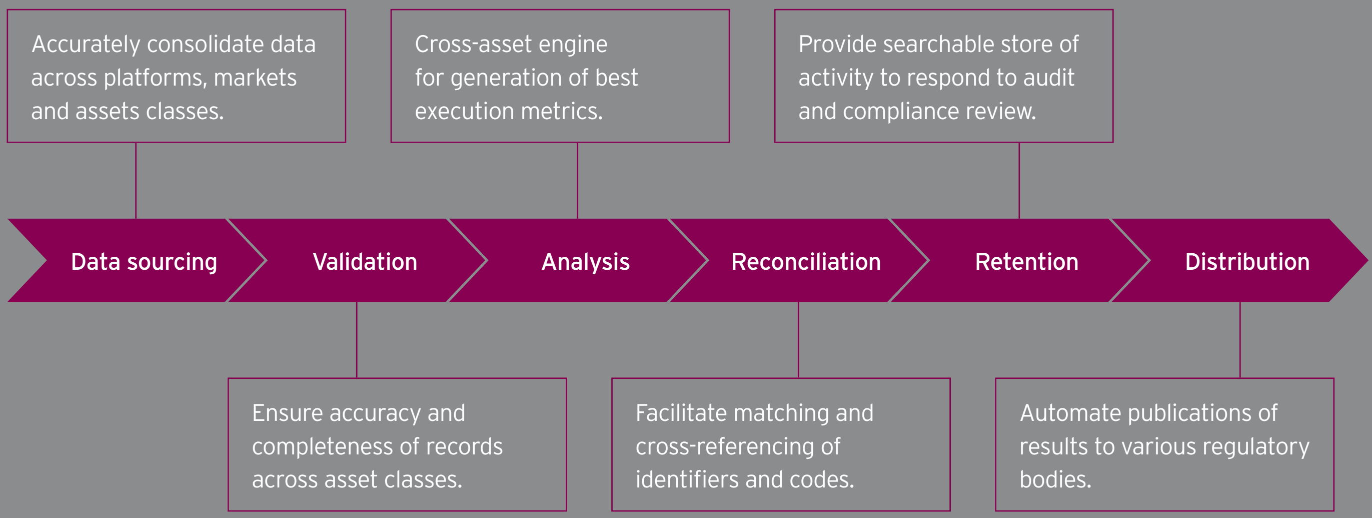
As a result, several opportunities emerge from the ability to harness transaction data through complex analysis functions and external sources:

- The new best execution requirements will help enhance the trade-reconstruction process at firms – examples of this include the ability to map and track price runs and chats and keep the information attached to trades.
- Enhanced reference, counterparty management and corporate action data will allow for more sophisticated post-trade and performance analysis at firms.
- This will only be the beginning of a longer process of understanding the second order effect of mandatory venue trading and transparency on market behaviour.

Data sourcing

MiFID II's extension of transaction reporting rules to new asset classes such as fixed income require vastly expanded information management capabilities, even beyond those required under the US Dodd-Frank reforms. The individual data points required by MiFID II expand well beyond trade level information, linking trades with firm and employee-level data (such as personal details of decision-makers executing trades at firms). Due to the likely fragmentation of trading systems across asset classes through the introduction of new venue types, the sourcing and construction of trade identifiers and venue codes will be necessary. In addition, the introduction of international securities identification numbers (ISINs) for individual derivatives also extend the trade data requirement significantly. Diverse sets of market data and analytics will be required to support trade execution benchmarks across equities, equity derivatives, OTC derivatives, FX and fixed income instruments.

MiFID II requires users to comply with a series of prescriptive industry codes and attributes that may not initially conform to a firm's internal standards.



Validation

For core data engines to produce execution metrics and further analytics output, the platform must provide controls for record completeness and data availability. This includes the ability to define the minimum realisable attributes by asset class and link client assets to the appropriate universe of security data (to establish the position relative to liquidity and block-size thresholds, for example). To enable the efficient resolution of discrepancies in data mapping within a bank or between two counterparties in the event of a trade break, it will be necessary to have centralised exceptions management capabilities for enforcing workflow dependencies related to the availability of data. These workflows will typically cut across many individuals and require dashboards that ensure an accurate view of application state and processing metrics. The goal here must be to automate much of the process, from pre-trade to the publication of data to regulators (and generating periodic reports analysing trade performance).

Analysis

A central theme of MiFID I and MiFID II is to increase market transparency and ensure efficient and fair price formation. To achieve the appropriate level of transaction analysis and trade reporting, mechanisms that accurately compare activity to market conditions across asset classes in the context of the prevailing market environment will be crucial. To provide the appropriate level of transparency, any compliant analysis must also be able to map and correlate trading strategies, portfolio management goals and the performance of algorithms affecting trade execution (algorithm-level information is also required for the reporting process in some asset classes). Smart workflows to identify variances or exceptions in trade activity and comparative metrics to relevant market peers will allow market participants to use this transparency to inform execution decisions.

Reconciliation

MiFID II requires users to comply with a series of prescriptive industry codes and attributes that may not initially conform to a firm's internal standards. Accordingly, processes for matching counterparties or clients to a centralised legal entity master, cross-referencing multi-listed assets with non-unique ISINs and internal transactions to trade venue identifiers will require robust reconciliation capabilities.

Reference data

MiFID II demands that every client (fund, account or natural person) must be identified in a standardised format. This amplifies the need for a truly global and central counterparty database in the context of counterparty checks, where KYC information and transaction reporting can be further refined to more efficiently manage trading risk profiles and systems.

Problem definition

MiFID II requirements for the collection, correlation, analysis and reporting of all financial transactions

Term

MiFID II and other reporting regimes require new technologies and approaches that are used for collecting, structuring and evaluating new data reporting and analysis requirements.

Data sets

The resulting regulatory requirements necessitate data sets that are too large, that are too complex and that change too quickly to be evaluated with existing in-house technologies.

Goals

Objectives will be to centralise the data sets from various subsystems into a data framework that supports validation, enrichment, analysis and distribution.

Implementation

Technical implementations requires new information architecture, software processing, and new calculation of analytics, and data distribution.

Retention

MiFID II mandates that data be retained for a minimum of five years in a durable and easily discoverable format, i.e. it should be easily provided to a national competent authority (NCA) on request. Systems must be able to track the audit trail for relevant modifications or corrections. To avoid enforcement issues, operations and compliance departments will need mechanisms to identify trades based on:

- Security references
- Data ranges
- Transaction types
- Exception types
- Statistical ranges

Distribution

The conduit for publishing firm data to NCAs under MiFID II is an "Approved Reporting Mechanism" (ARM) or via the trading venue where a transaction is executed. New post-trade data providers will be those providing Approved Publication Arrangements (APAs), and Consolidated Tape Providers (CTPs) will also collate and electronically disseminate firm and platform data. This wealth of freely available, timely data means trading venues and fund managers need to be aware of the distinct reporting requirements and metrics that flow from their execution decisions.

Clients' confidential or private data will be subject to data protection and privacy laws in a number of national jurisdictions requiring some ability to encrypt and decrypt data at different points in the processing chain. Initially it will be increasingly important to manage the dissemination of this information in line with internal standards and rules, given the likely variation in enforcement among NCAs in the early stages of compliance.

Clock synchronisation requirements

MiFID II requirements for clock-synchronisation are summarised in RTS 25 (see ESMA consultation paper,[3] published December 2015 for full details on proposals). They require firms and venues to timestamp events accurately relative to Coordinated Universal Time (UTC) and to an appropriate level of granularity depending on where a trade is executed and the gateway-to-gateway latency of the venue.

If viewed in isolation, RTS 25 appears to apply to trading venues and their members or participants, with non-venue members (e.g. the buy side) out of scope. RTS 25, however, should not be viewed in isolation from other MiFID requirements, market structure developments or other NCAs' decisions.

Clock synchronisation and time stamps could be identified as connected to best execution compliance mandates, which apply equally to the buy side and sell side. In particular, components such as smart-order routers (SORs), operated by broker-dealers on behalf of buy-side clients, are likely in scope for microsecond-level timestamp requirements. Many SORs are capable of generating orders in response to either a market data change or the receipt of an execution report in less than a millisecond, which would qualify them as trading systems that RTS 25 states need their audit trails to be kept in microsecond precision and their clocks be synchronised to UTC on that basis. Considering ESMA's interpretation, that best execution considers "likelihood of execution", and that SORs are typically evaluated on that basis, this will require sell sides to capture microsecond-level data and their clients to be able to interpret and analyse that data.

DRSPs and bringing it all together

Data Reporting Service Providers (DRSPs) are in a position to offer an end-to-end solution that addresses MiFID II requirements across financial information, transaction processing and versatile software platforms that are scalable. For example, IHS Markit's particular solution in this area includes connected building blocks of MarkitSERV, thinkFolio, EDM, TCA, Counterparty Manager and Best Execution allow for turnkey integration and workflow across the new information chain.

The ability to enhance and expand transaction data, trade and operational data exceptions, reconciliation and allow for data retention, retrieval and encryption will be useful as firms refine their trading workflow in the context of market reforms. As part of their overall MiFID II implementation planning, each individual firm will need to undertake analysis of their own capabilities and determine the best solutions and partnerships for them.

Imminent and future regulation

With DRSPs' capabilities and architecture, the compliance burden becomes an opportunity to integrate a firm's data infrastructure. Further compliance with the Basel Committee's Fundamental Review of Trading Book (FRTB) rules (related to quantitative and qualitative market risk disclosures for banks) and other regional regulations becomes a question of business configuration rather than massive technology build (or in some cases rebuild).

In fact, FRTB required disclosures are included within MiFID II required fields, which means that when set up correctly on client premises, a trade will be captured once, but normalised, enriched, reported and published, internally or externally, as many times as needed. This will also help to create a "plug-and-play" model for cross-border compliance across different regulatory regimes, with different transparency and reporting standards. This type of functionality will be a crucial advantage for global buy-side firms as they seek to retain the maximum amount of flexibility for their execution decisions.

Article written by IHS Markit.[4]

1 See http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0065&from=EN, last accessed on 2 August 2016.

2 See http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R0600&from=EN, last accessed on 2 August 2016.

3 From https://www.esma.europa.eu/press-news/esma-news/esma-consults-transaction-reporting-reference-data-record-keeping-and-clock, last accessed on 2 August 2016.

4 IHS Markit is a world leader in critical information, analytics and solutions for the major industries and markets that drive economies worldwide.

THE ASSET MANAGEMENT SURVEY: MiFID II AND MiFIR

MiFID II and its partner MiFIR is a wide-ranging piece of legislation and, depending on your business model, could affect a broad range of your firm's functions – from trading, transaction reporting and client services to IT and HR systems. It will radically change the regulation of EU securities and derivatives markets, and has the potential to have a significant impact on the investment management industry.

It is for this reason that we felt it would be invaluable for firms to be able to gain an insight into where their peers stand on the strategic thinking and implementation of a wide range of requirements under this amended directive and regulation.

Having surveyed a wide range of asset management firms, we have provided an overview of the questions and responses received below. The results are displayed in this way to anonymise the identities of firms that participated in the survey.

How prepared are you for the MiFID II/MiFIR go-live date in 2018?

Some firms started to address their MiFID II/MiFIR implementation projects a while ago, undertaking initial gap analysis or impact assessments and very quickly realising the magnitude and complexity of the task ahead.

Now that we know that there is a 1-year extension to the original deadline – from 2017 to 2018 – we thought it would be interesting to ask asset managers where they sit in terms of their implementation planning and the kind of strategic decisions that they have needed to make, or may still need to make, for their businesses.

Appropriateness regime

Under MiFID II, the range of products deemed too complex, and subject to the appropriateness regime, will be widened. Industry initially feared that non-UCITS retail schemes (or equivalent) would automatically fall into the category of complex, requiring assessment of an investor's knowledge and experience.

The Delegated Regulation (C (2016) 2398 final), published on 25 April 2016, appears to provide a degree of flexibility so that non-UCITS retail schemes (or equivalent) can be assessed on a case-by-case basis.

Q1 Have you undertaken any analysis of your non-UCITS retail schemes (or equivalent) to see whether they could be sold on an "'execution-only" basis?

Apart from those asset managers whose product ranges do not include non-UCITS retail scheme products (or equivalent), all respondents confirm that they have undertaken the relevant analysis. One respondent advises that they are awaiting legal confirmation that certain funds are out of scope for MiFID II, but the analysis has been undertaken as a precautionary measure.

Q2 Have you identified any non-UCITS retail scheme products (or equivalent) that would not meet the requirements to enable them to be sold on an "execution-only" basis?

All bar one respondent advises that no non-UCITS retail scheme products (or equivalent) have been identified by the asset management firms surveyed as not meeting the requirements to enable them to be sold on an "execution-only" basis.

Where one respondent flags yes in answer to this question, unfortunately further information has not been provided.

Trading venues

MiFID II/MiFIR introduces new types of trading venues, such as Organised Trading Facilities (OTFs).

Alongside regulated markets (RMs) and multilateral trading facilities (MTFs), this will be a third type of multilateral system in which multiple buying and selling interests can interact in a way that results in contracts. However, unlike RMs and MTFs, OTFs will only relate to bonds, structured finance products, emission allowances or derivatives. Operating an OTF will be an investment service so a person wishing to do so will need to be licensed as an investment firm. The operator of a RM will also be able to operate an OTF.

There has also been an extension of the Systematic Internaliser (SI) regime. This is a firm that deals on own account when executing client orders outside a trading venue. The definition of an SI has been updated to reflect the introduction of OTFs and to provide that a SI must deal on a substantial, as well as an organised, frequent and systematic basis.

Q3 Will the introduction and authorisation of new types of trading venues change the way in which your firm will place transactions?

There are mixed responses to this question, with an equal split between firms that believe the introduction and authorisation of new types of trading venues will change the way in which their firms place transactions and firms that do not believe it will.

By contrast, a minority of respondents believe it is too early to tell, with no clear view yet as to how OTFs will operate and how existing MTFs and/or other venue types will be authorised and operate. As a result, at this stage, it is not considered possible to be sure how or indeed whether this might eventually affect transactions.

A concern also expressed is that the impact of transparency requirements, particularly in relation to bond market liquidity, may impact in a negative manner the trading that is done in these markets.

Q4 Will your firm be caught as an MTF, and therefore require authorisation?

None of the asset managers taking part in the survey believe that their firms will be caught as MTFs and, as such, they will not require any additional authorisation.

