MiFID Crash Course for U.S. CCOs

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Administrative Items

The webinar will be recorded and posted to the FIA website following the conclusion of the live webinar.

A question and answer period will conclude the presentation.

- Please use the “question” function on your webinar control panel to ask a question to the moderator or speakers. Questions will be answered at the conclusion of the webinar.

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Overview – Outline

- This webinar will provide succinct introductions to key regulatory developments in Europe under the revised Markets in Financial Instruments Directive (“**MiFID II**”) and Markets in Financial Instruments Regulation (“**MiFIR**”).

- Topics covered:
  - Pre- and post-trade transparency
  - Trade execution requirements
  - Algorithmic trading
  - Direct electronic access
  - Straight-through processing
  - Indirect clearing
  - Transaction reporting
  - Position limits
  - Third-country framework

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Overview - Timeline

- May 2014
  - MiFID **II** and MiFIR adopted
- December 2014
  - publication of Consultation Paper for draft regulatory technical standards ("**RTS**") and implementing technical standards ("**ITS**")
  - publication of final technical advice to European Commission ("**EC**")
- September 2015
  - publication of some, but not all, final RTS
  - EC has 3 months to decide whether to adopt the RTS, subject to right of European Parliament and European Council to object
- December 2015
  - originally intended date for publication of remaining RTS, ITS and Guidelines
- February 2016
  - EC proposed to postpone MiFID II/MiFIR date of application
- June 2016
  - legislation delaying the application of MiFID II/MiFIR published in the Official Journal of the EU
- July 3, 2017
  - deadline for EU Member State transposition into national law
- January 3, 2018
  - current date for MiFID II and MiFIR take effect

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Topic I: Pre and Post Trade Transparency

Overview

- MiFIR introduces pre-and post- transparency requirements for non-equities, including derivatives, for the first time.
- Such transparency requirements are likely to produce implementation and operational challenges for investment firms.
- Regulated Markets ("**RMs**"), multilateral trading facilities ("**MTFs**") and organised trading facilities ("**OTFs**") will be required to:
    - publish bid and offer prices;
    - publish depth of trading interest information; and
    - disclose actionable indications of interest.
- Transparency data will be required to be published on a "continuous basis" during normal trading hours.
- Price, volume and time of trade data must be published in as close to real time as possible.

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Waivers

- Article 9 of MiFIR provides three basis' for granting transparency waivers:
  - orders large in scale, compared to normal market size;
  - indications of interest in requests for quotes and voice trading systems above a size specified for a particular instrument, such that disclosure would expose liquidity providers to undue risk; and
  - derivatives not subject to the trading obligation and for any instrument for which there is not a liquid market.

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Topic 2: Trade Execution Requirements

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Trading Obligation

- Article 28 of MiFIR (the "**Trading Obligation**") requires financial counterparties (or non-financial counterparties over the EMIR clearing threshold) to trade instruments either on an RM, MTF or OTF, or equivalent third-country trading venue, if the three following conditions are met:
  - the contract is of a class of derivatives that the European and Securities Markets Authority as deemed subject to the EMIR clearing obligation;
  - the class of derivative or "a relevant subset thereof" must be admitted to trading on at least one trading venue or third country equivalent trading venue; and
  - the class of derivatives is considered "sufficiently liquid".
- Intragroup transactions are excluded.

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Liquid market

- Article 2(1)(17)(a) of MiFIR defines a “liquid market” for non-equity instruments, including derivatives, as a market:
  - where there are ready and willing buyers and sellers on a continuous basis; and
  - where the market is assessed by considering the average frequency and size of transactions over a range of market conditions, the nature and life cycle of the transactions, the number and type of market participants and the average size of spreads.

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ESMA Proposals

- On September 20, 2016, the European Securities and Markets Authority ("**ESMA**") published a discussion paper ("**Consultation**") on the Trading Obligation.

- The Consultation sets out ESMA's proposals on the implementation of the Trading Obligation under MiFIR, and also details ESMA's analysis of potential classes of derivatives that could be subject to the Trading Obligation.

- The Consultation closes on November 21, 2016.

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ESMA Proposals

- ESMA clarifies in the Consultation that when determining the “sufficient liquidity” of a class of derivatives, ESMA is required to consider:
  - the average frequency of trades over a range of market conditions;
  - the average size of trades over a range of market conditions;
  - the number and type of active market participants; and
  - the average size of spreads.
- ESMA must also consider the anticipated impact of the Trading Obligation on the liquidity of a class of derivatives and must only assess the application of the Trading Obligation in respect of transactions below a certain size.
- ESMA performed preliminary liquidity assessment analysis on transaction level data over a period of 6 months, from July 1, 2015 to December 31, 2015. The liquidity assessment covered sub-asset classes already captured by the EMIR clearing obligation, including interest rate derivatives (“**IRD**”) and credit derivatives.
- For IRDs, ESMA considered imposing the Trading Obligation on a tenor basis, being the difference between the maturity and execution dates. For credit derivatives, the tenor of the underlying instrument was computed “selected indexes reference data and not from dates reported”.

