MiFID2 and MiFIR – moving to the next level
Seminar
November 2014

CLIFFORD CHANCE
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The focus of MiFID2 and MiFIR is moving to "the direction of travel on the final rules, and to consider the path to implementation" (David Lawton, Director of Markets at the FCA). Whilst the detailed rules are still being debated, there is now a sufficient framework to identify the areas which will be impacted by MiFID2 and MiFIR and to assess the risks of that impact.

With only 26 months remaining for implementation, firms need to prepare themselves for the significant effort which will be required to ensure compliance before this deadline.

To help firms put a framework around steps to implementation, this seminar will take a more granular look at the impact of the proposals and identify and discuss some of the key issues being debated between industry and ESMA for Level 2.

Timings

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<thead>
<tr>
<th>Time</th>
<th>Session</th>
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<tr>
<td>3:30pm</td>
<td>Registration &amp; afternoon tea</td>
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<tr>
<td>4:00pm</td>
<td>Introduction</td>
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<td>4:10pm</td>
<td>Panel 1: Regulating Markets – the product impact</td>
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<td>Commodities markets: regulatory scope and new limits and reporting regime</td>
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<td>5:00pm</td>
<td>Panel 2: Re-regulating Firms – emerging issues</td>
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<td>Why is transaction reporting more difficult this time?</td>
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<td>The impact of new rules on investment banking and research</td>
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<td>How much re-papering will be needed?</td>
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<td>The spreading extra-territorial impact of the new regime</td>
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<td>5:50pm</td>
<td>Closing Remarks</td>
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<td>6:00pm</td>
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Introduction
MiFID2 and MiFIR: expected timeline

<table>
<thead>
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<th>Year</th>
<th>Q1</th>
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<td>Consultations on national implementation</td>
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<td>New rules begin to apply (3 January 2017)</td>
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Notes:
- Very limited transitional provisions
- The Commission/ESMA may develop FAQs and guidelines
- Market Abuse Regulation starts to apply from 3 July 2016
- ESMA will likely also consult on RTS on OTC derivative trading mandate before new rules begin to apply
- Equivalence assessments required for third countries

Part of wider reform landscape

<table>
<thead>
<tr>
<th>Market regulation</th>
<th>Investor protection</th>
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<tbody>
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<td>Short selling</td>
<td>UCITS 5</td>
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<td>Securities finance*</td>
<td>AIFMD</td>
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<td>Benchmarks*</td>
<td>Transparency</td>
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<td>Credit rating agencies</td>
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<td>REMIT</td>
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<td>Shareholder rights*</td>
<td>Deposit guarantees</td>
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<td>Market abuse</td>
<td>CRD/CRR</td>
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<td>EMIR/CCPs</td>
<td>Bank recovery and resolution</td>
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<td>Central Securities Depositaries</td>
<td>Bank structure*</td>
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<td>Infrastructure</td>
<td>Banking Union</td>
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* Proposed legislation
Speakers’ Materials
Introduction – Chris Bates

Implementation challenges

Strategy
Clients
Non-EU impact
Systems
Documentation and compliance

Today’s panels

Panel 1
Regulating Markets – the product impact
- Market structure and equities trading
- How transparency will work in fixed income markets
- The new trading and clearing obligations for derivatives
- Commodities markets: regulatory scope and new limits and reporting regime

Panel 2
Re-regulating firms - emerging issues
- Why is transaction reporting more difficult this time?
- The impact of new rules on investment banking and research
- How much re-papering will be needed?
- The spreading extra-territorial impact of the new regime
Panel 1: Regulating Markets – the product impact
Equity Markets
Pre-Trade Transparency

Pre-trade transparency requires the publication of "orders" – what is an "Order"?

Order includes "Actionable Indication of Interest" (A-IOI)

Any communication which is an A-IOI must be made public under the rules relating to pre-trade transparency.

"A message from one member or participant to another within a trading system in relation to available trading interest which contains all the necessary information to agree on a trade" (Art 21(33) MiFIR)

Should only apply to "Binding" expressions

Equity Markets
Trading Obligation

Trading obligation for shares means that shares must be traded on an RM or MTF or with an SI.

No investment firm may execute an equity trade unless it is either:
- on an RM
- on an MTF
- with an SI

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.