Q5 Will your firm result in being captured under the extended definition of a systematic internaliser (SI)?

Similarly, the extended definition of an SI is not considered to pose any problems, as no respondents think that they will be captured. Though one advises that they are still analysing the requirements.

Investment research

MiFiD II imposes stringent conditions on clients' payments for research, including, as a possible option, the use of a dedicated research payment account (RPA) and regular assessments of research quality. Requirements are contained within the Delegated Directive – (C (2016) 2031 final) published on 7 April 2016.

Q6 How will your firm pay for broker research under the revised regime?

Option A: Directly from the firm's P&L?
Option B: Via the operation of an RPA?
Option C: Still to be determined?

The decision on whether or not to pay for investment research directly out of a firm's P&L or to establish (and operate) an RPA is still very much an open question. Of the asset managers taking part in the survey, less than a third are definite on their solution.

A small percentage advise that they would pay out of P&L, while a similar number of firms have opted to proceed through the use of an RPA.

However, the majority of respondents advise that they have not yet made a final decision. This is less due to paralysis than to ongoing analysis of business models; assessments of the advantages and disadvantages of each model; and taking into account their clients' interests.

Q7 If your firm has chosen to operate an RPA, do you plan to outsource to a third party?

While only a relatively small percentage of the respondents indicate that they will be using an RPA, just under half of the asset managers surveyed believe that if they choose to operate an RPA, then its operation will be outsourced to a third party.

Q8 Will the analysis of charges that require disclosure to investors be done manually or via an automated system?

The majority of asset managers advise that an automated system will be used where their analysis of charges require disclosure to investors. A significantly lower number advise they will undertake this work manually, while a similar number have yet to reach a decision.

Q9 If via an automated system, has this required a system development/build?

Just under 60% of asset managers confirm that the use of an automated system will require time to be spent on system development/build and incurring the inevitable costs, and while only a small percentage indicate that no such system development/build will be necessary, under a third advise this still needs to be confirmed.

Q10 If YES, how long did this or will this take?

The responses to this question are varied and ranged in terms of timing from 6 to 12 months, with qualifications on the latter timeframe that this will be a full-time project, to other managers advising that work has not begun and are reticent to advise an expected timeframe.

Based on the 3 January 2018 revised implementation date for MiFID II/MiFIR, then 12 months seems to be the maximum timeframe.

Q11 Will you continue to use Commission Sharing Agreements (CSAs) adapted to meet the requirements under MiFID II?

On the question of whether CSAs, adapted to meet the requirements under MiFID II, will be used, asset managers are not consistent in their approach, as numbers are split fairly equally between those who will continue to use and those who say they won't.

Transaction/trade reporting

MiFID II/MiFIR requires the reporting of both trades and transactions. By January 2018, MiFID II/MiFIR will have imposed a number of alterations to the previous rules of reporting:

i) MiFID II trade reporting (near-real-time) that will require firms to report via an Approved Publication Arrangement (APA). These reports are near-real-time broadcasts of trade data for price formation and operation of best execution obligations. These are reported via trade reporting venues from where they are disseminated to the market; and

ii) MiFIR Transaction Reporting (T+1). The Approved Reporting Mechanism (ARM) regime will remain in place. However, there are a number of changes. The number of reportable fields is increasing from 23 to over 60, the number of asset class covered has broadened and the buy-side is no longer exempt.

Q12 Will you be undertaking MiFIR transaction reporting in-house?

More than half of respondents confirm that they will be undertaking "in-house" MiFIR transaction reporting, with a third advising they will not. The remainder are still to confirm their approach.

In considering the above results, it is important to note that under MiFID II, all reportable transactions are to be reported through systems that comply with specific requirements as detailed in Article 12 of the MiFID Level 2 Regulation. In practice, what this means is that while a firm can perform transaction reporting in-house, it will still need to liaise with an ARM for the report to be submitted to the relevant national competent authority.

Disclosure requirements

Key areas of MiFID II/MiFIR will require increased disclosure of information to both investors and regulators. Areas, for example, such as:

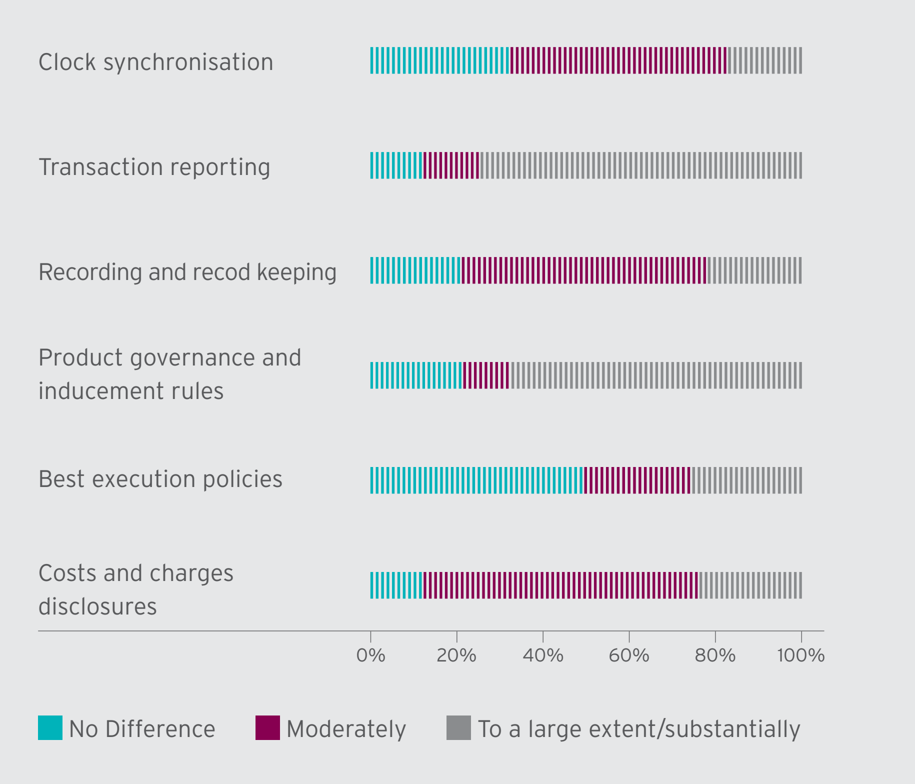
- Costs and charges (with links to pension and PRIIPs disclosure requirements)
- Best execution policies
- Product governance and inducement rules
- Recording and record-keeping requirements
- And transaction reporting

Q13 Will these requirements result in increased costs and operational changes for your business?

Where the respondents are asked to identify which requirements will result in both increased costs and operational changes, transaction reporting is flagged as the biggest impact with 74%.

Product governance and inducement rule changes is the next item (67%) where a large/substantial impact is considered.

In relation to impacts that are considered to have a moderate effect, costs and charges disclosures is the highest, ranked at 63%, followed by recording and record-keeping, at 56%.



Q14 Have these requirements provided any competitive advantages for your firm?

In the area of competitive advantage (for these new requirements) asset managers do not identify any areas that will provide substantial benefits. Indeed all are identified as providing either no different or only a minimal benefit. However, 15% of respondents say there are moderate competitive benefits to be found in best execution policies and the product governance and inducements rules.

Data and data protection

Linked to the above segment on increased disclosure and data come associated risks concerning data protection. For example, under the transaction reporting requirements for "natural" persons, the Legal Entity Identifier (LEI) is replaced with a natural identifier, e.g. a passport, along with other increased information disclosure.

Q15 Have you ensured that you are comfortable that any outsource providers are also able to comply with these same data protection requirements?

While a majority (67%) of asset managers confirm they are comfortable that any chosen outsourced provider will also be able to comply with the data protection requirements, the remainder advise it is either too soon to tell or that they weren't comfortable.

Q16 Will the extensive data demands arising from legislation such as MiFID II/MiFIR result in a greater level of outsourcing by your firm?

Firms are split on whether a greater level of outsourcing will be required as a result of the extensive data demands arising from the MIFID II/MiFIR legislation. 56% of respondents agree that it will, while the remainder do not.

Target market/appropriateness regime

Under product governance rules and the appropriateness regime, firms need to ensure that "target markets" are aligned with distribution strategies.

Product governance refers to the systems and controls firms have in place to design, approve, market and manage products throughout their lifecycle to ensure they meet legal and regulatory requirements. Good product governance should result in products that:

i. Meet the needs of one or more identifiable target markets.

ii. Are sold to clients in the target markets by appropriate distribution channels.

iii. And deliver improved consumer outcomes.

Q17 Have you engaged across your distribution chain to ensure that "target market" requirements can be met?

71% of asset managers confirm that they have engaged their distribution chain to ensure that the "target market" requirements can be met.

Q18 Has this engagement required a better understanding on your part, as the product manufacturer, of how the distribution of your product is achieved?

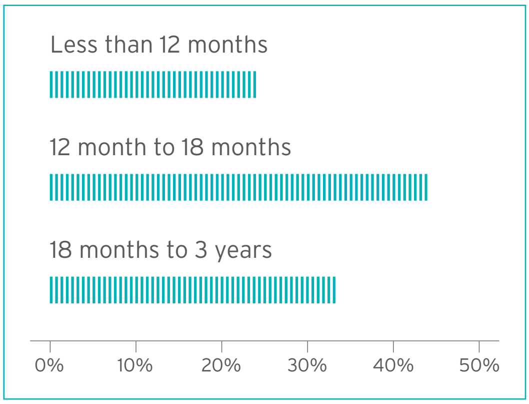
While 33% of those questioned advise that this was not an applicable consideration, an equal number of asset manages confirm the engagement has led to a better understanding of how the distribution of their product is achieved.

Interestingly, a third of respondents also advise the engagement has not required a better understanding, although specific reasons are not provided as part of the responses.

Q19 Will your firm be looking to use any industry association templates or guidance to assist you in meeting the target market requirements?

Three-quarters of respondents confirm that they will be looking to utilise an industry association template and/or guidance to help them in meeting their target market requirements.

Q20 How long have you been working on your MiFID II implementation plans?



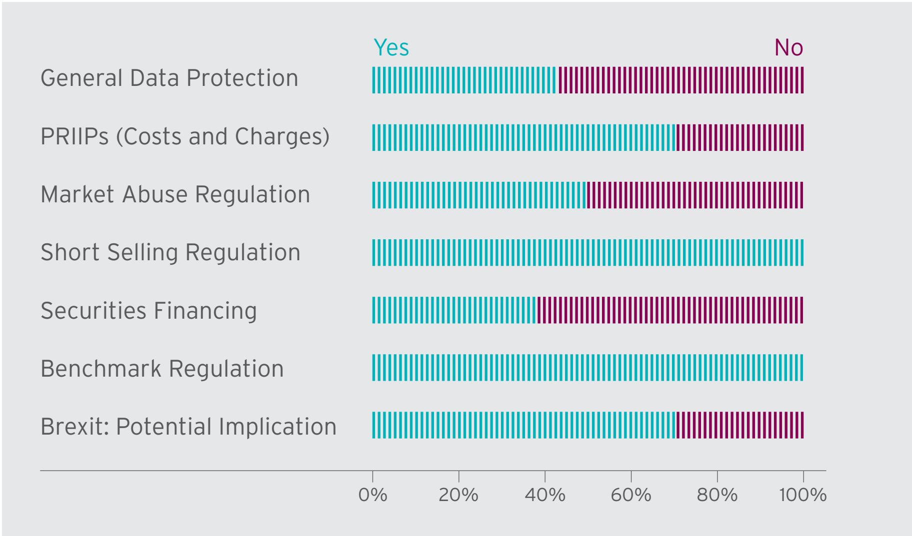
Q21 Will your firm be ready for the MiFID II/MiFIR go live date in 2018?

With the exception of one response that marked as uncertain, all other asset managers confirm that they will be ready for the revised 2018 implementation date.

Q22 Have you included other legislative packages or considerations as part of your MiFID II/MiFIR project?

Asset managers have also been questioned on whether, as part of their MiFID II/MiFIR projects, they have considered other legislative packages.

Many advise they have not, but the areas identified by asset managers that have been included are PRIIPs Costs and Charges (71%), Brexit: Potential Implications for MiFID II Passporting Rights (71%), and the Market Abuse Regulation (50%).



In conclusion

The survey results indicate that firms are still at varying stages in their implementation planning and decision-making. Why some of the firms are not yet in a position to have made any final decisions about how they will deal with certain aspects of the requirements is most likely due to the fact that there have been continuing delays in finalising the critical details that will be contained in Level 2 technical standards and Level 3 Q&A. These are necessary before some of the final puzzle pieces can be slotted in.

We would like to thank all respondents who contributed to our survey. We hope that they, as well as all our readers, find the collated results useful.

Amanda Hale
Head of Regulatory Services
Trustee and Fiduciary Services, Citi

Andrew Newson
Senior Fiduciary Technical Analyst, Citi

INCREASED TRANSPARENCY: THE IMPACT ON ASSET MANAGERS

Increasing transparency across markets is one of the key aims of the recast Markets in Financial Instruments Directive (MiFID II)[1] and related regulation (MiFIR).[2] It is hoped that a more transparent market will result in a stronger financial system.

This article focusses on the transparency regime under MiFIR, looking at the practical impact of post-trade transparency on asset managers and what increased market transparency may mean for the market.

The current MiFID regime

MiFID currently applies pre-trade and post-trade transparency rules specifically to shares that are admitted to trading on a regulated market (RM) (regardless of how they are in fact traded, be it on a multilateral trading facility (MTF) or over-the-counter (OTC)). For post-trade transparency, investment firms trading OTC are required to make public details of transactions to which they are a party. However, such publication is only required to be made once per transaction. Where both parties to a transaction are investment firms, the MiFID Implementing Regulation[3] provides that one of the following must, by agreement between the parties, arrange to make the information public: the investment firm that: a) sells the share; b) acts on behalf of or arranges the transaction for the seller; c) acts on behalf of or arranges the transaction for the buyer; or d) buys the share concerned. In the absence of such an agreement, the relevant investment firm is identified sequentially from point a) to d), until the first point that applies to the facts. Asset managers have, therefore, not been responsible for the publication of post-trade information with brokers traditionally agreeing to undertake such requirements.

The new regime

MiFID is being replaced by MiFID II and MiFIR, both of which take effect on 3 January 2018. The transparency regime is set out in MiFIR, which, as directly applicable law, should ensure uniform transparency rules across the European Union (EU) with less scope for variations in national implementation.

