MiFID II and MiFIR Brief: Impact on U.S. FCMs

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FOREWORD

The Briefing Notes presented in this volume identify certain of the potential compliance obligations that may arise for U.S. futures commission merchants ("**FCMs**") and their clients as a consequence of the revised Markets in Financial Instruments Directive ("**MiFID II**") and the associated Markets in Financial Instruments Regulation ("**MiFIR**"), both of which take effect from 3 January 2018. Part 1 of this volume provides an introductory summary of the application of MiFID II and MiFIR to "third-country firms", including FCMs and their non-EU clients. Parts 2 and 3 focus on "direct" impacts, where authorisation and ongoing compliance obligations may fall expressly on FCMs and/or their clients.[1] Part 4 addresses "indirect" impacts, where FCMs and/or their clients may be affected due to the application of new MiFID II and MiFIR obligations on the European market participants with which they do business. Including a topic area in Part 2, 3 or 4 is not meant to be determinative; FCMs and their clients should make their own assessment of the level of impact a particular compliance requirement may have on their business.

Each Briefing Note provides links to the relevant European legislation discussed in the Note. Where applicable, a Briefing Note contains an Annex that provides an explanatory flow chart or more detailed information on an aspect of the compliance requirements addressed in the Note. Finally, there is a Glossary that provides summary explanations of certain defined terms used throughout the series of Briefing Notes.

***DISCLAIMER**: These Briefing Notes were drafted by Katten Muchin Rosenman UK LLP on behalf of FIA. They are provided for informational purposes and based on public sources only and do not constitute legal advice or a full description of the applicable legal or regulatory requirements under MiFID II, MiFIR, the relevant EU-level implementing legislation, related EU-level guidance or, where referenced, national implementation measures. Accordingly, firms should make their own decision regarding the applicability of the topic areas addressed herein based on their own independent advice from their professional advisors. Although care has been taken to assure that the contents of these Briefing Notes are accurate as of the date of issue, FIA specifically disclaims any legal responsibility for any errors or omissions and disclaims any liability for losses or damages incurred through the use of the information herein. FIA undertakes no obligation to update the contents of these Briefing Notes following the date of issue.*

[1] Please note that one such "direct" impact – in relation to indirect clearing arrangements – is the subject of a separate FIA memorandum and analysis and is accordingly not addressed herein.

GLOSSARY

Set out below are certain terms used in the accompanying Briefing Notes as well as their respective definitions. In some cases, a summary definition is provided along with references to more detailed definitions in the relevant European legislation.

Term	**Definition**
Algorithmic Trading	trading in Financial Instruments where a computer algorithm automatically determines individual parameters of the orders with limited or no human intervention, other than any system that: (1) routes or processes orders without determining such parameters; (2) confirms trades; or (3) performs post-trade processing *See* Article 4(1)(39) of MiFID II; *see also* Article 18 of the Definitions Delegated Regulation.
AOR	automated order router
Capital Requirements Regulation	Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012
CCP	central counterparty *See* Article 2(1) of EMIR.
CRD IV	Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC
Credit Institution	an undertaking the business of which is to take deposits or other repayable funds from the public and to grant credits for its own account NB: For the reasons discussed in Briefing Note 1, a Third-Country Firm cannot be a Credit Institution for purposes of MiFID II and MiFIR. *See* Article 4(1) of the Capital Requirements Regulation.
DEA	direct electronic access (including DMA and SA) *See* Article 4(1)(41) of MiFID II; *see also* Article 20 of the Definitions Delegated Regulation.
Definitions Delegated Regulation	Commission Delegated Regulation (EU) 2017/565 of 25.4.2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the

Term	**Definition**
	purposes of that Directive
DMA	direct market access (*i.e.*, a form of DEA where the person electronically transmitting orders to a Trading Venue uses the infrastructure of the member/participant providing the access) *See* Article 4(1)(41) of MiFID II.
EC	European Commission
EMIR	the European Market Infrastructure Regulation (Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade reporting)
ESMA	the European Securities and Markets Authority
Exchange-Traded Derivative	a derivative traded on a Regulated Market or on a third-country market that benefits from Article 28 Equivalence (described in Briefing Note 10) *See* Article 2(1)(32) of MiFIR.
Financial Counterparty	means: • an Investment Firm authorised in accordance with MiFID I; • a Credit Institution authorised in accordance with Directive 2006/48/EC; • an insurance undertaking authorised in accordance with Directive 73/239/EEC; • an assurance undertaking authorised in accordance with Directive 2002/83/EC; • a reinsurance undertaking authorised in accordance with Directive 2005/68/EC; • a UCITS and, where relevant, its management company, authorised in accordance with Directive 2009/65/EC; • an institution for occupational retirement provision within the meaning of Article 6(a) of Directive 2003/41/EC; and • an alternative investment fund managed by AIFMs authorised or registered in accordance with Directive 2011/61/EU. *See* Article 2(8) of EMIR.
Financial Instrument	means: • transferable securities; • money-market instruments;

Term	**Definition**
	• units in collective investment undertakings; • options, futures, swaps, forward rate agreements and any other derivative contracts relating to securities, currencies, interest rates or yields, emission allowances or other derivatives instruments, financial indices or financial measures which may be settled physically or in cash; • options, futures, swaps, forwards and any other derivative contracts relating to commodities that must be settled in cash or may be settled in cash at the option of one of the parties other than by reason of default or other termination event; • options, futures, swaps, and any other derivative contract relating to commodities that can be physically settled provided that they are traded on a regulated market, a MTF, or an OTF, except for wholesale energy products traded on an OTF that must be physically settled; • options, futures, swaps, forwards and any other derivative contracts relating to commodities, that can be physically settled not otherwise mentioned in the immediately preceding category and not being for commercial purposes, which have the characteristics of other derivative financial instruments; • derivative instruments for the transfer of credit risk; • financial contracts for differences; • options, futures, swaps, forward rate agreements and any other derivative contracts relating to climatic variables, freight rates or inflation rates or other official economic statistics that must be settled in cash or may be settled in cash at the option of one of the parties other than by reason of default or other termination event, as well as any other derivative contracts relating to assets, rights, obligations, indices and measures not otherwise mentioned in this list, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are traded on a regulated market, OTF, or an MTF; and • emission allowances consisting of any units recognised for compliance with the requirements of Directive 2003/87/EC (Emissions Trading Scheme). *See* Section C of Annex I to MiFID II.
HFAT	high-frequency algorithmic trading *See* Article 4(1)(40) of MiFID II; and Article 19 of the Definitions Delegated Regulation
Investment Firm	a legal person whose regular occupation is the provision of one or more investment services to third parties and/or the performance

Term	**Definition**
	of investment activities on a professional basis NB: For the reasons discussed in Briefing Note 1, a Third-Country Firm cannot be an Investment Firm for purposes of MiFID II and MiFIR. *See* Article 4(1)(1) and 4(1)(2) of MiFID II; *see also* Sections A & C of Annex I to MiFID II.
LEI	legal entity identifier
MiFID I	the Markets in Financial Instruments Directive (Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC)
MiFID II	the revised Markets in Financial Instruments Directive (Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU)
MiFIR	the Markets in Financial Instruments Regulation (Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012)
MTF	multilateral trading facility (*i.e.*, a multilateral system that brings together multiple third-party buying and selling interests in Financial Instruments, in the system and in accordance with non-discretionary rules that results in a contracts in respect of such Financial Instruments and which operates in accordance with Title II of MiFID II) *See* Article 4(1)(22) of MiFID II.
NFC+	a non-financial counterparty (*i.e.*, an undertaking established in the EU other than a Financial Counterparty) above the EMIR clearing threshold and therefore subject to the EMIR clearing obligation *See* Articles 2(9) and 10(1)(b) of EMIR.
OTC Derivative	a derivative the execution of which does not take place on a Regulated Market or a third-country market considered equivalent to a Regulated Market under EMIR *See* Article 2(7) of EMIR.
OTF	organised trading facility (*i.e.*, a multilateral system other than a Regulated Market or MTF where multiple third-party buying and

Term	**Definition**
	selling interests in, *inter alia*, derivatives interact in the system in a way that results in a contract) *See* Article 4(1)(23) of MiFID II.
Regulated Market	a multilateral system that brings together multiple third-party buying and selling interests in Financial Instruments in the system and in accordance with non-discretionary rules that results in a contracts in respect of such Financial Instruments and which operates in accordance with Title III of MiFID II *See* Article 4(1)(21) of MiFID II.
RTS	regulatory technical standards (*i.e.*, secondary legislation adopted by the European Commission for purposes of technical implementation of the general principles set out in primary legislation such as MiFID II / MiFIR)
SA	sponsored access (*i.e.*, a form of DEA where the person electronically transmitting orders to a Trading Venue does not use the infrastructure of the member/participant providing the access) *See* Article 4(1)(41) of MiFID II.
SFTR	the Securities Financing Transaction Regulation (Regulation (EU) 2015/2365 of the European Parliament and of the Council of 25 November 2015 on transparency of securities financing transactions and of reuse and amending Regulation (EU) No 648/2012)
SOR	smart order router
STP	straight-through processing
Third-Country Firm	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 located within the EU *See* Article 4(1)(57) of MiFID II.
Trading Venue	a Regulated Market, MTF or OTF NB: This term refers to European venues only. *See* Article 4(1)(24) of MiFID II.

PART 1
THIRD-COUNTRY FIRMS

1. APPLICATION TO THIRD-COUNTRY FIRMS

Overview

This Briefing Note explains the MiFID II and MiFIR framework that applies to Third-Country Firms, including FCMs and their non-EU clients.[2] As an initial matter, MiFIR provides for a so-called "Third-Country Passport" (defined below) for Third-Country Firms involved in the wholesale financial markets, which is described in greater detail in the final section of this Part; this passport is only available after an equivalence determination by the European Commission, which is not expected in the near-term, and does not apply when providing investment services or performing investment activities with retail clients.[3]

Until any such equivalence determination is reached – which may take several years, if it occurs at all – a Third-Country Firm must assess its compliance obligations by: (1) determining how the territorial scope of MiFID II and MiFIR applies to its activities in the EU; and (2) where the Third-Country Firm is in scope, consulting the national implementation of MiFID II and MiFIR in the domestic laws of each EU Member State in which such Third-Country Firm conducts investment services and/or activities.

Parts 2, 3 and 4 of this volume identify those aspects of MiFID II and MiFIR that may apply directly to FCMs and/or their clients (addressed in Parts 2 and 3) as well as those aspects that, while not expressly applying to Third-Country Firms, may indirectly impact FCMs and/or their clients (addressed in Part 4). A set of due diligence questions to facilitate an FCM's assessment of its potential compliance obligations under MiFID II and MiFIR is set out in an Annex to this Briefing Note.

Territorial Scope of MiFID II and MiFIR

In General

MiFID II and MiFIR generally apply to certain types of entities, principally those that are Investment Firms. Some obligations apply to Credit Institutions, Financial Counterparties, and NFC+. Because of how these types of entities are defined in MiFID II, MiFIR and other relevant EU legislation, Third-Country Firms such as FCMs and their non-EU clients cannot qualify as either an Investment Firm, Credit Institution, Financial Counterparty or NFC+.

For example, Third-Country Firms are ineligible for authorisation under MiFID II as such authorisation may only be granted to an Investment Firm by the competent authority in its "home Member State"; to have a "home Member State", an Investment Firm must have its registered or head office in an EU Member State, effectively precluding Third-Country Firms such as FCMs or their non-EU clients from falling within the definition of Investment Firm.[4]

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[2] For the avoidance of doubt, the discussion in this Briefing Note does not constitute advice that any specific Third-Country Firm (or group thereof) is in-scope of MiFID II and MiFIR.