Applies to regulated firms only – non-investment firms are permitted to trade off-market.
Speakers’ Materials
Market structure and equities trading – Simon Gleeson

When is an equity trade outside the trading obligation?

ESMA mandate to produce guidance on the MiFIR exemptions is focused on

- 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

Interaction of trading obligation and pre-trade transparency requirement

Non-mandate trades are generally not subject to pre-trade transparency

Thus an SI wanting to enter into an equity securities financing transaction

- May negotiate the transaction without being subject to a pre-trade price transparency requirement
- May execute the transaction on- or off-venue
- The general exception from mandatory execution for “collateral management transactions” is not replicated in the pre-trade transparency rules.
- Thus there are some trades which are not subject to mandatory execution, but which will be subject to pre-trade transparency if executed in a trading venue.
SME Growth Markets (SME-GMs)

- Heavily signalled as a component of "Capital Markets Union"
- An MTF where at least 50% of issuers are SMEs
- Possible requirement for market operators to be satisfied as to applicants
  - Appropriateness of management and board
  - Appropriateness of systems and controls within the entity
  - Adequacy of working capital
- No requirement for PD prospectus
  - Possible requirements for market operator to require an admission document based on Annexes XXV to XXVIII of the PD (the proportionate schedules) with some further concessions
- Requirement for annual and half-yearly reports, but not further TD requirements
- MAR will apply to all SME-GMs (except for insiders list requirements)
How will transparency work in fixed income markets?

Recap of key elements:

- Pre and post trade transparency regimes
- Who: firms, SIs, OTFs, MTFs, RMs
- What: bonds and structured products, emission allowances, derivatives traded on a trading venue

- Pre-trade waivers:
  - Large in scale
  - Indications of interest in RFQ and voice trading systems above a specific size that would expose liquidity providers to undue risk
  - Derivatives not subject to trading obligation / other instruments without liquid market.

- Post-trade deferrals:
  - Large in scale
  - No liquid market
  - Size of trade would expose liquidity providers to undue risk

- Pre-trade:
  - Publish firm quotes and available to other clients and need to be transacted with clients where trade below a specified size
  - Non-discriminatory limits on transactions per quote and client access to quotes
  - No obligation to make public firm quotes if trade above specified size and no liquid market

- Post-trade:
  - SIs and investment firms must publish volume and price of trades at time concluded via APA
  - Scope and timing limits for deferral same as trading venues

Definition of a liquid market

Determination of liquid market is key for the application of transparency requirements:

- Trading in liquid instruments subject to real-time transparency vs illiquid instruments eligible for pre-trade transparency/deferred publication post-trade
- ESMA DP proposes threshold scenarios for determining liquidity of a bond but not for derivatives
- ESMA's to publish list of liquid instruments (together with SSTI and LIS threshold/s) on website
- NB: Liquidity assessment also key for determining application of trading obligation for cleared derivatives

ESMA liquidity criteria:

- Average frequency of transaction
  - Minimum number of transactions in specified period and minimum number of trading days on which at least 1 transaction occurs
- Average size of transaction
  - Total turnover over a period divided by number of trading days
- Data relating to market participants
  - Participant of trading venue involved in at least 1 transaction in a given market
- Average size of spreads
  - End of day relative bid-ask spreads

ESMA methodology for applying criteria:

- Classes of Financial Instrument Approach (COFIA)
  - Assets groups divided into granular classes based on qualitative criteria
  - Liquidity of class based on liquidity of all instruments within class
  - Instrument liquidity based on assessment of its class
  - ESMA favours granular COFIA for derivatives (approx 400 classes for IRS)
- Instrument by instrument (IBI) e.g. ISIN level
  - Instrument liquidity based on individual assessment
  - Option for bonds and structured finance products
Speakers’ Materials
How transparency will work in fixed income markets – Monica Sah

ESMA’s approach to calibration of fixed income transparency requirements

Pre-trade transparency

- Calibration at trading systems level:
  - Determines minimum amount of pre-trade information must offer and when transparency can be waived
- Extend MiFID1 regime for equities to fixed income to include request for quote (RFQ) and voice trading systems
  - Definition of RFQ?
- Use of electronic means in voice trading systems to comply with requirements
- Where waiver for actionable IOIs waiver, still make public at least indicative pre-trade bid/offer prices that are close to price of trading interests
  - Composition and calculation based on clear methodology

