MiFID2: Update and impact on the U.S. market

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Introduction

MiFID2 and MiFIR: the basics

Summary:

- MiFID2 and MiFIR update existing MiFID legislation but with some significant changes.
- MiFID2 and MiFIR are very broad in scope, covering regulation of markets and of asset management and advisory activity, as well as broker dealer activity.
- Covers authorization, conduct of business requirements, product governance rules, transparency requirements, transaction reporting, and rules applicable to trading venues and data reporting service providers.
- This session focuses on how MiFID2 and MiFIR might impact U.S. firms.

MiFID2 and MiFIR: key elements of the reforms

Market structure

- Introduction of a new multilateral, discretionary trading venue, the Organised Trading Facility (OTF), for non-equity instruments.
- Expanded scope of Systematic Internaliser (SI) category with increased transparency requirements.
- Requirement for investment firms to trade listed equities on a Regulated Market (RM), Multilateral Trading Facility (MTF) or SI and effective limitation of "pure" over the counter business for cash equities.
- New systems and controls requirements for organised trading venues.
- Introduction of trading controls for algorithmic trading activities.
- Obligation to trade clearable derivatives on organised trading platforms.
- Introduction of a harmonised EU regime for non-discriminatory access to trading venues, CCPs and benchmarks.

Commodities

- Change in scope of regulatory perimeter for commodities business.
- Introduction of a harmonised position limits regime for commodity derivatives to improve transparency, support orderly pricing and prevent market abuse.

Transparency and transaction reporting

- Equity market transparency to be increased.
- New transparency requirements for fixed income instruments and derivatives with scope of requirements calibrated for liquidity.
- "Consolidated Tape" for trade data. Requirement to submit post-trade data and transaction reports to authorised providers.
- Widening scope of MiFID transaction reporting obligations.

