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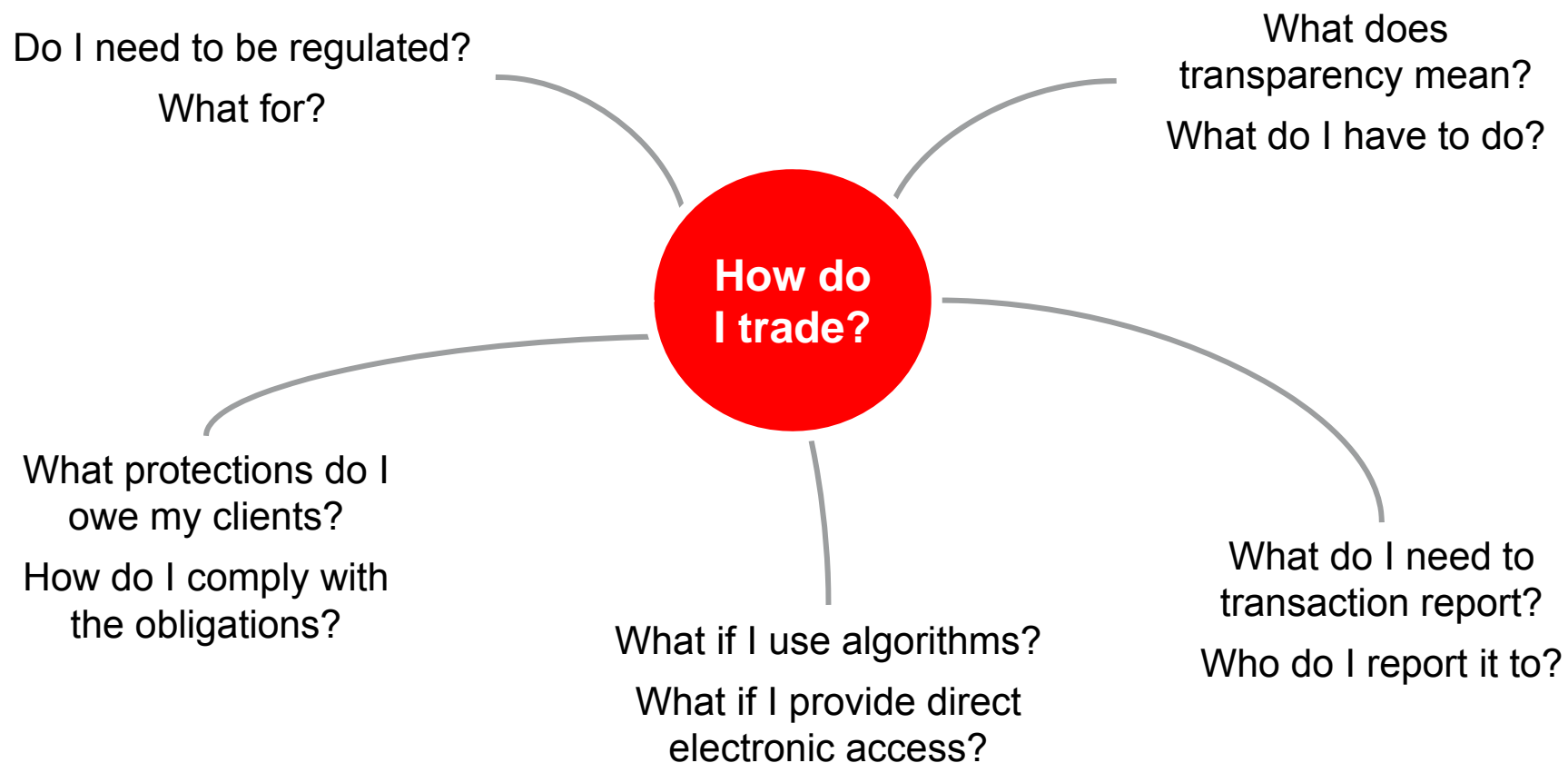
MiFID II / MiFIR seminar