Post-trade transparency

- Details of transactions to make available for each class of instruments:
  - Same as shares plus information on quantity notation
- SI’s identity
  - Disclose for overview of liquidity pools and align with pre-trade regime
  - Only identify transaction executed via SI and not name SI
- Identifiers for different types of transactions
  - Aim is to improve efficiency of price formation and support best execution
  - Use identifiers recommended in CESR Technical Advice, including flags for transactions executed under each pre-trade waiver and deferral, benchmark trade, agency cross trade, give-up/in trade, etc.
- Securities financing transactions where lending or borrowing liquidity?
  - ‘As close to real time’ means within 5 minutes
  - Regardless on RFQ, voice or hybrid system

Application of waivers and deferrals

Real-time transparency of trading in liquid instrument can be waived pre-trade or deferred post trade if individual trade:
- in excess of ‘size specific’ to the instrument (SSTI) or
- above a size that is ‘large in scale’ compared to normal market size (LIS)

Application

- ‘Large in scale’ thresholds higher than size specific thresholds: ESMA to set SSTI as percentage of LIS and then adjust per asset class
- Pre-trade, ‘size specific’ applies to trading in request for quote and voice trading systems only vs ‘large in scale’ applies to trading under all other trading models
- Post-trade, no restriction on application of ‘size specific’ and ‘large in scale’ deferrals so practically ‘size specific’ (lower threshold) results in shorter deferral than ‘large in scale’

Challenges

- Time periods for volume omissions too short – volume of transactions in illiquid instruments or above LIS masked for extended time period
- Packaged transactions
Speakers’ Materials
The new trading and clearing obligations for derivatives – Oliver Dearie

Overview: The trading obligation for derivatives

OTC derivative subject to the clearing obligation under EMIR

<table>
<thead>
<tr>
<th>Not an intragroup transaction under Article 3 EMIR</th>
<th>Not subject to transitional provisions under Article 69 EMIR</th>
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</table>

Relevant class/sub-class declared subject to mandatory venue trading obligation

Must be traded only on:
- RM
- MTF
- OTF
- Equivalent third country market

“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.

Trading obligation: The venue and liquidity tests

Derivatives

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 set liquidity thresholds per classes/sub-class of instruments
- How do you determine the relevant class/sub-class?
  - Classes of Financial Instruments Approach (“COFINA”) for derivatives
  - Instrument by Instrument Approach (“IBIA”) for bonds

Step 2 – Assessment of the liquidity of the class/sub-class 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
Speakers’ Materials
The new trading and clearing obligations for derivatives – Oliver Dearie

Trading obligation – Liquidity criteria and other key issues
Derivatives

Key Issues

- "Granular COF/A"
- Liquidity Criteria
- Packaged Transactions
- Exclusion of technical and risk reducing trades
- End-user involvement

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<thead>
<tr>
<th>Liquidity Criteria</th>
<th>ESMA’s Proposed Interpretation</th>
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<tr>
<td>Average frequency of trades</td>
<td>minimum number of transactions AND minimum number of trading days</td>
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<tr>
<td>Average size of trades</td>
<td>total turnover / number of trading days (AVT method)</td>
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<tr>
<td>Number and type of active market participants</td>
<td>any member or participant of a venue being involved in at least one transaction in a given market</td>
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<td>Average size of spreads</td>
<td>use publicly available end-of-day relative bid-ask spreads</td>
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The new clearing requirements for derivatives

Extension of clearing obligation to ETD
- Article 29(1) MiFIR extends the clearing obligation to ETD products
- RM must ensure that all transactions that are concluded on it are cleared by a CCP

CCPs, trading venues and clearing members are required to put in place effective systems, procedures and arrangements to ensure that transactions in cleared derivatives are accepted for clearing as quickly as technologically practicable using automated systems

ETD indirect clearing arrangements
- MiFIR requires ESMA to develop an RTS specifying the types of permissible indirect clearing arrangements and to ensure consistency with the requirements established for OTC derivatives
- EMIR indirect clearing requirements are problematic
- Indirect clearing arrangements are an established feature of the ETD market

