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# MiFID II / MiFIR: Your Survival Guide

## Market Structures – Tying it All Together

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15 October 2014

# Introduction

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# Tying it all Together – Market Structure Themes

- **Classification of structural entities / players**
  - The OTF category is being introduced into an already complex environment, featuring trading venues spanning all asset classes across the EU. It remains to be seen whether re-classification – of single dealer platforms, broker crossing networks, MTFs and third country platforms such as SEFs – will represent greater opportunity for flow, or impact the executable liquidity in non-equity markets
  - One thing is for certain – the complexity of quote-driven markets is about to increase
- **End of the OTC, bilateral world?**
  - The implementation of MiFID II will introduce, e.g., auction systems competing with dealer pricing, as products formerly traded OTC follow equities towards trading on venues
  - Impact of areas such as collateralisation and the “futurisation” of formerly traded OTC instruments
  - Evolution of OTC dealers to full market makers or more hybrid systems
- **How do we create sufficient liquidity in this landscape?**
  - MiFID II will stimulate a high degree of trading process changes over the next several years, including multiple types of competing trading venues with the potential for order-driven and quote-driven models
  - If MTFs/OTFs will be suitable platforms for HFT in non-equities trading, volumes could increase in these products as a result of substitution
- **Front-to-back infrastructure impact – is it all downside?**

**MiFID II/MiFIR**

Systematic Internalisers (SIs) execute client orders outside RM, MTF or OTF on an organised, frequent  systematic and substantial basis

SIs under pressure to move trades on market for both equities and derivatives

**MAR**

Broader scope to cover MTF and OTF traded instruments and related instruments

Captures spot commodity markets if related to a financial instrument subject to REMIT

Covers providing false or misleading inputs to, or manipulating, a benchmark

**REMIT**

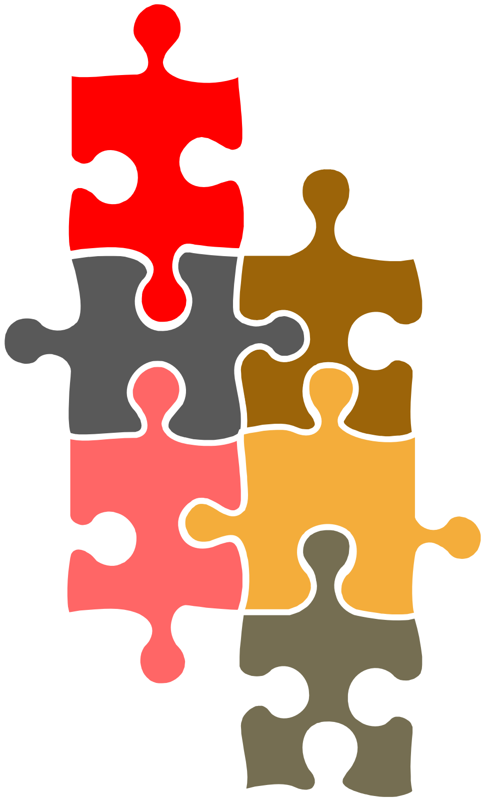
Market abuse provisions for electricity and gas markets based on MAD

Wholesale energy markets use both derivative and commodity trading; therefore, the approach to market manipulation and insider trading should be aligned and compatible between markets

Obligation to provide details of wholesale energy transactions to ACER

Reporting may be made via third party, trade reporting system or organised market (RM, MTF or OTF)

Reports made under MiFID or EMIR do not need to be double reported



**EMIR**

Uses MiFID definition of derivatives

Transitional exemption for oil and coal contacts that are traded on an OTF but must be physically settled from MiFID II

Changes in MiFID II financial instruments and exemptions will require firms to check their categorisations and re-do their clearing threshold calculations

**MiFID II/MiFIR**

Mandatory on-platform trading obligation applies to same counterparties as EMIR and selection of derivatives piggy backs off EMIR process

MiFIR transaction reporting links with position reporting to trade repositories

Various post-trade obligations reflect EMIR concepts e.g. open access, indirect clearing, compression