Break-out session 1 – The Institutional Landscape

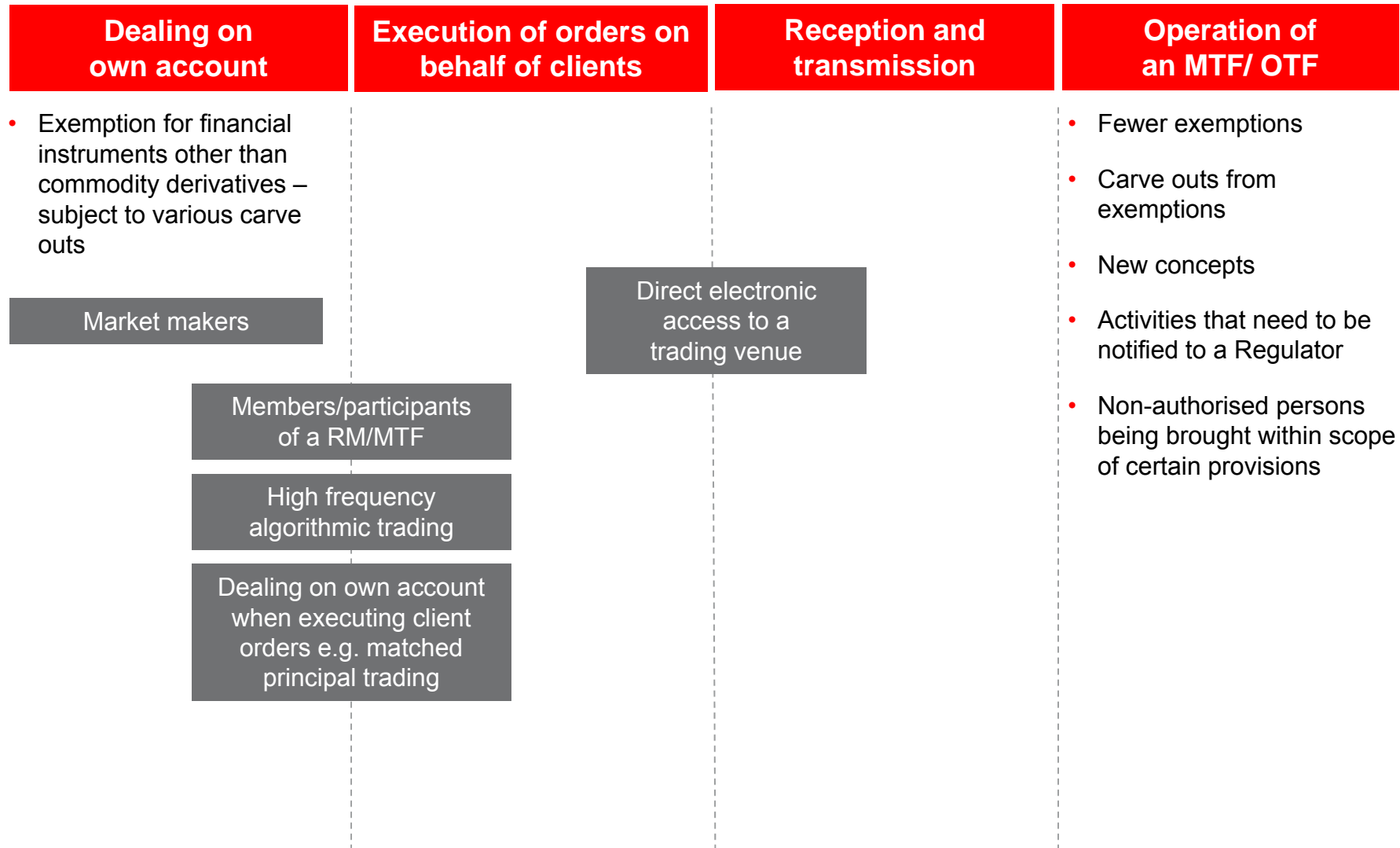
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15 October 2014

MFC 60.66

Overview



Investment services and activities: regulatory creep



Conduct of Business

Overview:

- Headline changes to the MiFID regime centre on market infrastructure and third country access
- BUT in a post-crisis reaction:
 - there are a **significant number** of micro changes being made to the existing investor protection regime; AND
 - there are a small number of new **macro changes** being introduced to the existing investor protection regime
- Together snowball into **significant regulatory reform** in the way firms conduct their business

Where are we at?

- Level 1:
 - finalised and adopted
 - into force 3 Jan 2017
- Level 2:
 - The devil is in the detail!
 - ESMA's proposes to **significantly alter** the agreed Level 1 landscape

What everyone should know by now...

