

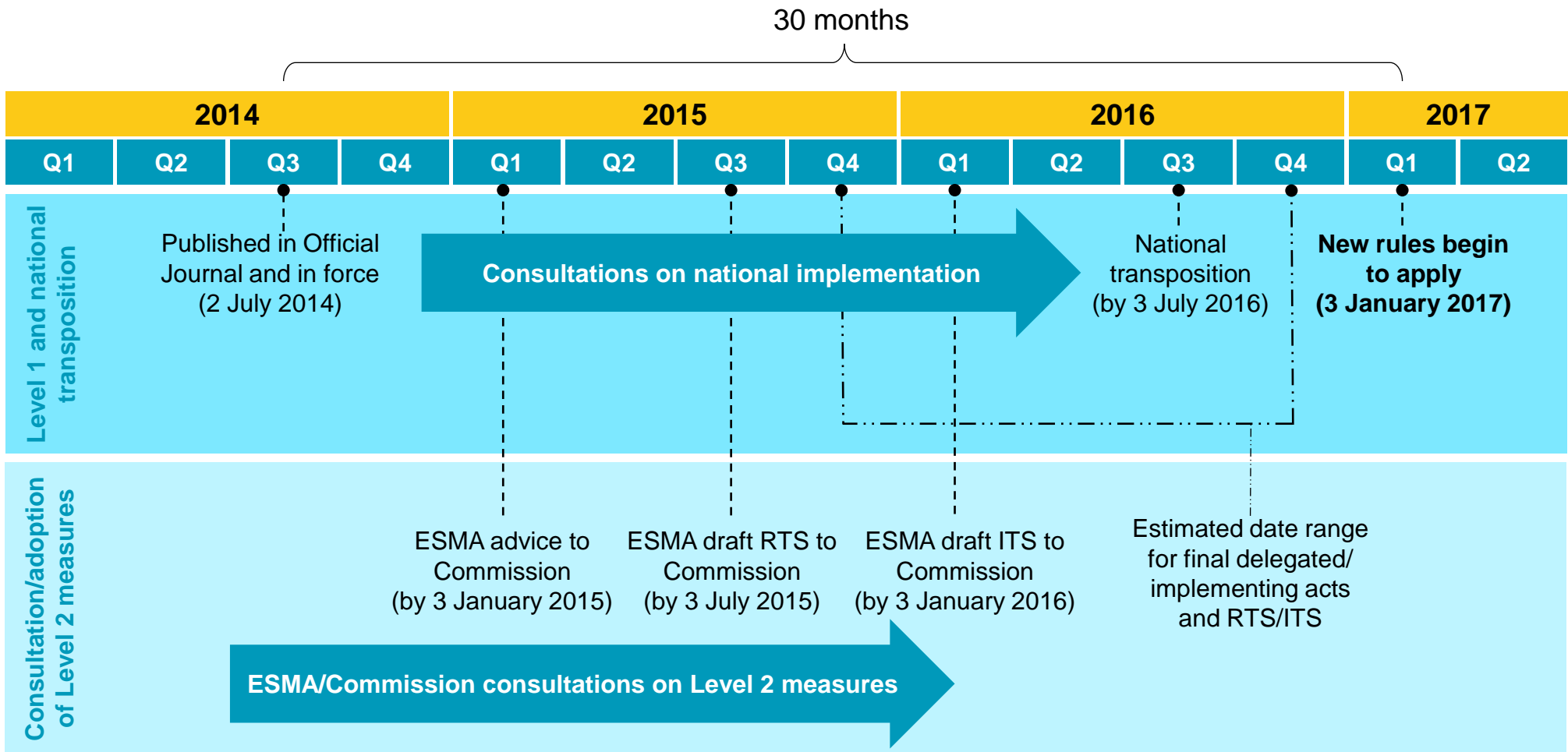
MiFID2/MiFIR issues for asset managers
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C L I F F O R D
C H A N C E