**Benchmarking**

New EU benchmark regulation in process

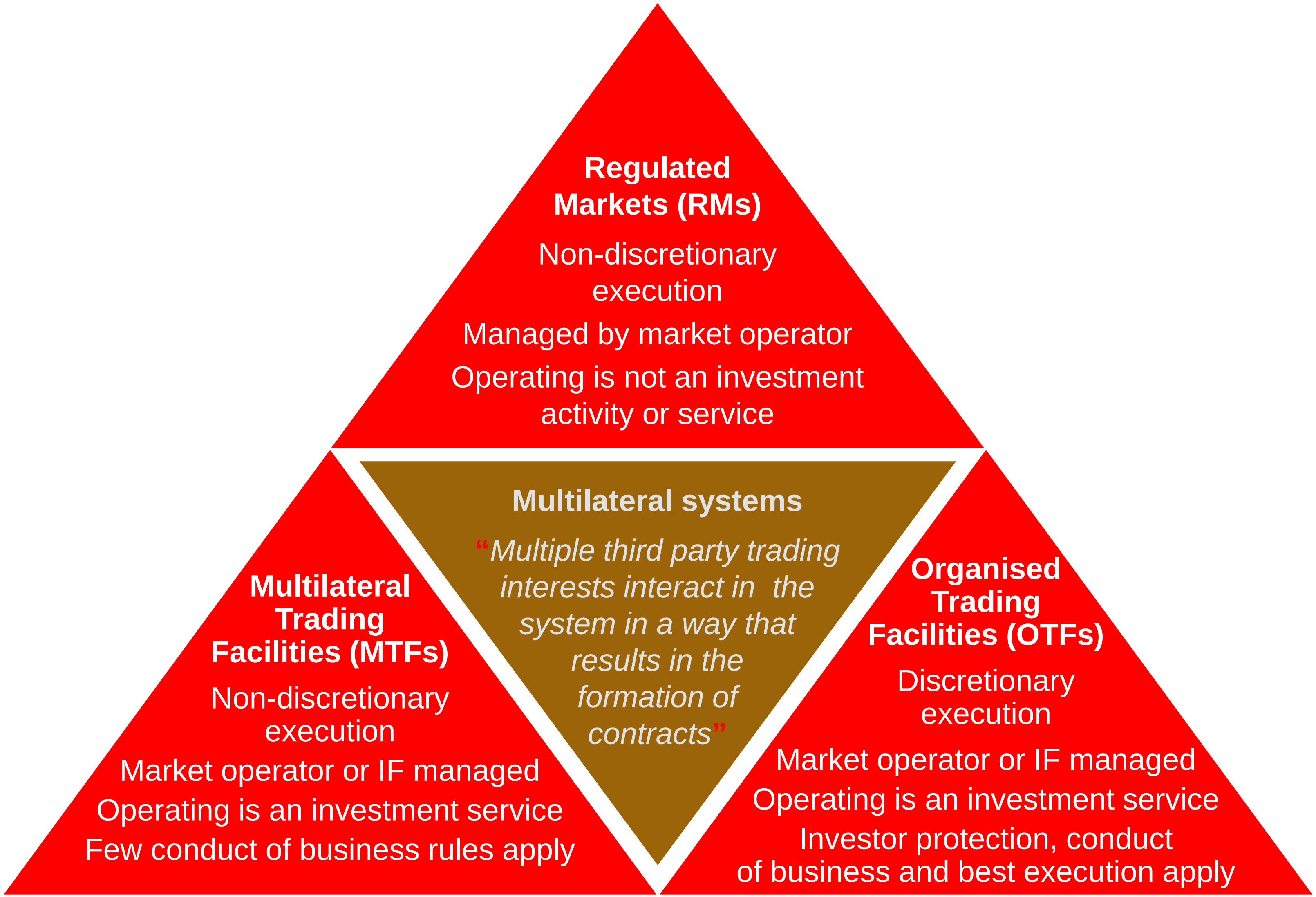
New systems and controls requirements for submitters and administrators

MiFIID II contains a package of provisions on enabling access to information on financial markets

Access covers the license and information on the composition, methodology and pricing of benchmarks for the purposes of clearing and trading

# Trading Venues & Systematic Internalisers

# Trading venues - new concepts and boundaries



# Where will you be able to trade under MiFIR?

## Equities

- **What?** Shares admitted to trading on a regulated market or traded on an MTF
- **Where?**
  - Regulated Market, MTF, Systematic Internaliser
  - Equivalent third country trading venue
- **Who?** Transactions between:
  - Two Investment Firms
  - Investment Firm & a non-Investment Firm

  Only investment firms can be direct members of trading venues

- **Trading obligation does not apply to trades that are:**
  - Non-systematic, ad hoc, irregular and infrequent;
  - Carried out between eligible and/or professional counterparties and does not contribute to price discovery;
  - In shares or equity instruments *not* admitted to trading on a regulated market or traded on an MTF; or
  - Between non-Investment Firms (only)

These parties / instruments can trade OTC

## Derivatives

- **What?** Derivatives that are traded on a trading venue that are sufficiently liquid and declared subject to the trading obligation
- **Where?**
  - Regulated Market, MTF, OTF
  - Equivalent third country trading venue
- **Who?** Transactions between:
  - An FC and another FC
  - An FC and an NFC+
  - An NFC+ and another NFC+

  (and third country entities that would be subject to clearing obligation)