Finalised Level 1:

<p>Client categorisation</p> <p>Discreet change:</p> <ul style="list-style-type: none"> - treatment of municipalities and local public authorities - extend the requirement to act honestly, fairly and professionally to ECPs 	<p>Client order handling</p> <p>No significant change to MiFID I</p>	<p>Conflicts of interest</p> <p>No significant change to MiFID I</p>
<p>Record-keeping</p> <p>No significant change to MiFID I</p>	<p>Inducements by firms (other than portfolio managers / independent advisers)</p> <p>No significant change to MiFID I</p>	<p>Client assets</p> <p>No significant change to MiFID I</p>
<p>Suitability</p> <p>Minor changes in relation to suitability reports and to the extent of information required to be obtained to assess suitability</p>	<p>Complaints handling</p> <p>No significant change to MiFID I</p>	<p>Financial promotions</p> <p>Extend the fair, clear and not misleading communication requirement to ECPs</p>
<p>Reporting and information</p> <p>No significant change to reporting requirements but extension to ECPs</p> <p>Enhancement of the information required to be provided to clients (including ongoing suitability reporting and reporting to ECPs)</p>	<p>Appropriateness / execution-only</p> <p>Appropriateness test is not changing</p> <p>List of 'non-complex' financial instruments being narrowed</p>	<p>Best execution</p> <p>Significant changes:</p> <ul style="list-style-type: none"> • new transparency requirements imposed • firms to take all "sufficient" steps • firms that RTO/place to have policies • policies to be more detailed

Key: ● Significant change compared to MiFID I ● Moderate change compared to MiFID I ● Minor / no changes compared to MiFID I

Implementing measures

Proposed Level 2:

<p>Client categorisation Proposes to narrow who can qualify as an elective ECP</p>	<p>Client order handling No changes proposed</p>	<p>Conflicts of interest Significant changes proposed: <ul style="list-style-type: none"> disclosure as a 'last resort'; over-reliance on disclosure implies conflict of interest policy is deficient bespoke (not generic) disclosure warning to be included in disclosures policies reviewed / updated frequently <u>Hot Topic</u>: placing and underwriting </p>
<p>Record-keeping Proposed extension of regime: <ul style="list-style-type: none"> minimum, non-exhaustive list of the types of records to be kept content of records prescribed duration prescribed </p>	<p>Inducements by firms (other than portfolio managers / independent advisers) Significant tweaks proposed, including: <ul style="list-style-type: none"> 'quality enhancement' test clarified further ESMA Recommendations and Guidelines to be developed 'minor non-monetary benefit' excluded as an inducement <u>Hot Topic</u>: treatment of research </p>	<p>Client assets Significant changes proposed, including: <ul style="list-style-type: none"> new dedicated officer responsible for client assets further restrictions on title transfer collateral arrangements requirements related to securities financing transactions, diversification, intra-group deposits, custody liens, etc. </p>
<p>Suitability Enhancements proposed include: <ul style="list-style-type: none"> proposals in relation to suitability assessments prescribe suitability report content prescribe requirements for periodic suitability reports </p>	<p>Complaints handling Enhancements proposed include: <ul style="list-style-type: none"> requirements for written complaints handling procedure and specific requirements in relation to firms' handling of complaints ESMA potentially producing more guidelines in future currently applies to all clients </p>	<p>Financial promotions Significant changes proposed: <ul style="list-style-type: none"> extending retail-like obligations to professional clients and ECPs </p>
<p>Reporting and information Significant extensions proposed: <ul style="list-style-type: none"> prescriptive requirements for reporting to clients - ESMA proposes that ECPs can 'opt-out' from certain requirements content, format, extent of information provided to clients prescribed <u>Hot Topic</u>: transparency of costs – link with PRIIPs </p>	<p>Appropriateness / execution-only Minor extension to include a further two criteria for determining when an instrument is 'non-complex'</p>	<p>Best execution Significant enhancements proposed including: <ul style="list-style-type: none"> additional transparency and disclosure requirements customised best execution policies separate summary sheet for retail clients no clarity on test of 'all sufficient steps' </p>

Key: ● Significant change compared to Level 1/MiFID I ● Moderate change compared to Level 1/MiFID I ● Minor / no changes compared to Level 1/MiFID I

Implementing measures

Impact on UK firms:

<p>Client categorisation</p> <p>Impact on firms who deal with municipalities, local public authorities and elective ECPs:</p> <ul style="list-style-type: none"> reassess client to see if qualifies in current client categorisation and, if not, recategorise may need to cease business with that client if permission profile not sufficient 	<p>Client order handling</p> <p>No change for UK firms</p>	<p>Conflicts of interest</p> <p>Depending on a firm's existing practices, either moderate change or significant:</p> <ul style="list-style-type: none"> review existing prevention measures update policies create disclosure documents for different client types/investment strategies consider how to ensure disclosure is used as a 'last resort' / balance against common law disclosure requirements
<p>Record-keeping</p> <p>Minor changes to existing record-keeping requirements may be needed once Level 2 finalised but UK super equivalent already</p>	<p>Inducements by firms (other than portfolio managers / independent advisers)</p> <p>Significant impact:</p> <ul style="list-style-type: none"> effectively 'killing' free research COBS 2.3 table to align to ESMA table 	<p>Client assets</p> <p>UK regime is already super equivalent</p> <p>New Client Assets Rules from PS14/9 already in force and coming into force Dec 2014 and June 2015 already represent significant impact to UK firms</p>
<p>Suitability</p> <p>Minor impact on UK firms – required to update suitability assessment material, review client facing documentation and consider whether 'churning'</p>	<p>Complaints handling</p> <p>Impact on UK firms:</p> <ul style="list-style-type: none"> if ESMA applies complaints handling process to retail clients only, little impact for UK firms but if applied to professional clients as well, moderate changes. Questionable if workable in practice no clarity on what amounts to a "complaint" 	<p>Financial promotions</p> <p>Impact on UK firms:</p> <ul style="list-style-type: none"> communications to professional clients will be almost indistinguishable from communications to retail clients communications with ECPs will need to be assessed to be fair, clear and not misleading
<p>Reporting and information</p> <p>Significant impact:</p> <ul style="list-style-type: none"> more detailed information provided more frequently to professional / retail clients new information / reports to ECPs PRIIPs: more disclosure (KIDs) <p>Tension: FCA separated cost of advice from product charges with RDR – Level 2 and PRIIPs associates them</p>	<p>Appropriateness / execution-only</p> <p>Impact on UK firms who provide execution-only services – reassess what amounts to a non-complex instrument</p>	<p>Best execution</p> <p>Significant impact:</p> <ul style="list-style-type: none"> additional transparency requirements and data / reporting requirements customised best execution policies separate summary for retail clients additional disclosure, recordkeeping no clarity on test of 'all sufficient steps' <p>Plus: FCA Thematic Review on Best execution (July 2014)</p>

Key: Significant change to MiFID I as implemented in UK Moderate change to MiFID I as implemented in UK Minor / no changes to MiFID I as implemented in UK

Research as an inducement

Level 2 (proposed)

ESMA's proposal: research is an inducement

To qualify as a 'minor non-monetary benefit':

- cannot impair duty to act in the **best interests of clients**;
- must be intended for **wide distribution** (lots of firms / public)
- **cannot allocate resource** to produce research for one firm;
- volume / quality of research **cannot be linked to volume** of transactions placed with that firm;
- content **cannot be tailored / bespoke** nor can its distribution or access be **restricted**.

Firms can still contract for, and buy, research:

- at **reasonable price** (essentially market rates);
- provided it is **not linked** to:
 - volume / value of transactions placed with that firm
 - needing to buy other services from that firm

SO ESMA's proposes that any "value-added" research will not be a minor non-monetary benefit.

Best execution

Level 1 (finalised)

New requirements on firms and trading venues

Firms must take all 'sufficient' steps to obtain best execution – uplift from 'reasonable' but little detail on change in standard

Requirement to produce data:

- Execution venues must publish data on quality of execution of transactions on that venue – at least annually
- Firms shall inform the client where an order was executed
- Periodic reports shall be provided with details on price, costs, speed and likelihood of execution for individual instruments
- The top five execution venues in terms of trading volumes in the preceding year
- Information on the quality of execution

Firms will also have to review the execution policy in light of the execution statistics

Will need to demonstrate best execution to regulators

Notify ongoing clients of material changes to the policy

Level 2 (proposed) ESMA's proposal:

Detailed and specific best execution policies

- **Customised** depending on the class of instrument and the service being provided
- List execution venues

Additional disclosure obligations

- Include information about third party payments
- Present costs of execution venues alongside other features of those venues, so that the focus of the client is not solely on the cheapest venue
- Indicate in the policy if the client's order may be executed outside a regulated market, MTF or OTF
- Guidance on 'material change' for review requirements

Firms will need to clarify to clients how they satisfy the best execution obligations when using **a single venue** or entity for execution

Reporting to clients

Level 1 (finalised)

- **minor changes** made to the current regime
- general reporting requirements now being **extended to eligible counterparties**
- new requirement for reports to include **periodic communications to clients**, taking account of the instrument type/complexity and the service provided
- requirement for reports to include the **costs of transactions and services undertaken**

Level 2 (proposed)

