



MiFID II: Core Action Items for Third-Country Firms

FIA Webinar

Monday, 13 November 2017

Nathaniel W. Lalone
Katten Muchin Rosenman UK LLP

Neil D. Robson
Katten Muchin Rosenman UK LLP



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.
- CLE certificates will be emailed shortly after conclusion of the webinar.



Upcoming Webinars and Events



Antitrust Considerations for Participants in Commodities Markets

November 16, 2017 | 10:00 AM – 11:00 AM EST | Webinar



Recordkeeping

December 14, 2017 | 10:00 AM – 11:00 AM EST | Webinar

Learn more and register at
FIA.org/events



Access additional MiFID II resources: FIA.org/key-issues/mifid



1. Introduction



MiFID II & MiFIR

- MiFID II – the EU’s revised Market in Financial Instruments Directive
- MiFIR – the accompanying Markets in Financial Instruments Regulation
- MiFID II and MiFIR take effect on 3 January 2018
 - Implementation has been delayed by 1 year.
- Implementation Challenges
 - Despite the extensive legal text and interpretive guidance, a number of key implementation gaps remain.
- Core Action Items
 - This presentation identifies several “action items” applicable to third-country firms in the run-up to January 2018.
 - It does not purport to be an exhaustive list!





2. Position Limits & Reporting

Position Limits

■ 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 held by “persons”.
 - Excludes physically-settled gas and electricity forwards covered by REMIT that are traded on OTFs.
 - cf. ESMA Opinion on contracts traded on third-country venues.

● Setting the Limits

- National regulators are responsible for setting limits on the commodity derivatives executed on venues in their jurisdiction.
- Where bespoke limits are not set (e.g., “illiquid” contracts), then a standard limit of 2,500 lots will apply.

● Aggregation

- EU aggregation rules apply on an ownership, not control, basis.



Position Limits

- Identify commodity derivatives that you are trading.
 - Which EU trading venues do you trade on?
 - Which of the products on those venues are commodity derivatives?
- Identify whether you enter into any EEOTC transactions.
 - Which OTC trades share similar features to the venue-traded products?
 - Do these OTC trades reach the standard of EEOTC?
 - What about trades on third-country venues?
- Determine your position aggregation status.
 - Is there a parent/subsidiary relationship?
 - If so, is the subsidiary a collective investment undertaking?
 - If so, does another party determine the sub's trading decisions?
- Be able to demonstrate compliance!



Position Reporting – Investment Firms

- Article 58(2) of MiFID II
 - ESMA guidance states that the “end-client” for purposes of the position reporting regime refers to the first non-investment firm.
 - Where the non-investment firm itself carries client accounts, it is considered a “nice-to-have” to look through to the positions of the underlying clients.
 - *Example.*
 - A US FCM provides a client with trading access to an EU venue through its EU-based investment firm affiliate.
 - The EU affiliate is an investment firm directly subject to the position reporting rules.
 - The US FCM is not an investment firm, meaning that the position reporting obligation “stops” with the US FCM.
 - What does Day 1 compliance look like for a US FCM?





3. Investment Research



Investment Research

- Research as an ‘inducement’?
 - In scope are research materials or services: (1) concerning one or several financial instruments or other assets; or (2) concerning the issuers or potential issuers of financial instruments; or (3) closely related to a specific industry or market such that it informs views on financial instruments, assets or issuers within that sector, and which in each case, explicitly or implicitly recommends or suggests an investment strategy and provides a substantiated opinion as to the present or future value or price of such instruments or assets, or otherwise contains analysis and original insights and reaches conclusions based on new or existing information that could be used to inform an investment strategy or be capable of adding value to a firm’s decisions on behalf of clients.



Investment Research

- Research payment account mechanism
 - Such research cannot be received for ‘free’.
 - Managers must either pay for it from their own P&L or pay from an RPA.
 - Administrative burden/ cost of compliance.
 - Application to US managers/ delegates of UK managers
 - Application for US FCMs and banks and brokers?
 - What charges will be charged for research?
- Recent SEC No-Action Relief
 - What does it mean for US firms?



Research Payments – US issues and ‘fix’

- Impasse: US B-Ds may not charge for research – vs – EU managers must pay for research!
- Issues:
 - US Advisers Act
 - US Investment Company Act
 - US Securities Exchange Act
- SEC no action relief





4. Documentation



Documentation

- EU Broker-Dealers are only now (early November) starting to send out their MiFID II documentation:
 - Revised Terms of Business
 - Refreshed client status disclosures (retail, professional or eligible counterparty)
 - Non-EU investment firm
- No significant changes overall



5. Legal Entity Identifiers



LEIs

■ No LEI – No Trade!!!