- **Trading obligation does not apply to:**
  - Non-equity instruments that do not pass the liquidity test so have not been declared subject to the trading obligation
  - Any trade with an NFC- (including trades with an FC or NFC+)

These parties / instruments can trade OTC or on an SI

# The Trading Obligation

## Mandatory on-platform trading for derivatives under MiFIR

| | | | |
|---|---|---|---|
| **Trading Obligation Test** | • **Within a class of derivatives subject to the EMIR clearing obligation** | • **Traded on at least one RM, MTF, OTF or third country trading venue** | • **Considered sufficiently liquid to be traded only trade on these venues** |

- ESMA power to apply to derivatives not CCP cleared / traded on trading venue
- If within scope then must trade on RM, MTF or OTF (or third country equivalent)
- Same scope as EMIR in relation to counterparties:
  - Trades between financial counterparties and in-scope non-financial counterparties
  - Trades between an EU captured entity and third country entities that would be subject to EMIR
  - Trades between third country entities that would be subject to EMIR if they were established in the EU where their transactions could have a direct, substantial and foreseeable effect within EU or necessary to avoid evasion
  - Excludes certain intra-group transactions
- The only derivatives contracts that will in future continue to trade OTC are those that do not meet the test of being ‘clearing eligible and sufficiently liquid’
- Derivatives not subject to the trading obligation may be traded:
  - On a trading venue or OTC via a Systematic Internaliser (transparency obligations apply)
  - OTC *not* via a Systematic Internaliser (transparency obligations *do not* apply)

# IFs as Market Operators: MTF v OTF v SI v SEF:

| | MTF | OTF | SI | SEF |
|---|---|---|---|---|
| **Assets** | All financial instruments | Non-equities only | All financial instruments (but OTC only) | Swaps only |
| **Matching System** | Non-discretionary<br>CLOB only | Discretionary<br>CLOB, RFQ, RFS | Full discretion (bilateral)<br>RFQ, RFS | Discretionary<br>CLOB, RFQ, RFS |
| **Restrictions on Multilateral trading** | Cannot execute against own capital and no matched principal trading | Matched principal is allowed if client is informed<br>Market making must be independent | Cannot operate a multilateral trading system | Permits limited matched principal trading |
| **Other Restrictions** | Can operate an SI and can connect to SI | Cannot operate an SI and cannot connect to another OTF | Cannot operate an OTF | Limit on dealer ownership |
| **Participants** | Regulated only (not for commodity derivatives) | Can be unregulated | Clients only | Eligible Contract Participants |
| **Investor Protection** | Very few COB rules | Full COB rules apply including best execution | Full COB rules apply including best execution | Core principles apply; SEF has discretion to examine best practices and regulations |
| **Resilience** | Limited requirements (mainly HFT focus) | Limited requirements (mainly HFT focus) | Limited requirements (mainly HFT focus) | Detailed requirements |
| **Purpose of new rules** | Requirements have been aligned with those of RMs in order to create a more level playing field | Replace broker crossing networks | Replace broker crossing networks | Replace broker crossing networks, as well as regulate secondary markets for swaps |



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# IFs as Market Operators: Multilateral Trading Facility

- **New obligations for operators:** New regulations regarding algorithmic trading, high frequency trading (HFT), direct electronic access (DEA) and market making

- **Not yet an RM:**
  - Whilst many of the new requirements on MTFs align with equivalent provisions for RMs, MTFs remain subject to less onerous resilience requirements (such as those related to systems and circuit breakers). Most requirements for MTFs focus on HFT issues
  - Difference in regulatory approach to RMs despite legal convergence
- **Implications:** Is it a one-way journey towards becoming RMs?
- **MTFs & SEFs:** fragmentation of cross-border liquidity
  - The CFTC's 'QMTF' regime effectively became full compliance with Dodd-Frank
  - CFTC's no-action relief has since expired
  - Fragmented US / EU liquidity across multiple asset classes
  - **Solution 1**: an EU-based SEF-MTF (subject to dual regulation)
  - **Solution X:** another means to combine liquidity without dual regulation or cross-border issues?

# IFs as Market Operators: Organised Trading Facility

- **The great 'silence' at Level 2:** Will ESMA Q&A cover this point?
- **Discretion:** Two different levels for the operator of the system: deciding to **place or to retract** an order; and deciding **not to match**, or **if, when and how much to match** of two orders (broker crossing networks)
- **Matched principal trading:** Permitted in **bonds** and **non-cleared derivatives** and to **deal on own account in sovereign debt where no liquid market**.
- **Best execution:** Just on own venue or on **venues in general?** NB ban on OTFs connecting to other OTFs. Ability to have a front end smart order router unclear.
- **Unregulated participants: Permitted**, unlike RMs & MTFs (where they must be regulated, except for commodities derivatives (prop traders e.g., locals, may be unregulated provided they (a) do not execute client orders or (b) perform HFT)
- **Collateral impact:** Like MTFs, positions **count towards EMIR clearing threshold** (except physically settled gas & power forwards) unlike on an RM
- **Bureaucracy: "detailed explanation"** may be needed on why an RM or MTF has not been used

