Agenda

Introduction – MiFID2 for Asset Managers

Panel 1
- Trading mandate
- Market transparency
- Indirect clearing
- Transaction reporting

Panel 2
- Algorithmic trading
- Commodities
- Product governance
- Research

Concluding remarks
Introduction – Simon Crown
Scope and application

- **Investment firms**
  - Portfolio managers
  - Managed accounts
  - UCITS and AIFM delegation arrangements
  - UCITS management entities and AIFMs carrying on broader activities

- **Application outside of investment firms**
  - Position limits
  - Trading obligation

- **Indirect application**
  - Buy-side will be affected by changes in rules for sell-side
  - E.g. transaction reporting – brokers will require information from managers (including for UCITS and AIFs)
### MiFID2 and MiFIR: expected timeline

#### 2014
- **Q1**: Published in Official Journal and in force (2 July 2014)

#### 2015
- **Q1**
- **Q2**: Consultations on national implementation
- **Q3**
- **Q4**: New rules begin to apply (3 January 2017)

#### 2016
- **Q1**: National transposition (by 3 July 2016)
- **Q2**: ESMA final RTS to Commission (by September 2015)
- **Q3**: ESMA final ITS to Commission (by 3 January 2016)
- **Q4**: Estimated date range for final delegated/implementing acts and RTS/ITS

#### 2017
- **Q1**: ESMA/Commission consultations on Level 2 measures
- **Q2**: Consultations on national implementation

### Notes:
- Very limited transitional provisions
- The Commission/ESMA may develop FAQs and guidelines
- 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
Trading mandate – Kikun Alo
“MiFID2 introduces a trading obligation for shares as well as a trading obligation for derivatives which are eligible for clearing under EMIR and are sufficiently liquid.

This will move trading in these instruments onto multilateral and well regulated platforms in accordance with the G20 commitments.”

~ European Commission Statement
15 April 2014
Trading obligation for equities

No investment firm may undertake trades in shares unless that trade takes place:

- on an RM
- on an MTF
- with an SI
- on an equivalent third country trading venue

Applies to all shares “admitted to trading on a regulated market or traded on an RM or MTF” unless the trades are:

- non-systematic, ad-hoc, irregular and infrequent, or
- carried out between eligible and/or professional counterparties and do not contribute to the price discovery process.

ESMA mandated to develop RTS to specify characteristics of non-contributing exemption

The particular problem of “international equities” and Article 23

- The breadth of “shares” caught by the Article 23 trading obligation is not limited to “EU shares”
- Even if currently not traded on venue, how will firms be able to monitor this?
- Are there any solutions to the problem?
  - Interpretational
  - Structural
  - Equivalent third country trading venues
When is an equity trade outside the trading obligation?

ESMA mandate on the MiFIR non-contributing transactions exemption is focused on

**“Non-addressable liquidity” trades**
- Transfers of equities between funds under common management
- “Give-up” arrangements
- Collateral management transactions where shares are accepted as collateral
- Securities financing on shares

**Trades determined by factors other than the current value of the share**
- Benchmark trades (such as VWAP trades)
- Portfolio trades (where the portfolio is priced as a whole)
- Delta-neutral equity hedge trades
- Equity exchange for physical
Trading obligation for derivatives

**“Bottom up” process**
1. Class of OTC derivatives is declared subject to mandatory clearing under EMIR
2. ESMA consults on whether to impose mandatory trading on that class or a subset of that class
3. ESMA proposes draft regulatory technical standards (RTS) to Commission within six months after adoption of RTS on clearing under EMIR
4. Mandatory trading may be phased-in for some counterparty types

**“Top down” process**
1. Where a class of OTC derivatives has not been declared subject to mandatory trading
2. ESMA shall regularly monitor activity in those derivatives to identify cases where this may pose systemic risk and to prevent regulatory arbitrage
3. ESMA shall, on its own initiative, identify and notify to the Commission derivatives that should be subject to the trading obligation but which no CCP is authorised to clear under EMIR or which are not admitted to trading.
The venue and liquidity tests

Venue Test

Is the relevant class/sub-class of instruments admitted to trading on a RM/MTF/OTF or equivalent third country market?

- In contrast to the US regime, the test is not ‘venue led’
- If the class/sub-class fails the venue test no need to consider liquidity. However, ESMA may consider using ‘top-down’ process

Liquidity Test

Is there sufficient third-party buying and selling interest in the class/sub-class so that such class/sub-class is considered “sufficiently liquid” to trade only on venue?

