MiFID II: What Are We Waiting For?

Second in a series

Nathaniel W. Lalone
Katten Muchin Rosenman UK LLP

Neil D. Robson
Katten Muchin Rosenman UK LLP

FIA Webinar
20 September 2017

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

A CFTC Enforcement Refresher and Overview of Cooperation Credit
October 4, 2017 | 10:00 AM – 11:00 AM EDT | Webinar

33rd Annual Futures & Options Expo
October 17-19, 2017| Hilton Chicago| Chicago, IL
*Includes multiples sessions on key MiFID II topics. CLE offered for select sessions on Wednesday, October 18

Learn more and register at
FIA.org/events

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

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

MiFID II & MiFIR

- Implementing Measures. The "Level 1" texts of MiFID II and MiFIR are implemented through "Level 2" measures:
  - Delegated Acts ("**DA**")
  - Regulatory technical standards ("**RTS**")
  - Implementing technical standards ("**ITS**")
  - 3(ish) DAs / 28(ish) RTS / 8(ish) ITS
- Additional Guidance. There are the following sources of guidance in addition to "Level 1" and "Level 2":
  - ESMA Questions and Answers ("**Q&A**")
  - ESMA Guidelines
  - ESMA Opinions

MiFID II & MiFIR

- Implementation Challenges.
  - Despite the extensive legal text and interpretive guidance, a number of key implementation gaps remain.
  - This reflects the "hand-off" from a legal-driven framework to an operational/implementation driven process.
- "Known Unknowns". This presentation will focus on a handful of "known unknowns" facing third-country firms:
  - position reporting & position limits;
  - mandatory trade execution requirements;
  - research payments;
  - redocumenting client relationships;
  - transparency and transaction reporting on third-country venues; and
  - direct electronic access & sub-delegation.

2. Position Limits & Reporting

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 – Setting of the Limits

- 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.
- National Position Limit Implementation
  - *France*
    - 10 August 2017: ESMA confirmed the AMF's proposed limits on rapeseed, corn and milling wheat.
  - *UK*
    - 29 August 2017: FCA established limits for several dozen commodity derivatives traded on the following UK venues:
      - ICE Futures Europe
      - LME
      - Tradition Energy
    - All other commodity derivatives will be subject to the "standard" limit of 2,500 lots.

Position Reporting – Investment Firms

- 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 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).
  - Reports are filed on a net, rather than gross, basis.

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 then happens where the US FCM's account is a client omnibus account?

2. Mandatory Trade Execution

Mandatory Trading

- 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.
- Cross-Border Challenges.
  - In-scope counterparties, in particular FCs and NFC+, will no longer be able to trade on third-country venues, e.g. SEFs, in the absence of an equivalence determination.
  - Non-EU counterparties on third-country venues, and the third-country venues, may need to "police" the application of an EU mandatory trading requirement on EU participants.
    - Some non-EU counterparties are also directly subject to compliance with an EU mandatory trading requirement.

Mandatory Trading

- 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

- 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

- Where are we on equivalence determinations?
  - The EU and the US authorities are aware of the potential disruption.
  - CFTC Chairman Giancarlo visit to Europe last week reportedly included discussions on trading equivalence.
  - Market participants and third-country venues must consider fall-back positions or other contingency plans should equivalence not be in place by January 2013.
- NB: The EU's mandatory trading rules for IRS and CDS have not yet been finalised.

Mandatory Trading

- A digression into equities…
  - Article 23 of MiFIR requires investment firms to trade shares admitted to trading or traded on an EU trading venue to trade only on:
    - a regulated market;
    - a multilateral trading facility;
    - a systematic internaliser; or
    - a third-country venue assessed as equivalent.
  - Potentially all dually-listed shares are in-scope of this obligation.
    - Example: Apple is traded on an EU venue as well as on Nasdaq.
    - EU investment firms may be prohibited from trading on Nasdaq.
  - To date, no equivalence determinations have been reached for third-country venues.

3. Research & Documentation

Research Costs: Application

- Under MiFID II, EU managers will have to agree a price for all research obtained from banks and brokers.
- 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?

Terms of Business: Repapering MiFID II

- Under MiFID II, significant changes will be needed to terms of business to ensure compliance with MiFID II:
  - LEIs required before any transaction
    - Look-through to underlying client?
    - Matched principal transactions/ intra-group trades?
  - Transaction reporting
  - Best execution
    - Client consent requirement
  - Costs of research/ other inducements?
  - Soft dollars/ commission sharing agreements?
  - Trade publication

4. Post-Trade Transparency & Transaction Reporting

Post-Trade Transparency

- **Article 10 MiFIR: Trades Concluded On-Venue**
  - The venue operator must make public the price, time and volume of derivatives executed on, or subject to the rules of, that venue.
  - Publication must take place "as close to real-time as technically possible".
  - Deferral of publication is permitted in certain cases:
    - trades that are "large-in-scale";
    - trades in illiquid instruments; and
    - trades that are above the "size specific to" a particular instrument.
  - The Article 10 requirements fall only on EU trading venues and therefore would not be imposed on third-country venues.

Post-Trade Transparency

- **Article 21 MiFIR: Trades Concluded Bilaterally**
  - 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, including:
      - obtaining the necessary data; and
      - establishing the necessary submission/reporting connections.
  - The costs could disincentivise EU investment firms from continuing to trade on third-country venues.