# IFs as Market Operators: Advantages of OTFs

- Trading venue operators can either concentrate on the percentage of the market which will trade on an RM / MTF or to also cater for those who would use an OTF
- Broadly, for non-commodity derivatives, members of MTFs or RMs must be regulated, whereas unregulated participants can use an OTF
- For commodities derivatives, the position is more nuanced; it appears that prop traders, e.g., locals, may be unregulated members of MTFs or RMs provided they (a) do not execute client orders or (b) perform HFT
- An OTF has a greater level of flexibility as it has discretion on order flow but has to be non-discriminatory
- Physically settled gas and power forwards traded on an OTF but not an MTF or RM will be outside MiFID II. The impact of this is that they are outside of the EMIR threshold calculation and the OTF debate



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# IFs as Market Operators: Disadvantages of OTFs

- Counts towards EMIR threshold (if outside narrow exception for gas / power forwards) unlike contracts on an RM
- Increased bureaucracy (particularly as it states a “detailed explanation” may be needed on why an RM or MTF has not been used)
- Full COB rules apply to operator, including best execution
- Issues over whether an OTF can connect with another OTF
- Reputational issues – does not have gold stamp of an RM (or possibly same reputation as MTF but this is more debatable)
- Does best execution mean best execution on your venue or best execution on venues in general?
- Equities are not going to be tradeable on an OTF

# IFs as Market Operators: Systematic Internaliser

- **Definition: "**An investment firm which, on an organised, frequent systematic and substantial basis deals on own account by executing client orders outside RM, MTF or OTF**"**
- **Equities:** Changes mean that SIs are likely to be more commercially attractive
  - Minimum quote sizes at least 10% of SMS
  - Old retail size limit has gone
  - Additional flexibility for professional client orders
- **Derivatives :** Flexibility on providing access in accordance with commercial policy provided that this is objective and non-discriminatory. Flexible criteria on discontinuing business relationship (e.g. credit rating or counterparty risk)
- **Discretion:** SIs can establish non-discriminatory and transparent limits on the number of transactions they undertake to enter into with clients for any quote
- **Commercial benefits:** Price improvement (without pre-trade transparency) is now permitted provided it is in a range close to market conditions
- **Level 2: "**frequent and systemic basis**"** and **"**substantial basis**"** to be defined in quantitative terms
- **Level 2:** SI regime *does* apply to non-liquid markets

# IFs as Market Operators: Systematic Internaliser

- **Obligation to make public firm quotes:** Applies where an IF is an SI for instruments that are **traded on a TV** for which there is a **liquid market**
- **Liquid market definition:**
  - "*a market with ready and willing buyers and sellers on a continuous basis, assessed in accordance with certain criteria (average frequency / size of transactions over a range of market conditions; number and type of market participants; and the average size of spreads) taking into consideration the specific market structures of the particular financial instrument*"
  - For the trading obligation to take effect, "*a class of derivatives is considered sufficiently liquid*" by ESMA. Although ESMA must conduct a public consultation, it is not required to apply the liquid market definition.
  - Therefore possible that some derivatives could be liquid but not (yet) subject to mandatory training
- **Application to derivatives is unclear:**
  - **Interpretation 1:** an equities carry over – as this is directed to trading off platforms, it can't ever apply to on market trading – but, again, unclear how the definition ties in with this
  - **Interpretation 2:** the obligation applies to on market trading under Arts. 18 & 21 MiFIR but where there is a liquid market and a firm is acting as an SI – however, again, unclear how the definition ties in with this

# IFs as Market Operators: Broker Crossing Networks

Policymakers have **bid to end the existence the non-platform, unregulated broker crossing networks**. This background informs the underlying purpose of aspects MTFs & OTFs.

**MTFs**

Internal matching systems (which might otherwise be Organised Trading Facilities) for equities and equity-like instruments must become MTFs

**OTFs**

Applies only to non-equities

No dealing on own account except for illiquid sovereign debt and can only conduct matched principal trades with client permission

These provisions take **cumulative effect** to achieve policymakers' aims. They are seen as **complementary** as they impose regulatory and transparency obligations, with MTFs taking multilateral equities activity and OTFs focussing on multilateral matching of client orders in derivatives.