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ESMA Proposals

- ESMA confirmed in the Consultation that the earliest date the Trading Obligation can apply is January 3, 2018.
- ESMA also proposed that the Trading Obligation would apply at the earliest date from which the EMIR clearing obligation comes into effect, as follows:

OTC derivative class	Category 1	Category 2	Category 3	Category 4
IRD (EUR, GBP, JPY, USD)	January 3, 2018	January 3, 2018	January 3, 2018	December 21, 2018
IRD (NOK, PLN, SEK)	January 3, 2018	January 3, 2018	February 9, 2018	August 9, 2019
Credit derivatives	January 3, 2018	January 3, 2018	February 9, 2018	May 9, 2019

- Note however, ESMA also acknowledged feedback from participants advocating for longer phase-in periods.

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Topic 3: Algorithmic Trading

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EU Regimes Prior to MiFID II

- National responses prior to passage of MiFID II and MiFIR:
  - Germany: New legislation took effect from May 2013 such that any high frequency trader (even if not providing services to third parties) must be licensed by BaFin (German regulator) – unless authorised to trade in another EU country and able to 'passport' cross-border to Germany.
  - Italy: The new Italian financial transactions tax (came into force in March 2013) subjects HFT transactions to a 0.02% tax on orders automatically generated by algorithms.

- MiFID II and MiFIR will apply to from January 2018 to:
  - persons using algorithmic trading techniques (whether or not MiFID-authorised); and
  - persons using high-frequency algorithmic trading techniques.

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Definition of Algorithmic Trading

- Article 4(1)(39) of MiFID II defines "algorithmic trading" as:
  - trading in financial instruments where a computer algorithm automatically determines individual parameters of orders such as whether to initiate the order, the timing, price or quantity of the order or how to manage the order after its submission, with limited or no human intervention, and does not include any system that is only used for the purpose of routing orders to one or more trading venues or for the processing of orders involving no determination of any trading parameters or for the confirmation of orders or the post-trade processing of executed transactions.

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Definition of HFT

- Article 4(1)(40) of MiFID II defines "high-frequency algorithmic trading technique" ("**HFT**") as an algorithmic trading technique that is characterised by*:*
  - infrastructure intended to minimise network and other types of latencies, including at least one of the following facilities for algorithmic order entry: co-location, proximity hosting or high-speed direct electronic access;
  - system-determination of order initiation, generation, routing or execution without human intervention for individual trades or orders; and
  - high message intraday rates which constitute orders, quotes or cancellations.

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High Message Intraday Rate

- For the purposes of defining a high-frequency algorithmic trading technique in the EU the European Commission has proposed (not yet approved by all necessary EU authorities) that a “high message intraday rate” shall consist of the submission on average of any of the following:

  (a) at least two messages per second with respect to any single financial instrument traded on a trading venue;

  (b) at least four messages per second with respect to all financial instruments traded on a trading venue.

- So that firms know if they meet the threshold(s), EU trading venues will have to publish estimates of the average of messages per second on a monthly basis two weeks after the end of each calendar month taking into account all messages submitted during the preceding 12 months.

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HFT - Compliance Consequences I

- By defining these concepts, EU regulators can identify HFT and regulate such activity on a pan-EU basis. The requirements include:
  - All EU HFT firms must be authorised/licensed and subject to regulatory supervision.
  - Systems and risk controls to ensure trading systems are resilient and prevent the sending of erroneous orders.
  - Measures to ensure that trading systems cannot be used for market abusive trading activities.
  - All automated trading firms must provide their regulator with details of their algorithmic trading strategies.
  - Market-makers must conduct their activities continuously during trading hours and provide liquidity on a regular and predictable basis.
  - Regulated markets must be able to (1) halt trading temporarily if a significant price movement occurs over a short period; and (2) limit the ratio of unexecuted orders.

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HFT - Compliance Consequences II

- The use of an algo to trade has complicated compliance requirements in relation to the tagging of algos, such that:
  - The algo tag must be used when transaction reporting and must be the same as that which was sent to the market at the time the order was entered.
  - Detailed rules relating to algo tags are not yet set, and there may be flexibility in how firms assign such tags (including for chains of algorithms). Tags must be unique, consistent and persistent.
  - If different algos are used to make an investment decision and to execute the order, both would have to be identified and tagged when the order is entered.