Many of the details of the transparency regime are clarified in two delegated regulations covering equity instruments[4] (Equity DR) and non-equity instruments[5] (Non-Equity DR) (together the Delegated Regulations), both of which were adopted by the European Commission (EC) on 14 July 2016. These Delegated Regulations introduce regulatory technical standards (RTS) and are often referred to as RTS1 and RTS2, respectively. The RTS were developed by the European Securities and Markets Authority (ESMA) and were published in September 2015.[6]

The MiFIR transparency regime:

- Retains the concepts of pre-trade and post-trade transparency.
- Impacts trading undertaken on or off EU trading venues, being RMs, MTFs or the new concept of an organised trading facility (OTF).
- Introduces transparency obligations on systematic internalisers (SIs) and other investment firms that trade OTC.
- Greatly increases the instrument scope from shares to:
  - Shares, depositary receipts, ETFs, certificates and other similar financial instruments traded on a trading venue (equity instruments).
  - Bonds, structured finance products, emission allowances and derivatives traded on a trading venue (non-equity instruments).

This article does not look at the detail of when transparency obligations apply. However, where this is the case, the transparency regime varies depending on: 1) whether the trading is taking place a) on an EU trading venue or b) with an SI or otherwise by an investment firm trading OTC; and 2) whether the instrument in question is an equity instrument or non-equity instrument.

For both equity instruments and non-equity instruments, the pre-trade (Articles 3 and 8 MiFIR) and post-trade transparency obligations (Articles 6 and 10 MiFIR) of trading taking place on an EU trading venue rest with the trading venue itself. For trading taking place off an EU trading venue, only SIs are required to provide pre-trade transparency (Article 14 and 18 MiFIR). For post-trade transparency (Articles 20 and 21 MiFIR), SIs and investment firms trading OTC are subject to post-trade transparency obligations.

Post-trade transparency for investment firms trading OTC: who's responsible?

Investment firms trading OTC, pursuant to Articles 20 and 21 MiFIR, are required to "make public the volume and price of those transactions and the time at which they were concluded" via an approved publication arrangement (APA). This has to be undertaken "as soon as real-time is technically possible". For equity instruments, this means (where the transaction takes place during the daily trading hours of the most relevant market in terms of liquidity of the instrument in question) one minute, and in any other case immediately on the opening of trading of that market on the following day. For non-equity instruments, this is phased in and means within 15 minutes of execution, until 2021, and thereafter 5 minutes.

As set out above, for post-trade transparency, all investment firms are potentially in-scope to make public details of transactions executed off an EU trading venue. However, only one post-trade publication is to be made per transaction so one needs to establish which trade counterparty should be making the publication. For both equity and non-equity instruments, where the transaction is executed OTC between two investment firms, the general rule is that the "seller" always reports unless one firm is an SI, in which case the SI must report (Article 12(4) and (5) Equity DR and Article 7(5) and (6) Non-Equity DR). Therefore, in the absence of an SI, it will be the selling investment firm's responsibility to provide post-trade transparency.

However, the question then arises: who is responsible where one of the trade parties is established outside the EU and therefore not technically an investment firm? MiFIR, Equity DR and Non-Equity DR are silent with respect to who it should be. However, this was not initially the case. It is interesting to note that in early drafts of the RTS on transparency for equity and non-equity instruments prepared by ESMA, the recitals stated that where the transaction is executed between an EEA investment firm and a non-EEA firm, the EEA firm must report (recital 5, RTS 8 and recital 12, RTS 9 of ESMA Consultation Paper on Regulatory Technical Standards on MiFID II/MiFIR 19 December 2014 | ESMA/2014/1570). Notwithstanding this, the accepted view is that where an investment firm is trading with a non-EU established entity, the investment firm will be required to undertake the post-trade transparency, regardless of whether it is the seller or buyer to the transaction in question. This is because the primary requirement set out in Articles 20 and 21 MiFIR states that it is the investment firms that shall make the transaction information public, while the Delegated Regulations specify which counterparty this should be where both are investment firms. Clearly, where there is only one investment firm party to the transaction, it shall be responsible for post-trade transparency.

The global financial crisis serves as a grim reminder of how complex and opaque some financial activities and products have become.

Michel Barnier, 2011 European Union Commissioner for the Internal Market

What is the impact on asset managers?

Where asset managers are trading with EU investment firms, it will predominantly be the case that the asset manager will be the buyer and therefore can rely on their counterparty to perform the post-trade transparency. However, where an asset manager is transacting with a non-EU counterparty, it will be the asset manager's responsibility to ensure post-trade transparency takes place. Another situation that may bring about a post-trade transparency obligation on asset managers involves agency cross-trades. In this scenario, as the asset manager acts as agent on behalf of both transaction parties, then that manager will be acting in the capacity as a seller and therefore be responsible for the post-trade publication. Today under MiFID, asset managers who undertake agency cross-trades are required to undertake post-trade transparency. However, given the increase of in-scope instruments to cover equity and non-equity instruments, this will have a greater impact on asset managers.

Being responsible for the post-trade publication of transaction information will likely require systems build for a number of asset managers, and the introduction of internal processes and procedures and engagement with APAs to whom the information is required to be provided. The Delegated Regulations detail further information with respect to the exact information, and the format of such, which will need to be distilled and built into these systems. One of the key challenges with post-trade transparency is the speed with which it needs to be reported. As summarised earlier in this article, this is "as soon in real-time as is technically possible", which is detailed as being within 15 minutes for non-equity instruments. The potential challenge for asset managers will be how they will be able to collate the required information, ensure it is in the correct format and get this to the APA in such a timeframe.

More data will be available

As the breadth of in-scope instruments and transactions is increased under this expanded transparency regime so will the amount of pricing data made available to the public. From a pre-trade transparency perspective, each EU trading venue and SI will be required to make public its bid/offer prices and quotes, enabling potential investors to have better visibility as to price discovery on a wide number of instruments. From a post-trade transparency perspective, executed transaction pricing will also be available.

What is the impact on asset managers?

The increased information in the market as a result of the extension of the transparency regime may assist asset managers in achieving better pricing. Having the ability to see quotes and executed prices will enable asset managers to negotiate pricing with brokers as they will be able to rely on publically available data. This may also mean that asset managers choose to vary the usual trading venues at which their trades are executed to ensure they receive the best price available, which, in turn, should reduce fragmentation of liquidity in the market. There is a potential that this increased transparency may mean asset managers wish to revisit current trading strategies to take advantage of increased pricing data.

There is some concern in the market that this increased transparency regime will affect liquidity as firms try to avoid the pre-trade transparency obligation by reducing the number of quotes they provide or provide quotes that are not subject to the transparency obligation. While this is a potential response to the MiFIR transparency regime, it is thought that generally firms are preparing themselves to open the doors on their prices.

Asset managers, along with other clients of brokers and other market participants who owe transparency obligations, may need to prepare for changes to fees and charges imposed by such entities. While firms owing transparency will not be able to directly pass back the costs of compliance with the transparency obligations, it may be the case that clients witness an increase in charges for services they are provided by their brokers.

What is the status and what happens next?

The EC adopted the Equity DR and Non-Equity DR on 14 July 2016. These Delegated Regulations are now subject to a scrutiny period by the European Parliament and Council. If neither the Parliament nor the Council objects to the Delegated Regulations, they will be published in the Official Journal and will enter into force twenty days later.

ESMA will also publish further guidance in the form of a Q&A document, which will provide ESMA's expectations with respect to MiFID II/MiFIR and be continually updated. We have not yet seen a draft of the Q&A. However, it is understood that this will not be published until all RTS have been finalised.

Peter Bevan
Partner
Linklaters LLP

[1] Directive 2014/65/EU of the European Parliament and of the Council.

[2] Regulation (EU) No 600/2014 of the European Parliament and of the Council.

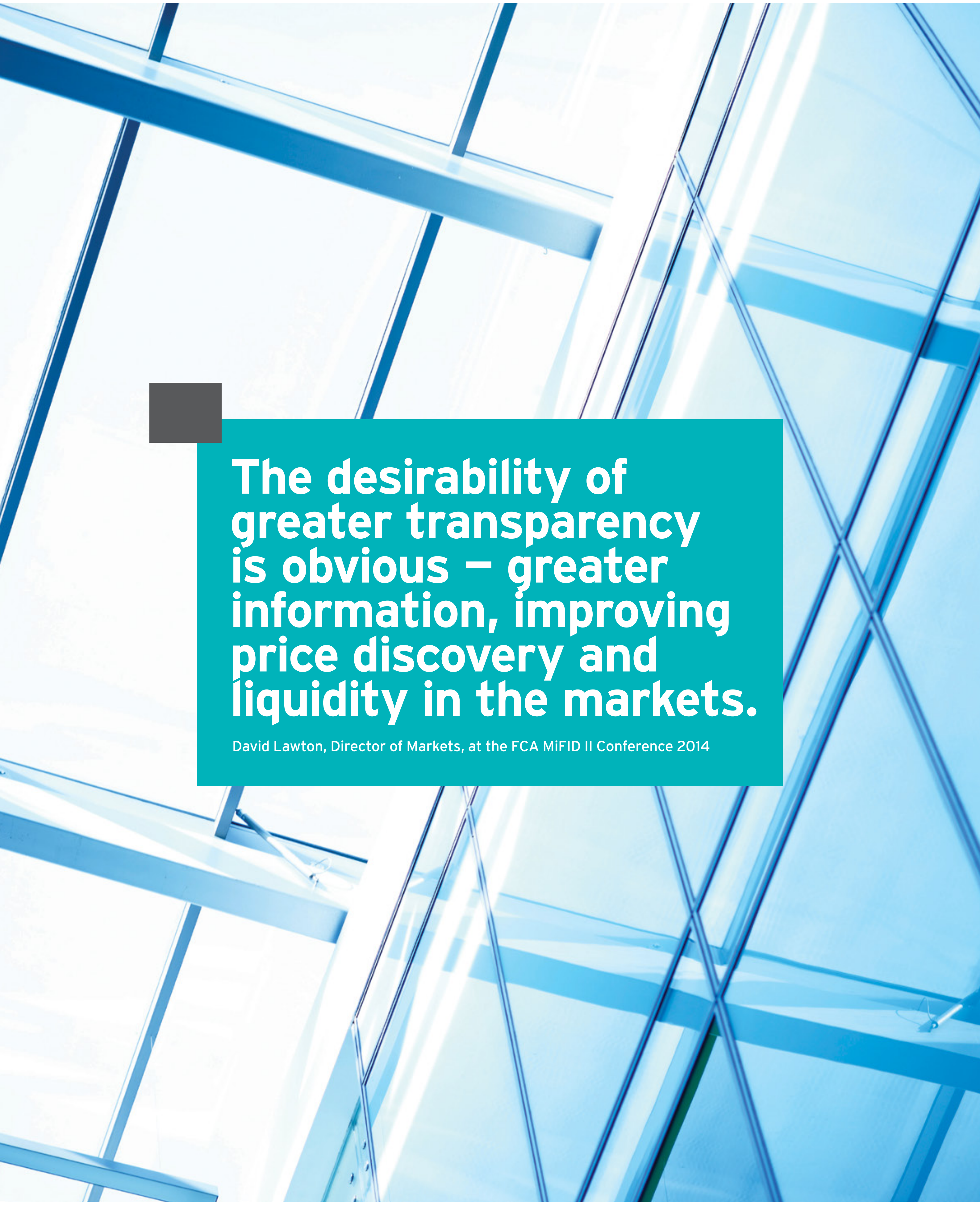
[3] Commission Regulation (EC) No 1287/2006.

[4] Commission Delegated Regulation C(2016) 4390.

[5] Commission Delegated Regulation C(2016) 4301.

[6] ESMA Final Report Draft Regulatory and Implementing Standards MiFID II/MiFIR 28 September 2015 | ESMA/2015/1464.

[7] "[A]s soon as real-time as is technically possible being: (a) for the first three years of application of Regulation (EU) No 600/2014, within 15 minutes after the execution of the relevant transaction; (b) thereafter, within 5 minutes after the execution of the relevant transaction."



The desirability of greater transparency is obvious – greater information, improving price discovery and liquidity in the markets.

David Lawton, Director of Markets, at the FCA MiFID II Conference 2014

BREXIT, THIRD COUNTRY RIGHTS AND SEGREGATED MANDATES: THE CHALLENGE FOR MANAGERS

The outcome of the UK EU membership referendum (Brexit) has focused UK managers on the so-called "third country" provisions in both the AIFMD and the MiFID II Directive and Regulation if, indeed, "out means out". An alternative arrangement, whereby the UK becomes a member of the European Economic Area (EEA), either as a European Free Trade Association (EFTA) member or as an individual state, negotiating access to the Single Financial Market, would bring attention back to the current arrangements, in which case a reconsideration of the position will be unnecessary.

In addition to the issues for home-grown fund managers in the UK, overseas managers who have set up in the UK and are passporting into the EU will face the same issues. The difference for them, and the challenge for policymakers hoping to retain the UK as a second home for overseas managers, is that the relocation of their entire operations to the EU may be an option: it is difficult to see how this would be so for properly so-called UK fund managers.

The current position: relief for EU AIFMs

At present, where a third country firm offers an investment service, such as managing a segregated mandate, to an investor in an EU Member State, that Member State's national rules governing the offer of non-Collective Investment Undertaking (CIU) products should apply. In this respect, the provisions of MiFID, which governs an EU entity that performs any investment service as a regular occupation or business on a professional basis, do not govern third country firms, either with respect to the imposition of duties or the granting of rights.

In addition, where a third country firm provides a MiFID investment service, such as delegated portfolio management services to an EU AIFM or UCITS manager under article 20 of AIFMD and Article 13 of the UCITS Directive, respectively, those directives will also not apply directly to that third country firm.

Alternative Investment Fund Managers (AIFMs) subject to the AIFMD

As is the case with so many of its provisions, Article 6(4) of the AIFMD borrows from Article 6(3) of the UCITS Directive the principle that the manager of a CIU should be free to provide investment services, such as segregated mandate management and investment advice, in addition to CIU-related services, such as AIF portfolio management and AIF administration.