# What about hybrid trading systems?

| Type of system | Description | Information required to be made public |
|---|---|---|
| Continuous auction order book trading system | A system that by means of an order book and a trading algorithm operated without human intervention matches sell orders with matching buy orders on the basis of the best available price on a continuous basis | The aggregate number of orders and the shares they represent at each price level, for at least the five best bid and offer price levels |
| Quote-driven trading System | A system where transactions are concluded on the basis of firm quotes that are continuously made available to participants, which requires the market makers to maintain quotes in a size that balances the needs of members and participants to deal in a commercial size and the risk to which the market maker exposes itself | The best bid and offer by price of each market maker in that share, together with the volumes attaching to those prices |
| Periodic auction trading System | A system that matches orders on the basis of a periodic auction and a trading algorithm operated without human intervention | The price at which the auction trading system would best satisfy its trading algorithm and the volume that would potentially be executable at that price |
| Trading system not covered by first three rows | A hybrid system falling into two or more of the first three rows or a system where the price determination process is of a different nature than that applicable to the types of system covered by first three rows | Adequate information as to the level of orders or quotes and of trading interest; in particular, the five best bid and offer price levels and/or two-way quotes of each market maker in the share, if the characteristics of the price discovery mechanism so permit |



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# What about hybrid trading systems?

- ESMA intends to base its advice on the existing Guidelines on Systems and Controls in an Automated Trading Environment published in February 2012, which already provide a useful framework
- For purposes of Art 17, 48 & 49 MiFID II "trading system" should be defined as the hardware, software and associated communication lines used by:
  - trading venues;
  - members or participants of trading venues including those falling under Art 1(5) MIFID II;
  - to perform their activity; and
  - any type of execution systems or order management systems operated by trading venues or investment firms, including matching algorithms
- Algorithmic trading is mostly relevant for continuous auction order book systems and quote-driven trading systems. Other systems such as RFQ or voice trading should not be considered within the scope of this specific piece of regulation

# Transparency & Transaction Reporting

# IFs as Market Operators: Delegation of Reporting

| Reporting type Legislation | Report data | Reporting parties | Report recipient | Timing | Fees | Instruments | Exemptions |
|---|---|---|---|---|---|---|---|
| **Pre-trade Transparency MiFIR** | Bid and offer prices and depth of trading | Trading Venues, Investment Firms, Systematic Internalisers, (obligatory, no delegation) | Public (via Trading Venue) | continuous basis during business hours | Charge for up to T+15 (commercially reasonable/ non-discriminatory)<br><br>Free after T+15 min | Equities, OTCD, ETD | Waivers for:<br>• Illiquid instruments<br>• Block trades<br>• Trades above a size specific to the instrument |
| **Post-trade Transparency MiFIR** | Price, volume, time of trade | Trading Venues, Investment Firms, (obligatory, no delegation) | Public (via an APA) | ASAP | Charge for up to T+15 (commercially reasonable/ non-discriminatory)<br><br>Free after T+15 min | Equities, OTCD, ETD | Deferrals for:<br>• Illiquid instruments<br>• Block trades<br>• Trades above a size specific to the instrument |
| **Transaction Reporting Article 26 MiFIR** | Trade data sufficiently detailed to allow NCAs to monitor for market abuse, regulatory breaches and systemic issue | MiFID firms Trading Venues (for non-MiFID firms) (obligatory, can delegate) | Competent authority (via an ARM/Trading Venue/other system TBD by ESMA) | T+1 day | No detail at Level 1 | Equities, OTCD, ETD | N/A |



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# Data Reporting Services: Key Differences

| | APA | CTP | ARM |
|---|---|---|---|
| **Purpose** | Publication of post trade data from IFs to the public | Consolidated continuous post-trade electronic data stream to the public | Enabling transaction reporting by IFs to regulators |
| **Delegation** | Takes responsibility away from IF | Responsibility remains with IF | Same as CTP |
| **Permitted roles** | IF, market operator, CTP | IF, market operator, APA | IF, market operator |
| **Pricing** | Reasonable commercial basis. Free 15 minutes after publication. | Same as APAs | |
| **Duties when disseminate information** | Efficiently & consistently in a way that ensures fast access on a non-discriminatory basis in a format that facilitates consolidation from other sources | Equivalent to APAs<br><br>Additionally, must ensure consolidation from all TVs and APAs for all relevant financial instruments | No obligation to facilitate consolidation of data from other sources |
| **Timing** | As close to real time as technically possible | Same as APAs | As quickly as possible and no later than the following working day |
| **Error checking** | Must check submissions for errors by IFs and request resubmission if find issues | N/A | Must check submissions for errors by IFs and the ARM itself. Must request resubmission if find issues |



