The MiFID II Primer:

Third-Country Framework

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Introduction

MiFID II & MiFIR

- MiFID II. The revised Market in Financial Instruments Directive ("**MiFID II**").
  - EU directives such as MiFID II require implementation in the national law of each EU Member State.
  - National implementation allows for a certain degree of discretion in how the EU-level principles are given effect.
- MiFIR. The Markets in Financial Instruments Regulation.
  - EU regulations have "direct effect" in EU Member States and do not require implementation.
  - This provides for a maximum level of harmonisation across the EU in the covered topic areas.
- MiFID II and MiFIR take effect on 3 January 2018.
  - Implementation has been delayed by 1 year

1. Third-Country Firms

Third-Country Firms

- What are third-country firms?
  - MiFID II defines a third-country firm as a firm that would be an investment firm (or a credit institution providing investment services or performing investment activities) if its head office or registered office was in the EU.
  - The status of a third-country firm is determined on an entity-by-entity basis.
    - For example, a U.S. FCM with its headquarters in New York will be a third-country firm, even if it has an affiliate, or parent entity, in the EU.
  - Currently, MiFID I has no formal approach to third-country firms.
    - Third-country firms must therefore look to the national regulatory regime in each EU Member State where it conducts investment activities or performs investment services.

Third-Country Firms

- Why does it matter to be a third-country firm?
  - MiFID II and MiFIR generally apply to certain types of entities, including:
    - investment firms;
    - credit institutions;
    - financial counterparties; and
    - NFC+.
  - A third-country firm cannot qualify as any of the foregoing types of entity.
  - For example:
    - Authorisation of an investment firm under MiFID II may only be granted by the national regulatory of the investment firm's "home [EU] Member State".
    - A third-country firm, which has no presence in the EU, will not have a "home [EU] Member State" and therefore is ineligible for authorisation

"Direct" Compliance Consequences

- <u>Authorisation Requirements</u>.
  - Certain activities in the EU can trigger investment firm authorisation:
    - provision/receipt of direct electronic access to an EU trading venue;
    - own-account trading on an EU trading venue using high-frequency algorithmic trading; and/or
    - own-account trading as "market maker".
  - To the extent that a third-country firm becomes subject to authorisation, it would be required to either:
    - establish a presence in the EU that is able to be authorised; or
    - cease the business altogether.
  - **NB:** National implementation of MiFID II may provide relief from the application of authorisation requirements.
    - For example: the overseas persons exclusion in the UK.

“Direct” Compliance Consequences

- <u>“Direct” Compliance Requirements</u>.
  - Position Limits
    - The new MiFID II position limits regime applies at the level of a “person”.
    - The regime extends to cover third-country firms trading in commodity derivatives and other covered contracts that fall within the scope of the regime.
  - Straight-Through Processing
    - EU CCPs and trading venues will be adopting or amending their rules to facilitate these STP requirements.
    - These rules will likely be binding directly on all relevant clearing members, even FCMs that are Third-Country Firms.
  - Mandatory Trade Execution
    - Certain mandatorily-cleared OTC Derivatives will be subject to on-venue execution.
    - Third-country firms will be subject to these requirements where they trade such derivatives with an EU firm that is a Financial Counterparty or NFC+.
    - There are also several circumstances in which trades between two Third-Country Firms may be caught by a direct mandatory trade execution obligation.
  - Indirect Clearing for Exchange-Traded Derivatives

"Indirect" Compliance Consequences

- "Indirect" Compliance Requirements.
  - Certain compliance obligations that do not fall directly on third-country firms but fall instead on their EU counterparties, in which case a third-country firm may be requested/required to take certain actions to help the EU counterparty meet its own compliance requirements.
  - General Clearing Member Obligations
    - EU investment firms that act as general clearing members of EU CCPs must comply with certain MiFID II requirements in connection with the clearing services they provide.
    - A third-country firm that accesses an EU CCP through an EU investment firm that is a general clearing member may be affected by the compliance obligations imposed directly on such clearing member.
  - Algorithmic Trading
    - MiFID II sets out a number of new requirements in connection with the use of algorithmic trading on EU trading venues.
    - These rules do not expressly apply to third-country firms, except that where a third-country firm is a member of an EU trading venue, it will be required to comply with such venue's rules relating to algorithmic trading.
    - In addition, where a third-country firm engages in algorithmic trading through an EU investment firm, the investment firm will likely expect cooperation from the third-country firm in meeting its compliance obligations
  - Transaction Reporting
    - MiFIR establishes an extensive new regime for transaction reporting on a T+1 basis.
    - Third-country firms are generally out of scope of the expanded transaction reporting regime; however, they will likely be required to provide an increased amount of information to the EU firms that are subject to the new regime.
    - **NB:** EU branches of third-country firms are directly subject to these new rules and will need to comply with them.
  - Clock Synchronisation
    - An FCM that is a member or participant of a Trading Venue may be required to synchronise its business clocks to UTC in accordance with new MiFID II rules