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Market Making

- Market making is not subject to any specific regulation currently under MiFID I as there's currently a broad exemption from the requirement for such persons to become licensed. A narrow exemption will continue under MiFID II – but only where such persons deal in commodity derivatives or emissions allowances or derivatives thereof and provided that:
  - the activities are ancillary to the main business of the firm;
  - it does not involve HFT; and
  - the firm notifies its regulator annually that it is relying on this exemption.

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Market Making - HFT

- MiFID II requires that those firms which use a HFT strategy to conduct market making (i.e., posting firm, simultaneous two-way quotes on trading venues) to carry out such market making activities continuously during a set proportion of the venues' trading hours so that they can provide liquidity on a "regular and predictable basis to the trading venue".

- New regulations will require market makers (whether such persons hold themselves out formally as market makers or informally on an ad hoc basis) to sign a contract with each relevant trading venue agreeing the firm's specific obligations, which could include specific quoting obligations vis a vis specific financial instruments, as well as requiring systems and controls so as to ensure that they can fulfil their obligations at all times.

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Market Making - Compliance

- MiFID II compliant market makers will have to comply with a prescriptive set of compliance requirements, including:
  - maintaining comprehensive conduct of business rules;
  - keeping detailed records that can distinguish between market making orders and other order flows (including keeping records of telephone conversations and other electronic communications);
  - having internal procedures to identify market making activities for the purposes of reporting to regulators;
  - having appropriate and effective surveillance, compliance and audit resources and frameworks to monitor their market making activities; and
  - committing to settle, close or transfer all open positions to another trading venue member or participant if the market maker ceases market making.

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MiFID Authorisation – EMIR & CRR

- MiFID-authorised firms are considered "financial counterparties" for purposes of EMIR and subject to additional EMIR obligations, including the following:
  - categorisation as a "Category 2" counterparty imposes a shortened transition period of 12 months to mandatory clearing;
  - compliance with the "frontloading" requirement to clear any contracts subject to mandatory clearing that the firm entered into following the date of authorisation of a CCP to clear such contracts; and
  - compliance with EMIR "risk management" obligations, including mark-to-model requirements, collateral requirements and valuation requirements.
- MiFID-authorised firms are also subject to the EU Capital Requirements Regulation and revised Capital Requirements Directive (together, "**CRD IV**"), including the following:
  - an ongoing obligation to maintain minimum net capital and other capital requirements set out in CRD IV; and
  - establishing and implement an Internal Capital Adequacy Assessment Programme.

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Topic 4: Direct Electronic Access

Definition

- Article 2(1)(d) – the traditional exemption from MiFID authorization for own-account dealing firms – has been narrowed under MiFID II to require authorization for firms that have direct electronic access ("**DEA**") to a trading venue.

- DEA is defined in Article 4(1)(41) of MiFID II as:
  - an arrangement where a member or participant or 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, participant or client, or any connecting system provided by the member, participant or client (referred to as "direct market access"); and
    - arrangements where such infrastructure is not used by a person (referred to as "sponsored market access").

- MiFID II prohibits unfiltered sponsored access.

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Risk Control Obligations

- Article 17 of MiFID II requires investment firms providing DEA to clients to engage in certain risk control activities, including the following:
  - maintain a compliance function that is sufficiently well-trained and familiar with client algorithms (or ensure proper controls over outsourced compliance functions);
  - establish arrangements to ensure the release of algorithms to the market in a "controlled and cautious" manner;
  - engage in annual stress testing of algorithms and prepare a validation report, which has been criticized by the industry as "disproportionate";
  - engage in real-time cross-market, cross-class, cross-product trading to detect any irregularities in trading and potential market abuse; and
  - impose a "kill switch" – either "nuclear" or "targeted" – on clients using DEA.

- Investment firms must enter into written arrangements with clients using DEA setting out rights and obligations relating to DEA services.

- DEA providers must also monitor in real-time the credit and market risk arising as a result of the clients' trading activity so that the DEA provider can adjust pre-trade controls on orders, credit and risk limits as necessary.

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Due Diligence/Onboarding

- A DEA client may be subject to heightened due-diligence/onboarding requirements beyond standard KYC/AML checks, including:
  - verification of governance and ownership structure;
  - specifying whether sponsored access or direct market access will be provided;
  - assessing the types of strategies to be undertaken by the client;
  - establishing access controls over order entry by the client at least equivalent to the pre-trade controls set out in MiFIR;
  - an evaluation of the client's operational set-up and systems;
  - allocation of responsibility for dealing with errors;
  - reviewing the financial standing of the client and the ability of the client to meet its financial obligations to the investment firm;
  - assessing the historical trading pattern and behaviour of the client; and
  - in the event of sub-delegation, verifying that the client maintains a due diligence framework at least as strict as the investment firm's framework.