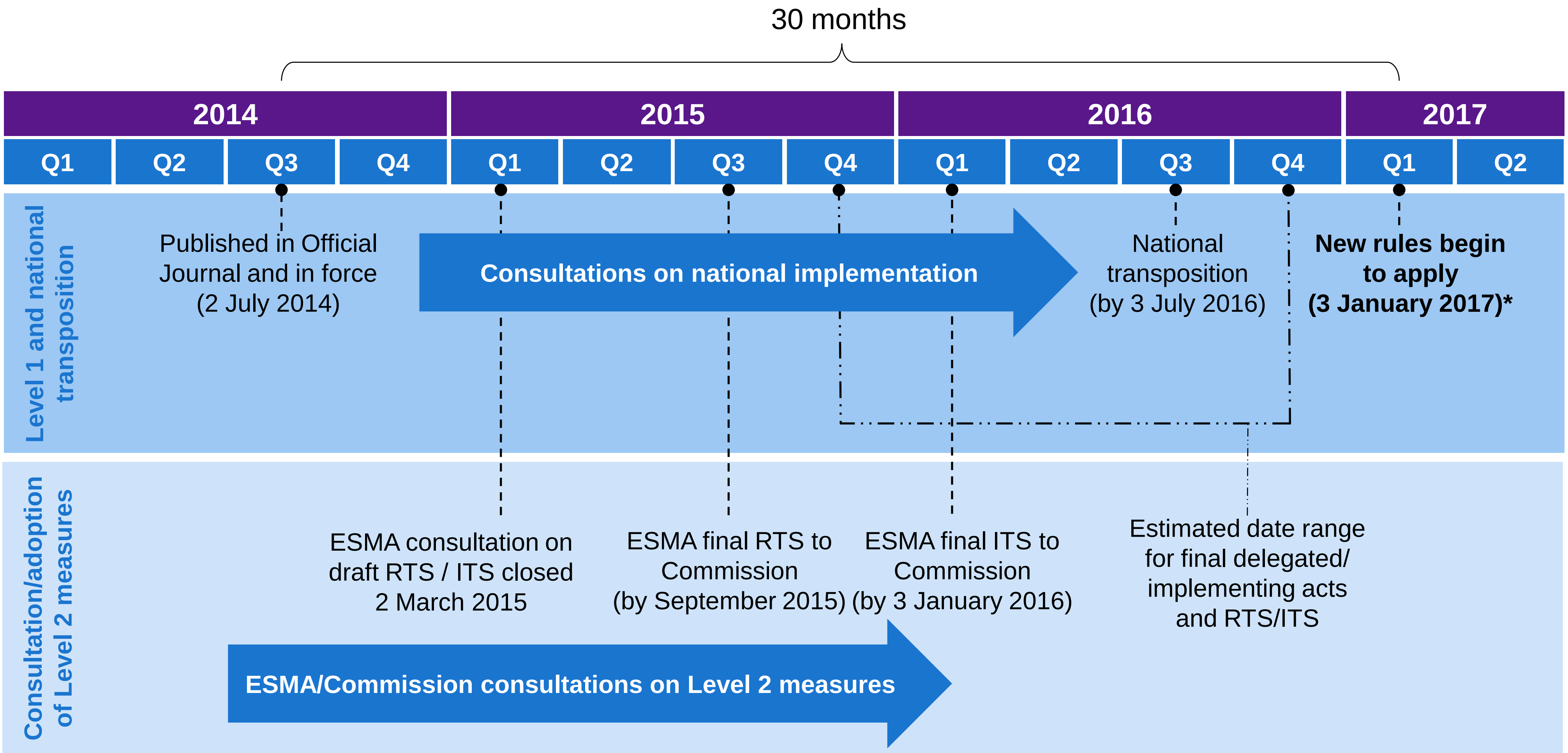
Conduct, supervision and product scope

- Increased conduct of business requirements to improve investor protection.
- Regulatory perimeter extended to cover structured deposits.
- Strengthened supervisory powers with new powers to ban products or services that threaten investor protection, financial stability or the orderly functioning of markets.
- Strengthened administrative sanctions to ensure effectiveness and harmonisation.

Third countries

- Limited attempt to harmonise regime for access to EU markets by third country firms.

MiFID2 and MiFIR: expected timeline



Notes:

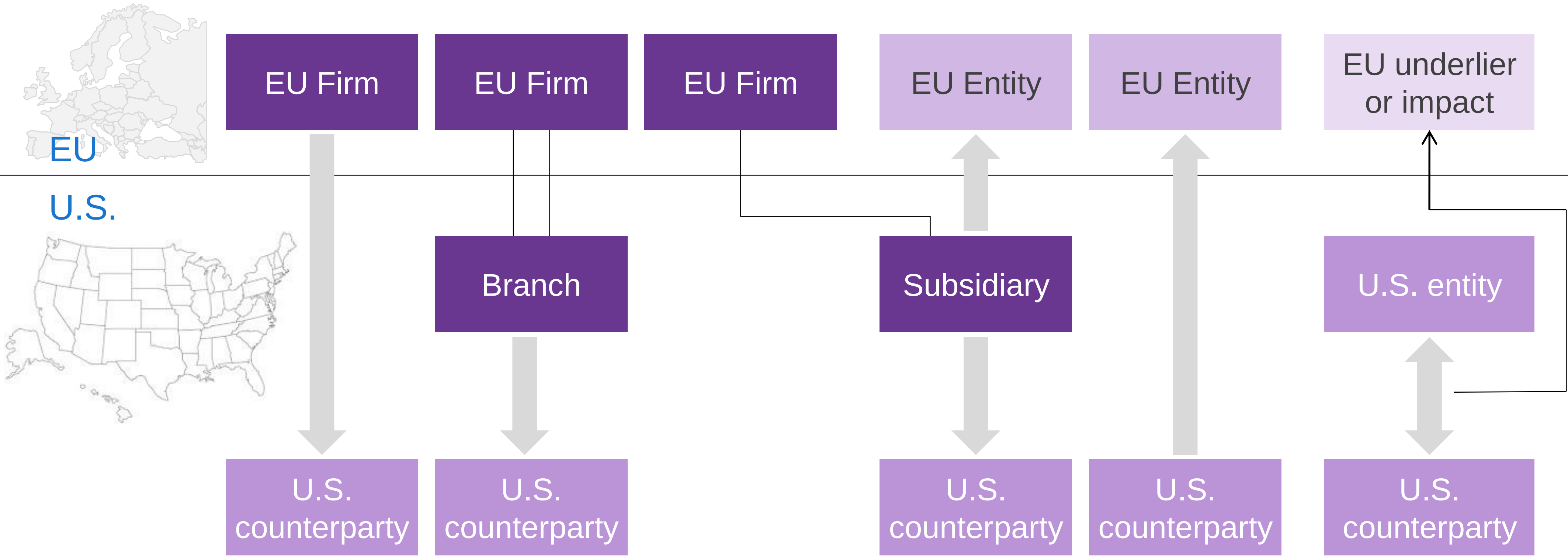
- * Possibility of one year delay (to January 2018) following Commission comments in November 2015. If application delayed to 2018, finalization of all outstanding Level 2 still expected Q1 2016. Delay requires amendment of Level 1 (not yet initiated)
- Market Abuse Regulation starts to apply from 3 July 2016
- Equivalence assessments required for third countries
- Addendum to RTS/ITS consultation closed 20 March 2015
- The Commission/ESMA may develop FAQs and guidelines