[3] An equivalence decision in respect of a third-country passport is only one of several different types of equivalence provided for in MiFID II and MiFIR. A summary of the different equivalence arrangements is set out in an Annex to this Briefing Note.

[4] *See* Article 4(1)(55)(a) of MiFID II.

Analogous definitional restrictions prevent a Third-Country Firm from being a Financial Counterparty,[5] an NFC+,[6] or a Credit Institution.[7]

Set out below are the principal compliance consequences for FCMs and their clients.

Authorisation Requirements – Direct Impacts

Many of the "direct" impacts of MiFID II concern requirements to be authorised as an Investment Firm, which are addressed in Part 2 (Briefing Notes 2-4). Where a Third-Country Firm's activities trigger any of these authorisation requirements, such Third-Country Firm cannot itself become an Investment Firm because, as noted above, it does not have a "home Member State."

It is important to note that the MiFID II provisions requiring authorisation of Investment Firms must be implemented in the national law of each EU Member State. These national implementation measures may differ and may, depending on all the facts and circumstances, provide Third-Country Firms such as FCMs and their non-EU clients some form of relief from MiFID II requirements to be authorised as an Investment Firm in that Member State. Third-Country Firms must therefore review the implementation measures in each EU Member State in which they conduct activities giving rise to authorisation requirements to determine whether any exemptive relief is available.

If there is no relief available under the relevant national MiFID II implementation measures, the Third-Country Firm would then need to consider whether to: (1) establish a presence in an EU Member State such that it is able to be authorised as an Investment Firm; or (2) restructure its business in a way that does not trigger any of the relevant authorisation requirements.

Ongoing Compliance Requirements – Direct Impacts

Beyond authorisation requirements, several ongoing compliance obligations under MiFID II and MiFIR may apply directly to an FCM and/or its clients under certain circumstances, even though they are Third-Country Firms. These are briefly summarised below and are addressed in more detail in Part 3 (Briefing Notes 5-7).

- Position Limits. The new MiFID II position limits regime applies at the level of a "person" and extends to cover Third-Country Firms trading in commodity derivatives and other covered contracts that fall within the scope of the regime.

- STP. MiFIR requires that certain types of derivatives are subject to clearing on a straight-through processing basis. European CCPs and Trading Venues will be adopting or amending their rules to facilitate these STP requirements, and these rules will likely be binding directly on all relevant clearing members, even FCMs that are Third-Country Firms.

- Mandatory Trade Execution. MiFIR's trade execution obligation for certain mandatorily-cleared OTC Derivatives will apply directly to Third-Country Firms where

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5 *See* Article 2(8) of EMIR.

6 *See* Article 2(9) of EMIR.

7 *See* Articles 8(1) and 13(2) of CRD IV.

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. As noted in the footnote to the Foreword, the indirect clearing requirements and their potential impact on U.S. FCMs will be analysed in a separate FIA memorandum.

Ongoing Compliance Requirements – Indirect Impacts

Subject to the three exceptions identified above, many of the ongoing compliance obligations under MiFID II and MiFIR – other than authorisation – generally apply only to Investment Firms (or Credit Institutions engaging in Investment Firm activities). FCMs and their clients will therefore not be directly impacted by many of these ongoing obligations because they are Third-Country Firms rather than Investment Firms (or Credit Institutions engaged in Investment Firm activities).

However, where an FCM and/or its clients engage in certain business activities either as a member of a Trading Venue or with or through an Investment Firm (or Credit Institution engaged in Investment Firm activities), they may be indirectly affected as a consequence of the compliance obligations imposed directly on such Investment Firm or Credit Institution. These "indirect" impacts are addressed in Part 4 (Briefing Notes 8-11).

Implementation in EU Member States

MiFID II, as an EU directive, must be implemented in the national law of each EU Member State. Accordingly, Third-Country Firms that find themselves within scope of the MiFID II and MiFIR regime – in particular in respect of the authorisation requirements referred to above and described in more detail in Briefing Notes 2-4 – should consult with their professional advisers to determine the specific obligations imposed on them under the national law of the EU Member State(s) concerned. In certain circumstances, national implementing measures may provide relief from certain authorisation and/or compliance obligations.[8]

Please note that these national implementing measures relating to Third-Country Firms will no longer be available to an FCM following an equivalence decision by the European Commission in respect of the United States. From the date that is three years following such decision, FCMs and other U.S. firms will be required to rely on the "Third-Country Passport" (defined below) by making a short-form notice filing with ESMA.

"Third-Country Passport"

MiFID I did not expressly address the treatment of Third-Country Firms. MiFIR does establish a formal third-country regime for Third-Country Firms that engage in wholesale investment services activities.[9] Under this regime, a Third-Country Firm may engage in wholesale

[8] For example, more information on the UK implementation of MiFID II is set out in the FCA's Policy Statement I on MiFID II Implementation, published on March 31, 2017, and available at: https://www.fca.org.uk/publication/policy/ps17-05.pdf ("**PS17/5**").

[9] MiFID II establishes a separate regime for Third-Country Firms engaged in retail investment services and activities which is not addressed in this Briefing Note. *See* Articles 39-42 of MiFID II.

investment services and activities across the European Union (the "**Third-Country Passport**") if:

- the European Commission has determined that the prudential and business conduct rules of the relevant third-country jurisdiction have equivalent effect to the provisions of MiFID II, MIFIR and CRD IV;
- the Third-Country Firm is subject to appropriate supervision in its home jurisdiction; and
- appropriate cooperation arrangements are in place between ESMA and the regulatory authorities of the relevant third-country jurisdiction.

The Third-Country Passport regime becomes mandatory three years following the equivalence determination referred to above. Prior to then, including prior to the making of the equivalence determination, Third-Country Firms must assess their MiFID II and MiFIR compliance obligations by reference to the national implementation of MiFID II and MiFIR in the domestic law of the EU Member State(s) in which they conduct investment services and activities, as described earlier in this Briefing Note.

Article 46(6) of MiFIR requires Third-Country Firms benefiting from the Third-Country Passport, prior to providing any investment services or performing any investment activities in respect of a client established in the EU, to offer to submit any disputes relating to such services or activities to the jurisdiction of a court or arbitral tribunal in an EU Member State.

The following chart sets out a timeline with the compliance obligations for Third-Country Firms under national implementing measures and how this is affected by the availability of a Third-Country Passport. Note that a Third-Country Firm may only rely on an equivalence decision in respect of its home jurisdiction.

Timeframe	**Third-Country Firm Compliance Obligations**
Phase 1. No equivalence decision	National Rules Only. A Third-Country Firm *must* comply with the national implementing measures in each EU Member State in which it conducts investment services and/or activities.
Phase 2. The three-year period following the date of an equivalence decision	Transitional Period. A Third-Country Firm *may* rely on either: (1) the Third-Country Passport; or (2) the national implementing measures in each EU Member State in which it conducts investment services and/or activities.
Phase 3. Following the expiry of the three-year period in Phase 2.	Third-Country Passport Only. A Third-Country Firm *must* obtain a Third-Country Passport.

APPLICATION TO THIRD-COUNTRY FIRMS – ANNEX

DUE DILIGENCE QUESTIONS FOR FCMS

The following list of due diligence questions is intended to facilitate a firm's initial assessment of its potential compliance obligations under MiFID II and MiFIR. It does not purport to comprehensively address the issues summarised in the accompanying Briefing Notes or to fully cover all aspects of MiFID II and MiFIR. A firm should make its determination based on independent advice from its professional advisors.

(1) Am I a member or participant of a Trading Venue?

If you answered "yes" to this question, you may need to synchronise your business clocks in accordance with MiFID II requirements. See Briefing Note 11.

(2) Am I a member or participant of a Trading Venue that provides one or more clients with trading access to the systems of the Trading Venue?

If you answered "yes" to this question, MiFID II authorisation requirements may apply to you and to your clients if such access constitutes "direct electronic access." See Briefing Note 2.

(3) Do I, or any of my clients, trade in Financial Instruments where a computer algorithm automatically determines individual parameters of the orders?

If you answered "yes" to this question, then, depending on the facts and circumstances, you or your clients may be engaged in Algorithmic Trading and subject to certain ongoing compliance requirements. See Briefing Note 9.

In addition, if you answered "yes" to this question and "yes" to question (1), you may be required to comply with the relevant Trading Venue's rules in respect of algorithmic trading. See Briefing Note 9.

(4) If I am engaged in Algorithmic Trading (see question (3) above), do I do so via infrastructure that minimises network or other latencies which relies on system-determination of orders without human intervention?

If you answered "yes" to this question, then, depending on the facts and circumstances, MiFID II authorisation requirements may apply to you and to your clients if such trading constitutes "high-frequency algorithmic trading." See Briefing Note 3.

(5) Do I trade for my own account in Financial Instruments where I hold myself out on a continuous basis as being willing to buy and sell Financial Instruments at prices defined by me?

If you answered "yes" to this question, then MiFID II authorisation requirements may apply to you as a "market maker." See Briefing Note 4.

In addition, if you answered "yes" to this question and "yes" to question (3), you may be subject to ongoing compliance obligations for engaging in algorithmic trading pursuant to a market-making strategy. See Briefing Note 4.

(6) Am I a clearing member of an EU CCP?

If you answered "yes" to this question, you may be required to comply with MiFIR's rules relating to straight-through processing of certain derivatives contracts. See Briefing Note 6.

(7) Do I access an EU CCP through an Investment Firm that is a clearing member?

If you answered "yes" to this question, you may be affected by the ongoing compliance obligations that apply directly to such Investment Firm as a "general clearing member." See Briefing Note 8.

(8) Do I, or my clients, transact in commodity derivatives on a Trading Venue and/or in OTC derivatives that are economically-equivalent to such commodity derivatives?

If you answered "yes" to this question, you will be required to comply with MiFID II's new position limits regime. See Briefing Note 5.

(9) Do I, or my clients, transact in Financial Instruments traded on a Trading Venue and/or in OTC derivatives that are based on such Financial Instruments?

If you answered "yes" to this question, you may be affected by the transaction reporting obligations that apply directly to Trading Venues and Investment Firms under MiFIR. See Briefing Note 10.

(10) Do I, or my clients, transact in Financial Instruments that are OTC derivatives subject to mandatory clearing requirements under EMIR?

If you answered "yes" to this question, you may be subject to the mandatory trade execution requirements of MiFIR in respect of such OTC derivatives. See Briefing Note 7.

EQUIVALENCE DECISIONS IN MIFID II AND MIFIR – ANNEX

Set out below is a summary of the different types of equivalence determinations provided for in MiFID II and MiFIR.