Step 1 – Determining the relevant liquidity thresholds
- ESMA will set liquidity thresholds for each of the four liquidity criteria
- ESMA proposes to apply different weightings of the four liquidity thresholds depending on the particular class/sub-class of instruments

Step 2 Assessment of the liquidity of the class/sub-class as against the relevant liquidity thresholds
- ESMA must also:
  - consider anticipated impact on liquidity of relevant derivatives and commercial activities of end users and whether the derivatives are only sufficiently liquid in transactions below a certain size
  - periodically review the liquidity of the relevant instrument/class and the liquidity thresholds
### Liquidity Criteria, impact on liquidity and size limitations

<table>
<thead>
<tr>
<th>Liquidity Criteria</th>
<th>ESMA’s Proposal</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average frequency of trades</td>
<td>Minimum number of transactions per day AND minimum number of trading days</td>
</tr>
<tr>
<td></td>
<td>(removal of technical trades where possible)</td>
</tr>
<tr>
<td>Average size of trades</td>
<td>Notional size divided by number of trading days (although flexibility for other</td>
</tr>
<tr>
<td></td>
<td>options – e.g. notional size divided by number of trades)</td>
</tr>
<tr>
<td>Number and type of active market participants</td>
<td>Number of members or participants of a venue being involved in at least one</td>
</tr>
<tr>
<td></td>
<td>transaction in a given market; or</td>
</tr>
<tr>
<td></td>
<td>Where member or participant has a contractual arrangement to provide liquidity</td>
</tr>
<tr>
<td></td>
<td>in a financial instrument at least on one trading venue.</td>
</tr>
<tr>
<td>Average size of spreads</td>
<td>Average size of weighted spreads over different time periods (end-of-day</td>
</tr>
<tr>
<td></td>
<td>spreads deemed too limited a snapshot)</td>
</tr>
</tbody>
</table>

#### Factors for assessing impact on liquidity and end-users

<table>
<thead>
<tr>
<th>Data on historical trading patterns</th>
<th>Align methodology with LIS waiver</th>
</tr>
</thead>
<tbody>
<tr>
<td>Type of trading venues on which derivatives are admitted / trade</td>
<td>Thresholds will not necessarily be identical; assessment on case-by-case basis</td>
</tr>
<tr>
<td>Whether the derivatives are subject to a trading obligation in another jurisdiction</td>
<td>Thresholds would take into account specific characteristics of the class/sub-class</td>
</tr>
<tr>
<td>Availability of alternative instruments which may lead to a migration of trading activity</td>
<td>Public consultation</td>
</tr>
</tbody>
</table>

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**Clifford Chance**
Market transparency – Charles Morris
The scope of pre- and post- transparency requirements is set to increase significantly.

MiFID sets out pre-trade transparency and post-trade reporting requirements for equities admitted to trading on regulated markets and MTFs.

MiFIR is broadening the scope of equity transparency requirements and introducing fixed income and derivative pre- and post- transparency requirements.

This impacts all trades, but impact will be felt most of all in the fixed income markets.

Perhaps the question is no longer “when do transparency requirements apply” but rather “when does it not apply?” – i.e. when transactions can remain “in the dark”?
Can you trade fixed income and derivatives in the dark?

How are you trading?
- OTC*
- SI †
- Venue

Liquid?
- Yes
- No

Large trade?
- Yes
- No

Other?
- Yes
- No

SSTI – Size specific to instrument
LIS – Large in scale
OMF – Order management facility

KEY
- No OTC for derivatives subject to venue trading obligation
- † If instrument is also traded on a venue
- ** If venue has relevant waiver