Post-Trade Transparency

- **ESMA Opinion**
  - ESMA published an opinion that an investment firm that transacts on a third-country venue would not be subject to Article 21 post-trade transparency requirements where certain the third-country venue:
    - operates a multilateral system;
    - is subject to authorisation in accordance with the legal and supervisory framework in its home jurisdiction;
    - is subject to supervision and enforcement on an ongoing basis in accordance with the legal and supervisory framework of the third country by a competent authority that is a full signatory to the IOSCO Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information; and
    - has a post-trade transparency regime in place, whereby transactions on the Third-Country Venue are published as soon as possible following execution or, in clearly defined situations, after a deferral period.
  - ESMA intends to publish a list of the third-country venues that meet the foregoing criteria.

Transaction Reporting

- **Article 26 of MiFIR**
  - Transaction reporting applies to derivatives that are admitted to trading on an EU trading venue as well as those that are concluded off-venue but which are "traded on a trading venue" ("**TOTV**").
- 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.
- 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 Reporting

- 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 TOTV;
  - financial instruments where the underlying is an index or basket of instruments that are TOTV.
- **NB:** The transaction reporting requirements apply to the foregoing instruments:
  - when executed on a trading venue; and
  - where in-scope counterparties trade in such products outside of a trading venue but where the product in question is TOTV.
- Question: How does this apply to trading on third-country venues?

Transaction Reporting

- The Challenge
  - Derivatives traded on third-country venues could fall within the transaction reporting regime to the extent they are seen as TOTV for purposes of MiFIR.
  - Certain types of standardised derivatives are traded both on EU venues as well as third-country venues.
  - The non-EU product could be characterised as TOTV, in which case the EU firm trading on the third-country venue may be subject to transaction reporting requirements in respect of such trading.
- The Solution
  - ESMA has published an opinion setting out the circumstances in which a financial instrument is considered TOTV for these purposes.
  - 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.

5. Direct Electronic Access

Direct Electronic Access

- **Definition.** DEA exists where two primary criteria are met:
  - a person (*i.e.*, the DEA client) uses the trader ID of a member or participant (*i.e.*, the DEA provider) when electronically transmitting orders directly to an EU venue; and
  - the DEA client has discretion as to the exact fraction of a second that an order hits the EU venue's order book and the lifetime of such order within that time frame.
- DEA includes:
  - the use of the infrastructure of the DEA provider, or any connecting system provided by the DEA provider, to transmit the orders (direct market access or "**DMA**"); and
  - where such infrastructure is not used (sponsored access or "**SA**").

Direct Electronic Access

- **Carve-Outs.** Several carve-outs from the definition of DEA exist, including the following.
  - No Discretion. Where a potential DEA client cannot exercise the necessary discretion, for example in the case of "on-line brokerage" where a person electronically submits orders to a member/participant, which then determines the time the order is submitted to the order book.
  - SORs. Smart order routers ("**SORs**") determine trading parameters – other than the EU venue(s) where the order should be submitted – and will be considered DEA only where the SOR forms part of the client's systems. Otherwise, for example where the SOR forms part of the systems of the member/participant, there will be no DEA.

Direct Electronic Access

- **Binary Consequence for Market Participants**
  - MiFID II requires own-account dealing firms with DEA to an EU venue to be authorised investment firms.
  - MiFID II also requires the venue member providing DEA to be an authorised investment firm or credit institution.
- **Challenge #1 – Scope Disagreements**
  - The definition, and carve-outs, are not granular enough to allow for a straightforward application to a myriad of trading flows.
  - It is unlikely that further express guidance will be published:
    - market participants must therefore make a good faith determination whether their trade flows constitute DEA; and
    - there is no guarantee all market participants will reach the same conclusion, nor that all national regulators will agree either.
  - This could lead to a situation where intermediaries and vendors must contend with clients engaged in the same workflows but with different interpretations of DEA.

Direct Electronic Access

- **Challenge #2 – Sub-Delegation**
  - DEA providers are subject to certain obligations in respect of their DEA clients that in turn provide DEA to their own clients via "sub-delegation".
  - What are the consequences for sub-delegate DEA providers?
    - Are they subject to MiFID II authorisation requirements?
    - Does the answer change depending on the number of sub-delegates?
  - Authorisation obligations are set out in the national implementation of MiFID II in different EU Member States.
    - There are no clear answers regarding sub-delegation.
    - But the "overseas persons exemption" in the UK.

Direct Electronic Access

- **Challenge #3 – Third-Country Firms**
  - National implementing measures must contend with the authorisation requirements for DEA providers and DEA clients.
  - These implementing measures do not always address the DEA issue squarely.
    - Authorisation for DEA providers is not an “investment service” or “investment activity”.
    - But the “overseas persons exemption” in the UK.
  - There is a persistent delta between the black letter requirements of national legislation and the views expressed by national regulators.
  - A number of EU Member States have yet to adopt any legislation to implement MiFID II.

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

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

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

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

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

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

LOS ANGELES – CENTURY CITY
2029 Century Park East
Suite 2600
Los Angeles, CA 90067-3012
+1.310.788.4400 tel
+1.310.788.4471 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

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

ORANGE COUNTY
100 Spectrum Center Drive
Suite 1050
Irvine, CA 92618-4960
+1.714.966.6819 tel
+1.714.966.6821 fax

SAN FRANCISCO BAY AREA
1999 Harrison Street
Suite 700
Oakland, CA 94612-4704
+1.415.293.5800 tel
+1.415.293.5801 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

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