Legislative Source	Description	Consequences of Equivalence
Article 2(1)(32) of MiFIR	Definition of "exchange-traded derivative"	Derivatives traded on a third-country venue benefiting from Article 28 equivalence (described below) will qualify as "exchange-traded derivatives" and *not* as OTC derivatives
Article 23 of MiFIR	Obligation to trade shares on a Regulated Market, MTF or systematic internaliser	Obligation can be met by trading on an equivalent third-country trading venue
Article 28 of MiFIR *see* Briefing Note 7	Mandatory trading of certain OTC derivatives subject to a clearing mandate on a Regulated Market, MTF or OTF	Obligation can be met by trading on an equivalent third-country trading venue
Article 33 of MiFIR *see* Briefing Note 7	Mandatory trade execution for derivatives and clearing obligation for derivatives traded on a Regulated Market	Obligation can be met by trading on an equivalent third-country trading venue
Article 38 of MiFIR	Non-discriminatory access to CCPs, trading venues and benchmark licenses	Third-country CCPs and trading venues may claim non-discriminatory access to EU CCPs, trading venues and benchmark licenses
Article 47 of MiFIR *see* Briefing Note 1	Provision of investment services and/or activities to wholesale financial market participants in the EU	Third-Country Firms can benefit from the Third-Country Passport
Article 25(4) of MiFID II	Investment Firm assessment of suitability and appropriateness of clients	A third-country trading venue can be treated as equivalent to a Regulated Market for determining whether it is necessary for a firm to enquire about a client's knowledge and experience with investments

PART 2
"DIRECT" IMPACTS: AUTHORISATION

2. DIRECT ELECTRONIC ACCESS (DEA)

Takeaway: An FCM that provides its client(s) with trading access to a Trading Venue must determine whether such access constitutes "direct electronic access", in which case both the FCM and its client(s) *may* be subject to authorisation as an Investment Firm, absent any available relief in the national implementing measures of the relevant EU Member State(s).

NB: *The discussion in this Briefing Note does not constitute advice whether a specific Third-Country Firm is in-scope of the DEA regime under MiFID II; Third-Country Firms and/or their clients should make their own determination in consultation with their professional advisors.*

Overview

This Briefing Note summarises the authorisation and other compliance obligations imposed by MiFID II on firms providing DEA ("**DEA Providers**") as well as on their clients ("**DEA Clients**") and relevant Trading Venues. Note that, for these purposes, a DEA Client may itself be an intermediary that, in turn, provides DEA to its underlying clients through permissible "sub-delegation".[10]

What is DEA?[11]

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 a Trading Venue; and
- the DEA Client has discretion as to the exact fraction of a second that an order hits the Trading Venue's order book and the lifetime of such order within that time frame.[12]

DEA includes DMA (*i.e.*, direct market access), which involves the use of the infrastructure of the DEA Provider, or any connecting system provided by the DEA Provider, to transmit the orders as well as SA (*i.e.*, sponsored access), where such infrastructure is not used.

Note that the use of an automated order router ("**AOR**") – which determines the Trading Venue(s) where the order should be submitted without changing any of the order's trading parameters – will be considered DEA where the foregoing criteria of DEA are met.

The DEA regime is generally intended to capture any circumstance in which a client of a Trading Venue member/participant is able to interact directly with the order book of such Trading Venue.

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10 ESMA is expected to publish further guidance on sub-delegation later in 2017.

11 Please note that industry groups such as FIA's E-Trading Working Group have given detailed consideration to the new DEA regime. These industry initiatives may be a valuable source of more detailed guidance for FCMs.

12 ESMA has recently published guidance on the scope of the DEA definition in Part 3 of its recent Questions & Answers on market structures topics, available at: https://www.esma.europa.eu/sites/default/files/library/esma70-872942901-38_qas_markets_structures_issues.pdf.

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 Trading 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.

Practical Consequences for DEA Providers

Authorisation

Under MiFID II, Trading Venues must require their members/participants that are DEA Providers to be authorised either as Investment Firms or as Credit Institutions.[13]

For the reasons discussed in Briefing Note 1, a Third-Country Firm cannot be authorised as an Investment Firm or a Credit Institution. Therefore, on a plain reading of the MiFID II text and absent some form of relief, an FCM that is a member of a Trading Venue and acts as a DEA Provider may find that it is required either to establish a presence in an EU Member State that is able to be authorised as an Investment Firm or to restructure its business in a way that it is no longer a DEA Provider. Note that national implementing measures in a given EU Member State may provide relief in limited circumstances to DEA Providers that are Third-Country Firms.[14]

Whether or not a Third-Country Firm that is a DEA Provider is subject to authorisation requirements under MiFID II, in practice such Third-Country Firms will likely be required to comply with the new rules to be adopted by Trading Venues (described below) which will

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[13] For the avoidance of doubt, acting as a DEA Provider is not an "investment activity or service" under MiFID II, instead there is an independent obligation for Trading Venues to require their DEA Provider firms to be authorised.

[14] For example, in the UK the FCA and HM Treasury have proposed the following language to apply where a Third-Country Firm is a DEA Provider to a Trading Venue operated by a UK recognised investment exchange ("**RIE**"):

> "*Where the [RIE] permits [DEA] to a trading venue it operates, it must:*
>
> *(1)(a) ensure that a member of, or participant in, that trading venue is only permitted to provide [DEA] to the venue if the member or participant:*
>
> ***
>
> *(iv) is a third-country firm providing the [DEA] in the course of exercising rights under Articles 46(1) (general provisions) or 47(3) (equivalence decision) of [MiFIR]; or*
>
> *(v) is a third-country firm providing the [DEA] in accordance with the relevant United Kingdom national regime for purposes of Article 54(1) (transitional provisions) of [MiFIR]; or*
>
> *(vi) is a third-country firm which does not come within paragraph (iv) or (v) and is otherwise permitted to provide the [DEA] under the [UK Financial Services and Markets Act 2000]".*

impose certain systems and controls requirements on their members that provide DEA services to clients.

Supervision and Oversight of DEA Clients

MiFID II establishes a general requirement that DEA Providers have effective systems and controls to ensure that:

- a proper assessment and review of the suitability of DEA Clients is undertaken;
- DEA Clients are prevented from exceeding appropriate pre-set trading and credit thresholds;
- trading by DEA Clients using the service is properly monitored; and
- appropriate risk controls prevent trading that may create risks to the DEA Provider or the market or contradict the rules of the Trading Venue.

DEA Providers must also implement policies and procedures to ensure that their DEA Clients comply with the relevant Trading Venue's rules and that the above requirements are met.

RTS 6 implements these general requirements and specifically requires DEA Providers to apply the following controls to their DEA Clients:

- 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.

In addition, 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 Clients;
- suspend or withdraw DEA services to any DEA Client; and
- carry out a review of the internal risk control systems of DEA Clients.

Due Diligence and Periodic Review

DEA Providers are required to conduct (and annually renew) due diligence assessments of prospective DEA Clients to ensure compliance with the requirements of RTS 6 and with the rules of the relevant Trading Venue(s). DEA Providers must also carry out an annual risk-based reassessment of the adequacy of the DEA Clients' systems and controls.

A DEA Client providing DEA to its underlying clients through permissible "sub-delegation" must have a comparable due diligence framework in place in respect of such underlying clients.

Delegation/Outsourcing

A DEA Provider may delegate or outsource performance of its supervision obligations; however, the DEA Provider remains ultimately responsible for such performance.

Unique ID

DEA Providers are required to assign a unique ID code to each DEA Client and the trading desks and traders of those DEA Clients.

Additional Requirements and Obligations

- Written Agreements – a DEA Provider must enter into binding written agreements with DEA Clients regarding their essential rights and obligations relating to DEA provision.
- Notifications to Regulators – a DEA Provider must notify its home state regulator(s) and the regulator(s) of the relevant Trading Venue that it provides DEA.
- Recordkeeping – a DEA Provider must keep sufficient records for its regulator to monitor compliance with MiFID II's DEA requirements.

Practical Consequences for DEA Clients

Authorisation

Many own-account dealing firms that are DEA Clients will not benefit from an exemption from authorisation requirements under MiFID II.[15]

For the reasons discussed in Briefing Note 1, a Third-Country Firm cannot be authorised as an Investment Firm. Therefore, on a plain reading of the MiFID II text and absent some form of relief, a Third-Country Firm that is a DEA Client may find that it is required either to establish a presence in an EU Member State that is able to be authorised as an Investment Firm or to restructure its business in a way that it is no longer a DEA Client. Note that national implementing measures in a given EU Member State may provide relief in limited circumstances to DEA Providers that are Third-Country Firms.

Supervision and Oversight by DEA Providers

Apart from the potential imposition of Investment Firm authorisation obligations, in practice DEA Clients will be subject to supervision and oversight by their DEA Providers as set out above, and should therefore expect to actively engage with such DEA Providers to ensure that each party's respective obligations and requirements are met.

[15] Article 2(1)(d) of MiFID I provided a generous exemption from authorisation requirements for own account dealing firms. The revised Article 2(1)(d) of MiFID II dramatically narrows this exemption and requires authorisation where, *inter alia*, an own account dealing firm has DEA to a Trading Venue.

Trading Venues

RTS 7 requires a Trading Venue that permits its members/participants to provide DEA services to adopt rules and conditions pursuant to which such access may be provided; these rules and conditions generally mirror the due diligence obligations imposed directly on DEA Providers in respect of their DEA Clients referred to above. A Trading Venue is also subject to certain general systems and controls requirements in respect of automated trading activities that will likely have a direct or indirect effect on DEA arrangements. Accordingly, DEA Providers should also expect to engage with Trading Venues in connection with ensuring that their DEA activities comply with MiFID II requirements.

In addition, the provision of SA to a DEA Client is subject to authorisation by the Trading Venue and the imposition of pre- and post-trade controls on the DEA Client.

Resources

MiFID II: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0065&from=EN

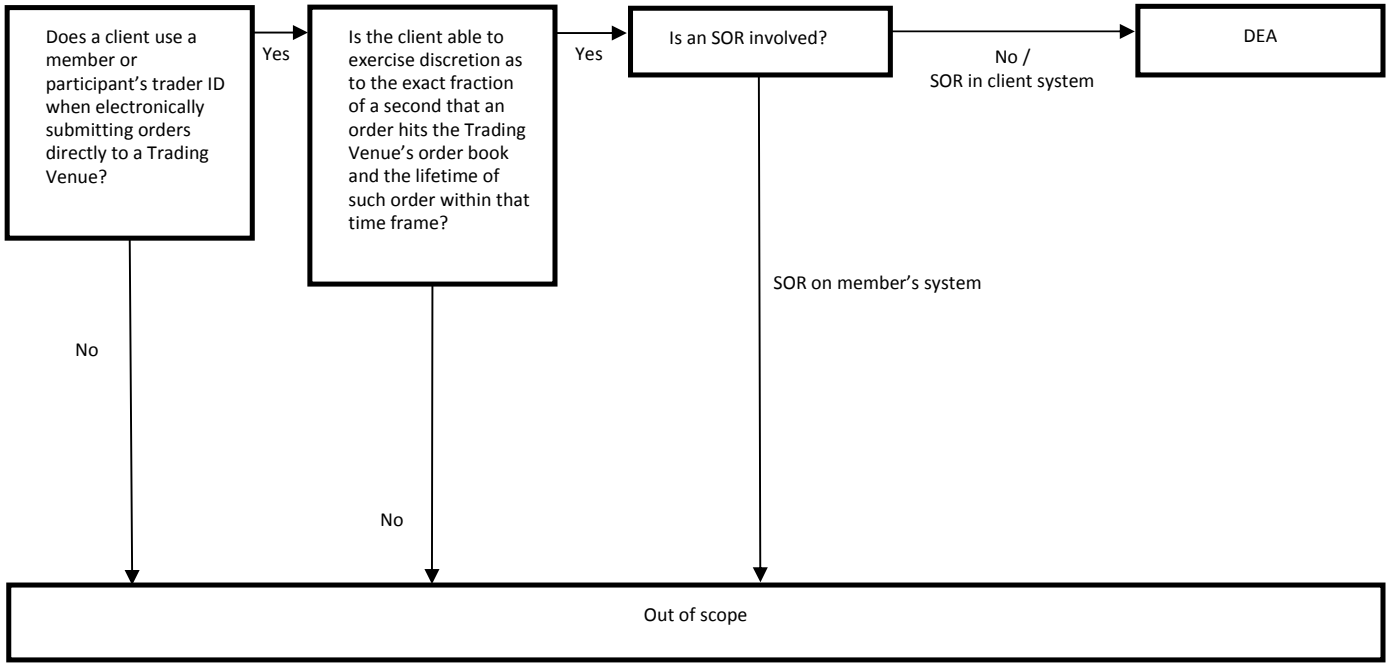
RTS 6: http://ec.europa.eu/finance/securities/docs/isd/mifid/rts/160719-rts-6_en.pdf

RTS 7: http://ec.europa.eu/finance/securities/docs/isd/mifid/rts/160714-rts-7_en.pdf

For capitalised terms not otherwise defined herein, please refer to the Glossary.