- firms to **agree nature and timing of reporting with eligible counterparties**
- **T+1 time limit for execution reports** to professional clients, and alignment of content for with **retail client standards**
- **portfolio management reports** to include information about activities undertaken and portfolio performance – frequency to be quarterly (and not six-monthly)
- firms to agree with retail clients for portfolio management, or whose accounts include leveraged instruments/contingent liability transactions, **thresholds which will trigger loss reporting**
- **client asset and funds statements at least quarterly**, and more frequently on request
- **client asset and funds statements** to state which assets are **not protected** (e.g. subject to TTCA), are subject to **security interests** and **market/estimated values**
- requirements for reporting **costs and charges**

Conflicts of interest

- MiFID II will strengthen current rules, but the real change is the new regulatory scrutiny of this area – rather than new rules
- In this, as in other areas, MiFID II addresses perceived failures in the implementation of MiFID I

- Firms should consider:
 - their record keeping practices and audit trail
 - conflicts policies: how comprehensive are they, and what level of detail will be expected in the new environment?

- Periodic reviews of their operations to identify new conflicts that need to be managed or disclosed
- Gifts and entertainments policies
- Remuneration structures
- Information and physical barriers, as well as electronic separation

- Staff training
- Restrictions on staff outside interests
- Independent management structures and reporting lines
- Personal account dealing policies
- Conflicts management committees

Conflicts: key points from ESMA

- ESMA proposed amendments to Article 22 of the MiFID Implementing Directive – intended to clarify / supplement, rather than replace, existing provisions – ESMA sees itself as **addressing uncertainty**
- Reiteration that disclosure to clients should be a measure of **last resort** – firms should not over-rely or use disclosure as a self-standing measure
- The first step for firms should be to consider what additional reasonable measures and arrangements can be put in place – NCAs requesting evidence from firms

- Disclosure should be used only where the firm's arrangements are **not sufficient** to ensure, with reasonable certainty, that damage to client interests is prevented
- **Where disclosure is required, disclosures must clearly state that the firm's arrangements are not sufficient**
- Disclosure must be made in a **durable medium**, and include a specific description of the conflict – taking account of the nature of the client
- NCAs have found disclosures to be too generic and unclear: not just an issue for the retail sphere

- Disclosures must explain the nature and/or sources of the conflict, the risks to the client and the steps taken to mitigate them – sufficient detail is needed to enable client to make **informed investment decisions**
- Proposal to formalise a requirement for **periodic** (and at least annual) review of conflicts policies
- ESMA sees this as a **concretisation** of existing business practice

- Feedback was invited from stakeholders in relation to the continued appropriateness of existing requirements that:
 - specify the situations firms must take into account when identifying conflicts (Article 21 MiFID Implementing Directive)
 - specifically impose requirements relating to the provision of investment research, including additional organisational requirements (Articles 24 and 25 MiFID Implementing Directive)

Algorithmic trading

“trading where a computer algorithm automatically determines ... parameters of orders such as whether to initiate the order, the timing, price or quantity ... or how to manage the order after submission, with limited or no human intervention”

It does not include a system only used to:

- route orders to trading venue(s)
- order processing where there is no determination of parameters
- order confirmation or post-trade processing of transactions

Algorithmic trading sub-sets

High frequency algorithmic trading technique (HFATT)

- Infrastructure that is intended to minimise latencies, including at least one of:
 - co-location
 - proximity hosting or
 - high-speed direct electronic access
 - System determination of order initiation, generating, routing or execution without human intervention for individual trades or orders and
 - High message intraday rates which constitute orders, quotes or cancellations
- Option 1 – specified parameters for colocation, latency and message frequencies based on German HFT package
 - Option 2 – daily lifetime of orders modified or cancelled shorter than median on trading venue
 - Engaging in HFATT on one trading venue or through one trading desk triggers requirements across the EU

Market making strategy

“as a member of a trading venue, its strategy, when dealing on own account, involves posting firm, simultaneous, two-way quotes of comparable size and at competitive prices relating to financial instruments on trading venues, with the result of providing liquidity on a regular and frequent basis”

