C L I F F O R D C H A N C E

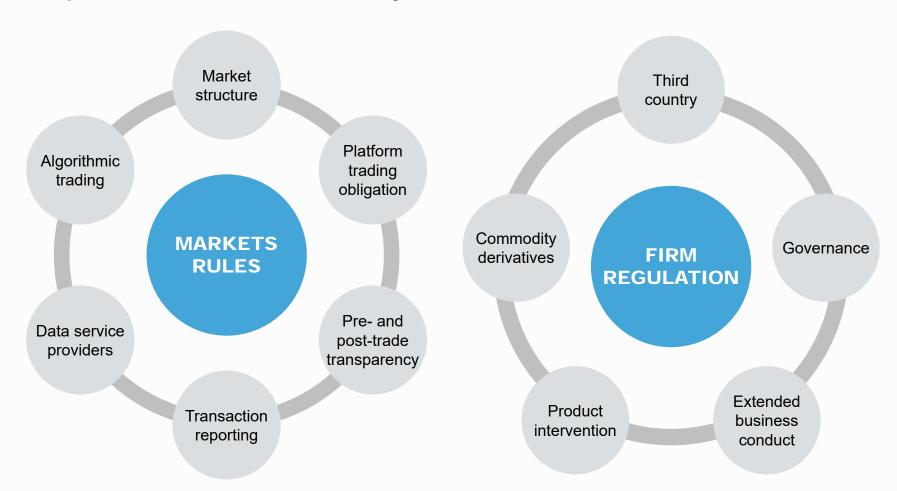


THE IMPACT OF MIFID2 ON ASIAN FINANCIAL INSTITUTIONS

May 2017

WIDE RANGING CHANGES TO EXISTING RULES

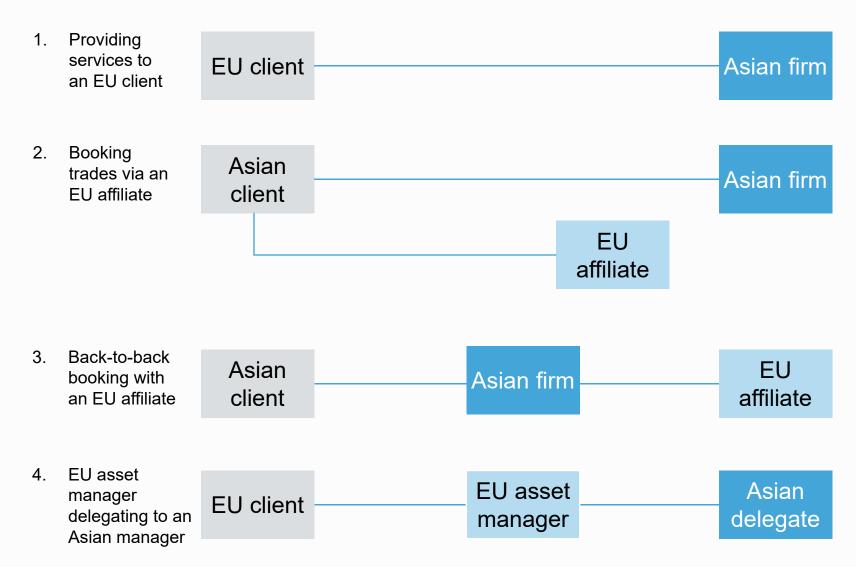
• Implementation deadline: 3 January 2018



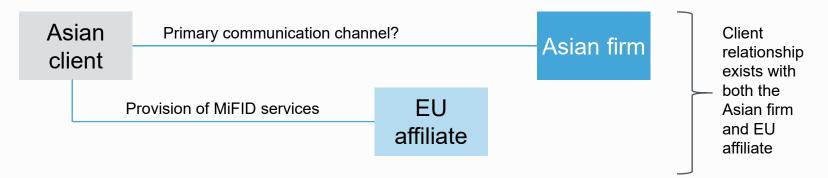
IS MIFID2 RELEVANT TO ME?

Distributing Trading on EU products in the trading venues EU Using an EU Distributing products with an affiliate to book EU manufacturer trades Non-EU entities **Providing Providing** execution and services to / trading with EU research to EU clients managers

KEY TRIGGERS - IDENTIFYING EU CLIENTS AND EU AFFILIATES



IMPLICATIONS FOR BOOKING TRADES VIA AN EU AFFILIATE



Information, disclosures and consents

- What additional information will the EU affiliate need from the client?
 - e.g. LEI, information for transaction reporting, commodity derivatives positions
- What additional information will the EU affiliate need to disclose to the client?
 - e.g. costs and charges, order execution policy, inducements and conflicts
- Are any additional client consents needed?