Liquid?
- Yes
- No

Venue
- Yes
- No

OMF?**
- Yes
- No

OTC*
- Yes
- No

SI †
- Yes
- No

Liquid?**
- Yes
- No

LIS or >SSTI?**
- Yes
- No

LIT
### Table 11
**Interest rate options – liquid classes**

<table>
<thead>
<tr>
<th>UNDERLYING TYPE</th>
<th>UNDERLYING</th>
<th>TIME TO MATURITY</th>
<th>LIS (€)</th>
<th>SSTI (€)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest rate</td>
<td>Three month euro (euribor)</td>
<td>up to 3 months</td>
<td>15,000,000,000</td>
<td>7,500,000,000</td>
</tr>
<tr>
<td>Interest rate</td>
<td>Three month euro (euribor)</td>
<td>equal or longer than 3 months</td>
<td>15,000,000,000</td>
<td>7,500,000,000</td>
</tr>
<tr>
<td>Interest rate</td>
<td>Three month euro (euribor) 2 year mid-curve</td>
<td>up to 3 months</td>
<td>15,000,000,000</td>
<td>7,500,000,000</td>
</tr>
<tr>
<td>Interest rate</td>
<td>Three month euro (euribor) 2 year mid-curve</td>
<td>equal or longer than 3 months</td>
<td>20,000,000,000</td>
<td>10,000,000,000</td>
</tr>
<tr>
<td>Interest rate</td>
<td>Three month euro (euribor) 3 year mid-curve</td>
<td>up to 3 months</td>
<td>10,000,000,000</td>
<td>5,000,000,000</td>
</tr>
<tr>
<td>Interest rate</td>
<td>Three month euro (euribor) 3 year mid-curve</td>
<td>equal or longer than 3 months</td>
<td>20,000,000,000</td>
<td>10,000,000,000</td>
</tr>
<tr>
<td>Interest rate</td>
<td>Three month euro (euribor) mid-curve</td>
<td>up to 3 months</td>
<td>75,000,000</td>
<td>37,500,000</td>
</tr>
<tr>
<td>Interest rate</td>
<td>Three month euro (euribor) mid-curve</td>
<td>equal or longer than 3 months</td>
<td>125,000,000</td>
<td>62,500,000</td>
</tr>
<tr>
<td>Interest rate</td>
<td>Three month sterling</td>
<td>equal or longer than 3 months</td>
<td>15,000,000,000</td>
<td>7,500,000,000</td>
</tr>
<tr>
<td>Interest rate</td>
<td>Three month sterling 2 year mid-curve</td>
<td>up to 3 months</td>
<td>20,000,000,000</td>
<td>10,000,000,000</td>
</tr>
<tr>
<td>Interest rate</td>
<td>Three month sterling 2 year mid-curve</td>
<td>equal or longer than 3 months</td>
<td>15,000,000,000</td>
<td>7,500,000,000</td>
</tr>
<tr>
<td>Interest rate</td>
<td>Three month sterling 3 year mid-curve</td>
<td>equal or longer than 3 months</td>
<td>15,000,000,000</td>
<td>7,500,000,000</td>
</tr>
<tr>
<td>Interest rate</td>
<td>Three month sterling mid-curve</td>
<td>up to 3 months</td>
<td>15,000,000,000</td>
<td>7,500,000,000</td>
</tr>
<tr>
<td>Interest rate</td>
<td>Three month sterling mid-curve</td>
<td>equal or longer than 3 months</td>
<td>15,000,000,000</td>
<td>7,500,000,000</td>
</tr>
</tbody>
</table>

### Table 12
**Interest rate options – classes not having a liquid market**

<table>
<thead>
<tr>
<th>INTEREST RATE OPTIONS - CLASSES NOT HAVING A LIQUID MARKET</th>
<th>LIS (€)</th>
<th>SSTI (€)</th>
</tr>
</thead>
<tbody>
<tr>
<td>OTHERS</td>
<td>10,000,000</td>
<td>5,000,000</td>
</tr>
</tbody>
</table>
Can you trade equities in the dark?

How are you trading?
- OTC*
- SI †
- Venue (Order)
- Venue (Negotiated)

Liquidity?
- Yes
- No

Size?
- Yes
- No

Price/other Terms?
- Yes
- No

> SMS

SI †
- Yes
- No

Venue (Negotiated)
- Liquid?
  - Yes
  - No

Venue (Order)
- LIS?**
  - Yes
  - No

Ref Price or OMF?**
- Yes
- No

Ref Price?**
- Yes
- No

VWS or NCMP?**
- Yes
- No

LIT

KEY
* Not if subject to venue trading obligation (with exceptions)
† If share is also traded on a venue
** If venue has relevant waiver

Reference price waiver for orders subject to volume cap if liquid (uncapped if not liquid)
SI transparency below SMS is firm quote obligation if liquid (if not liquid, disclosure to their clients on request)

SMS – standard market size
LIS – large in scale
OMF – order management facility
VWS – within volume weighted spread
NCMP – terms other than current market price

MiFID2 for Asset Managers
Indirect clearing – Will Winterton
Indirect clearing in the ETD World

Clearing Chain

Level 5 – Clients of Indirect Client

Level 4 – Indirect Client

Level 3 – Client

Level 2 – Clearing Member

Level 1 – CCP

End Client

Client or Brokerage

European Broker

Local CM

Local CM

Local CM

Asian Exchange/CCP

US Exchange/CCP

European Exchange/CCP

Local Exchange/CCP

MiFID2 for Asset Managers
Enhanced protection for ETD positions and collateral – but will it help you at Level 5 (clients of indirect client)?