- A legal entity wishing to trade with an EU investment firm, or through an EU broker-dealer, or on an EU trading venue MUST have a Legal Entity Identifier (“LEI”) before 3 January.
- Unique 20 character codes associated with legal entities, LEIs are currently required for all swap counterparties (and for EMIR reporting).
- LEIs are issued by various parties operating under the auspices of the Global LEI Foundation (<https://www.gleif.org/en>).
- In the US, a prominent issuer of LEIs is the Global Markets Entity Identifier (“GMEI”) utility operated by Business Entity Data B.V., a subsidiary of DTCC: <https://www.gmeiutility.org/index.jsp>



LEIs

- Application information includes details concerning the existence and legal status of the entity and identification of its direct and ultimate parent entities. The information provided is validated from third party information sources by the LEI issuer.
- Individuals generally are not eligible to receive an LEI. However, an individual “acting in a business capacity” as defined by GLEIF *can* obtain an LEI:
http://www.leiroc.org/publications/gls/lou_20150930-1.pdf
- The basic registration charge is \$119. See <https://www.gmeiutility.org/gmeiUtilityPricing.jsp>
- It ordinarily takes three to five business days from the time a request for an LEI is received for the LEI to be issued
- An LEI is valid for one year. They need renewing annually!





6. Transaction Reporting



Transaction Reporting

- The following are required to submit transaction reports:
 - EU investment firms;
 - EU credit institutions providing investment services or performing investment activities; and
 - EU branches of third-country firms.
- **NB:** Where a transaction is entered into on an EU trading venue and neither party is itself subject to the transaction reporting rules, then the venue submits the report.
- Transaction reports must be submitted in respect of:
 - financial instruments admitted to trading or traded on a trading venue;
 - financial instruments where the underlying instrument is traded on a trading venue;
 - financial instruments where the underlying is an index or basket of instruments that are traded on a trading venue.



Transaction Reporting

- Third-country firms will be indirectly affected by the need for their EU investment firm counterparts to submit reports.
- What should a third-country firm be doing?
 - Diligence all trade flows to European venues or with EU investment firm counterparts.
 - Identify the key legal entities and key personnel that are involved in the trade flows, including investment decision-making and responsibility for trade execution.
- Two important comments:
 - Your EU counterparties may be relying on you to get this right.
 - The ESMA Guidelines on transaction reporting are fiendishly complicated – this is not easy, so start now if you haven't already.



7. Third-Country Venues



EU Trading Obligation

- In General. Mandatory trade execution applies to OTC derivatives (or a class or subset thereof) that:
 - are subject to mandatory clearing under EMIR;
 - have been determined to be subject to mandatory trade execution; and
 - have been entered into between certain types of counterparties.
- US-EU Announcement on Venue Equivalence
 - Announcement did not declare equivalence; instead, it stated an intention for equivalence to be put in place.
 - We are expecting more information this month (November).
 - Two possible options for third-country (e.g., US) venues:
 - “automatic” equivalence – no action needed; or
 - “opt-in” equivalence – action required.
- NB: finalisation of EU trading obligation RTS.



Post-Trade Transparency

- Article 21 of MiFIR
 - Investment firms that conclude transactions in derivatives bilaterally are subject to post-trade transparency requirements where the underlying derivative is also listed for trading on a trading venue.
- Question: Are trades on third-country venues then considered “bilateral”?
 - An EU investment firm transacting on a third-country venue could be deemed to be engaged in “bilateral” trading and therefore subject to the Article 21 post-trade transparency requirements.
 - This could lead to significant challenges for EU investment firms, third-country venues, and the non-EU participants on third-country venues.



Post-Trade Transparency

- **ESMA Opinion**

- EU investment firms that transact on a third-country venue would not be subject to EU post-trade transparency requirements where the third-country venue:
 - operates a multilateral system;
 - is subject to authorisation in its home jurisdiction;
 - is subject to supervision and enforcement on an ongoing basis in its home jurisdiction by a regulator that is a full signatory to the IOSCO MMOU; and
 - has a post-trade transparency regime in place where transactions on the venue are published as soon as possible following execution or, in clearly defined situations, after a deferral period.
- Third-country venues – especially US SEFs and US DCMs – should be prepared to make the required filings (to the extent necessary).



Transaction Reporting

- The transaction reporting requirements also apply where in-scope counterparties trade in such products outside of a trading venue but where the product in question is TOTV.
- The Challenge
 - Certain types of standardised derivatives are traded on EU venues as well as on third-country venues.
 - The non-EU product could be characterised as TOTV, in which case an EU firm trading on the third-country venue may be subject to transaction reporting requirements in respect of such trading.
- ESMA Opinion – The Solution?
 - An off-venue derivative is only subject to transaction reporting where it “shares the same reference data details” as a derivative traded on an EU venue.
 - The values reported in the transaction reporting data fields (other than venue- and issuer-related fields) of the off-venue derivative must be *identical* to those of a derivative traded on an EU venue for the reporting obligation to apply.