Transparency and algorithmic trading

- Pre- and post- trade transparency
 - May need to educate clients / explain consequences of transparency rules
- Algorithmic trading
 - Algorithmic trading rules may apply e.g.
 where the EU affiliate uses an algorithm developed / maintained by the Asian firm

Question: Which firm will act as the primary communication channel with the client?



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

TRADING OBLIGATION FOR **EQUITIES** (CONTINUED)

Dual-listed securities and execution considerations

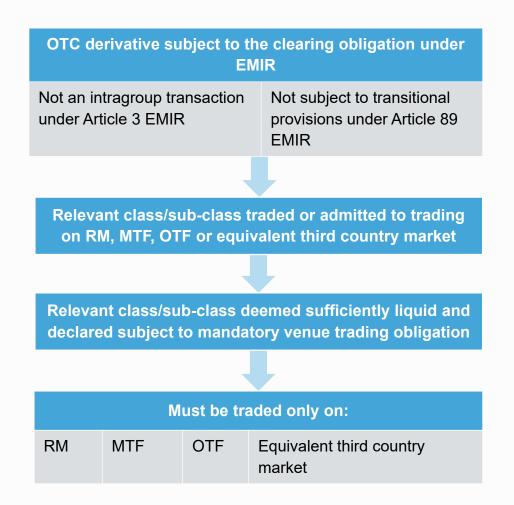


Question: will the mandatory trading obligation be satisfied where actual execution occurs through a back-to-back trade with an Asian firm on an Asian trading venue?

- If the transactions are treated as separate bilateral transactions, may still be non-compliant. But:
 - this would appear to prohibit riskless principal trading for equities subject to Article 23 MiFIR
 - investment firms would need to become members of a large number of stock exchanges
- Instead, the reference to "undertake" could be read as different from "execute", so that a chain of back-to-back transactions:
 - would be treated as a single "trade" (similar to mandatory clearing under EMIR)
 - would be compliant with Article 23 MiFIR, as long as ultimate execution takes place on an EU or equivalent third country trading venue
- Asian trading venue would need to be deemed "equivalent"

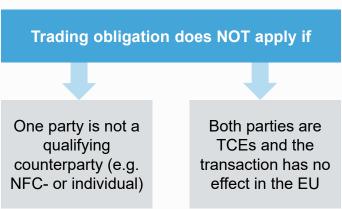
TRADING OBLIGATION FOR **DERIVATIVES**

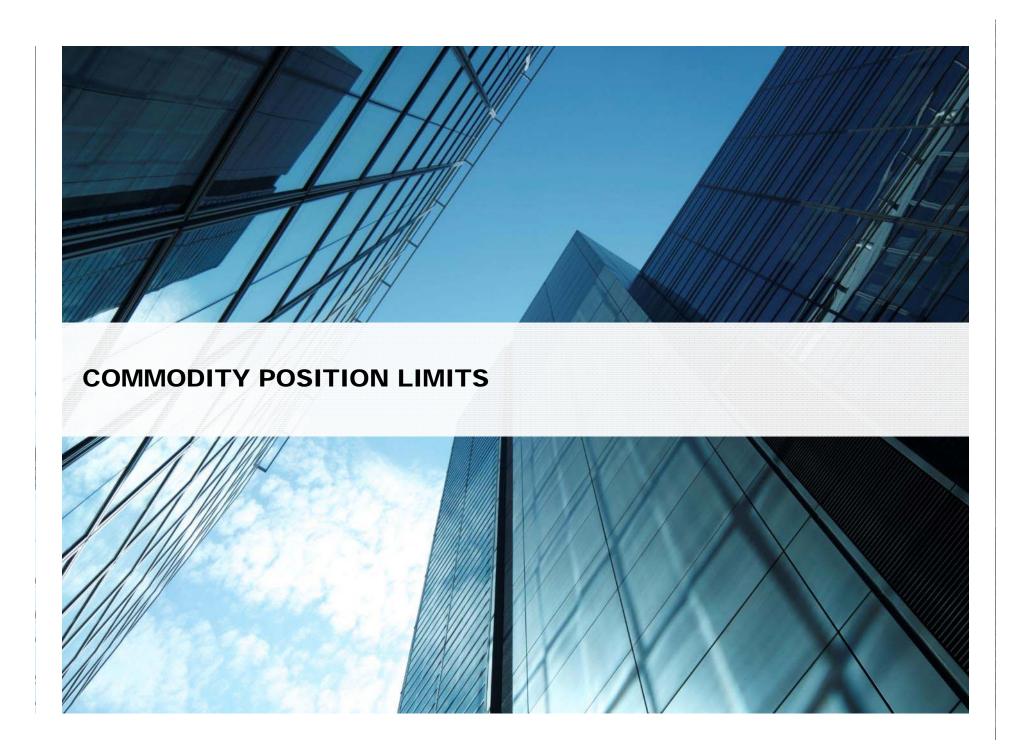
Like the clearing obligation in EMIR, the derivatives trading obligation applies to financial and nonfinancial counterparties, including counterparties outside the EU