Implementation issues:

- Risk of legal challenge on clearing member to indirect client leapfrog payments. Complicated by wide jurisdictional scope
- Repapering to address insolvency concerns
- Segregation requirements – NOSA or GOSA
- Timing
- Cost
Why is transaction reporting more difficult this time?

<table>
<thead>
<tr>
<th>Why is it changing?</th>
<th>What is changing?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purpose of MiFIR transaction reporting</td>
<td>More instruments/transactions within scope</td>
</tr>
<tr>
<td>Market integrity</td>
<td>Instruments traded on MTFs and OTFs as well as instruments admitted to trading on regulated markets</td>
</tr>
<tr>
<td>To allow regulators to detect and investigate instances of market abuse</td>
<td>Instruments where underlying traded on a trading venue or is an index or basket</td>
</tr>
<tr>
<td></td>
<td>Not just purchase / sale</td>
</tr>
<tr>
<td>To improve quality and consistency of data received</td>
<td>More information required on transaction reports</td>
</tr>
<tr>
<td>Technical requirements will be set out in RTS – harmonised across the EU</td>
<td>Currently &lt;30 core fields; ESMA draft RTS proposes &gt;80 fields</td>
</tr>
<tr>
<td></td>
<td>New fields include short sale and pre-trade transparency waiver flags</td>
</tr>
<tr>
<td>Why is it changing?</td>
<td>UK portfolio manager exemption still available?</td>
</tr>
<tr>
<td>Purpose of MiFIR transaction reporting</td>
<td>Order transmitters are exempt if orders include relevant details for reporting and a formal written transmission agreement is in place</td>
</tr>
<tr>
<td></td>
<td>Query whether existing FCA exemption for portfolio managers will remain</td>
</tr>
<tr>
<td>Dynamic data not discernible by delegatee</td>
<td>Unlike EMIR and existing MiFID reporting, information to be reported includes dynamic data which cannot be populated by delegatee – requires data feed to be built between manager and firm</td>
</tr>
</tbody>
</table>
What the regulators want to know

**Who?**

- Full picture of actors involved in execution of a transaction
  - Not just counterparties, but MiFIR also requires transaction reports to include information about
    - Decision makers at the executing firm
    - Employees involved in execution itself
    - Algorithms ‘making decisions’ or executing transactions
    - Underlying clients/beneficiaries of the transaction
  - Data protection risk for employees and clients who are individuals
    -Creation of a ‘golden source’?

**What?**

- Wide enough to capture all activity relevant to market integrity
  - Definition of “execution” of a “transaction”
    - Definitions proposed apply to transaction reporting only
  - Challenges in coming up with unique identifiers for certain types of instruments now in scope
    - Transactions on MTFs and OTFs likely to be more bespoke than transactions on regulated markets
    - OTC derivatives/baskets where underlying traded on venue
There are a number of legal and practical issues with:

- Availability and practicality of delegated reporting offerings (compare to EMIR and MiFID1)
- Systems build and lead time
- Commercial arrangements with ARMs (equivalent of TRs)

Assuming some transaction reporting is required, certain data issues will need to be resolved:

- ‘Golden sources’ / reference data to avoid duplication and ease implementation
- Many fields appropriate for securities only
- Other practicalities (change of address, passport data, etc)
- Economy of information (avoid proliferation of non-essential fields. ESMA 81 fields vs. previous FCA 27)
- Use of algorithms
- Data privacy concerns
Algorithmic trading – Owen Lysak
# Algorithmic trading