Member States will have the power to require a third country firm, which a UK manger will be after Brexit if no agreements are put in place, to become authorised if it manages an EU AIF once the third country passport comes into effect. Article 37(8) of the AIFMD indicates that Chapter II of the AIFMD, which includes Article 6(4), will apply mutatis mutandis to the authorisation of a third country firm, subject to certain conditions that are not relevant here. It is, therefore, clear that a Member State authority authorising a third country firm under the relevant provisions implementing Article 37 will have the power to authorise that third country firm to offer investment services, including segregated mandates.

MiFID II made an important amendment to the AIFMD, making it clear that an EU AIFM authorised to manage an EU AIF in one Member State may provide segregated mandates together with AIF management.

The problem, however, is that the MiFID II amendments have not been extended to include third country firms. In this respect, the revised Article 4(1)(r) refers to "the home Member State in which an *EU* AIFM provides the services referred to in Article 6(4)" (own emphasis). Similarly, the revised Article 33 is restricted to EU AIFMs: there is no similar amendment to Articles 39 or 40 or Article 4(1)(r) itself to extend the AIFMD passport for investment services to third country firms acting as AIFMs to EU and non-EU AIFs, respectively.

Unless the AIFMD is amended, a UK manager authorised as an AIFM under Article 37 wishing to offer segregated mandates in more than one Member State will be unable to do so under the Article 39 and Article 40 passports. The position will, therefore, be the same as that which currently exists with the AIFM having to offer segregated mandates on a Member State-by-Member State basis and not be able to rely on the AIFMD third country passport.

As to the solutions for UK managers, it may be that a UK manager would be better-off setting up a subsidiary under the AIFMD rather than MiFID where that manager wishes to provide segregated mandates. Except for the head office and registered office located in the same Member State requirement in Article 8(1)(e), the requirements for a non-EU AIFM established under Article 37 will be the same as those for an EU AIFM established under Chapter II. However, as mentioned above: unlike an AIFM authorised under Chapter II, an AIFM authorised under Article 37 will be unable to offer segregated mandates in reliance on an AIFMD passport. In this respect, therefore, the subsidiary of a non-EU manager authorised under the AIFMD, i.e. an EU AIFM, offering management services (which include segregated mandates) is better than the UK manager offering management services itself, as a non-EU AIFM.

Relief under the MiFID II third country passport?

The Markets in Financial Instruments Regulation (MiFIR) — which, together with the recast MiFID Directive (MiFID II Directive), make up the MiFID II package — will, in essence, permit third country firms to provide investment services to eligible counterparties, as defined in MiFID, and the entities identified in Section I of Annex II to MiFID ("per se" professional clients) throughout the EU. Under MiFIR, a third country firm will be able to do so without having to establish a branch in the EU but will have to become registered with ESMA. This is contingent on the Commission making an "Equivalence Decision", i.e. satisfying itself that the third country firm's home state legal and supervisory framework has "equivalent effect". Equivalent effect will be determined, in essence, by reference to prudential and business conduct requirements that the Commission will be required to judge in the context of the Capital Requirements Directive (CRD IV) and the Capital Requirements Regulation (CRR).

On the face of it, the MiFIR third country provisions may provide a solution for a UK manager that manages an AIF and also wishes to offer investment services. In effect, a UK manager entered onto the ESMA register will benefit from a third country firm "MiFIR Passport" with respect to investment services. MiFIR makes it clear that Member States will not be able to impose any additional requirements on any third country firm. However, a UK manager seeking to rely on the MiFIR Passport could face at least three issues:

- MiFIR is silent as to whether a third country firm that is also an AIFM may be entered on the ESMA Register. Whereas the common lawyer's response is that this means that ESMA is free to register such a third country firm, there is the risk that ESMA would look for an express power before registering an AIFM.
- Whereas Articles 39 and 40 of the AIFMD provide third country firms with passport rights with respect to any type of MiFID professional client, the MiFIR Passport will be restricted to services provided to eligible counterparties and per se professional clients. In practice this means that a third country firm would be limited to offering investment services to professional investors properly so-called, institutional investors, and national and regional governments. It could not offer such services to, for example, high-net-worth individuals or local public authorities and municipalities (unlike MiFID, the MiFID II Directive does not treat local public authorities and municipalities as per se professional clients).
- Echoing the AIFMD, there are what MiFIR describes as "transitional provisions" with respect to the MiFIR Passport. In essence, the MiFIR Passport will only be available three years after the Commission has made the Equivalence Decision.[1] Bearing in mind that MiFIR is only due to come into force in early 2018, the MiFIR Passport may not be available until early to mid-2021. Until then, the individual Member State rules will apply, i.e. the status quo remains.

Establishing a branch under MiFID II?

MiFID II will give Member States the power to allow a third country firm to provide investment services to elective professional clients and retail clients, i.e. those clients who are neither eligible counterparties nor per se professional clients. The third country firm will need to establish an authorised branch in the relevant Member State (host state) and comply with the host state rules that implement the MiFID II Directive.

As is the case with the MiFIR Passport, there are questions over how a UK manager that manages an AIFM could benefit under MiFID II Directive's third country provisions:

- The AIFMD indicates that a UK manager authorised as an AIFM under Article 37 would not be allowed to establish a branch under the MiFID II Directive. Instead, the core AIFMD services would have to be provided by an entity authorised under the AIFMD, with the branch of another entity (the MiFID Entity) or its subsidiary providing the investment services under the Member State rules implementing the MiFID II Directive (the separate entity model).
- Assuming that a UK manager's business model supports the separate entity model, the question arises as to whether investment services are better delivered through (a) the branch of a MiFID entity or (b) the subsidiary of a MiFID entity or AIFM. The difference, in practice, between a Member State's rules governing the branch of a third country firm authorised under the MiFID II Directive third country provisions and the full authorisation provisions that would apply to the subsidiary of a UK manager is difficult to predict. On the face of it, the MiFID II Directive third country provisions appear to be less onerous than the full authorisation provisions.
- It is unclear, however, whether, in practice, the regulatory burden for the branch of a UK manager would be materially less than that for a subsidiary. A branch will have to comply with the host state rules giving effect to many, but not all, of the provisions in the MiFID II Directive governing conduct of business. In this respect, it will be in a similar position to the branch of an EU investment firm exercising its freedom to

establish a branch in a Member State under a MiFID II Directive EU passport. Unlike an EU investment firm, however, there is no express home/host Member State division of supervisory powers. Rather, the limit of any Member State supervision lies in the fact that not all of the MiFID II Directive applies to third country firms. However, regulatory capital and organisational requirements do apply. Even though the MiFID II Directive prohibits Member States from imposing any additional requirements on the organisation and operation of the branch of a third country firm, the fact is that the requirements themselves are cast in broad terms. This means that the regulatory burden, ultimately, on the subsidiary of a MiFID entity or AIFM could be similar to that on the branch of a MiFID entity without the related rights as discussed below.

- Even though the MiFID II Directive provides greater scope for the provision of the investment services than MiFIR, in so far as the branch of a third country firm can provide investment services to elective professional clients and retail clients (in addition to eligible counterparties and per se professional clients) in the Member State in which it is established, it does not give the branch the right to provide these services to anyone in other Member States.

Time to think…

Whatever the solution, the victory won for UK managers as EU AIFMS wanting to passport their segregated mandate services under the AIFMD will be relatively short-lived if the UK's post-Brexit settlement renders the UK a third country and the AIFMD is not amended. That said, Brexit is still a way off if the current indications on the likely date for notifying the EU Commission remain.

Andrew Henderson
Partner
Eversheds LLP

[1] See MiFIR, Article 54.1.

MiFID II: A VIEW FROM THE UK

On 29 July, the UK's Financial Conduct Authority (FCA) published the second of four consultation papers presenting the planned implementation of MiFID II (CP16/19).[1]

Given the events that occurred at the end of June, it is no surprise that the FCA opened CP16/19 with a reference to the UK referendum on EU membership and mentioned in its statement of 24 June 2016 that "Firms must continue to abide by their obligations under UK law, including those derived from EU law and continue with implementation plans for legislation that is still to come into effect."

As MiFID II is within the category of legislation that has yet to come into effect (i.e. 3 January 2018), firms and the FCA still need to continue with their implementation plans.

Background

CP16/19 follows on from CP15/43 published in December 2015.[2] In this earlier paper, the FCA set out the background to the introduction of MiFID II, and its key objectives, and mainly covered issues relating to the new rules in MiFID II governing the secondary trading of financial instruments.

CP16/19, however, covers a wider range of issues including the framework for position limits, management and reporting for commodity derivative contracts, and the way that firms organise themselves to do business and comply with their regulatory obligations.

The policy in CP16/19 was developed in the context of the existing UK and EU regulatory framework so the FCA says that it will keep the proposals under review to assess whether any amendments will be required due to changes in the UK regulatory framework, including as a result of any negotiations following the UK's vote to leave the EU.

In addition to investment managers, who else will be affected by the proposals in the CP?

- Investment banks
- Interdealer brokers
- Stockbrokers
- Investment advisers
- Trading venues, including RMs, MTFs and prospective OTFs
- Prospective Data Reporting Service Providers (DRSPs)
- Corporate finance and venture capital firms

CP16/19 at a glance

In this CP, the FCA seeks views on proposed changes to the Handbook in the following areas:

- Commodity derivatives
- Supervision (SUP)
- Prudential rules
- Senior Management Arrangements Systems and Controls (SYSC)
- Remuneration
- Client Assets Sourcebook (CASS)
- Complaint handling (DISP)
- Whistleblowing
- Fees Manual (FEES)

Finally, to assist readers to understand the way that MiFID II is being implemented in the UK, the FCA has also included a Handbook "MiFID Navigation Guide for SYSC" in Appendix 2 of CP16/19.

Each chapter in more detail

Commodity derivatives (Chapter 2)

This chapter will be of particular relevance to trading venues (regulated markets (RMs), multilateral trading facilities (MTFs) and prospective organised trading facilities (OTFs)), MiFID investment firms trading commodity derivatives, and users of commodity derivatives markets, including non-financial firms that conduct significant amounts of trading.

HMT will partly transpose the requirements in MiFID II on position management, position limits and position reporting into UK legislation. In CP16/19, the FCA is proposing to introduce a new chapter in the Market Conduct sourcebook (MAR). This will include guidance on aspects of the legislation and rules on matters such as position management by investment firms operating MTFs and OTFs. In 2017, the FCA will set position limits to take effect on 3 January 2018.

The proposed new chapter in MAR, MAR 10, will be entitled "Commodity Derivative Position Limits and Controls and Position Reporting" and it will be split into five sections:

1. MAR 10 application
2. Position limit requirements
3. Position managment controls
4. Position reporting
5. Other reporting, notification and information requirements

FCA description of implications for firms in CP16/19

Persons, whether authorised or not, trading commodity derivatives will need to configure their trading activities so they are able to comply with position limits.[3] This will involve:

- Some unauthorised firms applying for exemptions from position limits.
- Persons making arrangements to report their positions or for their positions to be reported on a daily basis.
- Trading venues putting arrangements in place to provide position reports to regulators on a daily basis, and to report aggregated information about positions to the European Securities and Markets Authority (ESMA) on a weekly basis.
- And trading venues reviewing and adapting, as necessary, current rules and procedures they have regarding the monitoring and management of positions.

Position limits

Position limits will be set on all commodity derivatives traded on UK trading venues in line with the methodology established by ESMA.[4] The FCA will hold sufficient powers to enable it to obtain information, from trading venues and other sources, to be able to establish the position limits.

Position reporting will be an obligation on trading venues and investment firms in line with MiFID II and the FCA will provide guidance on its expectations for the production and submission of position reports, their methodology, content and format.

Supervision manual (SUP) (Chapter 3)

> The notification provisions in this chapter are relevant for all MiFID investment firms, the transitional provision to firms currently transaction reporting and the passporting provisions to MiFID investment firms that currently passport or intend to do so under MiFID II.

The FCA is proposing to make changes to SUP to cover three main issues related to MiFID II:

1. Make it clear that firms need to notify the FCA of a breach of directly applicable regulations under MiFID II or implementing regulations introduced by the Treasury, and to ensure that information given to the FCA is accurate and complete.
2. Introduce transitional provisions to deal with the revocation of the MiFID implementing regulation.
3. To update aspects of the passporting provisions.

As regards the transitional provisions in SUP, the FCA proposes to do two things that are of particular relevance to firms' transaction reporting obligations:

- The FCA makes it clear that an obligation that a firm incurs under SUP 17 or the MiFID implementing regulation on or before 2 January 2018 continues until it has been satisfied.
- And that the requirements in SUP relating to notification and remedy of breaches apply to breaches of MiFID implementing regulation, even if the breach comes to light after 2 January 2018.

FCA description of implications for firms in CP16/19

Firms will need to extend their existing arrangements for monitoring and reporting of breaches under MiFID to the new requirements under MiFID II. They will also need to prepare, with help and guidance from the FCA and ESMA, for the practical implications of the changeover from the current transaction reporting obligations to those under MiFID II.

Firms will also need to review whether they should revise existing passport notifications.

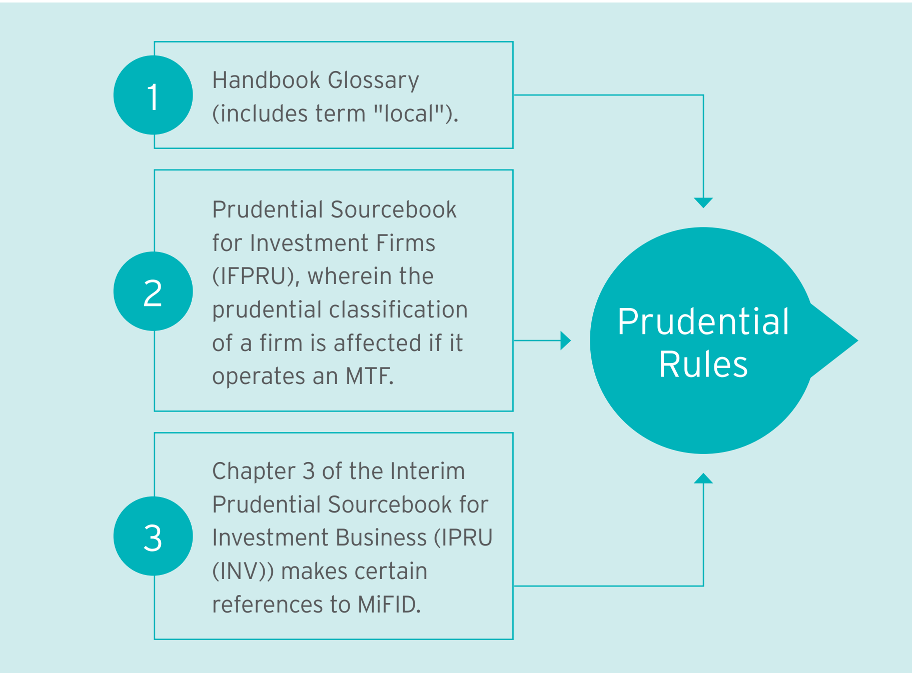
The MiFID implementing regulation is Commission Regulation (EC) 1287/2006.[5] The transaction reporting obligations are in Article 26 of MiFIR[6] and RTS 22.[7] The passporting provisions are in Articles 34 and 35 of MiFID II.