Straight-through processing

* Cleared derivatives are those derivatives which are:
  (i) subject to the EMIR clearing obligation,
  (ii) subject to the MiFIR clearing obligation or
  (iii) which are voluntarily cleared

Reference: MiFIR, Articles 29 and 30
Commodities markets: Regulatory scope and new limits and reporting regime

Exemptions for Commodities Dealers

“Ancillary activities”

- Limitation on the scope for commodities exemptions
  - Current Article 2(1)(k) deleted ("main activities consist of dealing on own account in commodities")
  - Current Article 2(1)(d) amended to exclude commodity derivatives ("dealing on own account")
  - Article 2(1)(j): retained for "dealing on own account in commodity derivatives" (and investment services in commodity derivatives to customers/suppliers of main business) where this is ancillary to main business

- Concept of "ancillary activity" crucial in the new world
- Article 2(1)(j): dependent on the activity being ancillary to the person's main business, measured on a group basis
- Tension between physical/financial boundary
- Quantitative (setting of numerical thresholds) vs. qualitative criteria

Scope of financial instruments

"Equivalence" to a venue traded contract

- Scope of MiFID financial instruments
- MiFID1 status quo - reasonably safe presumption that physically settled OTC forwards are not MiFID instruments
- Most contracts omit the "express statement" that they are equivalent to a venue traded contract
- ESMA consultation on meaning of "characteristics of other derivative financial instruments"
- Threatens to switch presumption in the other direction - key criteria becomes simple "equivalence" to a venue traded contract

Commodities markets: Regulatory scope and new limits and reporting regime (continued)

Position Limits

“Economically equivalent” OTC contracts

- Position limits to be imposed on:
  - Net position that a person can hold at all times;
  - In commodity derivatives traded on trading venues and economically equivalent OTC contracts;
  - 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
- Concept of "economic equivalence" is key to application of position limits
- Tension between physical/financial boundary
- Maximising potential netting benefits (supports wide definition) vs. economically equivalent contracts counting towards the position limit (supports narrow definition)
- ESMA to specify criteria for determining "economic equivalence"
- First approach:
  - same risk profiles
  - equivalent maturities and same deliverables
  - equivalent margining and netting treatment
- Second approach based around market practice of other jurisdictions
Panel 2: Re-regulating firms – emerging issues
Speakers’ Materials
Why is transaction reporting more difficult this time? – Laura Douglas

Why is transaction reporting more difficult this time?

**Why is it changing?**
- **Purpose of MiFID transaction reporting**
  - Market integrity
  - To allow regulators to detect and investigate instances of market abuse
- **To improve quality and consistency of data received**

**What is changing?**
- **More instruments/tradings within scope**
  - Instruments traded on MTFs and OTCs as well as instruments admitted to trading on regulated markets
  - Instruments where underlying traded on a trading venue or is an index/basket
- **More information required on transaction reports**
  - Currently <30 core fields; ESMA Discussion Paper proposes >90 fields
  - New fields include short sale and pre-trade waiver flags

FCA has indicated that it expects firms to start thinking now about how they can prepare for the changes to the transaction reporting regime.

What the regulators want to know

**“Who did what?”**

**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 OTCs likely to be more bespoke than transactions on regulated markets
    - OTC derivatives/baskets where underlying traded on venue

**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”
Speakers’ Materials
Why is transaction reporting more difficult this time? – Laura Douglas

Implications for asset managers
Transmission of orders and delegated reporting

Investment firms which transmit orders have the following choice

<table>
<thead>
<tr>
<th>Option 1</th>
<th>Transmit to the executing firm all relevant details for reporting</th>
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<tr>
<td>ESMA proposes that specific conditions be met for firms to discharge their duty to transmit all relevant details for reporting:</td>
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<tr>
<td>- Written agreement in place between the order transmitter and receiver</td>
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<td>- Relevant information transmitted as agreed</td>
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<td>- Transmitter has adequate systems and controls to ensure the information transmitted is accurate and complete</td>
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<tr>
<th>Option 2</th>
<th>Submit own transaction report</th>
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<tr>
<td>Alternatively, firms may submit their own transaction report relating to the transmitted order, if executed, stating that the report pertains to a transmitted order</td>
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Can reporting be delegated?

Yes, in theory BUT likely to be practical issues

- Not addressed explicitly in MiFIR (unlike EMIR) but possible in theory
- However, systems build and dynamic data issues likely to cause practical challenges for delegated reporting
- So, will asset managers need to self-report?