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Topic 5: Straight-Through Processing

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Overview

- Article 29(2) MiFIR requires that all derivatives – not just OTC derivatives – are cleared as soon as technologically practicable (“**ASATP**”).
- ESMA has proposed to implement this requirement by also imposing pre-execution limit checks on EU futures markets.
- This has raised some significant concerns in the application of the ASATP requirement to ETDs:
  - the concept of “certainty of clearing” has long been an inherent feature of Europe’s ETD markets;
  - clearing certainty is a key feature for permitting anonymous CLOB trading;
  - industry concerns that the pre-ex checks (the RTS refer to “limits” but it seems to be understood to be “credit limits”) would require a complete reengineering of the ETD markets in the EU to keep a set of credit limits dynamically updated during the course of the day.

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ETDs

- The STP for ETD proposal was also criticised as adding more complications to execution flexibility by using multiple brokers, average pricing of aggregated orders and post-trade allocation.
- ESMA recognised these concerns in the final RTS, and has instead proposed an exception from the STP requirements where, as in the case of the ETD markets, rulebooks and contractual arrangements establish clearing certainty.

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Other points

- STP for OTC Derivatives
  - Main distinction is whether an OTC derivative is executed on a trading venue.
- On-TV Execution
  - Must be submitted to CCP within 10 seconds; and
  - Rejected trades will be *void ab initio*.
- Bilateral Execution
  - Must be submitted to CCP within 30 minutes.
  - Creates challenges for clearing members where there are delays in receiving confirmation of execution.
  - ESMA has placed the burden of this risk squarely on clearing members, which are required to put in place procedures to obtain "evidence" of the timeframe for bilateral executions.
  - What is sufficient "evidence"?

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Topic 6: Indirect Clearing

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MiFIR and EMIR

- Article 30 MiFIR
  - Indirect clearing arrangements ("**ICA**") with regard to ETDs "are permissible" provided they:
    - do not increase counterparty risk; and
    - ensure that the assets/positions of the counterparty benefit from protections equivalent to those set out in EMIR.
- Linkage therefore to ICA concept under EMIR.
- Article 4(3) EMIR
  - To ensure access to clearing, a counterparty must be a clearing member, a client or establish an ICA with a clearing member.
  - Such ICA "must not increase counterparty risk" and must provide indirect clients with "protections with equivalent effect to those allowing segregation and portability for direct clients" under Articles 39 and 48 EMIR.

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EU Clearing Model

- Under the European clearing model, there are two separate sets of contracts between:
  - the CCP and the clearing member; and
  - the clearing member and its client.
- The CCP therefore faces the clearing member as a principal, even where a client trade is involved.
- Pre-EMIR, CCP rules and local insolvency regimes provided some comfort for porting/liquidation of clearing member positions held for clients.
- There was no mechanism to address "indirect" clearing, i.e., the presence of an additional link in the chain of principal-to-principal relationships.
- See diagram on following page.