Prudential Rules (Chapter 4)

> This chapter will be relevant to investment firms that wish to operate an OTF and to "local" firms currently exempt from MiFID.

A number of the prudential rules in the FCA Handbook use terms that appear in MiFID. With the implementation of MiFID II, certain references will need to be updated or removed.

This mainly affects three areas:



The FCA proposes to update the prudential classifications to reflect the addition of the new category of investment service in MiFID II of operating an OTF and to ensure that an investment firm operating an OTF, as with a firm operating an MTF, is classified as an IFPRU 730k firm[8], in line with the Capital Requirements Directive (CRD) IV.[9]

Secondly, the exemption in MiFID for a "local" is not being carried across to MiFID II. The FCA proposes deleting references to a "local" in Chapter 3 of IPRU (INV), which sets prudential requirements for various categories of firms other than most categories of MiFID investment firms, and in SUP 16.12.

The last proposal is a consideration of whether to delete certain references to MiFID in Chapter 3 of IPRU (INV) that are no longer needed because the relevant provisions now sit in the Capital Requirements Regulation (CRR) and are not included in MiFID II.[10]

FCA description of implications for firms in CP16/19
These proposals are consequential in nature, resulting from scope changes in MiFID II. Those relating to OTFs are to ensure that the correct CRR prudential treatment is applied to investment firms that conduct this new investment service.

The changes relating to a "local" firm reflect the fact that the current exemption under MiFID is not being carried across to MiFID II.

Senior Management Arrangements, Systems and Controls (SYSC) (Chapter 5)

> This chapter should be reviewed by common platform firms (i.e. BIPRU firms, banks, building societies, MiFID investment firms, designated investment firms, IFPRU investment firms, exempt CAD firms, local firms and document account fund operators). It will also be of interest to Article 3 MiFID firms such as retail financial advisers, boutique corporate firms and venture capitalist firms operating in the UK, as well as UK branches of non-EEA firms (third country firms).

This chapter of CP16/19 explains the changes that the FCA is proposing to make to SYSC to implement Article 9 (management body); Article 23 (conflicts of interest); and Article 16 (organisational requirements).

The FCA explains the changes to SYSC 4 – 10, which form the common platform requirements for common platform firms, and is relevant to UCITS investment firms and AIFM investment firms in respect of their MiFID business.[11]

Article 3 MiFID firms (Article 3 firms)
The large number of Article 3 firms that will now be captured should understand the new

requirements that they must comply with. Currently, the common platform requirements in SYSC 4-10 are applied to Article 3 firms as a mixture of rules and guidance. To ensure that Article 3 firms are subject to "at least analogous requirements" the FCA proposes to apply:

- Provisions in SYSC 4 to SYSC 9 implementing MiFID II by way of rules or guidance depending on whether they apply to MiFID firms as rules or guidance.[12]
- Articles 21 to 25, 30 to 32 and 72 of the MiFID implementing regulation as if such requirements applied to Article 3 firms as rules or guidance.[13]
- In both cases, the relevant obligations apply to Article 3 firms' regulated activities and other activities identified in SYSC 1 Annex 1 2.8AR (whether or not subject to MiFID).

Other non-common platform requirements apply to Article 3 firms in accordance with the application provisions of the relevant chapter.

FCA description of implications for firms in CP16/19
The application of "at least analogous" requirements will have a limited impact in the UK where Article 3 firms are already subject to very similar regulations to firms regulated under MiFID.

Common platform firms

Common platform requirements are currently in SYSC 4 — 10 covering the key aspects of the organisational requirements in MiFID and the CRD: general organisational requirements, employees, compliance, risk control, outsourcing, record-keeping and conflicts of interest.

The FCA intends to keep the common platform framework as it implements MiFID II, including the requirement to retain records for five years. While retaining the familiar structure of the "common platform", the FCA proposes to:

- Transpose the relevant MiFID II provisions to SYSC.
- Signpost in the application provisions to individual SYSC chapters the relevant provisions in the MiFID II implementing regulation that supplement the rules implementing the MiFID requirements (rather than copying them into the corresponding Handbook chapters).
- Create a new rule that extends the application of a number of articles of the MiFID II implementing regulation to all of a UK MiFID investment firm's designated investment business, whether or not subject to MiFID.

FCA description of implications for firms in CP16/19
Provisions in MiFID II, making up the common platform requirements, are substantially similar to those in MiFID. New provisions have been included in the MiFID II Delegated Regulation on the role of the compliance function, which build on the "Guidelines on certain aspects of the MiFID compliance function requirements" that ESMA published in 2012.[14] There have also been changes to the record-keeping requirements.

The FCA is retaining the application of certain common platform requirements in the form of rules and guidance in relation to other types of firms such as Article 3 firms and third country firms (these provisions are explained in more detail within this chapter in CP16/19).

Conflicts of interest

MiFID II does not fundamentally change the existing conflicts-of-interest provisions, but it does strengthen certain key requirements:

- It clarifies that firms must have effective organisational arrangements, not only to manage, but also to prevent, conflicts of interest.
- It strengthens the content and quality of disclosure when these arrangements fail and introduces new requirements on firms to assess, and periodically review, their conflicts of interest policy.
- And it requires senior management to receive on a frequent basis, and at least annually, written reports on the situations contained in the conflicts of interest record.

FCA description of implications for firms in CP16/19
Changes to general conflicts-of-interest provisions in MiFID II will require firms to update their existing organisational and administrative arrangements, in particular their approach to disclosure. However, the FCA does not expect these changes to necessitate a material change in firms' systems and controls.

Management bodies

This section of CP16/19 covers the implementation of Article 9 of MiFID II in relation to management bodies. Article 9 aims to enhance effective oversight and control over the activities of investment firms and requires the management body to assume clear responsibilities across the business cycle of the firm, including setting

strategic objectives, and responsibility for the risk strategy and the internal governance of the firm.

The FCA is proposing to extend the scope of SYSC 4.3A (which at present only applies to CRR firms including significant IFPRU firms) to all common platform firms. In addition, the FCA is proposing to extend the application of these requirements to Article 3 MiFID firms as rules.

Application to branches of third country firms

The FCA has taken account of the current application of certain SYSC provisions as rules or guidance, and the fact that the governance structures of branches are likely to be different to the governance structures of UK firms, and will also likely be subject to equivalent organisational requirements in their own country.

So where existing equivalent provisions apply to third country branches, the FCA proposes to maintain the status quo where possible, although there are a few exceptions to this; where the FCA proposes to change existing guidance into a rule.

FCA description of implications for firms in CP16/19

Common platform firms will be subject to new and enhanced requirements that will promote sound internal governance arrangements and a sound risk culture.

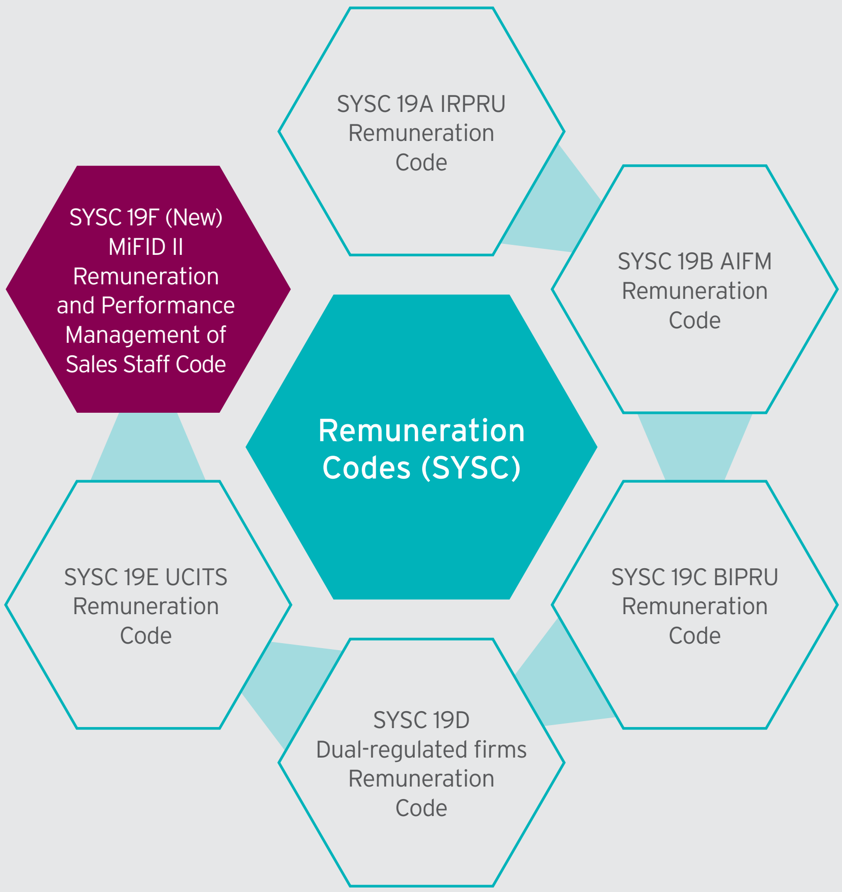
MiFID and FCA-related Handbook materials already contained provisions relating to the managing body of in-scope firms and third country branches so this should not have a significant impact on firms' systems and controls.

The FCA does point out, though, that ESMA and the European Banking Authority (EBA) will consult on joint guidelines on the assessment of the suitability of members of the management body and key function holders under CRD IV and MiFID II.

Remuneration (Chapter 6)

> The remuneration provisions in this chapter are relevant to MiFID investment firms, financial advisers and corporate finance firms exempt from MiFID under Article 3.

This chapter explains the FCA's views on changes it proposes to make to SYSC to implement Article 24(10) of MiFID II (and its implementing measures in Article 27 of the MiFID II Implementing Regulation) in relation to the remuneration of sales staff.



The diagram above describes, at a high level, the remuneration framework that will exist should the FCA proposals be adopted.

SYSC currently contains five separate remuneration codes. While these remuneration codes focus on the senior management of firms that are "material risk-takers", they do contain several principles that apply on a firm-wide basis.

Following feedback received by the FCA in response to DP15/3,[15] MiFID II remuneration requirements for sales staff will be transposed through a new section, SYSC 19F. In addition, it is proposing that Article 3 firms, third country firms and dormant-account fund operators must comply with a remuneration requirement similar to the one in Article 27 of the MiFID II Implementing Regulation.[16]

FCA description of implications for firms in CP16/19
Given the high-level nature of the MiFID II remuneration provisions, and existing domestic rules and guidance in this area, the FCA does not think these proposals will create large additional regulatory burdens for firms and significant costs are unlikely.

Client Assets sourcebook (CASS) (Chapter 7)

This chapter is relevant to all firms that hold client assets and conduct designated investment business.

This chapter explains the changes that the FCA plans to make to CASS arising from the implementation of MiFID II (including the MiFID II Implementing Directive.)[17]

The FCA says that its proposed implementation proposals do not mean significant changes to the existing CASS regime because MiFID II is broadly aligned to CASS. It will transpose new MiFID II requirements not already implemented in CASS through "intelligent copy out", and apply all new MiFID II requirements not implemented in CASS to all designated investment business, including non-MiFID business.

The proposals in CP16/19 cover:

- Delegation of safekeeping duties to a third-party.
- Depositing client money in a group bank.
- Taking collateral when arranging securities lending.

- Custody liens.
- Maintaining a single rulebook.
- Prohibition on Title Transfer Collateral Arrangements (TTCAs) with retail clients.
- Express consent from clients when depositing money in a QMMF.

- Inappropriate use of TTCAs.
- Preventing unauthorised use of client assets.
- Internal firm assessments when depositing client money in a qualifying money market fund.
- MiFID II requirements already implemented.

Complaint-handling (Chapter 8)

This chapter is of relevance to consumers and regulated firms.

The FCA proposes to implement the requirements of MiFID II in relation to complaint-handling by amending the Dispute Resolution: the Complaints sourcebook (DISP). It proposes to create a new definition for "MiFID complaint" covering those complaints that are subject to the new MiFID II complaint-handling requirements. It also proposes a new section, DISP 1.1A, which sets out the provisions that apply to relevant firms when handling MiFID complaints, such as those in MiFID II.

The FCA proposes using a copy-out approach to incorporate the complaint-handling requirements from Article 26 of the MiFID II (Delegated Regulation) into DISP 1.

FCA description of implications for firms in CP16/19
The FCA does not believe that most of its proposals will have a material impact on firms, given that it is applying largely the same requirements that currently exist.

Extending complaint record-keeping and reporting requirements to complaints from professional clients might have some (small) cost implications.

In line with the requirements of MiFID II, the FCA has extended the jurisdiction of the Financial Ombudsman Service to complaints about sales of and advice in relation to structured deposits and added an additional rule requiring branches of UK MiFID investment firms to adhere to the relevant Alternative Dispute Resolution (ADR) entities in each of the relevant EEA States in which they are established. These changes might result in additional costs to firms, but the FCA does not have any relevant data on these points.

Whistleblowing (Chapter 9)

Of relevance to investment firms and branches of non-EEA firms providing investment services.

The FCA does not think that it can create a "common platform" of whistleblowing requirements across various pieces of EU and UK legislation.

The FCA proposes two options in CP16/19, but its preference is a new Handbook chapter/subchapter to act as a single "home" for all the various whistleblowing requirements, which would include separate rules implementing each EU whistleblowing obligation requiring Handbook implementation and include (or at least reference) each domestic FCA whistleblowing rule. To implement this the FCA proposes a new section in SYSC to bring together domestic and EU whistleblowing requirements.

Fees manual (FEES) (Chapter 10)

This is of relevance to operators of OTFs, MTFs, DRSPs and those applying for VoPs. Also firms connecting to the FCA's market data processing system (MDP).