8. Direct Electronic Access



Direct Electronic Access

- **Key Scoping Questions:**
 - Do I provide/receive trading access to EU trading venues?
 - What role do I play? (e.g., client, provider, sub-delegate)
 - Does that form of access meet the definition of DEA?
- **What happens if you are (or may be) in scope?**
- **Legal Status in Relevant EU Member State(s)**
 - Where are the EU trading venues located?
 - How have the relevant EU Member State(s) implemented the new authorisation requirements for DEA clients/providers?
 - Are you eligible for any exemptive relief? If so, does this require a filing? By when?
 - Is there any updated regulatory guidance that provides greater clarity on jurisdictional scope?



Direct Electronic Access

- **Due Diligence Requirements**
 - DEA providers must diligence the following of their DEA clients:
 - governance and ownership structure;
 - types of strategies to be undertaken;
 - the operational set-up, the systems, the pre-trade and post-trade controls and the real time monitoring;
 - who is responsible for dealing with actions and errors;
 - historical trading pattern and behaviour;
 - level of expected trading and order volume;
 - Ability to meet financial obligations;
 - disciplinary history.
 - Also applies on a “sub-delegation” basis.
 - Annual renewals.



Direct Electronic Access

- **Systems/Controls for DEA Providers**

- A DEA provider must apply the following controls:
 - an automated surveillance system to detect market manipulation;
 - pre-trade controls on order entry, including price collars, maximum order values, maximum order volumes and maximum messages limits;
 - real-time monitoring of algorithmic trading activity; and
 - post-trade controls, including the monitoring of market and credit risk exposure.
- A DEA provider must ensure that its trading systems enable it to:
 - monitor DEA orders submitted by a DEA client;
 - automatically block or cancel such orders in certain scenarios;
 - stop order flows transmitted by its DEA client;
 - suspend or withdraw DEA services to any DEA client; and
 - review the internal risk control systems of DEA clients.



Direct Electronic Access

- A DEA provider must also:
 - assign a unique ID code to each DEA client and trading desks of such DEA client;
 - enter into a “binding written agreement” with each DEA client regarding the essential rights and obligations relating to DEA;
 - provide notice to the relevant regulator(s) that it provides DEA; and
 - maintain adequate records to substantiate its compliance.



Katten Locations

AUSTIN

One Congress Plaza
111 Congress Avenue
Suite 1000
Austin TX 78701-1073
+1.512.691.4000 tel
+1.512.691.4001 fax

HOUSTON

1301 McKinney Street
Suite 3000
Houston, TX 77010-3033
+1.713.270.3400 tel
+1.713.270.3401 fax

LOS ANGELES – CENTURY CITY

2029 Century Park East
Suite 2800
Los Angeles, CA 90067-3012
+1.310.788.4400 tel
+1.310.788.4471 fax

ORANGE COUNTY

100 Spectrum Center Drive
Suite 1050
Irvine, CA 92618-4960
+1.714.966.8819 tel
+1.714.966.8821 fax

WASHINGTON, DC

2900 K Street NW
North Tower - Suite 200
Washington, DC 20007-5118
+1.202.625.3500 tel
+1.202.298.7570 fax

CHARLOTTE

550 South Tryon Street
Suite 2900
Charlotte, NC 28202-4213
+1.704.444.2000 tel
+1.704.444.2050 fax

IRVING

545 East John Carpenter Freeway
Suite 300
Irving, TX 75062-3964
+1.972.587.4100 tel
+1.972.587.4109 fax

LOS ANGELES – DOWNTOWN

515 South Flower Street
Suite 1000
Los Angeles, CA 90071-2212
+1.213.443.9000 tel
+1.213.443.9001 fax

SAN FRANCISCO BAY AREA

1999 Harrison Street
Suite 700
Oakland, CA 94612-4704
+1.415.293.5800 tel
+1.415.293.5801 fax

CHICAGO

525 West Monroe Street
Chicago, IL 60661-3693
+1.312.902.5200 tel
+1.312.902.1061 fax

LONDON

125 Old Broad Street
London EC2N 1AR United Kingdom
+44 (0) 20 7776 7620 tel
+44 (0) 20 7776 7621 fax

NEWYORK

575 Madison Avenue
New York, NY 10022-2585
+1.212.940.8800 tel
+1.212.940.8776 fax

SHANGHAI

Suite 4906 Wheelock Square
1717 Nanjing Road West
Shanghai 200040 P.R. China
+86.21.6039.3222 tel
+86.21.6039.3223 fax



FIA