<table>
<thead>
<tr>
<th>What is algorithmic trading?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Algorithmic trading</td>
</tr>
<tr>
<td>High frequency algorithmic trading techniques</td>
</tr>
<tr>
<td>Direct electronic access (DMA / sponsored access)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>What are the obligations?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Systems and controls, user testing, kill functionality, business continuity</td>
</tr>
<tr>
<td>Notify competent authorities (competent authorities may request further details)</td>
</tr>
<tr>
<td>Record keeping obligations</td>
</tr>
<tr>
<td>Liquidity provision obligation where market making</td>
</tr>
<tr>
<td>Effective systems and controls regarding DMA / sponsored access</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Potential issues</th>
</tr>
</thead>
<tbody>
<tr>
<td>Any proportionality applied to the obligations?</td>
</tr>
<tr>
<td>Scope of algorithmic trading definition</td>
</tr>
</tbody>
</table>
Commodities

Changing Regulatory Landscape

MiFID2 – Key Reforms

Scope and Categorisation
“Commodity Derivatives”

Licensing
Ancillary Services Exemption

Transparency
Liquidity Determinations

Restrictions
Position Limits

Information
Position Reporting

Powers
Position Management

Regulatory Landscape

SFT & Benchmark Proposals
MiFID2 and MiFIR
MAR & REMIT
CRD IV
EMIR

MiFID2 for Asset Managers
Clifford Chance 28
What are “commodity derivatives” under MiFID2/MiFIR?

<table>
<thead>
<tr>
<th>Cash settled C(5)</th>
<th>Physically settled and exchange traded C(6)</th>
<th>Other physically settled C(7)</th>
<th>Cash / physically settled exotics C(10)</th>
<th>Securitised derivatives</th>
</tr>
</thead>
<tbody>
<tr>
<td>Must / may be settled in cash</td>
<td>Can be physically settled</td>
<td>Can be physically settled</td>
<td>Must / may be settled in cash; or</td>
<td>Securities giving the right to acquire / sell any transferable securities or giving rise to cash settlement by reference to relevant underlying</td>
</tr>
<tr>
<td>Includes forwards</td>
<td>Traded on RM, MTF or OTF</td>
<td>Not covered by C(6)</td>
<td>Derivative contracts that have the characteristics of other derivative financial instruments</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Carve-out for physically settled REMIT products traded on an OTF</td>
<td>Not for commercial purposes</td>
<td>Have the characteristics of other derivative financial instruments</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Expansion to cover instruments traded on OTF</td>
<td>Amendments to definition of “characteristics of other derivative financial instruments”</td>
<td>Amendments to definition of “characteristics of other derivative financial instruments”</td>
<td></td>
<td>Currently treated as transferable securities rather than derivatives under MiFID</td>
</tr>
</tbody>
</table>

MiFID2 for Asset Managers
Ancillary activities exemption

MiFID2, Article 2(1)(j)

- MiFID2 amends/deletes exemptions commodity dealers have historically relied upon
- New exemption for dealing on own account in commodity derivatives or emission allowances (and their derivatives) and providing investment services relating to those instruments to customers/suppliers of their main business on a group basis
- But exemption dependent on a number of criteria including: (i) the activity being ancillary to the person’s main business on group basis and (ii) annual notification of intention to use exemption
- Only “investment firms” (as defined) need to rely on exemption

Activities are ancillary if less than both:

- 5% of group capital employed
  - This represents a deviation from the approach suggested in the May 2014 DP in which a 50% threshold was proposed
- 0.5% of overall market activity in EU in at least one asset class:
  - Metals
  - Oil and oil products
  - Coal
  - Gas
  - Power
  - Agricultural products
  - Other commodities or C(10) underlyings
  - Emission allowances (and derivatives)

Relevant activities exclude intragroup transactions under EMIR, hedging transactions and mandated market making activities

* ESMA proposal in December 2014 Consultation Document
Position limits – an overview

National competent authorities will establish and apply position limits on the size of a net position which a person can hold at all times.

Calculating the net position ...

<table>
<thead>
<tr>
<th>Subject of the Limits</th>
<th>Aggregation</th>
<th>Non-financial entity hedge exemption</th>
</tr>
</thead>
<tbody>
<tr>
<td>positions held by that person in commodity derivatives traded on trading venues and economically equivalent OTC contracts</td>
<td>those held on its behalf at an aggregate group level</td>
<td>Positions objectively measurable as reducing risks directly related to the commercial activity of non-financial entity</td>
</tr>
</tbody>
</table>
Position limits – key issues and questions

Who does the regime apply to?
- Article 57 refers to "persons"
- Article 1(6) extends application of regime to "exempt persons"

How will the regime apply to non-EU persons / persons who do not require an exemption?