Note that operators of trading venues will need to report transactions executed though their systems by firms not subject to MiFIR
Speakers’ Materials
The impact of new rules on investment banking and research – Simon Crown

Investment banking: Underwriting and placing
Conflicts of interest and provision of information to clients

Key issues
- scope of “underwriting and placing”: primary and secondary markets?
- identification of relationships subject to potential conflicts of interest
- requires organisational arrangements specific to underwriting and placing
- prior to acceptance of a mandate, firm must explain to issuer the details of the targeted investors
- ESMA list of abusive inducements, including “laddering” and “spinning”

ESMA Technical Advice

Allocation
Pre-issuance process
Record keeping
Internal information governance
Proper pricing

Investment research

MiFID1 rules on investment research*
- how to define ‘investment research’
- distinction between investment research and marketing communications

MiFID2: ESMA work
- do current rules on conflicts continue to protect the objectivity and independence of financial analysts?
- ESMA CP Question 56: is the current distinction between investment research and marketing communications ‘sufficient and sufficiently clear’?
- portfolio managers/advisers: investment research as a prohibited inducement or permitted ‘minor non-monetary benefit’?

FCA Handbook (COBS 12)

* (Implementing Directive Articles 24 and 25)
Speakers’ Materials
How much re-papering will be needed? – Peter Chapman

Re-papering
Sources of requirement and documents likely to be affected

- Expansion of existing scope (e.g. more clients, more services subject to documentation)
- More detailed specification of information under existing rules (e.g. fair, clear and not misleading)
- New information/agreements required (e.g. Investment advice, packaged products, etc)
- Different approach to current rules (e.g. Inducements disclosures)
- Market developments (e.g. agreements with trading venues re algorithmic trading, new market structures, etc)

- Terms of business (client facing)
- Policies and procedures (client facing and/or internal)
- Reports (client facing)
- Market arrangements (market facing)
- Marketing collaterals (client facing)

Re-papering
Examples of specific areas for re-papering

- ESMA has proposed following expansion of scope for client agreements:
  - Firms providing investment services and safeguarding and administration to new professional clients as part of an ongoing relationship must now enter into a written agreement in paper / other durable medium
  - Firms providing ongoing investment advice to retail clients must enter into a written agreement
- ESMA has also proposed specific content requirements for agreements (including information on types of instruments that may be purchased/sold, prohibited transactions, main features of custody, etc)

- Changes principally to retail documents (but also some limited provisions for professional clients too) which include specific requirements regarding:
  - Font size and layout
  - Risk disclosure
  - Consistent use of language throughout T&Cs and all collaterals
- Firms will need to consider whether existing documents and communication practices will meet MiFID2 standards.

- There is a significant focus on transparency in MiFID2 and proposals for firms to provide specific and more extensive ex ante and ex post disclosures to clients.
- New requirement to inform clients (and calculate) about all costs and charges on an aggregate basis in order to allow clients to understand the overall cost as well as the cumulative effect on return of the investment.
- ESMA also proposes that detailed information on costs and associated charges should be made available to professional clients and eligible counterparties although firms may, by agreement, limit the application of the requirements.
Speakers’ Materials
How much re-papering will be needed? – Peter Chapman

Re-papering
Examples of specific areas for re-papering (continued)

- MIFID ‘grandfathering’ under transitional provisions may not continue to be available so firms may need to go back and categorise ISD ‘grandfathered’ clients for MIFID2 purposes.
- Changes to classification rules for municipalities and local public authorities and option for Member States to adopt criteria for assessment of expertise and knowledge of these counterparties is likely to mean change to on-boarding procedures.
- Classification issues of EMIR will continue for mandatory derivative trading obligation.
- Client classification (and other) obligations will now apply in respect of structured deposit clients.
- Opportunities on commodity derivative and emission allowance trading venues will need to classify participants (including categories such as ‘commercial undertaking’ and ‘operators’).

- New rules will require policies to provide:
  - List of factors used to select entity/type and relative importance of each
  - List of venues (including breakdown by financial instrument) and fees corresponding to use of each
  - Counterparty risk disclosure
  - Details on third party payments
  - Additional cost data for retail clients
- Firms will need to benchmark against the requirements and likely overhaul existing policies.