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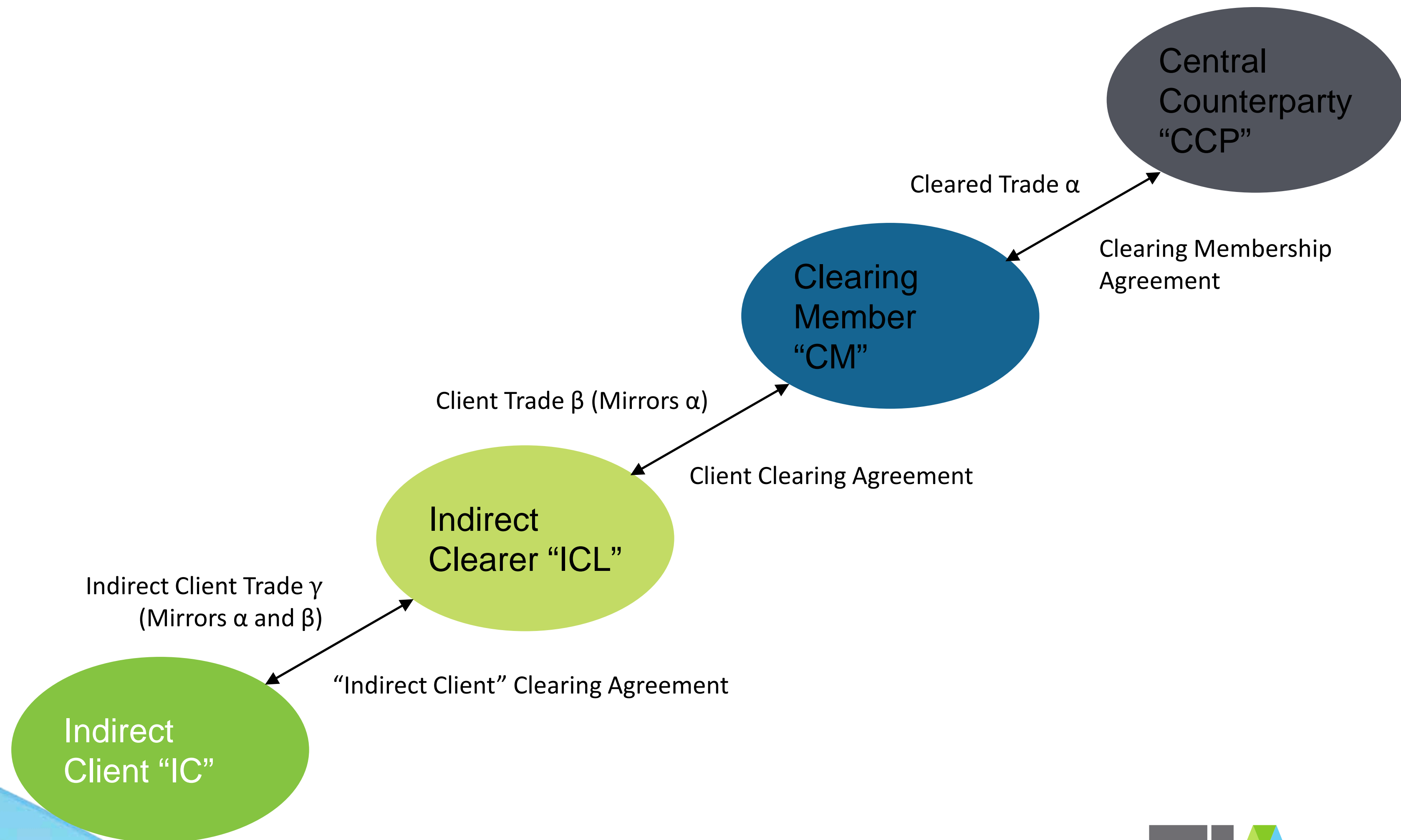
Indirect Clearing Diagram



Indirect Clearing

- EMIR ICAs are voluntary, not mandatory, for clearing members.
  - The conditions for EMIR ICAs set out in the relevant regulatory technical standards only need to be met when a clearing member "*is prepared to facilitate indirect clearing*".
- Challenges:
  - Legal relationship between clearing member and indirect client (agency v. principal-to-principal model; regulatory capital implications; onboarding/KYC obligations).
  - Application of default rules/procedures upon indirect clearing member default.
  - Portability of indirect client positions/assets to one or more backup indirect clearing members and/or clearing members.
  - Impact of national insolvency regimes where indirect client, indirect clearing member, clearing member and CCP may all be located in separate jurisdictions.
- Question: Is it any more reasonable to presume that MiFIR ICAs will be easier to implement than EMIR ICAs?

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Indirect Clearing

- In the MiFID II/ MiFIR Discussion Paper, ESMA suggested that the approach to ICAs under MiFIR should generally be similar to the approach under EMIR.
- However, MiFIR ICAs would "extend beyond the contractual relationship" to include the structure of the ICA and the relevant obligations of the CCP, clearing member and client.
- Uncertainty whether MiFIR ICAs would apply on a cross-border basis.

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Industry Concerns

- All of the legal and practical obstacles to EMIR ICAs would apply to MiFIR ICAs.
- The ETD market has an existing set of arrangements in place to facilitate client clearing and there is little evidence that these arrangements require significant reform.
- May require harmonisation of EU insolvency rules for financial market participants.
- To summarise: “If it ain’t broke, don’t fix it”.

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Industry Concerns

- Two Fact Patterns
  - US customers trading “foreign futures” on an EU exchange through an FCM’s omnibus client account with an EU broker.
  - EU customers trading futures on a US exchange through an EU broker’s omnibus client account with an FCM.
- Unanswered Questions
  - Would the relationship between a US customer and FCM be construed as that of an indirect clearing member and indirect client?
  - Is there an obligation to require a choice between ISA and OSA client segregation to US customers trading on an EU exchange, or to EU customers trading on a US exchange?
- Current Status
  - ESMA published draft RTS on indirect clearing in May 2016.

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Topic 7: Transaction Reporting

MiFID II Overview

1. Wider application;
   - (1) Branches of third country firms and (2) trading venues (where transactions are executed through their venues by firms not subject to MiFIR) are now captured under MiFID II/MiFIR.
2. Additional financial instruments;
   - MiFIR extends the reporting obligation to: (1) instruments admitted to a trading venue; (2) instruments where the underlying financial instrument is traded on a trading venue; and (3) instruments where the index or basket of financial instruments is traded on a trading venue.
3. Increased number of fields and data required in reports.
   - Table 2 of Annex I to the latest draft transaction reporting RTS increases the transaction report to 65 fields (compared to 25 under the existing FCA Handbook SUP 17 Annex requirements).