Algorithmic trading: obligations on investment firms

Internal systems and controls requirements	<ul style="list-style-type: none"> • Trading systems must: <ul style="list-style-type: none"> – be resilient and have enough capacity – be subject to appropriate trading thresholds and limits – prevent the sending of erroneous orders – not function in a way that contributes to a disorderly market – not be able to be used for any purpose that is contrary to the rules of the relevant trading venue • Must have effective business continuity arrangements to deal with system failure • Ensure trading systems are tested and monitored • Records sufficient for competent authority to monitor compliance and kept at least 5 years
Regulatory requirements	<ul style="list-style-type: none"> • Notify competent authority of home member state and trading venue • Competent authority can require details of algorithmic trading strategies (and above systems and controls), and any other relevant information
High frequency trading technique	<ul style="list-style-type: none"> • Keep accurate and time sequenced records of orders, cancellations, executions and quotes • Cannot rely on exemptions so will need to be authorised
Market making strategies	<ul style="list-style-type: none"> • Must carry out continuously during a specified proportion of trading venue's hours • Binding agreement with trading venue • ESMA proposes at least quoting and organisation requirements
ESMA proposals	<ul style="list-style-type: none"> • Minimum requirements based on ESMA Guidelines but firms to assess whether compliance is proportionate to nature, scale and complexity of firm's business and establish more stringent requirements if appropriate • Assessment to be signed off by management, reviewed at least twice yearly and audited – firms must justify any requirements considered not applicable • ESMA proposals include detailed testing requirements, flagging of different algos, traders and clients, kill button, real time alerts and monitoring, twice yearly review of algos, detailed IT requirements, specified pre-trade controls, systems to flag potential market abuse suspicions on a T+1 basis and reconciliation with external records

Direct electronic access

“an arrangement where a member or participant or a client of a trading venue permits a person to use its trading code so the person can electronically transmit orders relating to a financial instrument directly to the trading venue and includes arrangements which involve the use by a person of the infrastructure of the member or participant or client, or any connecting system provided by the member or participant or client, to transmit the orders (direct market access) and arrangements where such infrastructure is not used by a person (sponsored access)”

- ESMA is of the view that it:
 - includes automated order routing systems where client transmits order to market maker intermediary’s system, which is automatically transmitted to market for execution
 - does not include web based interfaces where electronic access to market is shared with other clients through a common connectivity channel and no specific capacity and latency is provided to any particular client

Direct electronic access

Regulatory status

Authorised as RM or investment firm operating MTF or OTF

Trading Venue
RM, MTF or OTF

Must be authorised credit institution or investment firm
Must be a member or participant of trading venue
Must notify own competent authority and that of trading venue – they may require information on systems and controls

Member
DEA Provider

Cannot be exempt by Art 2(1)(d) MiFID II but other exemptions may possibly apply e.g. Art 2(1)(j)
DEA Provider would have to take into account regulatory status of DEA User

Client
DEA User

Underlying Client
DEA User?

Main responsibilities

Only allow member/participant/client to provide DEA if:

- they are authorised credit institution or investment firm
- they retain responsibility for orders and trades in relation to MiFID II

Ensure clients using DEA comply with the requirements of MiFID II and rules of trading venue

Must have an agreement with trading venue setting out rights and obligations but DEA Provider must retain responsibility under MiFID II

DEA Provider retains responsibility for orders submitted and trades executed through the use of its DEA systems or trading codes

Monitoring and reporting to competent authority – breach of MiFID II or trading venue rules, disorderly trading, market abuse