This section of CP16/19 sets out the main fees implications of MiFID II. In the first part of the chapter, the FCA sets out proposals for consultation being:

- Fees for operators of OTFs and clarification of charge for variations of permission (VoPs) by operators of OTFs and MTFs and firms undertaking new regulated activities in structured deposits.

- And onboarding fees for establishing technical conformance with the FCA's market data processing (MDP) system for firms to submit the data prescribed under MiFID II.

Draft rules are contained in Appendix 1 and following consultation the FCA plans to publish the final rules and provide feedback on the responses received in a handbook notice (HN) or policy statement (PS) in December so the rules can take effect from 1 January 2017.

The second part of the chapter looks at clarifying some fee issues that the FCA feels does not require consultation:

- Update on earlier consultation: fees structure for data reporting service providers (DRSPs).
- And application and VoP fees relating to MiFID II.

Under paragraph 10.18 of this chapter, the FCA provides a summary table of application and VoP fees by entity/activity, providing a breakdown of what fees are proposed.

Next steps

The consultation period for CP16/19 will close for responses on 28 October 2016 so anyone wishing to respond still has time to make a submission.

Following CP15/43 in December 2015 and CP16/19, there are still a range of issues that the FCA needs to cover. It published a third CP (CP16/29)[18] on 28 September 2016 and plans to publish a further paper before the end of 2016.

The FCA had also previously indicated that it hoped to publish a Policy Statement (PS) on the matters covered in CP15/43 in the first half of 2016. In CP16/29, it stated that it will publish a single policy statement covering all aspects of implementation in 2017.[19]

The Treasury consulted in March 2015 on MiFID II implementation[20] and will also produce a policy statement in due course before presenting the legislation to Parliament.[21]

The Prudential Regulation Authority (PRA) published its initial CP9/16 in March 2016, which looked at passporting and algorithmic trading.[22] The PRA will consult on the remainder of its proposals in due course.

Amanda Hale
Head of Regulatory Services
Trustee and Fiduciary Services
Citi

1 See https://www.fca.org.uk/static/documents/consultation-papers/cp16-19.pdf, last downloaded on 4 August 2016.

2 See http://www.fca.org.uk/static/documents/consultation-papers/cp15-43.pdf, last downloaded on 4 August 2016.

3 "Persons" is defined in the FCA Glossary as "(in accordance with the Interpretation Act 1978) any person, including a body of persons corporate or unincorporate (that is, a natural person, a legal person and, for example, a partnership)."

4 High-level position limits, management and reporting requirements are in Articles 57 and 58 of MiFID II. RTS 21 contains details of the obligations on regulators in setting position limits. Article 82 of the MiFID II implementing regulation contains information on certain thresholds linked to the weekly aggregated reporting of positions published by ESMA. ITS 6 contains a format for daily and weekly position reporting of certain types of commodity derivatives, emission allowances and derivatives.

5 From http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2006:241:0001:0025:EN:PDF, last downloaded on 4 August 2016.

6 From http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R0600&from=EN, last accessed on 4 August 2016.

7 http://ec.europa.eu/transparency/regdoc/rep/3/2016/EN/3-2016-4733-EN-F1-1.PDF, last accessed on 30 August 2016.

8 Which the FCA Glossary definition defines as having "the meaning in IFPRU 1.1.11 R (Types of investment firm: IFPRU 730K firm) which in summary is an IFPRU investment firm that is not a collective portfolio management investment firm, a IFPRU 50k firm or a IFPRU 125k firm

9 From http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32013L0036&from=EN, last accessed on 4 August 2016.

10 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:321:0006:0342:EN:PDF, last downloaded on 4 August 2016.

11 The FCA will consider whether to consult on further changes to the rest of the UCITS managers and alternative investment fund managers' business at a later stage.

12 See Table B of the draft instrument contained in CP16/19 for full details

13 See Table C of the draft instrument contained in CP16/19

14 From www.esma.europa.eu/sites/default/files/library/2015/11/2012-388_en.pdf, last downloaded on 4 August 2016.

15 See https://www.fca.org.uk/publication/discussion/dp15-03.pdf, last downloaded on 4 August 2016.

16 See draft rules under SYSC 19F.1.1R for further details.

17 From http://ec.europa.eu/finance/securities/docs/isd/mifid/160407-delegated-directive_en.pdf, last accessed on 4 August 2016.

18 See https://www.fca.org.uk/sites/default/files/cp16-29.pdf, last downloaded on 11 October 2016.

19 Aspects of what the FCA consulted on in CP15/43 depend on the finalisation of legislation by HM Treasury.

20 From https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/418281/PU_1750_MiFID_II_26.03.15.pdf, last accessed on 4 August 2016.

21 In the meantime, the proposals in CP16/19 are based on the draft legislation in the Treasury's March 2015 CP.

22 From http://www.bankofengland.co.uk/pra/Documents/publications/cp/2016/cp916.pdf, last downloaded on 4 August 2016.

FCA'S MIFID II IMPLEMENTATION: CONSULTATION PAPER III (CP16/29)

This consultation paper (CP) forms part of the Financial Conduct Authority's process to make necessary changes to its Handbook in order to implement the Directive on 3 January 2018.[1]

The CP follows on from two previous consultation papers, CP15/43[2] and CP16/19[3], and is split into two parts:

- **Part I** deals with conduct of business issues.
- And **Part II** deals with other matters, covering a range of issues not covered in the FCA's previous two CPs, including product governance and additional perimeter guidance.

Strengthening investor protection is one of the key aims of MiFID II, and the changes to the conduct rules between MiFID and MiFID II pick up on several of the themes of the FCA's recent work in the UK on retail and wholesale conduct issues, such as those highlighted below.

Who does this consultation affect?

This consultation affects a wide range of firms authorised and recognised by the FCA (as well as unregulated entities trading commodity derivatives), but particularly those shown in the diagram opposite.

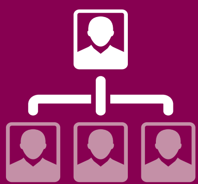
Summary of proposals

In this CP, the FCA seeks views on the proposed changes to the Handbook in the areas below, several of which reflect feedback they received to DP15/3.

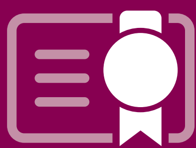
Part I: conduct of business

Inducements (including adviser charging)
The FCA's general approach is to implement the MiFID II provisions for MiFID business and

Introducing the concept of independent investment advice and requirements for firms to ensure employees providing investment advice have the necessary knowledge and competence. These are similar to the requirements of the Retail Distribution Review (RDR).



New product governance requirements that cover similar ground to the FCA guidance on the responsibilities of providers and distributors for the fair treatment of customers and to points raised in recent thematic reviews.



New rules on inducements and the receipt of research that will strengthen transparency and controls by investment firms over costs of third-party research. This will deliver better outcomes for investors in line with the FCA's work and publications on the use of dealing commission since 2012, including the FCA review in 2013/2014.

Enhanced rules on best execution, which will help to address some of the issues the FCA identified in its 2014 thematic review of firms' implementation of the existing rules.

the MiFID scope business of Article 3 firms, while keeping the existing rules in place for non MiFID business until it implements the Insurance Distribution Directive (IDD).

For retail clients, the FCA proposes applying the MiFID II inducements standards to both independent and restricted advice, continuing to ban the rebating of inducements, and extending this to portfolio management.

For personal recommendations on retail investment products (RIPs) to retail clients in the UK, the FCA will keep the existing RDR standard set out in the adviser charging rules, and clarify that it applies to the wider business of providing advice.

Inducements and research
Given the link in MiFID II to the inducements rules, the FCA proposes replacing its existing use of dealing commission rules[4] with a new section[5] to transpose the MiFID II rules. It also proposes that the MiFID II rules should apply to firms carrying out collective portfolio management, which includes UCITS management companies and Alternative Investment Fund Managers (AIFMs), including small authorised AIFMs, residual collective investment scheme operators and incoming EEA AIFM branches.

Furthermore, the FCA proposes the following:

Client categorisation
Criteria for the opting-up of local authorities (and local authority pension schemes) from retail client status to elective professional client status.

Disclosure requirements
Changes to implement the wide variety of disclosure requirements in MiFID II. These include information about the firm and the products it sells, disclosure of costs and charges and the provision of periodic reports to clients.

Independence
The application of the MiFID II independence standard for personal recommendations to recommendations relating to MiFID financial instruments, structured deposits and (in relation to retail clients in the UK) non-MiFID RIPs.

Suitability
Updating the current suitability rules in COBS 9 with the changes required by MiFID II. The changes will apply to MiFID business and to

Article 3 firms carrying on MiFID business. The current COBS rules will continue to apply to non-MiFID business, pending consultation on implementation of the IDD.

Dealing and managing
Changes to the FCA's existing rules to implement the new MiFID II standards across best execution, client order handling, personal transactions and requirements for investment firms underwriting and placing. The FCA also proposes to apply the MiFID II enhancements to the best-execution rules to firms that are carrying out collective portfolio management and are not subject to MiFID II, with some selected exceptions.

Investment research
To transpose the MiFID II rules into a single chapter in COBS.

Other conduct issues
The requirement for a written basic agreement will now also apply to professional clients for MiFID business. The FCA gives more specific detail of the content of these agreements. It also proposes some further changes in the COBS specialist regimes chapter for firms carrying out collective portfolio management activity in order to make it clearer.

Appropriateness
MiFID II extends the products classified as "complex", meaning the appropriateness test will apply more widely. The FCA is copying out the changes in MiFID II about the way in which the test operates, including more detailed criteria for determining whether a product is "non-complex". It proposes applying the revised rules to MiFID business only.

Part II: other matters

This section covers:

Product governance
The FCA proposes to implement product governance provisions in MiFID II as rules for firms engaged in MiFID business and as guidance for non-MiFID firms that manufacture or distribute MiFID products.

Knowledge and competence requirements
The FCA will comply with the European Securities and Markets Authority (ESMA) guidelines on knowledge and competence and propose to make small amendments to its Training and Competence (TC) sourcebook and Senior Management Arrangements, Systems and Controls (SYSC) to reflect this.

Recording of telephone conversations and electronic communications (taping)
The FCA proposes to update its current taping rules with the changes required by MiFID II. It is proposing that discretionary investment managers (DIMs) be fully subject to the requirement to tape, and the taping requirement applies to corporate finance business. Its view is also that taping should be extended to Article 3 firms, but it is open to considering other proposals to address consumer protection concerns in this area.

Supervision, authorisation and approved persons
The FCA proposes the introduction of a new Form A to get information on a firm's organisational structure and management body. Unlike other proposals, the consultation on this closes at the end of October so that the FCA can have the forms in place when it opens the gateway for firms seeking to be authorised in early 2017.

Perimeter guidance
The FCA proposes new guidance on scope changes in MiFID II. These include foreign exchange derivatives, emission allowances, commodity derivatives and exemptions for professional firms and commercial firms trading commodity derivatives.

Consequential changes to the Handbook
Based on FCA proposals in CP16/19 on SYSC and CASS (FCA Client Asset sourcebook), it proposes some consequential amendments to the Handbook. It also proposes updates to some references in their prudential rules.

Areas discussed in the CP following up on issues discussed in other areas of the FCA's work

Financial Advice Market Review (FAMR)[6]
The FCA considers that the new framework of conduct rules in MiFID II will reinforce and strengthen the retail and the wholesale conduct work that it has been doing in the UK.

HMT has also published a consultation paper[7] to amend the wording in Article 53 of the Regulated Activities Order to reflect the definition of a personal recommendation as set out in the original Markets in Financial Instruments Directive,[8] in line with the recommendation in FAMR.

Depending on the outcome of this consultation, the FCA may need to consider the impact of any changes on its proposals on inducements.

The FCA considers that the new framework of conduct rules in MiFID II will reinforce and strengthen the retail and the wholesale conduct work that it has been doing in the UK.

Insurance based investments, pensions, and structured deposits
The proposals on conduct in this CP follow up on the issues that the FCA raised in Discussion Paper (DP) 15/3.[9] There were two general issues covered in that DP:

- Whether the FCA would apply the MiFID II conduct rules to insurance based investment business and pensions.
- And whether the FCA would incorporate the MiFID II rules that apply to the activities of advising on or selling structured deposits into its Conduct of Business sourcebook (COBS).

The Insurance Distribution Directive (IDD) is due to come into force in the first quarter of 2018, shortly after MiFID II applies. Its implementing measures are still to be finalised so the FCA has not proposed applying MiFID II conduct rules to insurance-based investment business and pensions in this CP. However, it does think there remains a good case for having a significant degree of consistency of conduct rules across investment business. The FCA will return to this subject when consulting on implementing the IDD in 2017.

On structured deposits, respondents to DP15/3 were mainly in favour of putting MiFID II rules dealing with structured deposits into COBS. This is what the proposals in this CP do.

The FCA also believes that Article 3 firms can advise on and sell structured deposits, and, in doing so, should be subjected to the relevant analogous requirements. As such, the issues that arise out of this are dealt with in the relevant individual chapters in Part I of the CP.

Other non-MiFID business
Rules in COBS cover other non-MiFID business and insurance based investment business and pensions. This includes business conducted by firms exempt under Article 3, and other investment business covered by various specialist regimes,[10] including firms when carrying out collective portfolio management activity.

In CP16/19,[11] the FCA discussed its approach to implementing MiFID II for firms exempt under Article 3.[12] MiFID II requires that such firms are subjected to "at least analogous" requirements to each of the individual organisational and conduct requirements[13] and their corresponding implementing measures.

In this CP, the FCA proposes applying the same conduct rules to Article 3 firms as to MiFID investment firms where the conduct rules are on the list of analogous requirements. The issues that this approach creates are dealt with in each of the relevant chapters in Part 1 of this CP. In Part II of the CP, the FCA also makes proposals about taping for Article 3 firms, a systems and controls requirement that is on the list of analogous requirements that the FCA did not cover in CP16/19.

The FCA makes proposals in this CP for non-MiFID business that is not insurance-based investment or pensions business or investment business undertaken by Article 3 firms. The FCA indicates in relevant chapters in Part I where it does and does not seek to apply MiFID II standards to this business.

A significant number of firms conduct both MiFID and non-MiFID designated investment business. The FCA recognises that firms may find it more practical to take a single approach to compliance for closely connected lines of business, notwithstanding the differing regulatory standards.