Third-Country Firms – "Passport"

- Under MiFID II, third-country firms 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 third-country firm's home jurisdiction:
    - achieves the same objectives as the MiFID regime; and
    - provides EU firms equivalent access;
  - the third-country firm must submit an application to ESMA in the required format; and
  - for a 3-year transition period following an equivalence determination, a third-country firm may continue to rely on the national regulatory regimes in each EU Member State relevant to its business.
- A third-country firm 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/authorisations from EU national regulators.

2. 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.
- 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.
  - RTS 21 adopted by European Parliament in February 2017

Position Limits - Applicability

- 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; plus
    - commodity derivatives considered the "same" commodity derivatives as such commodity derivatives; plus
    - EEOTC contracts.
  - EEOTC contracts are defined as contracts with "identical contractual specifications and terms and conditions" as exchange-traded contracts.
    - Excludes differences based on different lot sizes, delivery dates that vary less than one calendar day and post-trade risk management.
  - Limits to be set for spot and all non-spot months.
  - Net position calculations can apply to contracts traded on third-country venues (e.g., a US futures exchange) that are economically equivalent (EE) to contracts traded on an EU trading venue if such third country trading venue is not listed in the ESMA Opinion 70-154-165 of 31 May 2017.

Position Limits – Commodity Derivatives

- "Commodity Derivatives". The term is defined in Article 2(1)(30) of MiFIR to include:
  - securities based on an underlying commodity;
    - financial instruments referred to in Article 4(1)(44)(c) of MiFID II which relate to a commodity or an underlying referred to in Section C(10) of Annex I to MiFID II
  - cash-settled derivatives;
    - financial instruments referred to in Section C(5) of Annex I to MiFID II
  - physically-settled derivatives other than REMIT products;
    - financial instruments referred to in Section C(6) of Annex I to MiFID II
  - other financial derivatives used as investments; and
    - financial instruments referred to in Section C(7) of Annex I to MiFID II
  - cash-settled derivatives with "exotic" underlyings.
    - financial instruments referred to Section C(10) of Annex I to MiFID II

Position Limits - Aggregation

- 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.
  - RTS 21 establishes a top-down aggregation rule as follows:
    - net positions must be calculated per subsidiary and at an overall group level;
    - excludes permissible risk-reducing hedges (for non-financial entities only); and
    - calculated for spot and non-spot month limits.
  - Aggregation exception for the parent undertaking of a collective investment undertaking where it does not in any way influence the investment decisions in respect of opening, holding or closing the positions.
  - cf. Article (4) and Recital (4) of RTS 21

Position Limits – Hedge Exemption

- <u>Risk-Reducing Hedging Exemption</u>
  - 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.
  - Provided the requirements of Article 7 of RTS 21 are met, the following are permissible:
    - macro/portfolio hedging;
    - proxy hedging; and
    - subsequent evolution of risks originally hedged.
  - A non-financial entity must apply to the relevant competent authority for a risk-reducing exemption, which has 21 calendar days to approve or reject the application.

Position Limits – Setting of the Limits (1)

- Procedure
  - 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.
- Spot Month
  - "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% (or 20% for certain foodstuffs), with scope for national regulators to set a limit from 5% to 35% based on certain factors.
  - Competent authorities calculate deliverable supply.

Position Limits – Setting of the Limits (2)

- 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 up to 35% or down to 5% (or to 2.5% for certain foodstuffs).
- 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

Position Limits - Compliance

- Monitoring and Enforcement Authority
  - National regulators 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.

Position Monitoring – Trading Venues

- 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.

Position Reporting – Trading Venues

- Article 58(1) of MiFID II
- 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.

Position Reporting – Investment Firms

- <u>Article 58(2) of MiFID II</u>
  - 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 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).