Scope: qualifying counterparties

- Both counterparties must be 'qualifying' counterparties'
 - Financial counterparties (FC)
 - Non-financial counterparties above the clearing threshold (NFC+)
 - A third country entity (TCE) that would be FC or NFC+ if established in the EU
 - Two TCEs, if the transaction has 'direct, substantial and foreseeable effect' in the EU





POSITION LIMITS - AN OVERVIEW

EU national competent authorities will establish and apply position limits on the size of a net position which "any person" can hold at all times

Calculating the net position ...

Subject of the Limits

positions held by that person in commodity derivatives traded on EU trading venues and economically equivalent **OTC** contracts

Aggregation

those held on its behalf at an aggregate group level

Non-financial entity hedge exemption

Positions objectively measurable as reducing risks directly related to the commercial activity of nonfinancial entity

POSITION MANAGEMENT AND **REPORTING**

Impact on Asian firms trading commodity derivatives arising from obligations on EU trading venues:

Position management

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

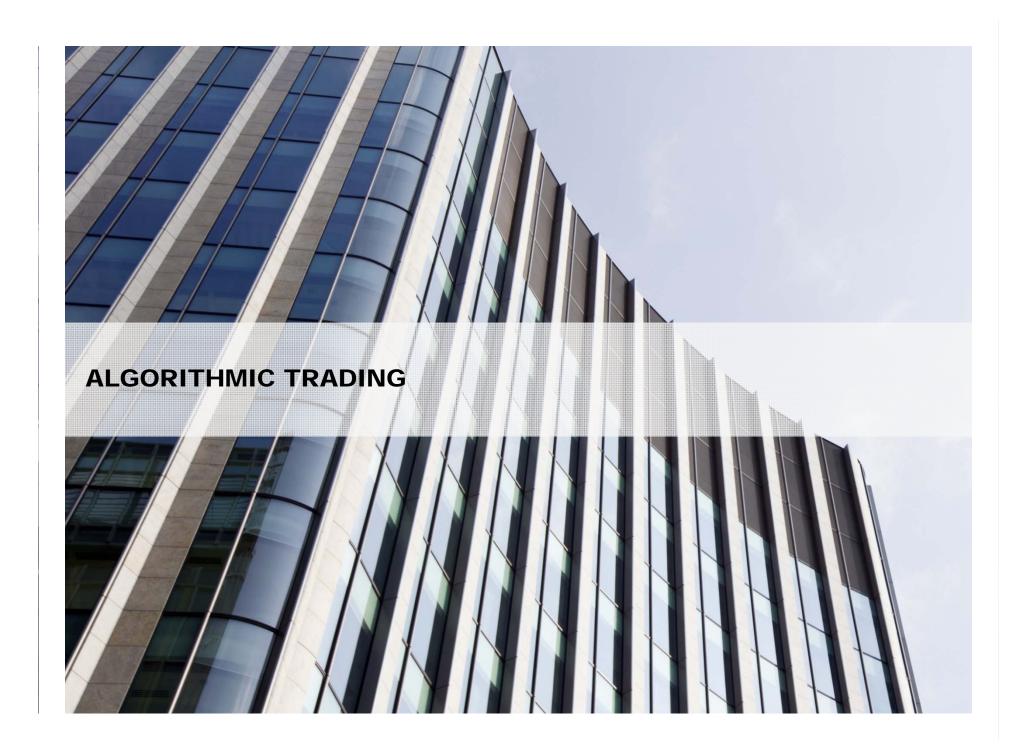
- Monitor open interest;
- Access information about size and purpose of a position;
- Require a person to terminate or reduce a position;
- Require a person to provide liquidity

Position reporting

Operators of EU trading venues trading commodity derivatives must:

- Weekly: make a public report of aggregate positions by class of person
- Daily: provide a complete breakdown of all positions (participants, clients, clients of clients) to competent authority
- Require participants to provide them with necessary information to enable them to report#

Daily position reporting requirements also apply to EU investment firms and disclosures can capture positions of end clients, even if outside the EU



ALGORITHMIC TRADING

What is algorithmic trading?

- Algorithmic trading
 - trading in financial instruments
 - computer algorithm automatically determines individual parameters of orders
 - with limited or no human intervention
- High frequency algorithmic trading techniques
- Direct electronic access (DMA / sponsored access)

What are the obligations?