How does EU legislation impact U.S. firms?

Outbound: EU firms transacting with U.S. counterparties directly and through U.S. branches and subsidiaries

Inbound: U.S. firms (incl. U.S. subsidiaries of EU banks) transacting with EU entities

"True ET": Transactions between U.S. firms that impact the EU



Market structure

Market structure - key definitions

Multilateral

Regulated Markets and MTFs

- a multilateral system... which brings together … multiple third-party buying and selling interests in financial instruments – in the system <u>and in accordance with non-discretionary rules</u> – in a way that results in a contract

OTFs (new)

- a multilateral system or facility, which is not a regulated market or MTF, ... in which multiple third-party buying and selling interests in financial instruments are able to interact in the system in a way that results in a contract

Multilateral system

- any system or facility in which multiple third parties buying and selling trading interests in financial instruments are able to interact

Bilateral

SIs

- an investment firm which, on an organised, frequent, systematic and substantial basis, deals on own account by executing client orders outside a regulated market or an MTF or an OTF, without operating a multilateral system.

OTC transactions

- Not defined in MiFID2 or MiFIR

Market structure – potential extraterritorial impacts of new MiFID2/MiFIR regime

Trading mandate for equities

- Listed equities must be traded on a regulated market, MTF or SI
- Applies to EU investment firms, but could have indirect impact
- This is an effective limitation of "pure" over the counter business for cash equities

Trading mandate for trades in OTC derivatives

- Trading mandate for certain OTC derivatives
- All EU counterparties subject to this, and some transactions between non-EU entities also caught, in similar circumstances as under EMIR

Worldwide position limit regime

- Applies to any person trading commodity derivative contracts traded on an EU venue **and** any OTC contract economically equivalent to such a contract
- Identifying relevant EU traded contracts and determining equivalence

Pre- and post-trade Transparency regime

- Extension of existing pre- and post-trade transparency regime for equities to cover other equity-like and fixed income instruments.
- Waivers are still available, though the conditions for applicability of waivers are more prescriptive

Market structure – potential extraterritorial impacts of new MiFID2/MiFIR regime

Indirect clearing rules for non-EU ETDs

- Indirect clearing especially important for EU firms' access to non-EU exchanges
- New rules will apply to ETD traded on trading venues in "equivalent" non-EU states
- New rules could operate as effective ban on indirect clearing

Algorithmic trading

- New requirements for European venues with members or participants which employ algorithmic trading techniques
- Measures may include "throttle limits" and "kill switches" in respect of certain members / algorithms

Direct electronic access

- New requirements applicable to firms providing clients with direct market access and/or sponsored access
- This may have paperwork and regulatory risk implications for U.S. firms accessing through EU investment firms

Third country firms

In-bound business of non-EU firms

Branch regime (retail and elective professional clients)

Scope

- Member states may require U.S. firms to establish branches when providing services to retail or elective professionals
- Alternatively, member states can allow such services to continue to be provided on the basis of existing member state rules

Criteria for authorisation

- If a branch is required, member states must impose:
  - criteria for authorisation
  - Compliance with MiFID conduct of business rules

Practical Impact

- Some member states may require branches for retail and elective professional services
- Requirement is optional, so practical impact may be limited
- Current UK position – preserving the status quo?