3. Mandatory Trade Execution

Mandatory Trading: Who

- Where an OTC derivative (or class or subset thereof) is subject to mandatory trading, the obligation must be discharged where the OTC Derivative has been entered into:
  - *between Financial Counterparties;
  - *between two NFC+;
  - *between a Financial Counterparty and an NFC+;
  - between a Financial Counterparty/NFC+ and a third-country firm that would be a Financial Counterparty/NFC+ if established in the EU; or
  - between two third-country firms that would be Financial Counterparties/NFC+ if established in the EU and where the trade has a "direct, substantial and foreseeable" effect in the EU, i.e. where either:
    - at least one third-country firm is guaranteed by an Financial Counterparty and the guarantee is:
      - ❖ in excess of €8 billion in total gross notional of such third-country firm's OTC derivatives and
      - ❖ at least equal to 5% of the guaranteeing Financial Counterparty's current exposures relating to OTC Derivatives; or
    - two third-country firms enter into the OTC derivative through their EU branches and both would qualify as Financial Counterparties if established in the EU.
- The obligation may also be imposed where necessary to prevent evasion.
- * **NB:** Does not include intragroup transactions or certain pension scheme trades.

Mandatory Trading: What (1/2)

- 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.
- Procedure.
  - **Step 1**.The OTC derivative (or class or subset thereof) must:
    - be admitted to trading, or traded on, at least one trading venue; and
    - ESMA must determine that there is sufficient liquidity (i.e., third-party buying and selling interests) to only be traded on trading venues.

Mandatory Trading: What (2/2)

- Procedure (cont'd).
  - **Step 2**.
    - ESMA is responsible for developing draft RTS covering the relevant OTC derivative (or class or subset thereof).
    - ESMA must undertake a public consultation.
    - The European Commission must then adopt the RTS.
  - **Step 3**.
    - Following adoption of the RTS, ESMA will enter the OTC derivatives into the mandatory trading register.
    - Compliance with mandatory trading will be subject to an implementation schedule set out in the RTS.
- ESMA has begun consultations on mandatory trading for certain interest rate and credit default swaps.

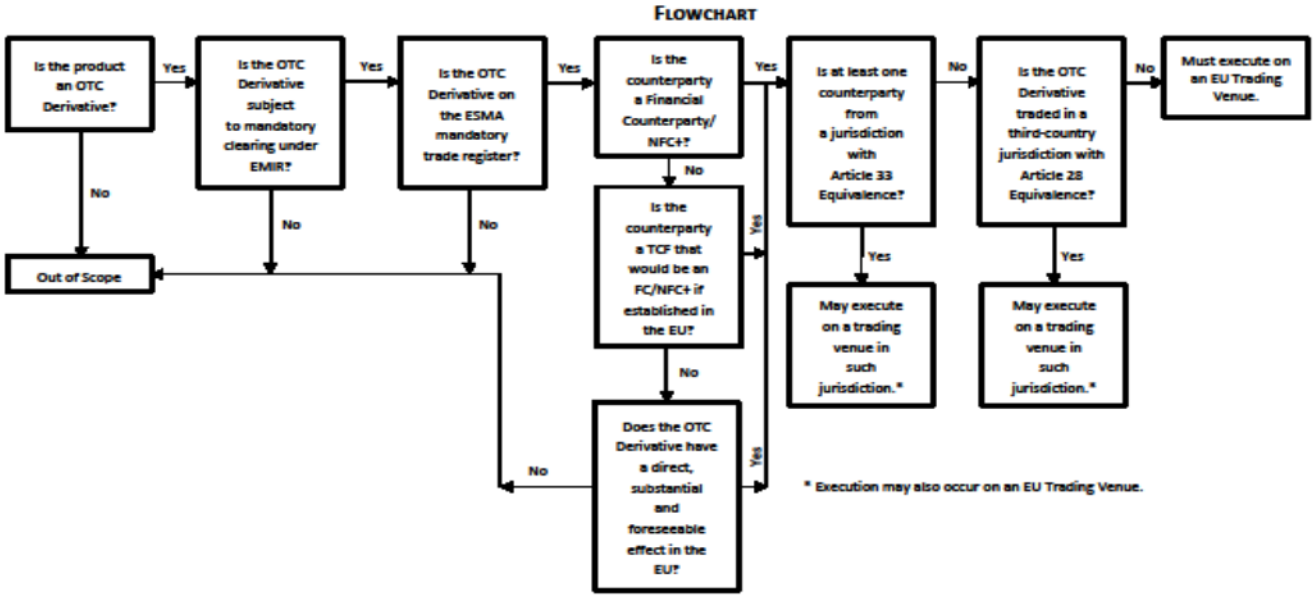
Mandatory Trading: Where (1/2)