- Tightening of inducements rules will necessitate review of current inducements language in terms of business and disclosure practices. In particular:
  - Ability to make general disclosures on the terms of the fee/commission arrangements with undertaking to provide additional information has not survived into MIFID2 and
  - There will be a new ex ante obligation to provide information on exact amount of inducement received and an obligation to provide individualised annual report on benefits received.
- Portfolio managers and independent investment advisors prohibited from accepting fees, commissions or other benefits – existing inducements language likely to need updating to reflect change.

- Proposal for new obligations on firms providing investment advice to provide information to clients on:
  - Independence and breadth of advice provided;
  - Whether the firm will provide periodic assessment of suitability; and
  - Details on the relevant financial instruments;
- Firms providing advice to retail clients must also provide a suitability statement specifying the advice given and how that advice meets the preferences, objectives and other characteristics of the client. Consent required to deliver the suitability statement post-trade.
- Whilst this concept may not be entirely new for the UK market, clearly to the extent the requirements do not match, re-papering may be necessary.

- MIFID2 provides that various provisions will apply to structured deposits including the following which entail some form of documentary requirement:
  - Art 25 (conflicts of interest)
  - Art 24 (general principles and information to clients)
  - Art 25 (assessment of suitability and appropriateness and reporting to clients)
  - Art 26 (client order handling rules)

- New requirements on firms offering an investment service together with another service or product as part of a package to:
  - Inform clients whether it is possible to buy the different components separately
  - Provide evidence on the costs and charges of each component part
  - Provide information about the risks involved in those component parts and in the package.
How much re-papering will be needed? – Peter Chapman

Re-papering
Examples of specific areas for re-papering (continued)

- Firms which manufacture and distribute products will need to put in place MiFID2-compliant governance procedures and product manufacturers will also be required to maintain a product approval process.
- The governance arrangements of firms offering or recommending third party financial instruments must ensure that the distributor understands the features of the products being distributed.
- Firms which distribute financial instruments issued by third country manufacturers will need to consider to what extent MiFID2-compliant governance procedures will need to be imposed contractually.

- Transaction reporting
  - Data which is required to be reported will potentially require firms to obtain information from clients (not just in the context of delegated reporting but also when dealing as agent).
  - Delegated reporting agreements will have to deal with significant dynamic data issues in order to be viable.

- Commodity position limit reporting
  - Operators of commodity derivative and emission allowance trading venues must be able to identify clients of participants in order to be able to report to NCA.
  - Firms will need to put in place terms to comply with obligations to report breakdown of their clients positions and the clients of those clients until the end client is reached.

- Firms providing direct electronic access must put in place effective systems and controls which ensure that:
  - It undertakes a proper assessment and review of the suitability of clients using the service;
  - Clients are prevented from exceeding appropriate pre-set trading and credit thresholds;
  - Clients cannot create risks to the firm, contribute to a disorderly market or behave in a way which constitutes market abuse or is contrary to the trading venue rules;
  - Firms must also ensure that clients comply with the requirements of MiFID2 and the trading venue’s rules.
  - Firms providing direct electronic access for clients must have a binding written agreement with the client (presumably covering much of the above in addition to setting out the parties’ rights and responsibilities).

Re-papering
Examples of specific areas for re-papering (continued)

- Matched principal trading is an exception to the prohibition on OTF operators executing client orders against proprietary capital of operator but is only permitted where the investment firm or market operator has specifically obtained consent from the client to do so.
- Firms operating platforms that become OTF’s (or MTFs) will need to think even more broadly about the re-papering exercise.

- Express obligation on firms that act as a general clearing member to have a binding written agreement with its client regarding the essential rights and obligations arising from the provision of that service.
- Increased drive to push derivatives OTC and ETD into clearing will mean more clearing arrangements – ESMA currently consulting on arrangements (including contractual arrangements to ensure information flow and/or margin transfers).
- Indirect clearing – ESMA currently consulting on arrangements (including contractual arrangements).