Therefore, if the FCA decides, post-consultation, to adopt its proposals, firms should be able, as far as is feasible, to choose to apply a single set of standards based on the higher standards. The FCA will consider further whether it needs to make specific proposals to support this.

Third-country firms

In CP16/19.[14] the FCA discussed its approach to implementing MiFID II for branches of non-European Economic Area firms (third-country firms). It said it would apply the same conduct rules to these firms as it does to MiFID investment firms to ensure they are treated no more favourably than branches of EEA firms. The conduct proposals in this CP for MiFID investment firms therefore also apply to branches of third-country firms.

EU legislation and the Handbook

A significant part of the conduct rules in MiFID II are regulations that are directly applicable. In light of the links between the MIFID II provisions and the delegated regulation, and the use that a wide range of firms make of COBS, the FCA proposes to copy out various conduct provisions in the delegated regulation into the Handbook.

In drafting the Handbook, the FCA has also decided that the clearest approach is to have separate chapters for MiFID and non-MiFID business in some cases.

Under Article 4 of the MiFID implementing directive, Member States were able to impose additional requirements to those under MiFID in certain circumstances. The UK has made a number of "Article 4" notifications to do this.[15] MiFID II allows certain additional requirements that have been notified to the Commission under MiFID to be retained, and allows, in more limited circumstances than under MiFID, Member States to notify new additional requirements.

Wider UK implementation of MiFID II

The implementation of MiFID II also involves changes to UK legislation and changes to the rules of the PRA. The proposals in this CP are based on the draft statutory instruments that HMT published in its March 2015 CP and both the drafting and the policy may be subject to change. The PRA will publish in due course a Policy Statement that follows the policy proposals in its CP9/16, which covered passporting and algorithmic trading.

Finalising transposition

As part of its transposition work, the FCA continues to analyse all the consequential changes that need to be made within the Handbook. The FCA thinks this work will lead to issuing a further consultation later this year.

The FCA will publish a policy statement covering all aspects of its implementation of MiFID II in the first half of 2017.

Next steps

Comments are to be provided to the FCA by 4 January 2017, except for Chapter 16, Supervision (SUP), authorisation and approved persons, where responses should be provided by 31 October 2016.

The FCA will then consider firms' feedback and publish its rules in a Policy Statement in the first half of 2017.

The FCA will publish a further CP on the other Handbook changes required to implement MiFID II.

Amanda Hale
Head of Regulatory Services
Trustee and Fiduciary Services
Citi

1 See https://www.fca.org.uk/sites/default/files/cp16-29.pdf, last downloaded on 29 September 2016.

2 See https://www.fca.org.uk/publication/consultation/cp15-43.pdf, last downloaded on 29 September 2016.

3 See https://www.fca.org.uk/publication/consultation/cp16-19.pdf, last downloaded on 29 September 2016.

4 COBS 11.6.

5 COBS 2.

6 See http://www.fca.org.uk/static/fca/documents/famr-final-report.pdf, last downloaded on 29 September 2016.

7 See https://www.gov.uk/government/consultations/amending-the-definition-of-financial-advice-consultation, last accessed on 29 September 2016.

8 See http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:02004L0039-20110104&from=EN, last accessed 29 September 2016.

9 See https://www.fca.org.uk/static/documents/discussion-papers/dp15-03.pdf, last downloaded on 29 September 2016.

10 COBS 18.

11 Paragraphs 1.17 to 1.23.

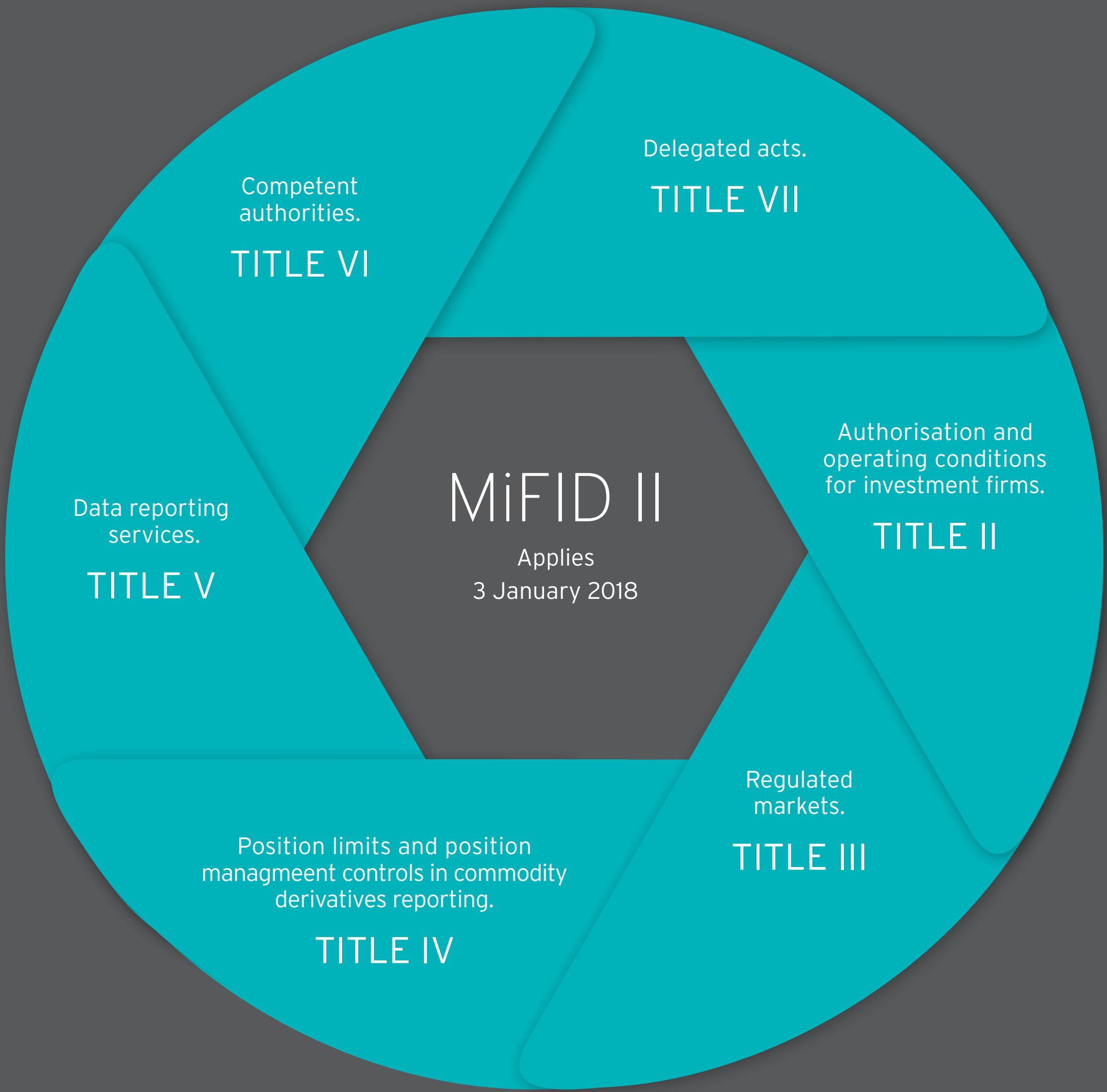
12 These are firms that are providing investment advice and/or receiving and transmitting client orders in relation to a restricted range of financial instruments but that do not hold client assets or money and do not do business outside the UK.

13 Listed in Article 3(2)(a) to (c) of MiFID II.

14 Paragraphs 1.13 to 1.16

15 See http://ec.europa.eu/finance/securities/isd/mifid_implementation/index_en.htm, last accessed on 29 September 2016.

MiFID II: LEVEL 1 OVERVIEW



Scope

See Title I for full details

Key impacts

- Inducements/commission
  - P&L or RPA
  - IT development, legal contract renegotiation
- Recording of telephone conversations
- Best execution
- Investor protection

Delegated acts

- TITLE VII

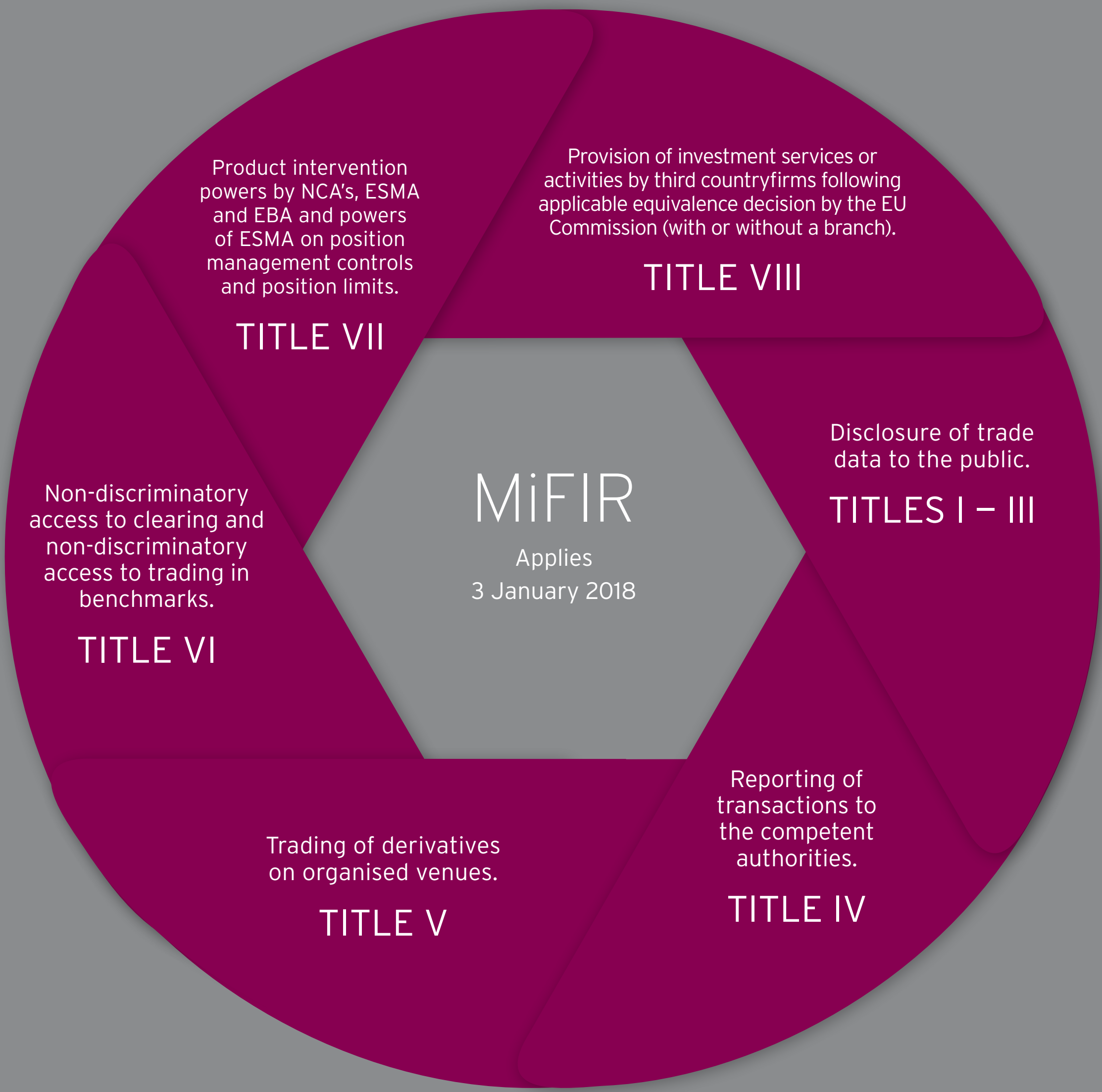
Transitional provisions

- Clearing obligations Article 4
- Risk-mitigation techniques Article 11(3) Article 54

Exemptions

See Article 2 for full details.

MiFIR: LEVEL 1 OVERVIEW



Scope

Investment firms, credit institutions (when providing investment services +/or performing investment activities), market operators (including any trading venues they operate, financial counterparties and all non-financial counterparties (subject to EMIR), CCPs and persons with proprietary rights to benchmarks, third country firms providing investment services or activities within the EU (subject to applicability test).

Key impacts

Transaction reporting

- Costs
- IT development
- Broker reliance vs. own reporting.

Delegated acts

- Article 50

Transitional provisions

- Article 54

Exemptions

European Central Banks (ESCB) excluded in specific capacities.

Regulated markets, market operators and investment firms in respect of transactions where the counterparty is a member of the ESCB.

List of RTS/ITS and Delegated Acts linked to Directive 2014/65/EU (MiFID II) and Regulation (EU) No 600/2014 on Markets in Financial Instruments (MiFIR).

RTS/ITS	Topic	Link to Level 1	Adopted by EU Commission	End scrutiny period
RTS 1 and Annexes	Transparency requirements for trading venues & investment firms in respect of shares, depositary receipts, exchange traded funds, certificates and other similar instruments	MiFIR Articles 4(6), 7(2), 14(7), 20(3), 22(4) & 23(3)	14 July 2016 C(2016) 4390	14 October 2016
RTS 2 and Annexes	Transparency requirements for trading venues & investment firms in respect of bonds, structured finance products, emission allowances & derivatives	MiFIR Articles 1(8), 9(5), 11(4), 21(5) & 22(4)	14 July 2016 C(2016) 4301	14 October 2016
RTS 3 and Annexes	Volume cap mechanism & provisions of information for purposes of transparency & other calculations	MiFIR Article 5(9), 22(4)	13 June 2016 C(2016) 2711	13 September 2016
RTS 4	Criteria for determining whether derivatives subject to the clearing obligation should be subject to the trading obligation	MiFIR Article 32(6)	26 May 2016 C(2016) 2710	26 August 2016
RTS 5	Direct, substantial & foreseeable effect of derivative contracts within the Union	MiFIR Article 28(5)	13 June 2016 C(2016) 3544	13 September 2016
RTS 6 and Annexes	Specifying organisational requirements for investment firms engaged in algorithmic trading	MiFID Article 17(7) (a) & (d)	19 July 2017 C(2016) 4478	22 November 2016
RTS 7and Annexes	Organisational requirements of facilities trading venues allowances & derivatives	MiFID Article 48(12)(a), (c) & (g)	14 July 2016 C(2016) 4387	14 October 2016
RTS 8	Requirements on market making agreements & schemes	MiFID Article 17(7)(a), (b) & (c) & Article 48(12) (a) & (f)	13 June 2016 C(2016) 3523	13 September 2016
RTS 9 and Annexes	Ratio of unexecuted orders to transactions	MiFID Article 48(12)(b)	18 May 2016 C(2016)2775	18 August 2016
RTS 10	Requirements to ensure fair & no-discriminatory co-location services & fee structures	MiFID Article 48(12)(d)	6 June 2016 C(2016) 3266	6 September 2016
RTS 11 and Annexes	Tick size regime for shares, depositary receipts & ETFs	MiFID Article 49(3) & (4)	14 July 2016 C(2016) 4387	14 October 2016
RTS 12	Determination of a material market in terms of liquidity relating to halt notifications	MiFID Article 48(12)(e)	26/05/2016 C(2016) 3020	26 August 2016
RTS 13	Authorisation, organisational requirements and the publication of transactions for data reporting services providers	MiFID Articles 61(4), 64(6) & (8), 65(6), (8) & 66(5)	2 June 2016 C(2016) 3020	2 September 2016
RTS 14	Specification of the offering of pre- and post-trade data and the level of disaggregation of data.	MiFIR Article 12(2)	2 June 2016 C(2016) 3206	2 September 2016
RTS 15 and Annexes	Clearing access in respect of trading venues and central counterparties.	MiFIR Articles 35(6) and 36(6)	24 June 2016 C(2016) 3807	26 September 2016

Source: http://ec.europa.eu/finance/securities/isd/mifid2/index_en.htm, last accessed on 7 October 2016.