- In General. The general rule is that an OTC Derivative (or class or subset thereof) subject to mandatory trade execution requirements and entered into between the relevant type(s) of counterparties must be executed on either a regulated market, MTF or OTF.
- Article 28 Equivalence.
  - The EC may determine that a third country's legal and supervisory regime for trading venues is equivalent to MiFIR for purposes of mandatory trade execution.
  - Where Article 28 equivalence applies, counterparties subject to mandatory trade execution may discharge this requirement by executing the OTC derivative on a venue in such third country.
  - There is no express restriction on the availability of Article 28 equivalence based on the location or establishment of the counterparties to the OTC derivative.

Mandatory Trading: Where (2/2)

- Article 33 Equivalence.
  - The EC may also determine that a third country's legal and supervisory regime is equivalent to MiFIR for purposes of:
    - mandatory trade execution; and
    - the clearing obligation for derivatives traded on a regulated market; and
  - that such regime is being applied in an equitable and non-distortive manner.
  - Where Article 33 equivalence applies, the mandatory trade execution requirement of MiFIR may be discharged by executing the OTC derivative on a trading venue in such third country
    - **however**, at least one counterparty to the OTC derivative must be established in such third country and the OTC derivative must be executed in accordance with the applicable legal and supervisory arrangements of such third country.
  - The third-country regime must also have professional secrecy obligations equivalent to those set out in MiFIR.

Mandatory Trading: Flowchart



NB: Capitalised terms are defined in the accompanying Briefing Note.

IMPORTANT NOTE: This flowchart is intended to provide an indicative overview of the application of MiFIR's mandatory trade execution requirements. It does not constitute legal advice of any kind and does not, and does not purport to, describe all material issues relating to the relevant subject matter. It should be read in conjunction with the accompanying Briefing Note and should not be relied upon in connection with any particular transaction or otherwise.

4. Straight-Through Processing

STP: Overview

- STP requirements apply to the following “cleared derivatives”:
  - exchange-traded derivatives (i.e., a derivative traded on an EU regulated market or equivalent third-country market);
  - OTC derivatives (concluded bilaterally or on an MTF/OTF) subject to a mandatory clearing determination; and
  - all other derivatives that the counterparties agree to clear.
- Submission and acceptance for clearing must occur “as quickly as technologically practicable”.
- STP obligations vary depending on whether the cleared derivative is concluded electronically or non-electronically on a trading venue, or concluded bilaterally.

STP: Bilaterally-Concluded

- Bilaterally-Concluded: 30 / 60 / 60 / 10
  - **30 Minutes**. The clearing member is responsible for ensuring that the counterparties send the relevant information to the CCP within 30 minutes.
    - The clearing member is required to obtain "evidence" from its client of the time the cleared derivative was concluded.
  - **60 Seconds**. The CCP must then send the information received from the counterparties to the clearing member within 60 seconds.
  - **60 Seconds**. The clearing member then has 60 more seconds to accept/reject the trade.
  - **10 Seconds**. The CCP must then accept/reject the trade within 10 further seconds.
  - **NB**: Where the CCP's rules require a clearing member to set and maintain limits on its clients and provide for the automatic clearing where a trade falls within those limits, steps two through four above do not apply.
  - **Rejection**.
    - A CCP must inform the clearing member of rejection on a real-time basis; the clearing member then must inform its client as soon as it has been informed by the CCP.
    - The rejected trade will then be subject to the arrangements (if any) between the counterparties to the trade.
    - 1-hour resubmission window where failure to clear is due to a clerical or technical error.