- Product intervention powers may lead to need for:
  - Preparation for exercise of powers;
  - Representations, warranties and undertakings from clients;
  - Selling restriction language;
  - Risk disclosures;
  - Classification.
Speakers’ Materials
How much re-papering will be needed? – Peter Chapman

Re-papering
Other considerations for the “re-papering” mix

- Level 2 measures
- The MiFID2 big bang
- Correcting documentary defects (e.g. out-of-date references, scope of consents, etc.)
- Contemporaneous regulatory reforms and document fatigue
- Identification of systems changes
- Continuing internal offering developments
- Two-way consent
Speakers’ Materials
The spreading extra-territorial impact of the new regime – Chris Bates

Inbound business of non-EU firms
The “patchwork” continues

Cross-border business with per se professionals and eligible counterparties

- Can continue on basis of national rules
  - Until 3 years after an equivalence decision for the relevant jurisdiction
  - Liberal rules in UK, Belgium, Ireland, Lux. can continue
  - But restrictive regimes in other Member States also continue to apply

If there is an equivalence decision for a non-EU state:

- Authorised firms from that state will have to register with ESMA
- But will be able to continue to do business subject to limited EU rules (status disclosure, submission to jurisdiction)

Will there be any equivalence decisions (requires equivalence plus reciprocity)?

Cross-border business with retail clients and EU branches of non-EU firms

- Member states will have to choose whether to impose a branch requirement
  - Many member states already restrict this business

If the UK chose this option, could impact non-EU firms:

- Relying on exemptions to do cross-border retail business (e.g. formerly overseas client exemptions)
- Authorised under FSMA without a branch in UK
- Doing MiFID2 business through an existing UK branch because of new requirements for:
  - Cooperation agreement with home state regulator
  - Qualifying tax information exchange treaty
  - Initial capital in the branch
- But branches could benefit from a “passport” for cross-border wholesale business in the EU if there was ever an equivalence decision on home state

Outbound business of EU firms
New issues for EU entities serving non-EU clients

New rules apply to business booked in EU - even if clients are outside EU

- New trading and transparency regime will apply to many non-EU instruments
  - If those instruments traded on EU venues e.g. Börse Berlin trades 15,000 shares from 62 countries
  - Restriction on trading shares outside an EU venue
  - SI pre-trade transparency rules – IBIA v COFIA
  - Post-trade transparency – competitive disparity
  - Trading restriction for liquid cleared OTC derivatives

- New conduct of business rules for non-EU clients
- Reporting transactions and commodity derivative positions for non-EU clients
- Challenges in re-papering non-EU clients

Unclear how new regime will apply to business in non-EU branches

- Conflicting Commission statements on application of MiFID1 in non-EU branches
- Current UK approach to applying MiFID1 rules in non-EU branches
  - Conduct rules: No (with exceptions)
  - Client assets: No
  - Common platform rules: No (exc. In prudential context)
  - MTF operation: Yes
  - Post-trade transparency: No
  - Transaction reporting: ?

- New derivatives trading obligation likely to apply to non-EU branches (follow EMIR)
- Potential for wider regime shift?
Speakers’ Materials
The spreading extra-territorial impact of the new regime – Chris Bates

Other extraterritorial impacts of new regime

- Indirect clearing esp. 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

Worldwide position limit regime
- Limits apply worldwide to any person trading any contract economically equivalent to a commodity derivative contract on an EU venue.
- Identifying relevant EU traded contracts and determining equivalence

Trading mandate for TCE-TCE trades in OTC derivatives
- Third country entities (TCEs) trading with each other subject to trading mandate for OTC derivatives
- Similar circumstances (and complexities) as clearing mandate for TCE-TCE trades under EMIR

New product intervention powers
- Unprecedented powers for national regulators (and ESMA) to ban products and practices
- Likely to affect cross-border activity into the EU
- With potential spillovers to non-EU activity (e.g., UK ban on marketing CoCos)