Wide ranging changes to existing rules



MiFID2 and MiFIR: expected timeline

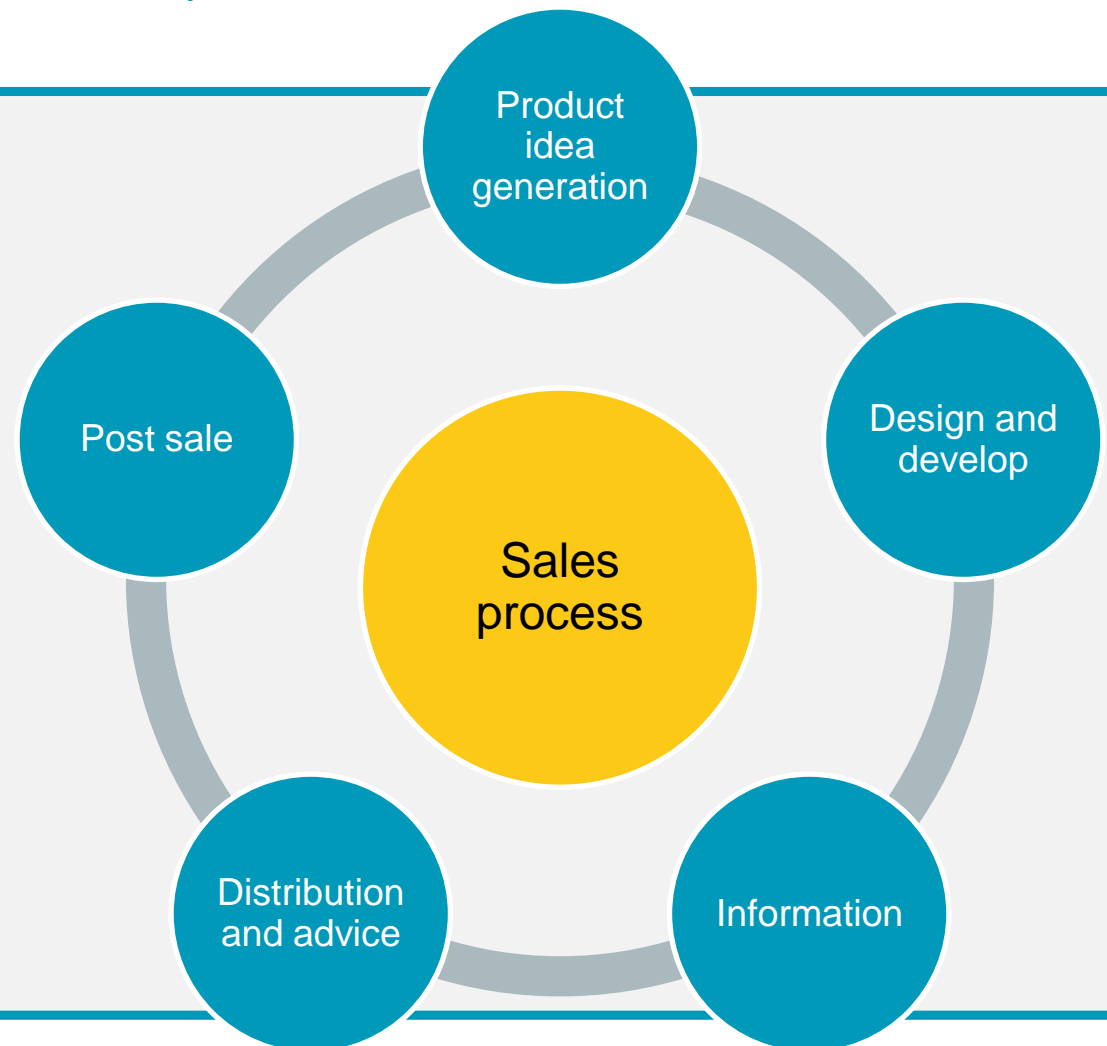


Notes:

- 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

Addressing investor protection higher up the sales process value chain

Areas of investor protection controls:



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?

Fair, clear and not misleading, information to clients

- Some information requirements extended to professionals e.g. information not reference benefits without highlighting relevant risks, not obscure important statements and be accurate and up-to-date
- Provide information about scope and features of advice (whether independent or not)
- If advice includes ongoing suitability assessment then must disclose frequency, how information is reassessed and updated information is communicated to the client

Cost disclosure

- Extensive detail on cost and charges:
- Cost information rules apply to professionals and ECPs but can opt out except where investment advice or portfolio management is being provided and in any case, the financial instrument imbeds a derivative
- Full point of sale disclosure of aggregated information on costs where a firm recommends or markets financial instruments to clients or whether KID/KIID is provided – client needs enough time to consider material information
- Third party payments received by investment firm viewed as part of the cost of the service provided
- Annual post-sale periodic disclosure about all costs and charges during life of the investment if firm recommends or markets financial instruments to clients or whether KID/KIID is provided and continuing relationship

Best execution: how does this change under MiFID2?

- Main features of best execution requirements from MiFID retained
- Firms must take all sufficient steps to achieve the best possible results (rather than all reasonable steps as currently required)
- Firms executing orders for professional clients to assess firm's own commissions and costs on each venue when comparing merits of venues (MiFID applied this to retail business only)
- Firms must not receive remuneration for executing client orders contrary to inducements or conflicts of interest rules (e.g. payments for order flow, intra-group reliance)
- All trading venues must publish data on execution quality (e.g. price, costs, speed) - will assist firms in complying with execution monitoring requirements
- New obligation on firms to inform client, post execution, where the order was executed
- Clarification of existing obligation on firms to provide information on order execution policy. Requires, in respect of each class of financial instrument, information on relevant venues and factors affecting choice of venue. Requires a clear explanation of how orders will be executed.