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Application

The EU/UK transaction reporting regime applies to:

- Investment firms;
- Credit institutions providing investment services or performing investment activities (Article 1(2) of MiFIR);
- Branches of third country firms (as per Article 14 of the draft RTS 22);
- Trading venues (where transactions are executed through their venues by firms not subject to MiFIR).

But note, there are wider implications for third country firms (like those in the US) trading with EU/UK firms subject to the transaction reporting regime. In order to comply with the reporting requirements, the above firms may request increased amounts of information from counterparties.

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Obligation and Timing

Article 26(1) of MiFIR

Investment firms which *execute transactions* in financial instruments shall report complete and accurate details of such transactions to the competent authority as quickly as possible, and;

no later than the close of the following working day.

Article 26(5) of MiFIR

Requires trading venue operators to report details of transactions in financial instruments traded on its platform,

which are executed through its systems by a firm which is not subject to MiFIR.

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Financial Instruments

Under Article 25 of MiFID, the requirement to report transactions applied to '*any financial instruments admitted to trading on a regulated market*'.

Article 26(2) of MiFIR expands the scope of instruments captured to include:

I. financial instruments which are admitted to trading or traded on a trading venue or for which a request for admission to trading has been made;
II. financial instruments where the underlying is a financial instrument traded on a trading venue; and
III. financial instruments where the underlying is an index or a basket composed of financial instruments traded on a trading venue.

'**Trading venue**' means an RM, an MTF or an OTF.

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Key terms

'Transaction' - Article 2 of the draft RTS 22

- the conclusion of an *acquisition* or *disposal* of a financial instrument shall constitute a transaction.

'Execution of a transaction' – Article 3 of the draft RTS 22

- Where an investment firm performs any of the following services or activities that result in a transaction within the meaning of Article 2, it shall have executed that transaction:

  (i) Reception and transmission of orders in relation to one or more financial instruments;

  (ii) Execution of orders on behalf of clients;

  (iii) Dealing on own account;

  (iv) Making an investment decision in accordance with a discretionary mandate given by a client;

  (v) Transfer of financial instruments to or from accounts.

Excludes 'transmitted orders' transmitted in accordance with Article 4 of the draft RTS 22.

'Transmitting' orders - Article 26(4) of MiFIR

Investment firms which *transmit orders* shall either:

- include in the transmission of that order all the details specified in Article 26(1) and (3); or
- report the transmitted order, provided the transaction report states state that it pertains to a transmitted order.

However note the requirements of Article 4 of the draft RTS 22

Content of Transaction Reports

MiFID	MiFIR
Article 25(4) of MiFID	**Article 26(3) of MiFIR**
1. Names and numbers of the instruments bought or sold; 2. the quantity; 3. dates and times of execution; and 4. transaction prices and means of identifying the investment firms concerned.	1. Names and numbers of the financial instruments bought or sold; 2. the quantity; 3. the dates and times of execution; 4. the transaction prices; 5. a designation to identify the clients on whose behalf the investment firm has executed that transaction, 6. a designation to identify the persons and the computer algorithms within the investment firm responsible for the investment decision and the execution of the transaction; 7. a designation to identify the applicable waiver under which the trade has taken place; 8. means of identifying the investment firms concerned; 9. a designation to identify a short sale as defined in Article 2(1)(b) of *Regulation (EU) No 236/2012* in respect of any shares and sovereign debt within the scope of Articles 12, 13 and 17 of that Regulation 10. For transactions not carried out on a trading venue, the reports shall include a designation identifying the types of transactions in accordance with the measures to be adopted; 11. For commodity derivatives, reports shall indicate whether the transaction reduces risk in an objectively measurable way;