Limited relief through third country equivalence assessments

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<tr>
<th>Relevance of equivalence assessment</th>
<th>Comment</th>
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| Equivalent third country regulated markets (securities) | Investment firms may satisfy mandatory trading requirement for shares by execution on these markets (Article 25(1) MiFIR).
| Appropriateness requirements are waived for execution-only transactions in certain shares and bonds admitted to trading on these markets (Article 25(6)(a) and (b) MiFIR). |
| Under Article 25(4)(a) MiFIR, a third country market is considered equivalent to a regulated market for these purposes if it is considered equivalent to a regulated market for the purposes of the rules on offers of securities to employees under Article 4(1) of Prospectus Directive. A competent authority must request an equivalence determination by Commission with respect to the third country (but no determinations have yet been made). |
| Equivalent third country trading venues (OTC derivatives) | Counterparties may satisfy mandatory trading requirement for OTC derivatives by execution on venues established in an equivalent third country (Article 26(1)(b) MiFIR). |
| Commission determines equivalence of third country regime under Article 26(4) MiFIR. |
| Equivalent third country regulated markets (ETD) | Rules on indirect clearing under Article 30 MiFIR apply to ETD, which includes derivatives executed on third country venues equivalent to regulated markets. |
| Article 21(1)(32) MiFIR defines ETD to include derivatives traded on a third country market considered equivalent to a regulated market under Article 28 MiFIR (see above). |
| Duplicit and conflicting rules (derivatives) | Deemed compliance with rules on execution and clearing of derivatives in Articles 28 and 29 MiFIR where one counterparty is established in an equivalent third country and counterparties comply with rules in that country (Article 33 MiFIR). |
| Commission determines equivalence of third country regime under Article 33(2) MiFIR. Third country rules must be effectively applied and enforced in an equitable and non-discriminatory manner. Commission (with ESMA) must monitor third country rules and report annually to European Parliament and the Council. |
| Access rights for third country CCPs and trading venues* | Third country trading venues and CCPs have rights of access to EU CCPs, trading venues and benchmarks if they are established in equivalent third countries (Article 38 MiFIR). |
| Commission determines equivalence of third country regime under Article 38(3) MiFIR. Third country trading venues may only request access to CCPs if equivalent under Article 29 MiFIR and third country CCPs may only request access to EU trading venues if recognised under EMIR (Article 38(1) MiFIR). |
| Cross-border services* | Third country firms from equivalent jurisdictions must regular with ESMA to provide cross-border services to eligible counterparties and per se professional clients on the basis of their home-state rules (Article 46 MiFIR). |
| Commission determines equivalence of third country regime under Article 47(1) MiFIR. Firms must be authorised in the third country and additional criteria must also be satisfied under Article 46, including the existence of cooperation arrangements with ESMA. |

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* A reciprocity requirement applies, i.e. there must be an effective equivalent system for recognising or giving access to EU firms.

† The exemption from the mandatory trading requirement for intragroup transactions involving third countries depends on an equivalence assessment under EMIR.
Speakers’ Biographies
Speakers’ Biographies

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Chris is a partner and head of the financial regulation group. Chris advises banks, securities firms and other financial institutions on issues associated with the regulatory response to the financial crisis, the impact of the EU single market programme, financial services regulation and regulatory capital, as well as advising on derivatives transactions and securities offerings and mergers and acquisitions in the financial sector. He is also an active participant in industry committees and working groups on regulatory issues. He is currently a member of the International Regulatory Strategy Group advising the City of London and TheCityUK on regulatory issues.

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Simon is a partner in the financial regulation group, specialising in financial markets law and regulation. He has advised Governments, regulators and public bodies as well as banks, investment firms, fund managers and other financial institutions on a wide range of regulatory issues. He advised the World Economic Forum on their report on their 2009 Report on The New Global Financial Architecture, and has worked with regulators and governments around the world on the establishment of regulatory regimes. He has been a member of the Financial Markets Law Committee, chairs the Institute of International Finance’s Committee on Cross-Border Bank Resolution, has written numerous books and articles on financial regulation, and is the author of “International Regulation of Banking”, recently published by Oxford University Press. Simon is a visiting professor at the University of Edinburgh.

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Monica is a partner in the financial regulation group, specialising in financial markets law and regulation. Previously, she was a Managing Director at Morgan Stanley and Head of Legal for International Wealth Management. Monica advises financial institutions (sell-side and wealth managers) on a full range of legal and regulatory issues on maintaining a multi-product and jurisdictional platform, including cross custody and client money issues, product development, platform expansions, enforcement of collateral arrangements and client assets segregation issues. She also advises on FIG M&A transactions. Recently she has been advising the FOA and other trade associations on the EU Regulation Implementation Handbook and a number of custodian banks and the Association of Global Custodians on the implementation of the Alternative Investment Fund Managers Directive (AIFMD).
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