Setting the limits
- Methodology proposed by ESMA sets limits for spot and non-spot months (cash and physical) at 25% of deliverable supply (DS)
- NCAs can vary +/- 15%

How will DS be calculated where there is no physical underlying and for non-spot months?

Economically Equivalent OTC Contracts ("EEOTC")
- Do EEOTC need to be "commodity derivatives"?
- Register of EEOTC?

Does holding only EEOTC trigger limits?

Calculating the Net Position
- Limits apply to "net position"
- Competent authority to determine which positions will be netted against each other?

Will the calculation reflect risk by including non-MiFID instrument offsets?

Group Aggregation
- EU group / positions only?
- Do ultimate holding companies who hold no positions have to aggregate?
- Requirement to aggregate funds under common management?

Do you have to aggregate up the ownership chain?
## Position reporting and position management powers

### Reportable Products: commodity derivatives, emission allowances and related derivatives and (for firm/participant reporting) EEOTC

**Venue Reporting**

<table>
<thead>
<tr>
<th>Aggregated Daily Breakdown</th>
<th>Firm/Participant Reporting</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Content:</strong> A complete breakdown of the positions held by all persons on that venue</td>
<td><strong>Content:</strong> Members/participants/clients of an EU trading venue must report details of their own and client (down to end-client) positions</td>
</tr>
<tr>
<td><strong>Report to:</strong> relevant NCA</td>
<td><strong>Report to:</strong> relevant venue</td>
</tr>
</tbody>
</table>

**Daily Venue Report**

- **Content:** Aggregated weekly breakdown of positions held by different categories of persons traded on that trading venue specifying number of long and short positions, changes since previous report, percentage of open interest represented by each category and number in each category
- **Report to:** NCA and ESMA

**Daily Off-Venue Report**

- **Content:** Investment firms trading outside an EU trading venue must report a complete breakdown of their own and client (down to own-client) positions in in-scope products traded on EU trading venues and economically equivalent OTC contracts
- **Report to:** relevant NCA of venue or central NCA, in accordance with the transaction reporting regimes under MiFIR and, if applicable, REMIT

### Key Implementation Issues

- Duplicative reporting
- End-client reporting – data protection, confidentiality and commercial concerns

### 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
- Require a person to provide liquidity

### 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 class of persons to enter into a commodity derivatives

### ESMA powers

- Market monitoring and power to ban products / activities
- Co-ordination of national measures
- Additional position management powers
Product governance – Monica Sah
Product governance

Addressing investor protection higher up the sales process value chain

Areas of investor protection controls:

- Product idea generation
- Design and develop
- Information
- Distribution and advice
- Post sale
Obligations on manufacturers and distributors

ESMA proposes product governance obligations for manufacturers and distributors:

Product manufacturer product governance obligations:

- Manufacturer:
  - manage conflicts of interest as part of product processes
  - governance processes for effective oversight and control over processes
  - assessment of potential target market
  - assessment of poor investor outcomes
  - consideration of charging structure and impact on outcomes for target market
  - regular review of investment products
- Positive duty to check product functions as intended

Distributor product governance obligations:

- Products and services compatible with needs of target market
- Information to manufacturers to assist in post-sale governance
- Compliance function reviews product governance arrangements
- Management/governance body endorses investment products and services and target markets
- Where TCF or non-MiFID manufacturers, must ensure reliable and adequate information from manufacturer to ensure distribution in accordance with needs of target market

Q: What are the responsibilities of manufacturers regarding distribution? What are the obligations of a distributor when dealing with a third country/non MiFID firm manufacturer?
Thematic Review

Structured Products: FCA Thematic Review on Product Governance (TR 15/2)

- Issued March 2015
- Scope
  - Consumer research; Discovery work with firms
- Key findings – some firm falling below expected standards
  - Lack of understanding of retail consumers of relative merits and drivers of return
  - Senior management must do more to put customers first – target market analysis
  - Robust stress testing
  - Clear and balanced information on product and risks
  - Strengthen monitoring of products
  - Do more to ensure fair treatment of customers
- Next steps
  - Assessed firms to explain how ensure fair treatment
  - Possible remediation work for those firms leading to possible redress for customers and use of “regulatory tools”
Research – Stephanie Peacock
Creating a ‘hard dollar’ research market