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Transaction Report Fields

Details to be reporting in transaction reports

1. Report status
2. Transaction Reference Number
3. Trading venue transaction identification code **(*)**
4. Executing entity identification code
5. Investment Firm covered by Directive 2014/65/EU **(*)**
6. Submitting entity identification code **(*)**
7. Buyer identification code
8. Country of the branch for the buyer **(*)**
9. Buyer - first name(s) **(*)**
10. Buyer - surname(s) **(*)**
11. Buyer - date of birth **(*)**
12. Buyer decision maker code **(*)**
13. Buy decision maker - First Name(s) **(*)**
14. Buy decision maker – Surname(s) **(*)**
15. Buy decision maker - Date of birth **(*)**
16. Seller identification code
17. Country of the branch for the seller **(*)**
18. Seller - first name(s) **(*)**
19. Seller - surname(s) **(*)**
20. Seller - date of birth **(*)**
21. Seller decision maker code **(*)**
22. Sell decision maker - First Name(s) **(*)**
23. Sell decision maker – Surname(s) **(*)**
24. Sell decision maker - Date of birth **(*)**
25. Transmission of order indicator **(*)**
26. Transmitting firm identification code for the buyer **(*)**
27. Transmitting firm identification code for the seller **(*)**
28. Trading date time
29. Trading capacity
30. Quantity
31. Quantity currency
32. Derivative notional increase/decrease **(*)**
33. Price
34. Price Currency
35. Net amount **(*)**
36. Venue
37. Country of the branch membership **(*)**
38. Up-front payment **(*)**
39. Up-front payment currency **(*)**
40. Complex trade component ID **(*)**
41. Instrument identification code
42. Instrument full name
43. Instrument classification
44. Notional currency 1 **(*)**
45. Notional currency 2 **(*)**
46. Price multiplier
47. Underlying instrument code
48. Underlying index name **(*)**
49. Term of the underlying index **(*)**
50. Option type
51. Strike price
52. Strike price currency **(*)**
53. Option exercise style **(*)**
54. Maturity date
55. Expiry date **(*)**
56. Delivery type **(*)**
57. Investment decision within firm **(*)**
58. Country of the branch responsible for the person making the investment decision **(*)**
59. Execution within firm **(*)**
60. Country of the branch supervising the person responsible for the execution **(*)**
61. Waiver indicator **(*)**
62. Short selling indicator **(*)**
63. OTC post-trade indicator **(*)**
64. Commodity derivative indicator **(*)**
65. Securities financing transaction indicator **(*)**

(*) Indicates new fields (or no comparable existing field) introduced under MiFID II (as at December 2015), in comparison to the FCA Handbook - SUP 17 – Annex I

Topic 8: Position Limits

Position Limits – Overview

- MiFID I
  - To date there has been no comprehensive EU-wide position limit or position management regime.
  - Where such limits have been established they have been applied at the level of individual exchanges.
    - Example: Section P of ICE Futures Europe Rules
- MiFID II
  - A new three-pillar framework: (1) position limits; (2) position management; and (3) position reporting.
  - Regime applies to commodity derivatives and economically-equivalent OTC ("**EEOTC**") contracts.
  - Excludes physically-settled gas and electricity forwards covered by REMIT that are traded on OTFs.

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Position Limits

- Article 57(1) of MiFID II
  - National regulators will be responsible for establishing and applying position limits on the size of the net position that a person may hold on commodity derivatives traded on venues and EEOTC contracts.
  - EEOTC contracts are defined as contracts with "identical contractual specifications and terms and conditions" as exchange-traded contracts.
  - Limits to be set for spot and all non-spot months.
    - *Compare* CFTC regime with spot and all-month limits.
  - Net position calculations do not apply to contracts traded on third-country venues (*e.g.*, a US futures exchange).

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Position Limits

- Position limits apply to the net position of a “person” as well as positions held at an “aggregate group level”.
  - The scope of the term “person” is unclear, but appears intended to reach through to the end-client, similar to the notion of “trader” under the CFTC regime.
  - ESMA has proposed a top-down aggregation rule, *i.e.* a person must aggregate its positions with those of its subsidiaries.
  - In relation to funds, where an investor does not control the fund’s trading decisions, the fund’s position need not be aggregated with that of the investor.
    - *Compare* the independent account controller regime under the CFTC rules.

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Position Limits

- Bona Fide Hedging Exemption
  - Trades by a non-financial entity that are objectively measurable as reducing risks directly relating to the commercial activities of that entity are not counted towards the limit.
  - Aligns the test for identifying hedging trades with the test in EMIR and as interpreted in ESMA's EMIR Q&A.
  - However separate MiFID II amendments will require many commodity firms to be authorised, and hence "financial entities" and therefore unable to rely on this exemption.

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Position Limits

- <u>Procedure</u>
  - ESMA establishes the methodology for national regulators to set limits.
  - National regulators submit proposed limits to ESMA, which has 2 months to issue an opinion.
- <u>Spot Month</u>
  - "Spot month" refers to the contract next to expire; an EEOTC contract is in the spot month when its equivalent contract is in its spot month.
  - Limits to be based on deliverable supply (or, where there is no deliverable supply, on open interest).
  - Baseline set at 25%, with scope for national regulators to vary the limit based on certain factors.
  - Trading venues will provide information on deliverable supply in the spot month.