RTS/ITS	Topic	Link to Level 1	Adopted by EU Commission	End scrutiny period
RTS 16	Access in respect of benchmarks.	MiFIR Article 37(4) (a), (b), and (c)	2 June 2016 C(2016) 3203	2 September 2016
RTS 17	Admission of financial instruments to trading on regulated markets.	MiFIR 3rd subpara Article 51(6)	24 May 2016 C(2016) 3017	24 August 2016
RTS 18	Suspension and removal of financial instruments from trading reporting and services providers.	MiFID 10th subpara Article 32(2) & 10th subpara Article 52(2)	24 May 2016 C(2016) 3014	24 August 2016
RTS 19	Description of the functioning of MTFs and OTFs.	MiFID 3rd subpara Article 18(11)	24 May 2016 C(2016) 3019	N/A ITS in EU Official Journal
RTS 20	Criteria to establish when an activity is considered to be ancillary to the main business.	MiFID Article 2(4)		
RTS 21	Application of position limits to commodity derivatives.	MiFID Article 57(3) & (12)		
RTS 22 and Annexes	Reporting of transactions to competent authorities.	MiFIR 3rd subpara Article 26(9)	28 July 2016 C(2016) 4733	22 November 2016
RTS 23 and Annexes	Supply of financial instruments reference data.	MiFIR 3rd sub para Article 27(3)	14 July 2016 C(2016) 4405	14 October 2016
RTS 24 and Annexes	Maintenance of relevant data relating to orders in financial instruments.	MiFIR 4th subpara Article 25(3)	24 July 2016 C(2016) 3821	26 September 2016
RTS 25 and Annexes	Level and accuracy of business clocks.	MiFID 3rd subpara Article 50(2)	7 June 2016 C(2016) 3316	7 September 2016
RTS 26	Specifying obligation to clear derivatives traded on regulated markets and timing and acceptance for clearing (STP).	MiFIR Article 29(3)	29 June 2016 C(2016) 3944	29 September 2016

Source: http://ec.europa.eu/finance/securities/isd/mifid2/index_en.htm, last accessed on 7 October 2016.

RTS/ITS	Topic	Link to Level 1	Adopted by EU Commission	End scrutiny period
RTS 27 and Annexes	Data to be provided by execution venues on the quality of execution of transactions.	MiFID Point (a) of 1sr subpara Article 27(10)	8 June 2016 C(2016) 3333/4	8 September 2016
RTS 28 and Annexes	Annual publication by investment firms of information on the identity of execution venues and on quality of execution.	MiFID Point (b) 1st subpara Article 27(10)	8 July 2016 C(2016) 3337/3	8 September 2016
RTS	Authorisation	MiFID Article 7(4)	14 July 2016 C(2016) 4417	14 October 2016
ITS	Authorisation.	MiFID 3rd subpara Article 7(5)	29 June 2016 C(2016) 3917	
RTS	Passporting.	MiFID 3rd subpara Article 34(8) 3rd subpara Article 35(11)		29 September 2016
ITS	Passporting.	MiFID Articles 34(9) & 35(12)		
RTS	Cooperation between authorities.	MiFIR Article 46(7)	14 July 2016 C(2016) 4415	14 October 2016
RTS	Registration of third country firms.	MiFID Article 80(3)	14 July 2016 C(2016) 4407	14 October 2016

Delegated acts linked to Level 1 provisions (MiFID and MiFIR)

Type	Linked to	Adopted by EU Commission	Covering	
Delegated Directive	MiFID	7 April 2016 C(2016) 2031	Safeguarding of financial instruments and funds belonging to clients, product governance obligations and rules applicable to the provision or reception of fees, commissions or any monetary or non-monetary benefits.	Link to Directive here.
Delegated Regulation	MiFID	25 April 2016 C(2016) 2398 & Annex	Organisational requirements and operating conditions for investment firms and defined terms.	Link to Regulation here. Link to Annex here.
Delegated Regulation	MiFIR	18 May 2016 C(2016) 2860 & Annex	Definitions, transparency, portfolio compression and supervisory measures on product intervention and positions.	Link to Regulation here. Link to Annex here.
Delegated Regulation	MiFID & MiFIR	23 June 2016 – published in EU OJ 30 June 2016	Regulation (EU) 2016/1033: amending MiFIR (Regulation (EU) No 600/2014)), MAR (Regulation (EU) No 909/2014)) and CSDR (Regulation (EU) No 909/2014)). Directive (EU) 2016/1034: amending MiFID (Directive 2014/65/EU).	Link to Regulation here.

Source: http://ec.europa.eu/finance/securities/isd/mifid2/index_en.htm, last accessed on 7 October 2016.

GLOSSARY

AFR	Annual Funding Requirement
AIFMD	Alternative Investment Fund Managers Directive
AIF	Alternative Investment Fund
AIFM	Alternative Investment Fund Manager
AIMA	Alternative Investment Management Association
AML	Anti Money Laundering
APA	Approved Publication Arragement
APER	Statements of Principle and Code of Practice for Approved Persons – FSA High Level Standard
ARM	Approved Reporting Mechanism
ARROW	Advanced Risk-Responsive Operating FrameWork
Basel III	International regulatory framework in the banking sector
BCBS	Basel Committee on Banking Supervision
BIPRU	UK Prudential Sourcebook for Banks, Building Societies and Investment Firms
BRIC	Brazil, Russia, India and China
CBU	UK Conduct Business Unit
CCP	Central Counterparty
CDS	Credit Default Swap
CF	Control Functions
CFT	Counter-financial Terrorism
CIS	Collective Investment Scheme
COBS	Conduct of Business Sourcebook
CRD	Capital Requirements Directive
CRE	Commercial Real Estate
CSSF	Commission de Surveillance du Secteur Financier
DEA	Direct Electronic Access
DFI	Development Finance Institution
Dodd-Frank	Dodd-Frank Wall Street Reform and Consumer Protection Act
EBA	European Banking Authority
EBRD	European Bank for Reconstruction and Development
ECB	European Central Bank
ECON	EU Parliament's Economic and Monetary Affairs Committee
EEA	European Economic Area

EEC	European Economic Community
EFAMA	European Fund and Asset Management Association
EFSF	European Financial Stability Facility
EIOPA	European Insurance and Occupational Pensions Authority
EIU	European Intelligence Unit
EMEA	Europe, the Middle East and Africa
EMIR	Emerging Markets Infrastructure Regulation
EP	European Parliament
ESA	European Supervisory Authorities
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
ETF	Exchange-traded Fund
EU	European Union
EVCA	European Private Equity and Venture Capital Association
FAIF	Fund of Alternative Investment Fund
FATCA	Foreign Account Tax Compliance Act
FATF	Financial Action Task Force
FCA	UK Financial Conduct Authority
FCP	Fonds Communs de Placement
FFI	Foreign Financial Institution
FI	Finansinspektionen – Swedish Financial Supervisory Authority
FINMAR	Financial Stability and Market Confidence Sourcebook
FPC	Financial Policy Committee
FSB	Financial Stability Board
FSMA	UK Financial Services and Markets Act 2000
G20	The Group of Twenty Finance Ministers and Central Bank Governors
GDP	Gross Domestic Product
G-SIBs	Global Systemically Important Banks
G-SIIs	Global Systemically Important Insurers
HFT	High Frequency Trading
HIRE	Hiring Incentives to Restore Employment Act
HMT	Her Majesty's Treasury
IA	Investment Association
IAIS	International Association of Insurance Supervisors

IBC	Independent Banking Commission
ICAV	Irish Collective Asset-management Vehicle
ICSD	Investor Compensation Scheme Directive
IFA	Independent Financial Adviser
IFC	International Finance Corporation
IFI	International Finance Institutions
IFIA	Irish Funds Industry Association
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IMS	Investment Management Strategy
IOSCO	International Organisation of Securities Commissions
IRS	Internal Revenue Service
JFSC	Jersey Financial Services Commission
KIID	Key Investor Information Document
LHFI	Lag om Handel med Finansiella Instrument – Swedish Financial Trading Act
LVM	Lag om Vardepappersmarknaden – Swedish Financial Markets Act
MAD	Market Abuse Directive
MEP	Member of the European Parliament
MiFID	Markets in Financial Instruments Directive
MiFIR	Markets in Financial Instruments Regulation
NAV	Net Asset Value
Newcits	A phrase used to describe hedge fund strategies used within the UCITS III framework
NBNI G-SIFIs	Non-Bank and Non-Insurer Globally Systemically Important Financial Institutions
NFFE	Non-Financial Foreign Entity
NURS	Non-UCITS Retail Scheme
OECD	Organisation for Economic Co-operation and Development
ORA	Ongoing Regulatory Activity
OTC	Over-the-counter (derivatives)
PBU	UK Prudential Business Unit
PCF	Pre-Approved Control Functions
PIF	Professional Collective Investment Scheme
PFFI	Participating Foreign Financial Entity
PRA	UK Prudential Regulation Authority

PRIIPs	Packaged Retail and Insurance-based Investment Products
PRO	Prudential Risk Outlook
QCF	Qualifications and Credit Framework
QI	Qualifying Intermediary
QIF	Qualifying Investor Fund
QIS	Qualified Investor Scheme
RCRO	Retail Conduct Risk Outlook
RDR	Retail Distribution Review
RIS	Regulatory Information Service
SAR	Special Administration Regime
SEC	Securities and Exchange Commission
SEPA	Single European Payments Area
SICAV	Société d'Investissement à Capital Variable
SICAR	Sociétés d'Investissement en Capital à Risque
SIF	Significant Influence Function
SIF	Specialised Investment Funds
SIFA	Swedish Investment Funds Association
SIFIs	Systemically Important Financial Institutions
SLD	Securities Law Directive
SME	Small and Medium Sized Enterprises
SOPARFI	Sociétés de Participation Financière
SUP	Supervision – FCA Regulatory Process
SYSC	Senior Management Systems and Controls – FCA High Level Standard
TIEA	Tax Information Exchange Agreement
TSC	UK Treasury Select Committee
UCIs	Undertakings for Collective Investment (Part II Funds)
UCIS	Unauthorised Collective Investment Scheme
UCITS	Undertakings for Collective Investment in Transferable Securities
UKTI	UK Trade & Investment
USFI	US Financial Institution
VaR	Value at Risk

CONTACTS

If you would like to comment on any of the articles covered in this *Special Edition of Global Trustee and Fiduciary Services News and Views*, share ideas for future content or write an article in the next issue, contact Amanda Hale, Andrew Newson or Matthew Cherrill at cititechnical@citi.com.

INTERNATIONAL

David Morrison
Global Head of Trustee and Fiduciary Services
david.m.morrison@citi.com
+44 (0) 20 7500 8021

Amanda Hale
Head of Regulatory Services
amanda.jayne.hale@citi.com
+44 (0) 20 7508 0178

Ann-Marie Roddie
Head of Product Development
annmarie.roddie@citi.com
+44 (0) 1534 608 201

ASIA

Caroline Chan
APAC Head of Fiduciary Services
caroline.mary.chan@citi.com
+852 5181 2602

Stewart Aldcroft
Chairman Cititrust Limited
stewart.aldcroft@citi.com
+852 2868 7925

IRELAND

Shane Baily
Head of Fiduciary Services, Ireland
shane.baily@citi.com
+353 1 622 6297

Ian Callaghan
Head of Trustee Client Management
and Fiduciary Monitoring
ian.joseph.callaghan@citi.com
+353 1 622 1015

LUXEMBOURG

Patrick Watelet
Head of Fiduciary Services, Luxembourg
patrick.watelet@citi.com
+352 451 414 231

Pascale Kohl
Fiduciary Relationship Manager
pascale.kohl@citi.com
+352 451 414 279

Ulrich Witt
Fiduciary Relationship Manager
ulrich.witt@citi.com
+352 451 414 520

THE NETHERLANDS

Jan-Olov Nord
Head of Dutch Fiduciary Services
janolov.nord@citi.com
+31 20 651 4313

SWEDEN

Johan Ålenius
Head of Swedish Fiduciary Services
johan.alenius@citi.com
+46 8 723 3529

UNITED KINGDOM

Ian Davis
Head of UK Trustee and Fiduciary Services
ian.james.davis@citi.com
+44 (0) 20 7508 3652

Francine Bailey
Senior Fiduciary Client Manager
francine.bailey@citi.com
+44 (0) 20 7500 8580

Thérèse Craig
Senior Fiduciary Client Manager
therese.craig@citi.com
+44 (0) 131 524 2825

Iain Lyall
Senior Fiduciary Client Manager
Ian.lyall@citi.com
+44 (0) 20 7500 8356

Andrew Newson
Senior Fiduciary Technical Analyst
andrew.c.newson@citi.com
+44 (0) 20 7500 8410

Matthew Cherrill
Senior Fiduciary Technical Analyst
matthew.charles.cherrill@citi.com
+44 (0) 20 7500 3382