DEA – ANNEX

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 MiFID II's DEA regime. It does not constitute legal advice of any kind and does not, and does not purport to, describe all material 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.*

3. HIGH-FREQUENCY ALGORITHMIC TRADING

Takeaway: Where an FCM and/or its client(s) engages in own-account dealing via high-frequency algorithmic trading, each may be subject to authorisation as an Investment Firm, absent any available relief in the national implementing measures of the relevant EU Member State(s).

NB: *The discussion in this Briefing Note does not constitute advice whether a specific Third-Country Firm is in-scope of the high-frequency algorithmic trading regime under MiFID II; Third-Country Firms and/or their clients should make their own determination in consultation with their professional advisors.*

Overview

This Briefing Note summarises the heightened obligations imposed by MiFID II on firms that engage in a subset of Algorithmic Trading[16] referred to as high-frequency algorithmic trading ("**HFAT**").

What is HFAT?

Generally

HFAT is a form of Algorithmic Trading that involves the following three additional criteria:

- infrastructure intended to minimise network and other types of latencies such as 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" (further defined below) constituting orders, quotes or cancellations.

High Message Intraday Rates

A "high message intraday rate" consists of the submission of, on average:

- at least 2 messages per second[17] with respect to any single financial instrument traded on a Trading Venue; or
- at least 4 messages per second[18] with respect to all financial instruments traded on a Trading Venue.

When calculating the average number of messages, the following should be included:

- messages relating to Financial Instruments with a liquid market; and

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16 *See* Briefing Note 9 (Algorithmic Trading) for further information.

17 For example, using an 8-hour trading day, this would amount to 57,600 messages per day.

18 For example, using an 8-hour trading day, this would amount to 115,200 messages per day.

- messages relating to Financial Instruments where the firm pursues a market making strategy while engaging in Algorithmic Trading.

Only messages relating to financial instruments where the firm deals on own account should be included. This means that client messages, such as messages submitted by DEA Clients to DEA Providers, are excluded from the calculations. This is subject to an anti-avoidance measure to ensure that if the firm's execution technique is structured in such a way to avoid execution taking place on own account, for instance through group entities, then it will still count towards the number of messages.

To aid the calculation exercise, Trading Venues are under an obligation to make available, on request, estimates of the average of messages per second on a monthly basis, taking into account all messages submitted during the preceding 12 months.

Obligations For Firms Engaging in HFAT

Authorisation

Many own account dealing firms that engage in HFAT will not benefit from an exemption from authorisation requirements under MiFID II.[19]

For the reasons discussed in Briefing Note 1, a Third-Country Firm cannot be authorised as an Investment Firm. Therefore, on a plain reading of the MiFID II text and absent some form of relief, a Third-Country Firm that engages in HFAT may find that it is required either to establish a presence in an EU Member State that is able to be authorised as an Investment Firm or to restructure its business in a way that it is no longer engaging in HFAT. Note that national implementing measures in a given EU Member State may provide relief in limited circumstances to Third-Country Firms engaging in HFAT.

Algorithmic Trading

Firms engaged in HFAT will need to comply with all requirements relating to Algorithmic Trading.[20]

Recordkeeping

Firms engaging in HFAT must, immediately after order submission, record the details of each order, and keep such information updated, in a prescribed format.[21] Order records must be kept five years from the date the order is submitted to a Trading Venue, or to another Investment Firm for execution.

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19 MiFID II requires authorisation where, *inter alia*, an own account dealing firm engages in HFAT. The own account dealing exemption in MiFID II is only available to firms that do not transact in commodity derivatives or emissions allowances (or derivatives thereof) and that do not engage in any other investment services or activities.

20 *See* Briefing Note 9 (Algorithmic Trading) for further information.

21 *See* Tables 2 and 3 of Annex II of RTS 6.

Resources

MiFID II: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0065&from=EN

Definitions Delegated Regulation: https://ec.europa.eu/transparency/regdoc/rep/3/2016/EN/3-2016-2398-EN-F1-1.PDF

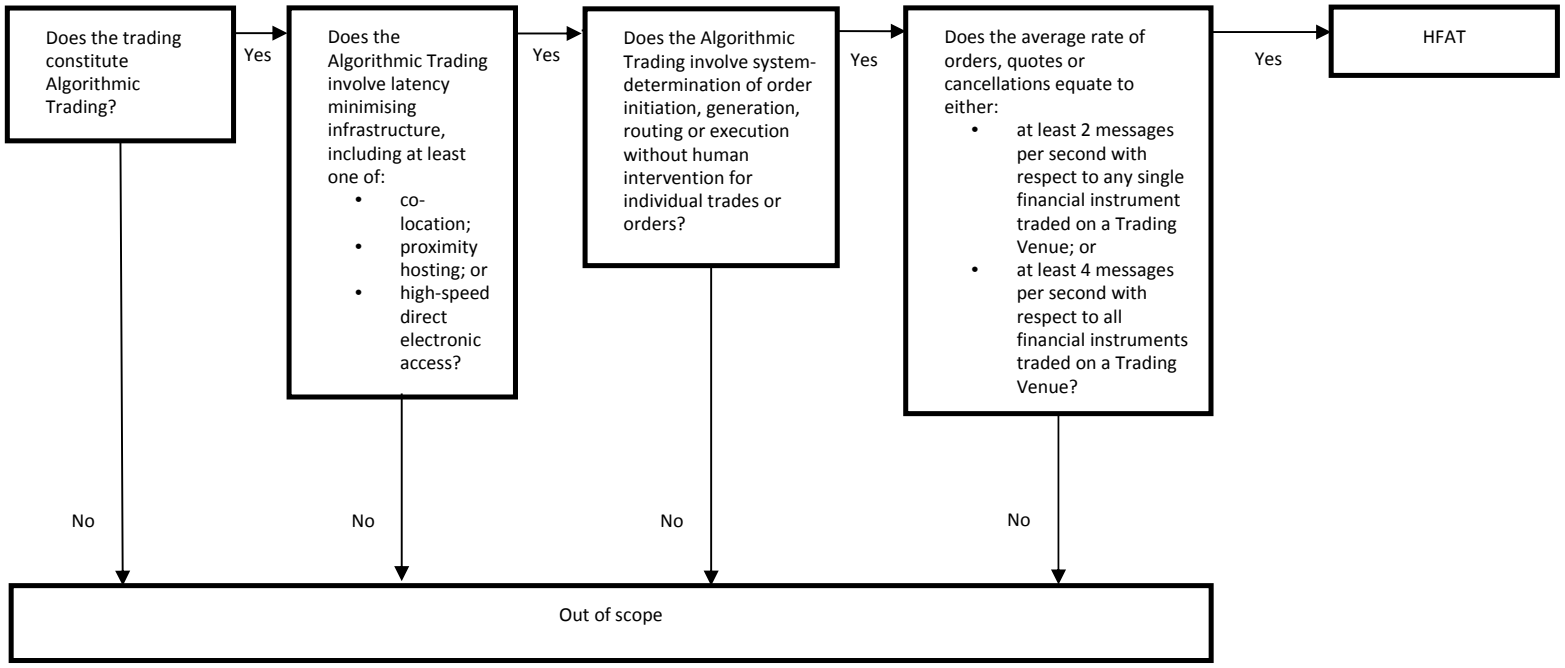
RTS 6: http://ec.europa.eu/finance/securities/docs/isd/mifid/rts/160719-rts-6_en.pdf

RTS 6 Annex: http://ec.europa.eu/finance/securities/docs/isd/mifid/rts/160719-rts-6-annex_en.pdf

For capitalised terms not otherwise defined herein, please refer to the Glossary.

HFAT – ANNEX

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 MiFID II's HFAT regime. It does not constitute legal advice of any kind and does not, and does not purport to, describe all material 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. MARKET MAKING

Takeaway: Where an FCM and/or its client(s) act as a "market maker", each may be subject to authorisation as an Investment Firm, absent any available relief in the national implementing measures of the relevant EU Member State(s).

NB: *The discussion in this Briefing Note does not constitute advice whether a specific Third-Country Firm is in-scope of the market making regime under MiFID II; Third-Country Firms and/or their clients should make their own determination in consultation with their professional advisors.*

Overview

This Briefing Note summarises the authorisation obligation imposed by MiFID II and RTS 8 on market makers ("**Market Makers**").

What is a Market Maker?

MiFID II defines a "Market Maker" as a person who holds himself out on the financial markets on a continuous basis as being willing to deal on own account by buying and selling Financial Instruments against that person's proprietary capital at prices defined by that person. This definition is effectively identical to the definition used in MiFID I.

Authorisation Implications

MiFID II has narrowed previous exemptions for authorisation requirements, making it more difficult for persons dealing on own account, including Market Makers, to escape the need for authorisation. Persons dealing on own account in instruments other than commodity derivatives, that are also Market Makers, are unable to rely on an exemption unless the activity is ancillary to its main business and no High-Frequency Algorithmic Trading[22] is used.

For the reasons discussed in Briefing Note 1, a Third-Country Firm cannot be authorised as an Investment Firm. Therefore, on a plain reading of the MiFID II text and absent some form of relief, a Third-Country Firm that is a Market Maker may find that it is required either to establish a presence in an EU Member State that is able to be authorised as an Investment Firm or to restructure its business in a way that it is no longer a Market Maker. Note that national implementing measures in a given EU Member State may provide relief in limited circumstances to Market Makers that are Third-Country Firms.

Requirements for Investment Firms engaging in Market-Making Strategies

Third-County Firms are not expressly bound by the following requirements. Investment Firms that engage in Algorithmic Trading pursuant to a market-making strategy are subject to requirements relating to the regular and frequent provision of liquidity, entry into written market-making agreements ("**MMA**") and implementation of systems and controls in relation to the MMA. Trading Venues are also required to continuously monitor the Investment Firm's compliance with the MMA.

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22 *See* the accompanying Briefing Note on High-Frequency Algorithmic Trading for further information.

Resources

MiFID II: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0065&from=EN

MiFIR: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R0600&from=EN

RTS 8: https://ec.europa.eu/transparency/regdoc/rep/3/2016/EN/3-2016-3523-EN-F1-1.PDF

For capitalised terms not otherwise defined herein, please refer to the Glossary.

PART 3
"DIRECT" IMPACTS: ONGOING COMPLIANCE

5. POSITION LIMITS FOR COMMODITY DERIVATIVES

Takeaway: FCMs and their client(s) that transact in "commodity derivatives" traded on a Trading Venue and economically-equivalent OTC contracts must comply at all times with the new EU position limits, position management and position reporting regime.