In its final technical advice to the European Commission, ESMA sets out two permissible payment structures for research:

1. Direct payment out of the firm’s own resources

or

2. Payment through a separate ‘research payment account’ funded by a specific, separate charge to the firm’s clients, which is agreed and disclosed up front
The research payment account

<table>
<thead>
<tr>
<th>Specific research charge</th>
<th>Firm oversight</th>
<th>Separate pricing by brokers</th>
</tr>
</thead>
<tbody>
<tr>
<td>A (reasonable) research charge must be agreed with each client and any budget increases require the client’s written agreement.</td>
<td>Account controlled by the firm, but administration may be delegated.</td>
<td>Firms providing execution services must separately identify transaction execution costs and research costs.</td>
</tr>
<tr>
<td>Based on a research budget set by the firm and <strong>not</strong> linked to the volume and/or value of transactions executed by the firm on behalf of its clients.</td>
<td>Purchased third party research must be subject to controls and senior management oversight.</td>
<td>The supply of research must not be influenced by (or be conditional on) levels of payment for execution services.</td>
</tr>
<tr>
<td>Any surplus must be rebated to the client or offset against the research charge for the next period.</td>
<td>Quality of research must be regularly assessed against robust quality criteria and its ability to contribute to better investment decisions.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Firms must have a written policy demonstrating how the quality of research is assessed and how costs are allocated as fairly as practicable amongst clients.</td>
<td></td>
</tr>
</tbody>
</table>
Key issues

Diversity of research coverage

What is research?

Territorial impact

ESMA’s proposals on research

Inflexibility

Application to fixed income
# Production of research and other communications under MiFID2 and MAR

<table>
<thead>
<tr>
<th></th>
<th>MAD rules on fair presentation / disclosure</th>
<th>MiFID1 rules on:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Conflicts management for ‘investment research’</td>
<td>General conflict management</td>
</tr>
<tr>
<td>Investment research</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Non-independent research*</td>
<td>✓</td>
<td>✗</td>
<td>✓</td>
</tr>
<tr>
<td>Marketing / other communications</td>
<td>✗</td>
<td>✗</td>
<td>✓</td>
</tr>
<tr>
<td>Personal recommendations†</td>
<td>✗</td>
<td>✗</td>
<td>✓</td>
</tr>
</tbody>
</table>

The MAR rules on fair presentation / disclosure will apply to a wider range of research materials because of the increased scope of MAR.

Trade ideas and sales notes are generally treated as marketing / other communications under MiFID1 and MAD. ESMA’s proposals for MAR implementing measures envisage a wider concept of ‘distribution channels’ which may affect this characterisation, with the consequence that the MAR rules on fair presentation / disclosure and the MiFID2 rules on conflicts management for investment research may apply.

ESMA’s proposals for MiFID2 implementing measures extend the application of the conflicts management rules in Article 22(3) of the MiFID1 Implementing Directive to non-independent research.

ESMA’s proposals for MiFID2 implementing measures include mandatory physical separation of personnel.

* Non-independent research must be treated as marketing communications and must be ‘clearly identified as such’ and contain prescribed warnings.
† Personal recommendations may constitute investment advice which is subject to rules on suitability.
Concluding remarks
A practical discussion of the legal, regulatory and commercial issues for asset managers and funds in today's international markets.

*Insights for Asset Managers* is a series of calls offering a practical overview of the issues faced by the asset management and funds sector in today’s international legal, regulatory and commercial environment. Each call will last for around 30 minutes and will focus on specific topics, followed by an update on recent developments.

The topics covered in the first session were:

- Accessing China – the opportunities and pitfalls for international asset managers and funds
- EMIR Margin for Uncleared OTC Derivatives – update and implementation challenges

The next call will take place on 8 July 2015, when the topics covered will include:

- VAT and Pension Fund Management – the new guidance
- Remuneration – what is on the horizon for asset managers and funds as a result of the EBA consultation?

Topics to be included in later sessions will include:

- AIFMD Marketing – emerging trends in marketing strategies for EU and non-EU fund managers
- Real Estate Finance – shaping the trends for asset managers and funds
- PRIIPs – what's in store for manufacturers and distributors of structured products?

To register for *Insights for Asset Managers* please contact Dara Obembe at Dara.Obembe@CliffordChance.com.
We would be delighted to discuss any aspect of MiFID with you further. Please do not hesitate to get in touch with any of our MiFID experts.

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