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# MiFID II & MiFIR

## Scope & Impact Analysis

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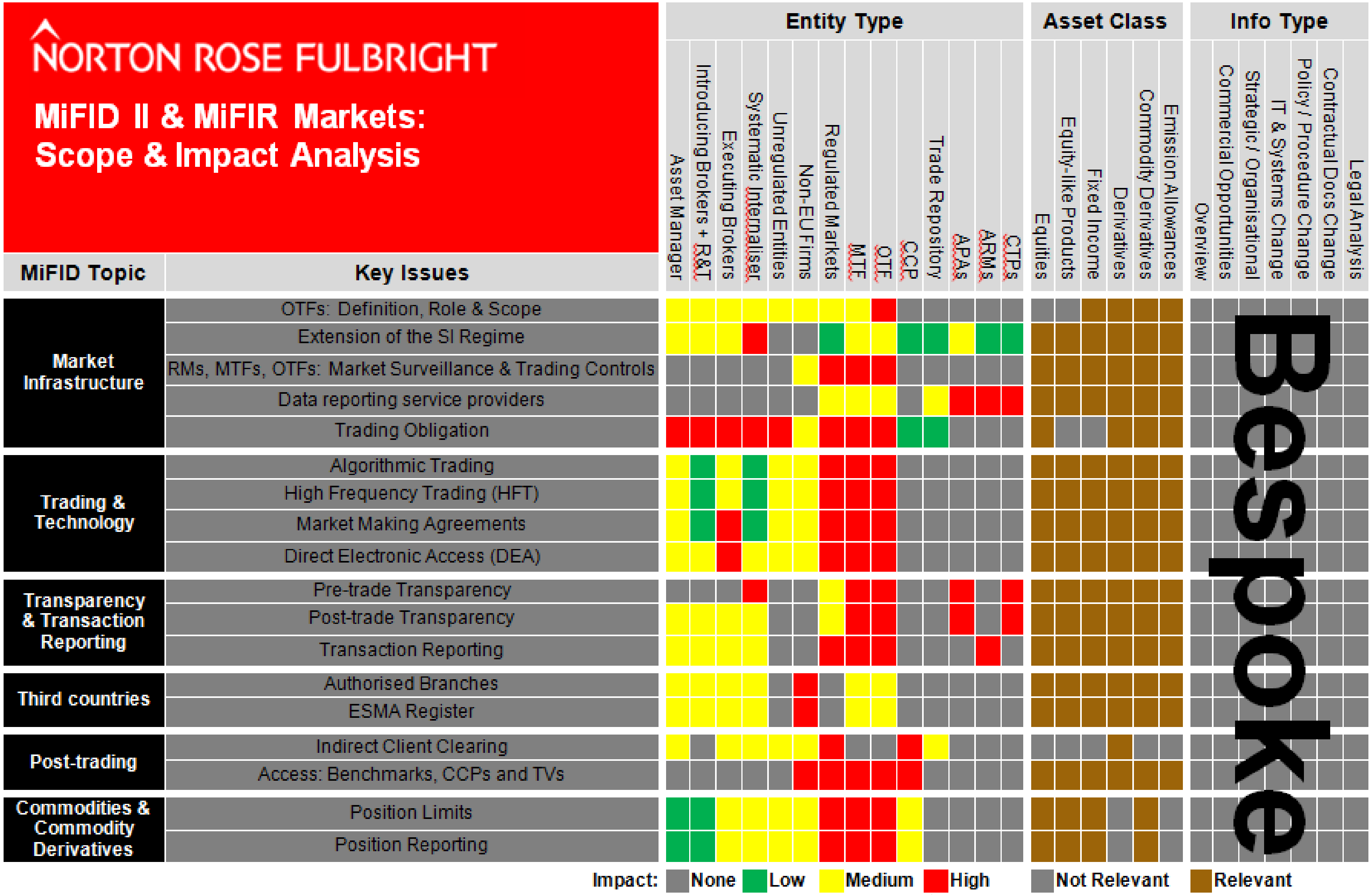
# MiFID II & MiFIR Markets: Scope & Impact Analysis



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# Post-trading

## Indirect Client Clearing

## Benchmarks

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# Indirect Client Clearing

- Additional way that the clearing obligation for OTC derivatives can be met
- For OTC derivatives:
  - Does not have to be offered by a CM, but if CM does offer it, must offer to all eligible Clients:
    - credit institutions, investment firms and third country equivalent
  - Contractual terms must be agreed between Client and Indirect Client after consultation with CM:
    - including contractual requirement on client to honour all obligations of indirect client towards CM
- Can be used for ETDs provided arrangements:
  - do not increase counterparty risk
  - ensure assets and positions benefit from equivalent protection to that provided by segregation and porting requirements under EMIR
  - further details on the requirements for use with ETDs will be set out in MiFIR RTS