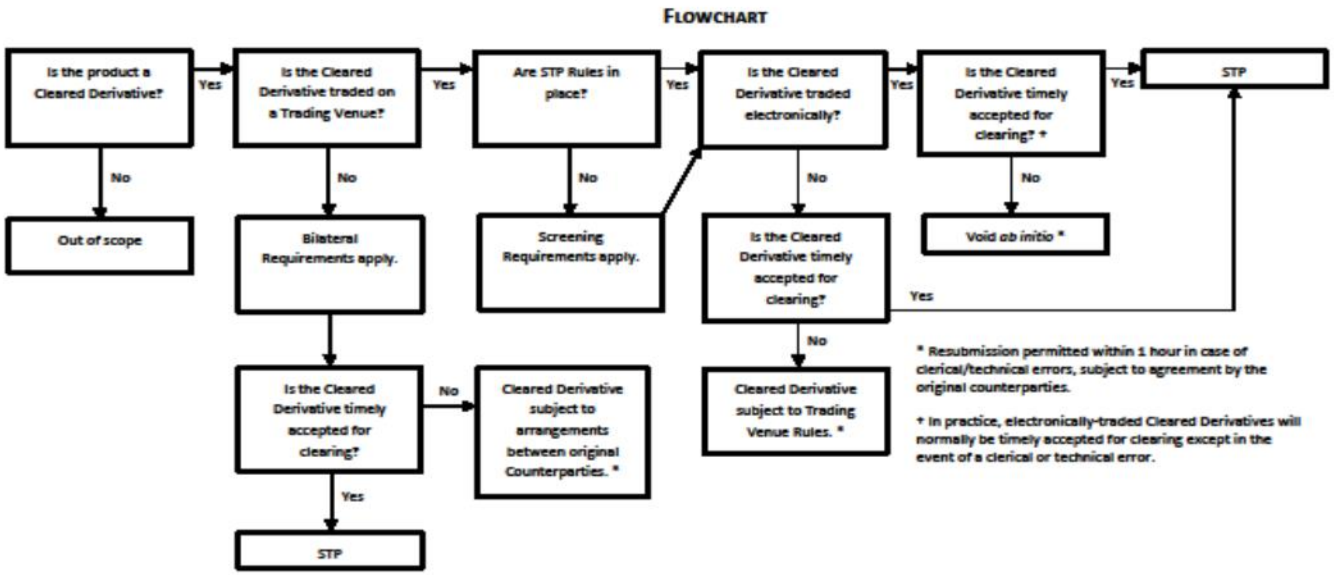
STP: On-Venue, Electronically Traded

- On-Venue, Concluded Electronically: 60 / 10 / 10
  - **NB:** The following requirements do not apply where the trading venue and CCP have adopted rules that meet certain criteria.
  - **Pre-Trade Screening – 60 Seconds**.
    - A clearing member must engage in pre-conclusion screening on an order-by-order basis to ensure that the relevant client limits are not breached.
    - The trading venue must ensure that the limits are not breached within 60 seconds.
      - ❖ A breach must be notified to the clearing member and client on a real-time basis.
  - **10 Seconds**. The trading venue then has 10 seconds to submit the trade to the CCP.
  - **10 Seconds**. The CCP must then accept/reject the trade within 10 further seconds.
  - **Rejection**.
    - A CCP must inform the clearing member and the trading venue of rejection on a real-time basis; the clearing member and trading venue then must inform the counterparty as soon as it has been informed by the CCP.
    - The rejected trade will then be void *ab initio*.
    - 1-hour resubmission window where failure to clear is due to a clerical or technical error.

STP: On-Venue, Non-Electronic

- On-Venue, Not Concluded Electronically: 10 / 10 / 10
  - **NB:** The following requirements do not apply where the trading venue and CCP have adopted rules that meet certain criteria.
  - **Pre-Trade Screening – 10 Minutes**.
    - A clearing member must engage in pre-conclusion screening on an order-by-order basis to ensure that the relevant client limits are not breached.
    - The trading venue must ensure that the limits are not breached within 60 seconds.
      - A breach must be notified to the clearing member and client on a real-time basis.
  - **10 Minutes**. The trading venue then has 10 minutes to submit the trade to the CCP.
  - **10 Seconds**. The CCP must then accept/reject the trade within 10 further seconds.
  - **Rejection**.
    - A CCP must inform the clearing member and the trading venue of rejection on a real-time basis; the clearing member and trading venue then must inform the counterparty as soon as it has been informed by the CCP.
    - The rejected trade will then be subject to the rules, if any, of the trading venue.
    - 1-hour resubmission window where failure to clear is due to a clerical or technical error.

STP: Flowchart



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