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Position Limits

- Non-Spot Months
  - Refers to the remainder of the contract curve (*i.e.*, not all months).
  - Limits to be based on open interest.
  - Baseline set at 25%, with scope for national regulators to vary the limit based on certain factors.
- Factors for Raising/Lowering Baseline
  - Maturity;
  - Deliverable supply;
  - Open interest (ex-correlated instruments);
  - Volatility;
  - Number and size of participants;
  - Underlying commodity markets;
  - New/Illiquid contracts.

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Position Limits

- Monitoring and Enforcement Authority
  - National regulators to have the authority to require persons to liquidate their positions or prevent persons from entering further transactions in contracts.
  - ESMA is responsible for monitoring how national regulators establish and enforce position limits.
  - ESMA is given emergency backstop authority to impose position limits and force position-holders to liquidate their positions or prevent further transactions in contracts where the national regulator is unable or unwilling to do so.

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Position Monitoring

- Article 57(8) of MiFID II
  - Requires operators of trading venues (i.e., RMs, MTFs, and OTFs) to apply position management controls including:
    - monitoring the open interest of "persons";
    - access information and documentation from "persons" regarding the size and purpose of a position and cash-market activities;
    - require a "person" to exit or reduce a position; and
    - require a "person" to provide controlled liquidity back into the market.
  - Position management arrangements must be disclosed to the relevant venue's national regulator.

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Position Reporting

- <u>Article 58(1) of MiFID II</u>
  - Requires trading venues to publish weekly reports of the aggregate positions held by the following categories of persons for the different commodity derivatives listed on the venue:
    - investment firms or credit institutions;
    - investment funds (AIFs or UCITS);
    - other financial institutions;
    - commercials; and
    - persons subject to EU emissions rules (for emissions contracts).
  - Reports must contain:
    - number of long and short positions per category of person;
    - changes since the previous report;
    - percentage of open interest attributable to each category;
    - number of persons in each category.

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Position Reporting

- Article 58(2) of MiFID II
  - Requires an investment firm that trades commodity derivatives OTC to submit a daily report to either:
    - the national regulator of the trading venue where the commodity derivative(s) are traded; or
    - the national regulator of the trading venue where the most significant volume of such commodity derivative(s) are traded.
  - Reports must contain a "complete breakdown" of:
    - the firm's positions taken in commodity derivatives traded on-exchange and EEOTC contracts; and
    - such positions for the firm's clients, and the clients of those clients "until the end-client is reached".
  - Similar reports to be filed with the relevant trading venue(s).

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Topic 9: Third-Country Framework

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Third-Country Framework

- Currently, MiFID has no formal approach to third-country (i.e., non-EU) firms.
- Under MiFID II, these third-country firms ("**TCFs**") that are otherwise required to be authorised because they are engaged in investment services or activities with EU clients may be eligible to rely on a "third-country passport" if certain conditions are met, including:
  - a decision by the European Commission determining that the applicable regulatory regime in the TCF's home jurisdiction:
    - achieves the same objectives as the MiFID regime; and
    - provides EU firms equivalent access;
  - the TCF must submit an application to ESMA in the required format; and
  - for a 3-year transition period following an equivalence determination, a TCF may continue to rely on the national regulatory regimes in each EU Member State relevant to its business.

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Third-Country Framework

- A TCF that benefits from this "passport" will be permitted to provide investment services and activities to eligible counterparty and *per se* Professional Clients throughout the EU without having to establish a branch or subsidiary, and without requiring any further approvals or authorisations from EU national regulators.
- However, the third-country passport may not be a panacea for U.S. firms:
  - there is as yet no concrete guidance on the passporting regime for TCFs, including in particular whether the passport would be available for firms required to be authorised due to HFT, market making, or algo trading, as these are not expressly included on the list of MiFID "investment services and activities";
  - given the difficulties in obtaining an equivalence determination by the EC for U.S. CCPs under EMIR, it is likely that any equivalence determination under MiFIR may be similarly slow to arrive; and
  - ongoing concerns that equivalence may be held up on the basis that the US has no corresponding regulatory status for HFT firms under MiFID II/MiFIR.

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Third-Country Framework

- In the absence of an equivalence determination by the European Commission, TCFs may continue to rely on the national regulatory regime in each EU Member State relevant to their European business.
- Points to consider:
  - HM Treasury's proposal for implementing MiFID II under UK law indicates an intent to retain the so-called "overseas persons exemption" that provides generous exemptions from MiFID II authorisation requirements for TCFs conducting certain financial activities into the UK.
  - Unclear whether other EU Member States may adjust their national regulatory regimes to *de facto* reflect the new requirements of MiFID II in national law.
  - Possibility of an ongoing "patchwork" approach to EU business for US-based firms.

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FIA Webinar: MiFID Crash Course for U.S. CCOs

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