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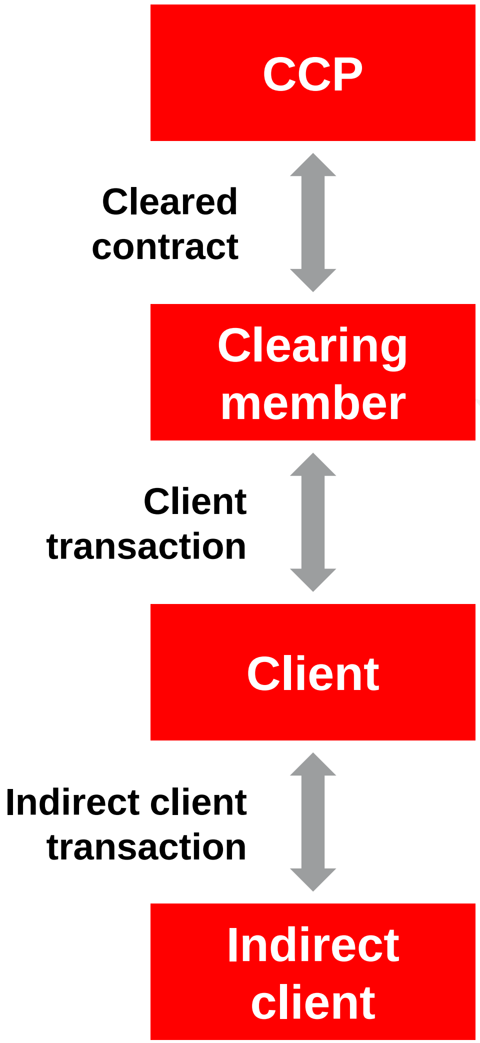
# Indirect Client Clearing: Responsibilities




- Maintain separate records and accounts enabling Client to distinguish between its own and its Indirect Clients' positions and assets
- Open segregated account for Indirect Clients (at least an omnibus account per Client)
- Identify, monitor and manage material risks

- Implement Indirect Client's choice of accounts: individual or omnibus segregation
- Have robust procedures to manage default of Client including a credible mechanism for porting and prompt liquidation of Indirect Client's assets and positions
- Identify, monitor and manage any risks resulting from indirect clearing

- Offer Indirect Client choice of accounts: individual and omnibus segregation and provide risk information
- Provide Clearing Member with risk information and, if Clearing Member fails, all information



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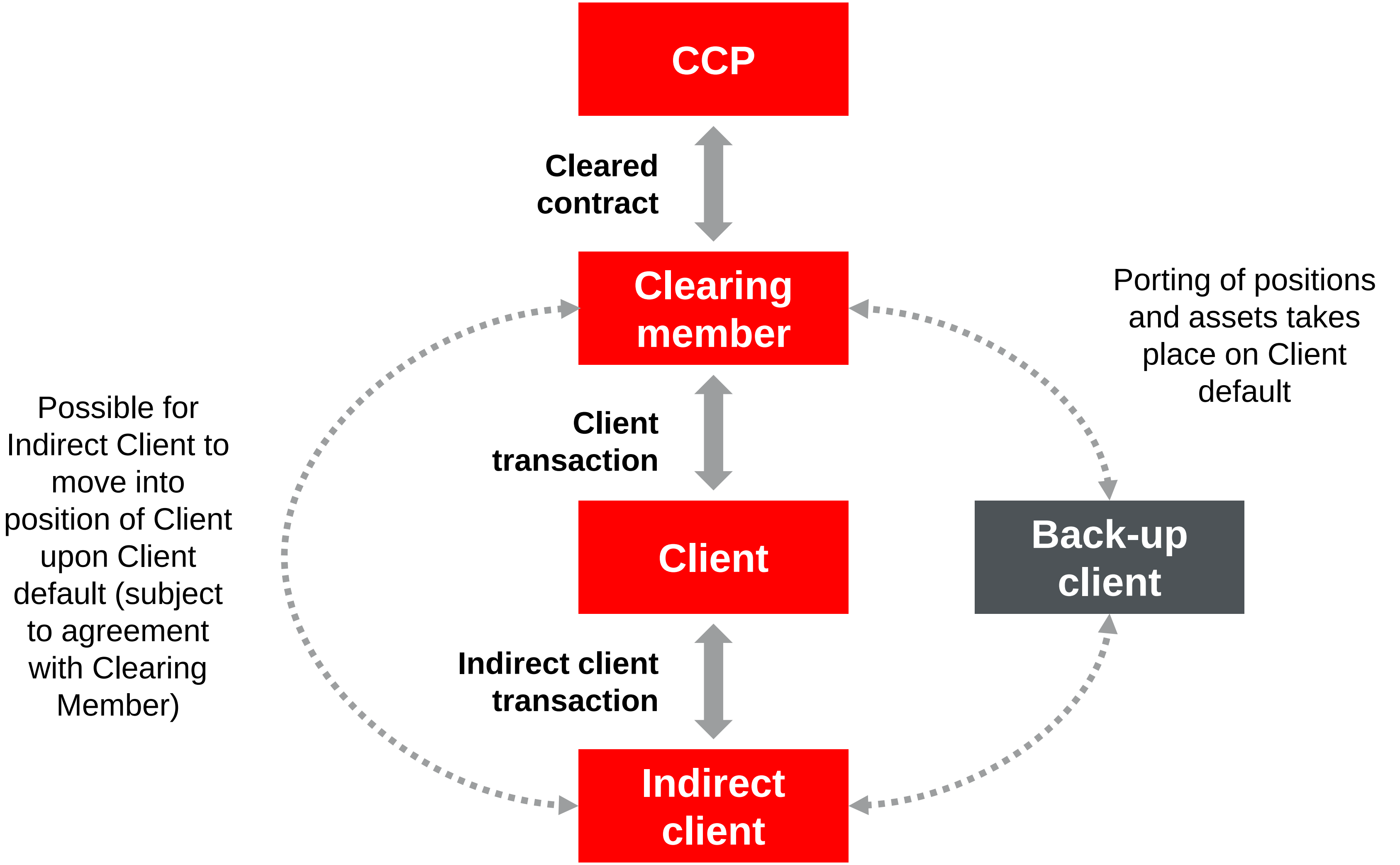
# Indirect Client Clearing: Client Default