Overview

MiFID II establishes the first pan-European position limits regime as well as new regimes relating to position management and position reporting. This Briefing Note summarises the scope of these new regimes and certain practical aspects of the application of these regimes to trading activities.[23]

Position Limits

Basic Test

The new regime applies limits on the size of a person's net position in:

- a Commodity Derivative[24] traded on a Trading Venue; plus
- other Commodity Derivatives that are the "same"[25] as such Commodity Derivative; plus
- "economically-equivalent"[26] OTC contracts ("**EEOTC**").

The position limits regime does not apply in respect of wholesale electricity and natural gas products (as defined in REMIT) that must be physically settled and are traded on OTFs.

Contracts Traded on Third-Country Platforms

ESMA has recently published an opinion addressing whether commodity derivatives contracts traded on third-country platforms – and hence not on Trading Venues – are to be considered EEOTC for the EU position limit regime.[27] The Position Limits Opinion provides that, where a third-country platform meets certain specified criteria (*i.e.*, operation of a multilateral system,

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[23] ESMA has published, and frequently updates, its guidance on the new position limits regime for commodity derivatives, available at: https://www.esma.europa.eu/sites/default/files/library/esma70-872942901-28_cdtf_qas.pdf.

[24] The definition of "Commodity Derivative" is provided in an Annex to this Briefing Note. Note also that the new regime applies to certain types of securitisations that are not covered by this Briefing Note.

[25] A Commodity Derivative will be the "same" as a Commodity Derivative traded on a Trading Venue where they both have identical contractual specifications and terms and conditions, other than post-trade risk management, and where they form a single fungible pool of open interest. *See* Article 5(1) of RTS 21.

[26] A contract will be "economically equivalent" where it has identical contractual specifications and terms and conditions of a Commodity Derivative traded on a Trading Venue other than differences based solely on lot sizes, delivery dates that vary less than a single calendar day and post-trade risk management. *See* Article 6 of RTS 21.

[27] "Opinion: Determining third-country trading venues for the purpose of position limits under MiFID II", ESMA70-156-112 (31 May 2017) ("**Position Limits Opinion**").

authorisation in accordance with the relevant domestic legal and regulatory regime, and supervision by a regulator that is a full signatory to the IOSCO Multilateral Memorandum of Understanding), then commodity derivatives contracts traded on such platform will not be treated as EEOTC for purposes of the EU position limit regime. ESMA intends to publish a list of the third-country platforms that meet these requirements, which will be updated on an ongoing basis.

Aggregation

Position limits apply to the net position of a person[28] as well as by parent undertakings at an "aggregate group level." Therefore, in a group context, net positions must be calculated per subsidiary, and then an aggregate net position must be calculated by the parent at a group level. These calculations must be performed for spot and non-spot month limits.

There is a limited exemption from the aggregation rules for certain collective investment undertakings. Specifically, where a parent does not control the trading decisions of a collective investment undertaking that is a subsidiary, the subsidiary undertaking's position need not be aggregated with that of the parent.

Risk-Reducing Hedges

The position limits regime provides a limited exclusion for a non-financial entity – which would not include an Investment Firm, for example[29] – in respect of trades that are objectively measurable as reducing risks directly relating to such entity's commercial activities, and expressly permits both proxy hedging as well as macro/portfolio hedging.[30] In addition, an entity is not required to engage in *ex post* evaluations of risk-reducing hedges due to subsequent evolutions of the risks hedged.

Any non-financial entity intending to rely on the risk-reducing hedge mechanism must apply for an exemption from the national regulator that sets the limit for the relevant Commodity Derivative, which then has 21 days to approve or reject the application.

Spot Month & Non-Spot Month Limits

Position limits are set for the spot month and for all non-spot months combined.

- Spot Month – the "spot month" refers to the contract next to expire; an EEOTC is in the spot month when its equivalent contract is in its spot month. The limit is set at 25% of deliverable supply (or, where no such supply exists, of open interest), which can be varied down to 5% or up to 35% based on a set of enumerated factors.[31] Where the

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28 The scope of the term "person" is unclear, but appears intended to reach through to the end customer.

29 RTS 21 makes clear that a Third-Country Firm will only be considered a non-financial entity for these purposes if it would not require authorisation under, *inter alia*, MiFID II if it was based in the EU and subject to EU law. Therefore it is unlikely that an FCM would qualify as a non-financial entity for these purposes. *See* Article 2(1) of RTS 21.

30 A non-financial entity intending to rely on the risk-reducing hedge exemptions must ensure that the trade either reduces risks in the circumstances set out in RTS 21 or qualifies as a hedging contract pursuant to IFRS. The entity must also have appropriate policies and procedures in place relating to its risk-reducing trading activity and be able to provide a disaggregated view of its trading portfolio. *See* Article 7 of RTS 21.

31 The factors include: maturity; deliverable supply; open interest; volatility; number and size of market participants; and the features of the underlying cash market. *See* Articles 16-21 of RTS 21.

underlying commodity is a food intended for human consumption with total combined open interest in excess of 50,000 lots over a consecutive three-month period, the base limit is set at 20% and can be varied down to 2.5%.

- Non-Spot Months – this limit applies to the remainder of the contract curve and is based on open interest, with a baseline of 25% which can be varied up to 35% or down to 5%. As for spot months, the limit can be varied down to 2.5% for qualifying foodstuffs.

National regulators are responsible for establishing limits in their jurisdiction and for determining open interest and deliverable supply. National regulators must follow the methodology set by ESMA and submit proposed limits to ESMA, which has 2 months to issue an opinion validating the proposed limits.

New and Illiquid Contracts

Special rules apply to thinly-traded Commodity Derivatives.[32] Specifically, rather than setting the spot month and the all non-spot month limits as a percentage of deliverable supply or open interest as described above, Commodity Derivatives with a total combined open interest in spot and non-spot month contracts not exceeding 10,000 lots over a consecutive 3-month period will be subject to a fixed *de minimis* limit of 2,500 lots. In addition, Commodity Derivatives with a total combined open interest in spot and non-spot month contracts greater than 10,000 lots but not exceeding 20,000 lots over a consecutive 3-month period will have their limit set between 5% and 40%.

Trading Venues are obliged to notify the relevant national regulator when the total open interest in any Commodity Derivative reaches any of these thresholds, which will trigger a review of the then-applicable position limit.

Position Management

Trading Venues are required to establish and apply position management controls, including at least:

- monitoring the open interest of "persons";
- accessing information and documentation from "persons" regarding the size and purpose of a position and cash-market activities;
- requiring a "person" to exit or reduce a position; and
- requiring a "person" to provide controlled liquidity back into the market.

A Trading Venue's position management controls must be disclosed to its national regulator.

Position Reporting

The new position reporting framework applies both to Trading Venues and Investment Firms.

[32] In the UK, the FCA has estimated that, given the low levels of open interest in many Commodity Derivatives, a significant percentage of Commodity Derivatives may be subject to the limits described in this section.

Trading Venues

Trading Venues must publish weekly reports of the aggregate positions held by the following categories of persons for the different Commodity Derivatives and emissions allowances (or derivatives thereof) listed on the Trading Venue:

- Investment Firms or Credit Institutions;
- investment funds (alternative investment funds or UCITS);
- other financial institutions;
- commercials; and
- persons subject to EU emissions rules (for emissions contracts).

These position reports must contain: (1) the number of long and short positions per category; (2) any changes since the previous report; (3) the percentage of open interest attributable to each category; and (4) the number of persons in each category.

Trading Venues must also send to national regulators a breakdown of positions of all position holders for all members or participants, including their clients and the clients of such clients, until the end-client is reached. These reports must be filed on at least a daily basis.

Investment Firms

An Investment Firm that trades Commodity Derivatives OTC outside a Trading Venue must submit a daily report to the national regulator of the Trading Venue where such Commodity Derivative(s) are traded.[33] Reports must contain a "complete breakdown" of the firm's positions taken in Commodity Derivatives and emissions allowances (or derivatives thereof) traded on a Trading Venue and EEOTC as well as such positions for the firm's clients, and the clients of those clients "until the end-client is reached." Members and participants of Trading Venues must file similar daily reports with such Trading Venues.

Resources

MiFID II: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0065&from=EN

RTS 21: http://ec.europa.eu/finance/securities/docs/isd/mifid/rts/161201-rts-21_en.pdf

Position Limits Opinion: https://www.esma.europa.eu/sites/default/files/library/esma70-156-112_cdtf_opinion_eeotc_third_countries.pdf

For capitalised terms not otherwise defined herein, please refer to the Glossary.

[33] Where more than one such Trading Venue exists, the report must be sent to the national regulator of the Trading Venue where the most significant volume of such Commodity Derivative(s) are traded.

POSITION LIMITS – ANNEX

DEFINITION OF "COMMODITY DERIVATIVE"

Article 2(1)(30) of MiFIR defines "commodity derivative" to include the following:

- 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;

  this means: *securities based on an underlying commodity* (*i.e.*, any securities (but not shares in companies or equivalent securities nor bonds or other forms of securitised debt) giving the right to acquire or sell any transferable securities or giving rise to a cash settlement determined by reference to transferable securities, currencies, interest rates or yields, commodities or other indices or measures which relate to a commodity or to climatic variables, freight rates or inflation rates or other official economic statistics);

- Financial Instruments referred to in Section C(5) of Annex I to MiFID II;

  this means: *cash-settled commodity derivatives* (*i.e.*, options, futures, swaps, forwards and any other derivative contracts relating to commodities that must be settled in cash or may be settled in cash at the option of one of the parties other than by reason of default or other termination event);

- Financial Instruments referred to in Section C(6) of Annex I to MiFID II;

  this means: *physically-settled commodity derivatives other than REMIT products* (*i.e.*, options, futures, swaps, and any other derivative contract relating to commodities that can be physically settled provided that they are traded on a regulated market, a MTF, or an OTF, except for wholesale energy products traded on an OTF that must be physically settled);

- Financial Instruments referred to in Section C(7) of Annex I to MiFID II; and

  this means: *other commodity derivatives used as investments* (*i.e.*, options, futures, swaps, forwards and any other derivative contracts relating to commodities, that can be physically settled not mentioned in Section C(6) and not being for commercial purposes, which have the characteristics of other derivative financial instruments);

- Financial Instruments referred to in Section C(10) of Annex I to MiFID II.

  this means: *cash-settled commodity derivatives with "exotic" underlyings* (*i.e.*, options, futures, swaps, forward rate agreements and any other derivative contracts relating to climatic variables, freight rates or inflation rates or other official economic statistics that must be settled in cash or may be settled in cash at the option of one of the parties other than by reason of default or other termination event, as well as any other derivative contracts relating to assets, rights, obligations, indices and measures not otherwise mentioned in Section C, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are traded on a regulated market, OTF, or an MTF).

6. STRAIGHT-THROUGH PROCESSING (STP)

Takeaway: An FCM that is a clearing member of an EU CCP will be subject to new rules on straight-through processing for certain types of derivatives; although this regime expressly applies only to clearing members that are Investment Firms, in practice the implementing rules adopted by EU CCPs and Trading Venues will likely apply to all clearing members, including Third-Country Firms.

Overview

MiFIR requires that the following types of Derivatives ("**Cleared Derivatives**") are submitted and accepted for clearing "as quickly as technologically practicable" following execution:

- Exchange-Traded Derivatives;
- OTC Derivatives (whether concluded bilaterally or transacted on an MTF or OTF) subject to a mandatory clearing determination; and
- all other derivatives which the relevant counterparties agree to clear.