Systems – to ensure suitability of clients, risk controls, thresholds

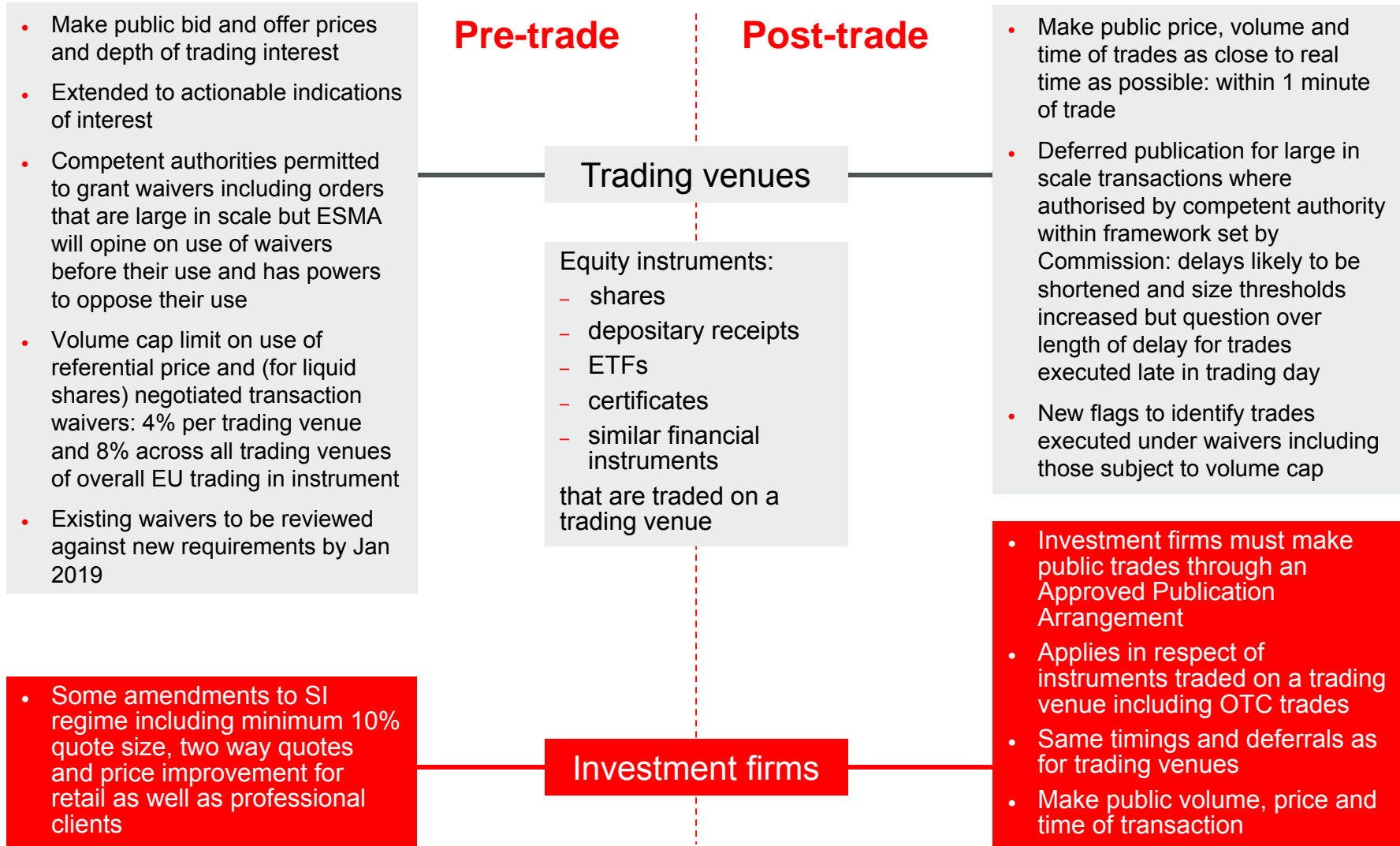
Controls in relation to sponsored access to be at least equivalent to direct market access

Record keeping – to enable competent authority to monitor compliance

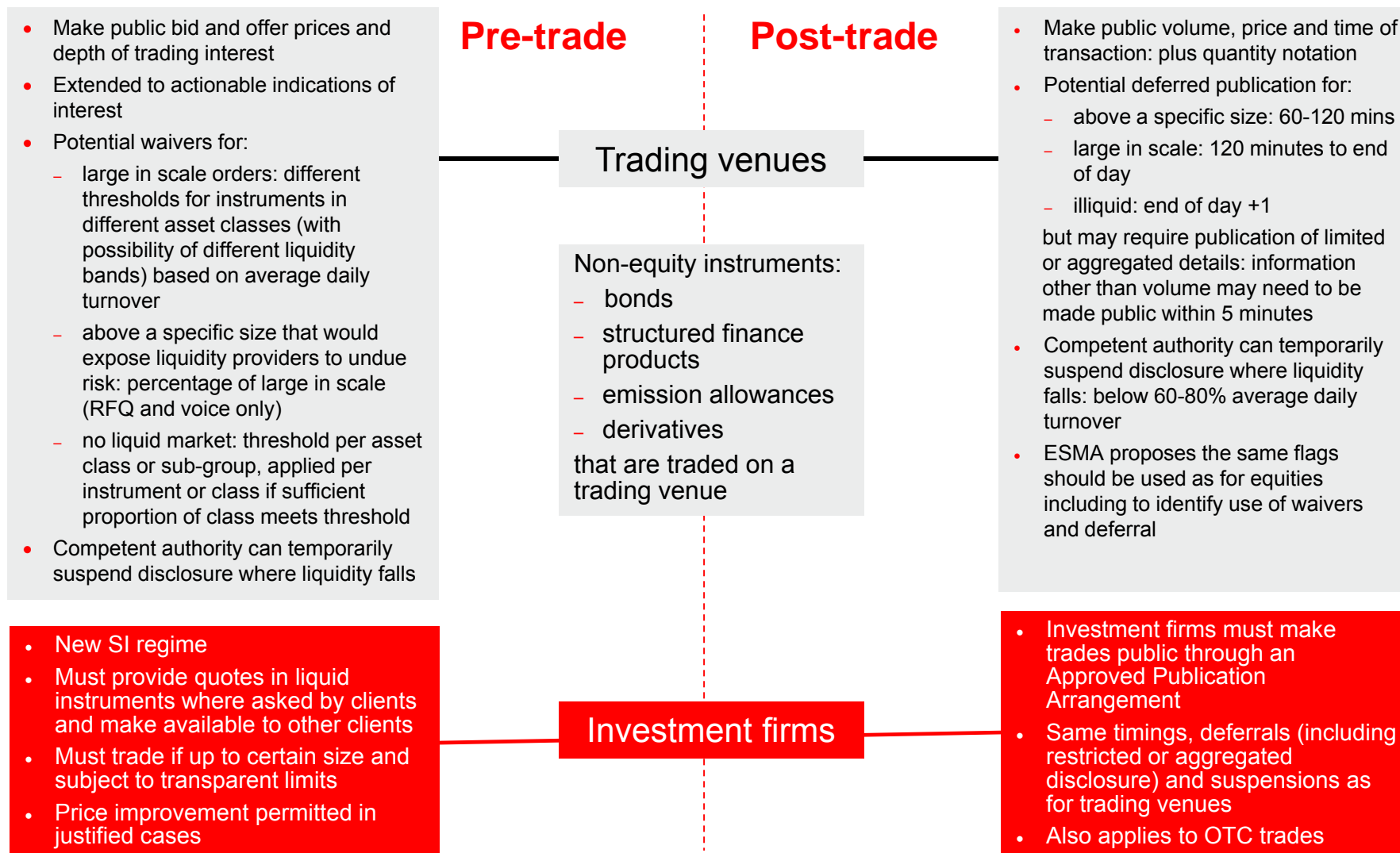
Direct electronic access: obligations on firms