- Systems and controls, user testing, kill functionality, business continuity
- Notify competent authorities (competent authorities may request further details)
- Record keeping obligations
- Liquidity provision obligation where market making
- Effective systems and controls regarding DMA / sponsored access

Potential indirect impact

- Asian firm engaging in algorithmic trading on an EU trading venue
- Asian firm accessing EU trading venue via DEA
- EU firm / affiliate using an algorithm developed by Asian firm



KEY TERMS - MANUFACTURERS AND DISTRIBUTORS

Manufacturer

■ Manufacturing "encompasses the creation, development, issuance and/or design of financial instruments" (MiFID2 Delegated Directive)

Co-manufacturer

- May be multiple manufacturers, e.g. issuer SPV, sponsor, third parties involved with aspects of product design
- Co-manufacturers collaborate with the manufacturer to create, develop, issue and/or design a product
- Requirement to set out mutual responsibilities in a written agreement indirect impact on comanufacturers not directly subject to MiFID2

Distributor

Distributor offers or recommends financial instruments

ARE MIFID2 PRODUCT GOVERNANCE RULES RELEVANT TO ME?

Scenario 1 - EU manufacturer



Scenario 2 - EU distributor



OBLIGATIONS ON MANUFACTURERS AND DISTRIBUTORS

The MiFID2 Delegated Directive sets out product governance obligations for EU 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?

REGULATORY POWERS

Product intervention/banning powers under MIFIR may have an indirect impact on Asian manufacturers (and distributors, if distributing into the EU)

MIFIR allows for both national action and co-ordinated EU responses

Aim: to reinforce supervisory powers and strengthen investor protection

ESMA power to temporarily ban or restrict the marketing, sale or distribution of certain financial instruments or types of financial activity or practice EBA power to temporarily ban or restrict the marketing, sale or distribution of particular structured deposits or a form of financial activity or practice

Powers for national regulators to ban or restrict the marketing, sale or distribution of certain financial instruments or structured deposits or types of financial activity

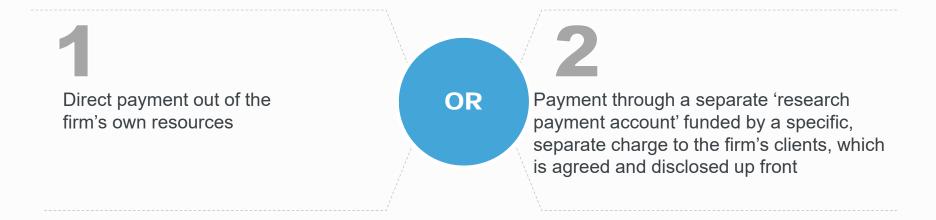
Key issues:

- · Product provider vs. distributor responsibility
- Regulatory scrutiny and challenges of product design will increase before a product is brought to market
- Should firms get pre-approval for product launches? Will this be possible?
- · Retail vs. wholesale markets
- What if investors are already in a product? Will agreements be unenforceable?



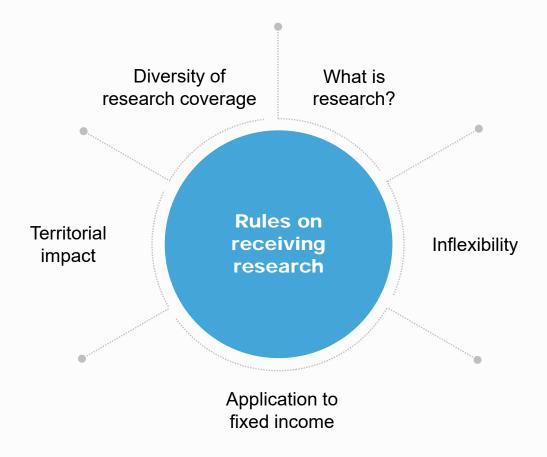
CREATING A 'HARD DOLLAR' RESEARCH MARKET

The MiFID2 Delegated Directive sets out two permissible payment structures for research:



The restriction applies to the EU firm receiving research **BUT** indirect impact on Asian firms providing research to EU clients under commission sharing arrangements or sharing research within a global group

KEY ISSUES





BRANCH REGIME

Scope

- Member states may require TCFs 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
- Current UK position preserving the status quo?



CROSS-BORDER REGIME

Registration with ESMA

- TCF registered with ESMA may provide services on a crossborder 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 TCF 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 TCFs to provide cross-border services to eligible counterparties and per se professionals under national regimes



CROSS-BORDER REGIME

(CONTINUED)

Effect of equivalence decision

- ESMA-registered TCFs 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)
- TCFs with MiFID2 branch in one member state can provide crossborder services to eligible counterparties/per se professionals in other member states on the basis of rules in branch state (subject to prior notice)
- TCFs can continue to provide cross-border services in Member States in accordance with national regimes for 3 years after an equivalence decision has been reached

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