This Briefing Note summarises the STP obligations for Cleared Derivatives imposed on Trading Venues, CCPs, Investment Firms that are Clearing Members,[34] and counterparties to bilaterally-concluded OTC Derivatives.

Submission and Acceptance for Clearing

The STP obligations vary depending on whether the Cleared Derivative in question is concluded electronically or non-electronically on a Trading Venue, or concluded bilaterally.

Trading Venue – Concluded Electronically

Requirements for pre-trade screening and other submission timelines do not apply where the Trading Venue and the CCP have adopted rules ("**STP Rules**") that meet certain enumerated criteria.[35] In such cases, the STP Rules themselves ensure that MiFIR's STP requirements are met.

However, where STP Rules are not in place, then certain requirements ("**Screening Requirements**") apply. A Clearing Member must engage in pre-conclusion screening on an order-by-order basis to ensure that the relevant limits set by the Clearing Member for the

[34] Although the STP obligations apply only to clearing members that are Investment Firms – which would exclude Third-Country Firms such as FCMs – in practice, the rule sets adopted by EU CCPs and Trading Venues are unlikely to distinguish between clearing members located in the EU and those located in third-countries. Accordingly, FCMs should expect to be subject to the STP requirements described herein where they are clearing members of an EU CCP.

[35] The Trading Venue's rules must require that each member either is, or has a contractual arrangement with, a Clearing Member whereby the Clearing Member automatically becomes counterparty to the Cleared Derivative and must provide that the member (or its client) becomes counterparty to the Cleared Derivative following clearing. The CCP's rules must provide for the automatic and immediate clearing of the Cleared Derivative with the Clearing Member becoming counterparty. *See* RTS 26 Article 2(1)(a)-(c). FIA is actively undertaking a review of CCP and Trading Venue rules to determine whether the aforementioned criteria have been met.

specific client are not breached, and the Trading Venue must ensure that the limits are not breached within 60 seconds from receipt of the order. In the event of a breach, the Trading Venue must notify the Clearing Member and the client on a real-time basis.

Where there is no breach, the Trading Venue must submit the trade to the CCP within 10 seconds from the conclusion of the trade, and the CCP must accept or reject the trade within 10 seconds of receipt from the Trading Venue.

Trading Venue – Not Concluded Electronically

As above, where STP Rules are in place, MiFIR's STP requirements are met.

Where STP Rules are not in place, the Screening Requirements apply, except that a Trading Venue must ensure that a client's limits are not breached within 10 minutes from the receipt of the order and, in the event of a limit breach, must notify the Clearing Member and the client within 5 minutes from the time the check was performed.

Where there is no breach, the Trading Venue must submit the trade to the CCP within 10 minutes from the conclusion of the trade, and the CCP has 10 seconds to accept or reject the trade.

Bilaterally Concluded

A Clearing Member is required to obtain "evidence" from its client of the time the Cleared Derivative is concluded, and must ensure that the counterparties send the relevant information relating to the Cleared Derivative to the CCP within 30 minutes (collectively, "**Bilateral Requirements**").[36]

The CCP must then send the Clearing Member the information submitted by the counterparties within 60 seconds, and the Clearing Member has a further 60 seconds to accept or reject the trade. The CCP must then accept or reject the trade for clearing within 10 seconds of the Clearing Member's acceptance or rejection. However, where the CCP's rules require that a Clearing Member set and maintain limits on its client, and provide for automatic clearing of a Cleared Derivative falling within such limits, the foregoing notification and timing requirements do not apply; for the avoidance of doubt, the Bilateral Requirements would continue to apply in such circumstances.

Derivatives Not Accepted for Clearing

Bilaterally Concluded

Where a Cleared Derivative is concluded bilaterally, the CCP must inform the Clearing Member of non-acceptance on a real-time basis, and the Clearing Member must in turn notify the counterparty as soon as it has been informed. The Cleared Derivative will then be subject to the arrangements (if any) between the relevant counterparties, subject to potential resubmission as described below.

[36] Meeting these requirements will likely require amendments to be made to existing trading documentation.

Trading Venue – Concluded Electronically

Where a Cleared Derivative concluded electronically on a Trading Venue is not accepted for clearing, the CCP must inform the Clearing Member and the Trading Venue on a real-time basis, and the Clearing Member and Trading Venue must in turn notify the counterparty as soon as they have been informed. The Cleared Derivative will be void *ab initio*, subject to potential resubmission as described below.

Trading Venue – Not Concluded Electronically

The same timeframes apply as for Cleared Derivatives concluded electronically; however, the Cleared Derivative will not be void *ab initio* and will instead be subject to the rules of the Trading Venue. The Cleared Derivative may be resubmitted subject to the conditions set out below.

Resubmission

Where a Cleared Derivative is not accepted for clearing due to a clerical or technical error, it may be resubmitted for clearing within 1 hour provided the counterparties consent to such resubmission.

Resources

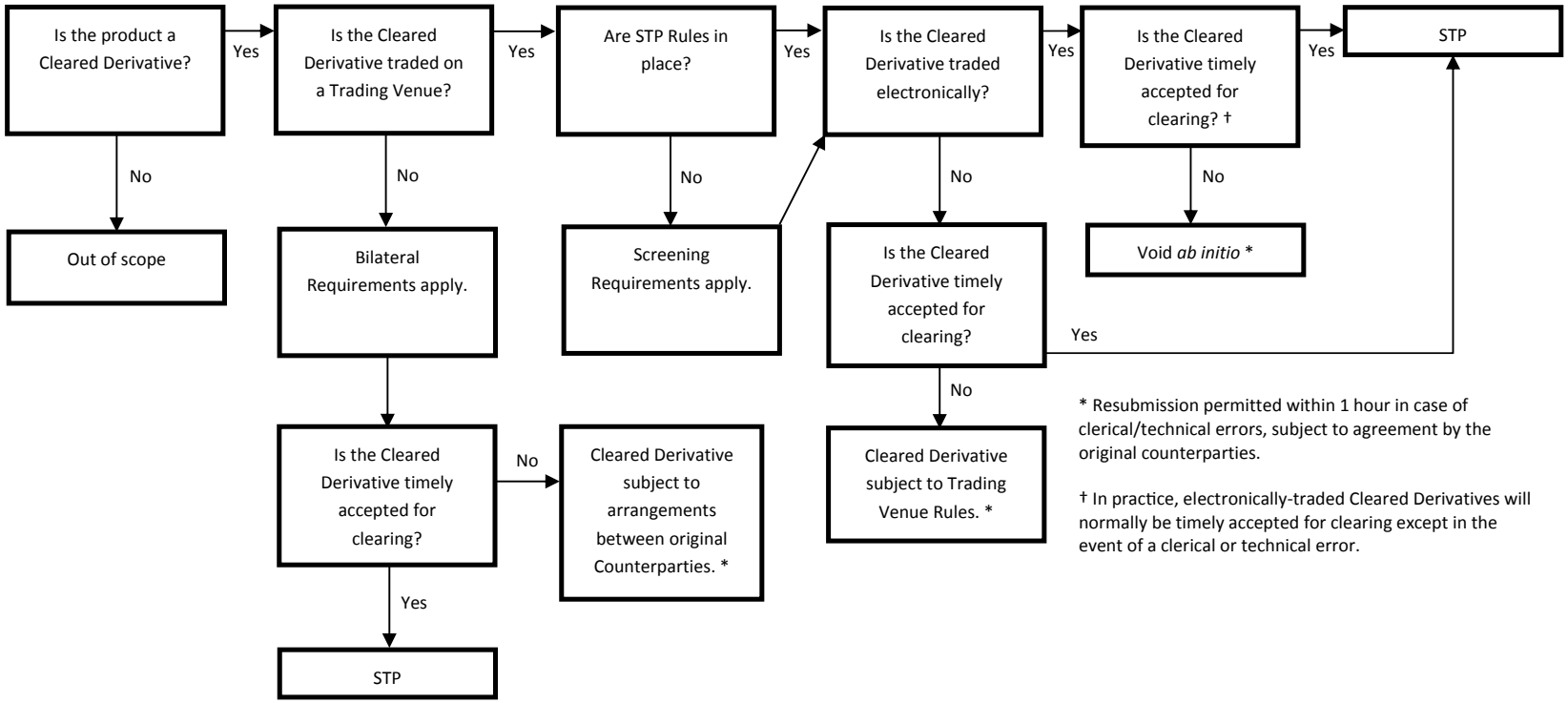
MiFIR: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R0600&from=EN

RTS 26: http://ec.europa.eu/finance/securities/docs/isd/mifid/rts/160629-rts-26_en.pdf

For capitalised terms not otherwise defined herein, please refer to the Glossary.

STP – ANNEX

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 STP requirements to Cleared Derivatives. It does not constitute legal advice of any kind and does not, and does not purport to, describe all material 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.*

7. MANDATORY TRADE EXECUTION

Takeaway: FCMs and their clients may be required to execute certain OTC Derivatives on a Trading Venue where they are entered into with an EU counterparty. In certain circumstances, transacting in such OTC Derivatives by two non-EU counterparties may also be in scope. Execution on a third-country venue (*e.g.*, a DCM) may be possible where an equivalence determination has been made.

Overview

MiFIR imposes mandatory trade execution obligations in respect of OTC Derivatives that:

- are subject to mandatory clearing under EMIR;[37]
- have been determined to be subject to mandatory trade execution; and
- have been entered into between certain types of counterparties.

Where mandatory trade execution applies, an OTC Derivative must generally be executed on an EU Trading Venue (*i.e.*, Regulated Market, MTF or OTF). However, in certain circumstances identified below, execution may be permitted on a third-country trading venue.

ESMA has recently published a consultation paper proposing that certain OTC Derivatives should be subject to a mandatory trading obligation.[38]

Procedure

Conditions Precedent

For an OTC Derivative (or class or subset thereof) to be considered for mandatory trade execution, it must be admitted to trading, or traded on, at least one Trading Venue and there must be sufficient third-party buying and selling interest for ESMA to determine that the market in such OTC Derivative (or class or subset thereof) is sufficiently liquid to be traded only on Trading Venues (or permissible third-country trading venues).[39]

RTS Adoption

Where the conditions precedent identified above are met, ESMA is responsible for developing draft RTS covering the relevant OTC Derivatives (or class or subset thereof) to be subject to mandatory trade execution requirements, including a public consultation, as well as the

[37] ESMA maintains a "Public Register for the Clearing Obligation" which identifies the OTC Derivatives subject to mandatory clearing under EMIR, available at: https://www.esma.europa.eu/regulation/post-trading/otc-derivatives-and-clearing-obligation.

[38] The Consultation Paper, including the proposed dates on which the mandatory trading obligation would take effect for different counterparties, is available at: https://www.esma.europa.eu/file/22446/download?token=Fy_0W4TJ.

[39] In making a determination of sufficient liquidity, ESMA is required to consider the criteria set out in RTS 4 which include, in respect of both OTC and exchange trading: average frequency of trades; average size of trades; the number and type of active market participants; and the average size of spreads.

effective date of such requirements and the availability of any phase-in periods.[40] The EC may adopt the RTS proposed by ESMA in accordance with its standard procedures. Following adoption, the OTC Derivatives subject to mandatory trade execution will be entered into a register maintained by ESMA for that purpose.