# Indirect Client Clearing: ETD Industry Thoughts

*“Absent a harmonised global (or even pan-European) insolvency regime that recognises indirect clearing arrangements, porting of indirect client assets and positions and/or return of the liquidated proceeds directly to the indirect clients would be highly susceptible to legal challenge.”*

*“ESMA should adopt a different approach as between OTCD and ETD in light of the fundamental differences between the OTCD and ETD markets”*

*“ESMA should adopt a different approach from the one under EMIR in light of fundamental problems associated with the EMIR indirect clearing rules”*

*“Clearing members subject to the laws of certain non-EU jurisdictions, including the United States, cannot satisfy the requirement […] to provide EMIR equivalent account segregation due to conflicting local law requirements.”*

# Benchmarks: Three Regimes

- Global regime: IOSCO Principles
  - EU regime
  - EBA/ESMA Guidelines
  - MAR
  - MiFIR(draft)
  - Benchmarks regulation (draft)
- UK regime
  - Regulated activities relating to defined ‘specified benchmarks’
  - Criminal regime for manipulation of ‘relevant benchmarks’
- Range of asset classes and instruments affected
  - interest rate manipulations
  - foreign exchange trading
  - commodity derivatives
- Range of market participants
  - Banks
  - other financial institutions
  - clearing houses
  - price reporting agencies
- Administrators can include calculation agents and benchmark publishers

# Benchmarks: Global Regime - IOSCO

- IOSCO PRA Principles
  - Published in October 2012 with an 18 month implementation period
  - Applies to oil price reporting agencies
  - More relevant for commodities derivatives
  - Fairly general obligations and require methodologies, conflicts of interest procedures, internal oversight and audit trail provisions
  - The structure of internal governance policies is left to the PRA, or to be decided through industry codes.
- IOSCO Financial Principles
  - Published in July 2013 with a 12 month implementation period
  - Applies to all financial benchmark administrators that fall within the definition
  - Requirements broadly align with those in the PRA Principles, but are more prescriptive and structured; e.g. oversight committee, business continuity and transition provisions, detailed methodology requirements, submitter code of conduct, etc.

# Benchmarks: EU Regime

- EBA / ESMA Guidelines
  - Captures - administrators, benchmark calculators, publishers, submitters and users
  - Submitters - conflicts of interest, record keeping, oversight and transparency requirements, and an obligation to submit to the benchmark administrator a statement of compliance with the Principle
  - Benchmark users required to dd administrators
  - ESMA and the EBA will review application 18 months after publication
- MAR
  - Focus on manipulation of benchmarks
- MiFIR
  - Access to benchmarks by Trading Venues and CCPs
  - Cuts across current exclusivity arrangements

# Benchmarks: UK Regime

- Regulated activities:
  - Administering a specified benchmark
  - Providing information in relation to a specified benchmark
- Implications:
  - Both administrators and submitters will require authorisation
  - Fees and financial stability requirements
  - Approved persons – CF 40 and CF 50, application of APER, FIT, SUP, SYSC, COND, GEN
  - Extra-territorial impact for submitters with an establishment in the UK
  - Two INEDS on oversight committee along with user and submitter representatives
- Parallel criminal regime for manipulation of "relevant benchmarks"
- Currently the UK regimes only cover LIBOR – HMT consulting on extending to:
  - SONIA
  - RONIA
  - WM/Reuters FX
  - ISDAFix
  - ICE Brent Futures
  - LBMA Silver Price
  - London Gold Fix

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