Internal systems and controls requirements	<ul style="list-style-type: none">• Ensure proper assessment and review of suitability of clients using the service• Clients are prevented from exceeding pre-set trading and credit thresholds• Proper monitoring of trading by clients• Appropriate risk controls to prevent:<ul style="list-style-type: none">– risks to investment firm– creation or contribution to disorderly markets– breaches of the market abuse regime– breaches of the rules of the trading venue• Records sufficient for competent authority to monitor compliance – at least 5 years
Documentation requirements	<ul style="list-style-type: none">• Binding written agreement with the client• Investment firm must retain responsibility for its compliance with MiFID
Regulatory requirements	<ul style="list-style-type: none">• Competent authorities of home member state and trading venue• Competent authority can require description of the systems and controls and evidence that they have been applied
ESMA proposals	<ul style="list-style-type: none">• DEA providers are responsible for client trading – need procedures to ensure compliance• Undertake and periodically review due diligence on DEA users – expect equivalent systems as client would have if it were a direct market member• Pre-trade controls including automatic rejection of orders outside certain price and size parameters• Ability to separately identify each DEA user and halt their trading and require DEA users to register their algos

Transparency for equity instruments



Transparency for non-equity instruments



Transaction reporting for investment firms

Which trades?	<ul style="list-style-type: none"> • Investment firms that execute transactions in financial instruments: <ul style="list-style-type: none"> - that are admitted to trading or traded on a trading venue or for which a request has been made - where the underlying is a financial instrument traded on a trading venue - where the underlying is an index or basket of financial instruments traded on a trading venue
To whom?	<ul style="list-style-type: none"> • Must be reported to competent authority as quickly as possible and no later than end of next working day in electronic and machine readable form • Branches must report to home competent authority which will share information with other relevant authorities
Which information?	<ul style="list-style-type: none"> • More information to be provided than previously – ESMA proposes up to 93 fields – including client ID, and IDs of trader and algo responsible for decision and execution • ESMA suggests 4 tier approach to identifying individuals and using LEIs or BICs for legal entities
How?	<ul style="list-style-type: none"> • Firms that transmit orders will have to transmit list of information proposed by ESMA or report trades themselves • Firms can report themselves or through an ARM or trading venue – they must take reasonable steps to ensure compliance where they don't report themselves and remain responsible • Trading venues will report trades executed by firms not subject to reporting obligation
Who must report?	<ul style="list-style-type: none"> • Wide definition of execution: any action that results in a transaction – i.e.. a change in the firm's or client's position • Does not matter whether action is performed directly by firm or through third party or whether as principal or agent
Link to EMIR?	<ul style="list-style-type: none"> • Transactions reported to a trade repository under EMIR count provided: <ul style="list-style-type: none"> - that trade repository is also an ARM - the report contains all the required details - trade repository transmits information to competent authority

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