Relevant Counterparties

Where an OTC Derivative (or class or subset thereof) is subject to RTS imposing a mandatory trade execution requirement, the obligation must be discharged where the OTC Derivative has been entered into:

- between Financial Counterparties, between NFC+'s, or between a Financial Counterparty and an NFC+ (in each case, other than intragroup transactions or certain pension scheme trades);
- between a Financial Counterparty or NFC+ on the one hand, and a Third-Country Firm on the other hand, where the Third-Country Firm would be a Financial Counterparty or NFC+ if it was established in the EU; or
- between two Third-Country Firms that would be Financial Counterparties or NFC+ if established in the EU and where the trade has a "direct, substantial and foreseeable" effect in the EU.[41]

The obligation may also be imposed where necessary to prevent evasion.

In Addition

ESMA has the authority to identify OTC derivatives (or classes or subsets thereof) that should be subject to mandatory trade execution requirements but which are not accepted for clearing by any authorised CCP or admitted to trading, or traded, on a Trading Venue.

Permissible Venues

In General

The general rule is that an OTC Derivative (or class or subset thereof) subject to a mandatory trade execution requirement and entered into between the relevant type(s) of counterparties must be executed on 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 ("**Article 28 Equivalence**").

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[40] Where a mandatory trade execution requirement has been adopted, ESMA has the authority to amend or withdraw the relevant RTS imposing such requirements whenever there is a material change to the data supporting the "sufficient liquidity" determination.

[41] The criteria for "direct, substantial and foreseeable" are set out in RTS 5 and are generally congruent with the meaning ascribed to the phrase under EMIR, *i.e.*, where: (1) at least one Third-Country Firm is guaranteed by a Financial Counterparty in the EU where such guarantee exceeds €8 billion in total gross notional of such Third-Country Firm's OTC Derivatives and is at least equal to 5% of the guaranteeing Financial Counterparty's current exposures relating to OTC Derivatives; or (2) where two Third-Country Firms enter into the OTC Derivative through their EU branches and would both would qualify as Financial Counterparties if established in the EU.

Where Article 28 Equivalence applies, counterparties otherwise subject to mandatory trade execution may discharge this requirement by executing the OTC Derivative on a trading venue in such third country (or, if applicable, the relevant subset of trading 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.

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 ("**Article 33 Equivalence**").[42] 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 provided that at least one counterparty to the OTC Derivative is established in such third country and the OTC Derivative is executed in accordance with the applicable legal and supervisory arrangements of such third country.

Resources

MiFIR: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R0600&from=EN

RTS 4: http://ec.europa.eu/finance/securities/docs/isd/mifid/rts/160526-rts-4_en.pdf

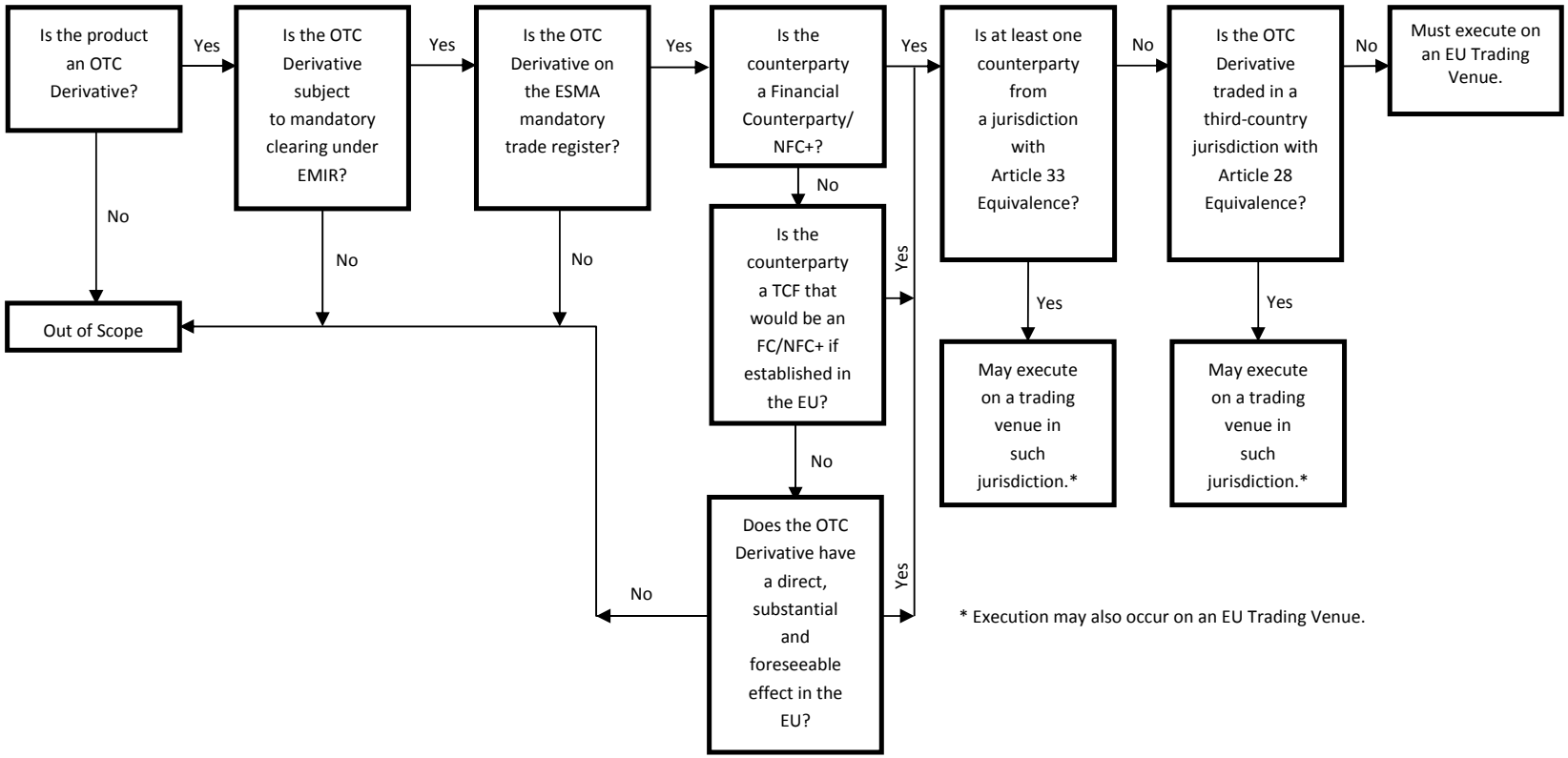
RTS 5: http://ec.europa.eu/finance/securities/docs/isd/mifid/rts/160613-rts-5_en.pdf

For capitalised terms not otherwise defined herein, please refer to the Glossary.

[42] The third-country regime must also have professional secrecy obligations equivalent to those set out in MiFIR.

TRADE EXECUTION – ANNEX

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.*

PART 4
"INDIRECT" IMPACTS

8. GENERAL CLEARING MEMBER OBLIGATIONS

Takeaway: A Third-Country Firm such as an FCM is not directly subject to the requirements described below. However, an FCM that accesses an EU CCP through an Investment Firm that is a general clearing member may be affected by the compliance obligations imposed directly on such clearing member.

Overview

An Investment Firm[43] that acts as a general clearing member of an EU CCP ("**GCM**") must comply with certain MiFID II requirements in connection with the clearing services its provides.

For the reasons discussed in Briefing Note 1, a Third-Country Firm is not an Investment Firm and will not therefore be directly subject to the requirements described below. However, a Third-Country Firm that accesses an EU CCP through an Investment Firm that is a general clearing member may be indirectly affected by the compliance obligations imposed directly on such Investment Firm.

Compliance Requirements[44]

Systems and Controls

A GCM's systems that support the provision of clearing services to clients must be subject to certain due diligence assessments, controls and monitoring.

Due Diligence

A GCM must undertake initial and ongoing assessments of prospective and existing clients against at least the following criteria:

- credit strength (including guarantees);
- internal risk controls;
- intended trading strategy;
- payment systems and arrangements ensuring timely transfer of margin for cleared trades;
- systems and access to information ensuring the client respects trading limits;
- collateral (if any) provided to the GCM;
- operational resources (including technological interfaces and connectivity); and

[43] Note that the compliance obligations described herein apply equally to Credit Institutions engaged in Investment Firm activities. For the reasons described in Briefing Note 1, Third-Country Firms cannot be Credit Institutions.

[44] Please note that industry groups such as FIA's GCM Requirements Working Group have given detailed consideration to this issue. These industry initiatives may be a valuable source of more detailed guidance for FCMs.

- any history of involvement in a breach relating to market integrity, including market abuse, financial crime or money laundering.

The foregoing reviews must be updated not less than annually and the due diligence criteria and frequency of review must be memorialised in the written agreement between the client and the GCM, including provisions setting out the consequences for a client that fails to comply with these criteria.

Limits and Monitoring

A GCM must establish trading and position limits for each client in order to mitigate and manage its counterparty, liquidity, operational and other risks; these limits must be communicated to clients.[45]

The GCM must monitor each client's positions against the relevant limits as close to real-time as possible and must have appropriate pre- and post-trade procedures, including margining, to manage the risk of any breaches of such limits. These procedures must be documented in writing and must record whether the client complies with them.[46]

Disclosure

A GCM must offer clearing services on reasonable commercial terms and must publish the conditions under which such services are offered, including the different levels of protection available and the costs associated with different types of client segregation on offer, including in respect of insolvency. It is not anticipated that this would impose additional disclosure requirements beyond those already required by clearing members under EMIR.

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[45] Derivatives concluded on a Trading Venue may fall outside the scope of these requirements to the extent that certain straight-through processing rules are in place at both the Trading Venue and the relevant CCP. *See* Briefing Note 6.

[46] We understand that the following Q&A was sent to ESMA to confirm that when conditions in Article 2(1) of RTS 26 are met, then the pre-trade checks required by Article 25(2) of RTS 6 do not include pre-trade order-by-order screening. The Q&A has not yet been published by ESMA.

> *MiFID II, RTS 26, Article 2(1) provides for exemption from pre-trade order-by-order checking for on-venue traded cleared derivatives if there is a contractual framework in place between the trading venue, the CCP and the EB/CB that guarantees that a contract executed on-venue will automatically be cleared. In the absence of the exemption in RTS 26 Article 2(1), the same RTS in Article 2(2) requires trading venues to provide tools to ensure pre-execution screening on an order-by-order basis by CM of the limits set and maintained by that CM for its client pursuant to Commission Delegated Regulation XX/XX of XXXXX supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to regulatory technical standards specifying the organisational requirements of investment firms engaged in algorithmic trading [not yet published in the EU OJ but widely known as MiFID II RTS 6]. It is also understood that the reference in Article 2(2) is to Chapter IV of RTS 6 which is a standalone Chapter of the RTS imposing certain requirements on investment firms that act as general clearing members, whereas the remainder of RTS 6 applies to investment firms that engage in algorithmic trading.*
>
> *Question: Given that Chapter IV of RTS 6 is a standalone Chapter of the RTS, it is understood that, provided the conditions of RTS 26 Article 2(1)(a), (b) and (c) are met, the "appropriate pre-trade … procedures for managing the risk of breaches" set out in RTS 6 Article 26(2) do not extend to the requirements set out in RTS 26 Article 2(2), (3) or (4).*

Resources

MiFID II: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R0600&from=EN

RTS 6: http://ec.europa.eu/finance/securities/docs/isd/mifid/rts/160719-rts-6_en.pdf

RTS 6 Annex: http://ec.europa.eu/finance/securities/docs/isd/mifid/rts/160719-rts-6-annex_en.pdf

For capitalised terms not otherwise defined herein, please refer to the Glossary.