In-bound business of non-EU firms

Cross-border regime (professional clients and eligible counterparties)

Registration with ESMA

- Third country firms registered with ESMA may provide services on a cross-border basis (or without registration on own exclusive initiative of client/counterparty)
- Limited to investment services/activities to eligible counterparties and per se professionals
- Registration contingent on third country firms being authorised and subject to effective supervision/enforcement in its home state and cooperation agreement between ESMA and home state regulator

Equivalence

- Registration by ESMA also contingent on equivalence decision
- Requirement for reciprocity from third countries
- Until equivalence decision, member states may allow third country firms to provide cross-border services to eligible counterparties and per se professionals under national regimes

Effect of equivalence decision

- ESMA-registered third country firms can provide cross-border services to eligible counterparties/per se professionals in all member states on the basis of their home state rules (subject to limited additional requirements)
- Third country firms with MiFID2 branch in one member state can provide cross-border services to eligible counterparties/per se professionals in other member states on the basis of rules in branch state (subject to prior notice)
- Third country firms can continue to provide cross-border services in Member States in accordance with national regimes for three years after an equivalence decision has been reached

Extraterritorial impact

Extensive new restrictions to Soft Commissions / rules on Dealing Commission

MiFID2 requirements	Rationale
Prohibition ■ Ban on receipt of non monetary benefits from third parties unless minor (restrictive definition of minor benefits, not including research). **Unbundling of payments** ■ Payments for research must be unbundled from payments for execution.	■ Eliminate conflicts of interest – managers tempted to route order flow to those who provide high quality research.

Extensive new restrictions to Soft Commissions / rules on Dealing Commission

Impacts on the market

Commission Sharing Agreements

- Commission Sharing Agreements – even though aimed at eliminating conflicts – do not totally delink deal flow and research and so will not be allowed in current form

Research

- ESMA would allow research to be paid by manager (presumably then recouped from fees) or from a prefunded research account paid for by client but delinked from execution volumes

Other things to note:

- Member States can "gold plate" the requirements sent out at an EU level.

Impacts for U.S. firms

EU managers

- U.S. brokers will not be able to offer EU managers research on a soft commission basis / linked to order

International firms

- International firms will need to structure their research and brokerage models differently in EU / for EU manager clients – potentially leading to restructuring of economic model for research / smaller research market

In the future:

- Demand for greater transparency around payments for research may spread internationally

Other extraterritorial impact

Product governance

- New product governance regime impacting distributors of investment products
- Such firms will require explicit product governance arrangements, including an understanding of the financial instruments being offered or recommended
- Unprecedented powers for national regulators (and ESMA) to ban products and practices
- Likely to also affect cross-border activity into the EU

Investor protection

- MiFID2 requires EU firms to provide greater information to their clients, particularly where investment advice is provided to clients
- EU distributing agents likely to require greater information from U.S. firms

Other EU initiatives / things to be aware of

MAR & MAD2

- The recast market abuse directive, together with a new market abuse regulation
- MAR already in force, begins to apply 3 July 2016
- Wider prohibitions on insider dealing and market manipulation
- Broader product reach
- Extraterritorial and wider definitions of material non-public information than in the U.S.

"Brexit"

- The possibility that the UK may leave the European Union
- Referendum due by end of 2017

SFTR

- New regulation on securities financing transactions
- First rules apply from January 2016 but phased implementation of other aspects
- New reporting requirements for securities and commodity financing transactions
- Additional disclosure requirements

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