Relevant Articles
MiFID2 Article 27; Recital 97

Best execution: how does this change under MiFID2?

- New obligation on firms to summarise and make public on an annual basis, for each class of financial instrument, the top five execution venues in terms of trading volume and information on the quality of execution obtained
- Firms obliged to take account of newly required execution quality data published by venues and firms
- New obligation on firms to demonstrate to competent authorities, on request, that they have executed client orders in accordance with their order execution policy
- Level 2 measures likely to make additional changes to existing arrangements
- ESMA working on: detail to be included in order execution policies; content, format and timing of execution quality data

Investment firms must inform clients whether advice will be provided on an independent basis. A firm which offers independent advice must:

- assess a sufficient range of financial instruments available on the market;
- which must be sufficiently diverse with regard to their type and issuers or product providers to ensure that the client's investment objectives can be suitably met; and
- must not be limited to financial instruments issued or provided by the investment firm itself, entities having close links with the investment firm or other entities with which the investment firm has such close legal or economic relationships, such as contractual relationships, as to pose a risk of impairing the independent basis of the advice provided.

Selection process - sufficient range of sufficiently diverse financial instruments available on the market.

- Selection process to foster a fair and appropriate comparison of different instruments, not limited to products for which the recommendation could be biased.
- Commission will develop implementing measures specifying the elements of the selection policy.
- Not appropriate, in ESMA's view, to set specific or minimum number of instruments or product providers to be considered – the number, types and product providers to be compared will depend upon the scope of the advice to be given and client preferences and needs.
- Crucial that the selection allows an appropriate consideration of what the market offers as an alternative to the products issued by the investment firm or entities with close links or relationships.

Following selection of the different instruments for comparison, final selection must not be flawed because of close links to the investment firm (taking into account conflict of interest rules).

It is possible for an investment to provide:

- Investment advice on an independent basis that focuses on certain classes or a specified range of financial instruments.
 - Scope of service must still allow for a fair comparison between different instruments coming from different providers.
- Both independent and non-independent advice, provided that the firm:
 - Does not hold itself out as independent for its business as a whole.
 - Has adequate organisational requirements and controls to ensure that both types of advice services and advisers are clearly separated from each other and that clients are not confused about the type of advice being provided and are given the type of advice that is appropriate to them.
 - Does not permit individuals to provide both independent and non-independent advice.

Relevant Articles
MiFID2 Article 24(4), (7) and (13); Recital 73

Rules on avoiding and managing conflict of interests enhanced:

- Must take **all appropriate steps** to identify and prevent or manage conflicts
- Over-reliance on disclosure not permitted; generic disclosure not sufficient
- Inducements:
 - Independent advisors and portfolio managers must **not accept and retain** any monetary or non monetary benefits. ESMA clarified that this means that third party fees and commissions can be accepted but must be transferred to the client; minor monetary benefits enhancing quality of service are permissible
 - Other investment services – third party payments must enhance quality of service, not impair ability to act in best interest of client and must be clearly disclosed to the client
 - Specific provision prohibiting investment firms from receiving any monetary or non monetary benefits for routing client orders to a particular trading venue or execution venue where it would infringe the conflicts of interest or inducements rules

Q: What is a minor non monetary benefit?
How will the access to research be affected?

Relevant Articles
MiFID2 Articles 23, 24 and 27

Why is transaction reporting more difficult this time?

Why is it changing?

Purpose of MiFIR transaction reporting

- Market integrity
- To allow regulators to detect and investigate instances of market abuse

To improve quality and consistency of data received

- Technical requirements will be set out in RTS – harmonised across the EU

What is changing?

More instruments/ transactions within scope

- instruments traded on MTFs and OTFs as well as instruments admitted to trading on regulated markets
- instruments where underlying traded on a trading venue or is an index or 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

The 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 OTFs 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’?

Implications for asset managers

Transmission of orders and delegated reporting

Investment firms which transmit orders have the following choice

Option 1

Transmit to the executing firm all relevant details for reporting

ESMA proposes that specific conditions be met for firms to discharge their duty to transmit all relevant details for reporting:

- Written agreement in place between the order transmitter and receiver
- Relevant information transmitted as agreed
- Transmitter has adequate systems and controls to ensure the information transmitted is accurate and complete

Option 2

Submit own transaction report

Alternatively, firms may submit their own transaction report relating to the transmitted order, if executed, stating that the report pertains to a transmitted order

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 through their systems by firms not subject to MiFIR



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