9. ALGORITHMIC TRADING

Takeaway: The new rules on Algorithmic Trading do not expressly apply to Third-Country Firms such as FCMs, except where an FCM is a member of a 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 Investment Firm, the Investment Firm will likely expect cooperation from the Third-Country Firm in meeting its compliance obligations.

Overview

This Briefing Note summarises the obligations under MiFID II relating to Algorithmic Trading, which are detailed in RTS 6 and RTS 7.

What is Algorithmic Trading?

Generally

Algorithmic Trading is defined as trading in Financial Instruments where a computer algorithm automatically determines individual parameters of the orders with "limited or no human intervention" (as further defined below), other than any system that: (1) routes or processes orders without determining such parameters; (2) confirms trades; or (3) performs post-trade processing.

Limited or No Human Intervention

Systems will be considered to have "limited or no human intervention" where, for any order or quote generation process or any process to optimise order-execution, an automated system makes decisions at any of the stages of initiating, generating, routing or executing orders or quotes according to pre-determined parameters.

Compliance Requirements for Trading Venues

Trading Venues are required by RTS 7 to adopt certain rules and procedures regarding Algorithmic Trading, including rules applicable to their members. The compliance obligations are similar to those described below for Investment Firms, although they apply more broadly to any Trading Venue that "enables" or "allows" Algorithmic Trading by facilitating order submission and order matching by electronic means. The RTS 7 obligations relate to compliance, staffing, outsourcing and procurement, business continuity and deployment and review of trading systems and apply in respect of a Trading Venue's "members" whether or not such members are Investment Firms. Certain obligations also apply to the trading undertaken by a member's clients.

A Trading Venue's means of complying with RTS 7 will likely require a significant amount of cooperation with its members – including members that are Third-Country Firms such as FCMs – which may in turn require such members to obtain information from, or otherwise cooperate with, their clients. In addition to the above, Trading Venues are required to:

- require their members to undertake conformance testing relating to trading systems and Algorithmic Trading;

- have members certify that their algorithms have been tested;
- provide access to a testing environment; and
- test and monitor the performance and capacity of their systems.

Accordingly, members should expect to engage with Trading Venues in connection with ensuring that their Algorithmic Trading activities and treading systems comply with MiFID II requirements.

Compliance Requirements for Investment Firms

The compliance obligations in RTS 6 described below are directed primarily at Investment Firms and therefore would not expressly apply to Third-Country Firms. However, Investment Firms may expect, or require, cooperation from Third-Country Firms in the discharge of their compliance obligations relating to Algorithmic Trading, in particular as regards testing and deployment of algorithms and trading strategies, annual due diligence reviews and real-time trade monitoring. In addition, Third-Country Firms may be affected to the extent an Investment Firm imposes controls over trading or exercises its "kill functionality."

General Organisational Requirements

At a high level, as part of its overall governance and decision making framework, Investment Firms must establish and monitor trading systems and algorithms through a clear and formalised governance arrangement. This should set out clear lines of accountability, effective procedures for the communication of information within the Investment Firm and separation of tasks and responsibilities of trading desks, on the one hand, and supporting functions, including risk control and compliance functions, on the other.

In addition to the above, there are specific organisational requirements for Investment firms contained in RTS 6, including the following:

- Compliance Function – an Investment Firm is required to ensure its compliance function has at least a general understanding of how the Algorithmic Trading systems of the firm work, with access to and contact with those with detailed knowledge;
- Staffing – an Investment Firm is required to employ a sufficient number of staff with the skills necessary to manage its Algorithmic Trading, including in respect of algorithmic trading strategies and trading algorithms it deploys (which may be on behalf of clients); and
- IT Outsourcing and Procurement – if an Investment Firm outsources or procures software or hardware, it will remain fully responsible for its obligations in relation to Algorithmic Trading.

Testing and Deployment of Algorithmic Trading Systems and Strategies

RTS 6 places obligations on Investment Firms engaging in Algorithmic Trading during the lifecycle of development, from testing and deployment, to post-deployment and maintenance of algorithmic trading systems, trading algorithms or algorithmic trading strategies.

Prior to deployment or a substantial update to an algorithmic trading system, trading algorithm or algorithmic trading strategy, Investment Firms are required to have clearly delineated methodologies to develop and test such systems, algorithms and strategies, addressing such things as design, performance and approval, to, amongst other things, ensure the algorithm behaves as intended and complies with the rules and systems of Trading Venues and regulations. Firms are required to maintain records of material changes to algorithmic trading software to allow it to determine when and who made changes and what was changed.

Investment Firms are then required to perform conformance testing of the algorithmic trading system, trading algorithm or algorithmic trading strategy with the systems of Trading Venues and DMA providers in certain situations to ensure the algorithm is working properly. This is required to be conducted in an environment separate to the production environment, specifically for testing.

Before deploying a trading algorithm, Investment Firms are required to set predefined limits on:

- the number of financial instruments being traded;
- the price, value and numbers of orders;
- the strategy positions; and
- the number of trading venues to which orders are sent.

Post-Deployment Management

Investment Firms must perform annual self-assessment and validation processes and issue validation reports to review, evaluate and validate their algorithmic trading systems, algorithms and strategies, as well as governance and accountability, business continuity and general compliance with its requirements under MiFID II. The self-assessment must include an analysis of compliance with the criteria set out in Annex I to RTS 6. The report must be internally audited and approved by senior management.

As part of the annual self-assessment, Investment Firms must perform stress tests to see if their algorithmic trading systems, procedures and controls can withstand increased order flows or market stresses. Investment Firms must design such tests to include:

- running high messaging volume tests using the highest number of messages received and sent by the Investment Firm during the previous six months, multiplied by two;
- running high trade volume tests, using the highest volume of trading reached by the Investment Firm during the previous six months, multiplied by two.

Proposed material changes to the production environment related to Algorithmic Trading need to be pre-reviewed by a person designated by senior management and changes must be communicated to traders in charge of the trading algorithm and to the compliance and risk management functions.

Ensuring Resilience

RTS 6 implements a number of measures designed to ensure the resilience of Algorithmic Trading. Specifically, Investment Firms engaging in Algorithmic Trading are required to implement the following controls:

- "kill functionality", allowing a firm to immediately cancel any or all of its unexecuted orders submitted to a Trading Venue;
- an automated surveillance system to detect market manipulation;
- business continuity arrangements appropriate to the nature, scale and complexity of its business;
- 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;
- post-trade controls, including the monitoring of market and credit risk exposure; and
- an IT strategy with defined objectives and measures in compliance with, amongst other things, the firm's business and risk strategy and effective IT security management.

Additional Requirements and Obligations

- Notifications to Regulators – an Investment Firm engaging in Algorithmic Trading must notify its home state regulator(s) and the regulator(s) of the relevant Trading Venue at which it engages in Algorithmic Trading.
- Recordkeeping – an Investment Firm must keep sufficient records for its regulator to monitor compliance with MiFID II's Algorithmic Trading requirements.

High-Frequency Algorithmic Trading

See Briefing Note 3 (High-Frequency Algorithmic Trading).

Algorithmic Market-Making Strategies

See Briefing Note 4 (Market Making).

Resources

MiFID II: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0065&from=EN

Definitions Delegated Regulation: https://ec.europa.eu/transparency/regdoc/rep/3/2016/EN/3-2016-2398-EN-F1-1.PDF

RTS 6: http://ec.europa.eu/finance/securities/docs/isd/mifid/rts/160719-rts-6_en.pdf

RTS 6 Annex: http://ec.europa.eu/finance/securities/docs/isd/mifid/rts/160719-rts-6-annex_en.pdf

RTS 7: http://ec.europa.eu/finance/securities/docs/isd/mifid/rts/160714-rts-7_en.pdf

For capitalised terms not otherwise defined herein, please refer to the Glossary.

10. TRANSACTION REPORTING

Takeaway: 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 Investment Firms and Credit Institutions that are subject to the new regime. Note that EU branches of Third-Country Firms are directly subject to these new rules and will need to comply with them.

Overview

MiFIR significantly expands the transaction reporting regime established under MiFID I. While it is not expected that the new regime will apply directly to Third-Country Firms, the Investment Firms directly subject to the regime will likely request an increased amount of information from Third-Country Firms, including FCMs and their clients.

Product Coverage

The MiFIR transaction reporting regime applies in respect of the following Financial Instruments:

- Financial Instruments admitted to trading or traded on a Trading Venue;
- Financial Instruments where the underlying Financial Instrument is traded on a Trading Venue; and
- Financial Instruments where the underlying is an index or basket of Financial Instruments traded on a Trading Venue.

Persons Required to Submit Reports

The following firms are required to submit transaction reports:

- Investment Firms;
- Credit Institutions providing investment services or performing investment activities; and
- EU branches of Third-Country Firms.

In addition, a Trading Venue is responsible for transaction reporting in respect of in-scope Financial Instruments traded on its platform where the firm(s) in question are not subject to MiFIR.

Timeline

Transaction reports must be submitted "as quickly as possible" and no later than the close of the following working day, *i.e.*, T+1.

Execution of "Transactions"

The reporting regime applies principally in respect of the execution of a "transaction" in an in-scope Financial Instrument.

"Transaction"

A "transaction" means the conclusion of an "acquisition" or a "disposal" of a Financial Instrument, including:

- the purchase/sale of a Financial Instrument;
- entering into/closing out a derivative contract in a Financial Instrument; and
- an increase/decrease in the notional amount of a derivative that is a Financial Instrument.

The term "transaction" also includes the simultaneous acquisition/disposal of an in-scope Financial Instrument where there is no change in ownership but where the acquisition and disposal are subject to MiFIR's post-trade transparency regime. RTS 22 includes a list of events that are not considered "transactions" for these purposes.[47]

"Execution of a Transaction"

An Investment Firm will be deemed to have "executed a transaction" where it performs any of the following activities that result in a "transaction" as defined above:

- reception and transmission of orders in relation to one or more Financial Instruments;
- execution of orders on behalf of clients;
- dealing on own account;
- making an investment decision in accordance with a discretionary mandate given by a client; and
- the transfer of Financial Instruments to or from accounts.

Transmission of Orders

In addition to "transactions," separate obligations apply in respect of "transmissions of orders." Where a firm transmits an order, it must include all the details required for a transaction report in such order or, if the order is executed, report the executed transaction.

For these purposes, an order is "transmitted" by a firm ("**Transmitting Firm**") to another firm ("**Receiving Firm**") where the following conditions are met:

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[47] The list includes: securities financing transactions subject to the SFTR; contracts arising in connection with clearing/settlement activities; acquisitions/disposals in connection with custodial activities; portfolio compression; post-trade novation or assignment of a derivative; creation/redemption of units of a collective investment undertaking; and post-execution changes to the composition of an index or basket. For the full list of excluded events, see Article 2(5) of RTS 22.

- the order was received from the Transmitting Firm's clients or results from the firm's decision to acquire/dispose of a specific Financial Instrument in accordance with a discretionary mandate;

- the Transmitting Firm transmits the relevant identifying details to the Receiving Firm; and

- the Receiving Firm is subject to MiFIR reporting requirements and either agrees to report the resulting transaction or to transmit the order details to another firm.[48]

Reports

There are 65 separate fields of data that must be included in each transaction report, which are set out in an Annex to this Briefing Note. RTS 22 has also provided guidance on several practical issues.

Multi-Leg Reporting

Similar to EMIR trade reporting, MiFIR transaction reporting applies to each Investment Firm in a multi-leg chain, which may therefore require a number of reports to be submitted in respect of a single transaction in an in-scope Financial Instrument.

Packages

RTS 22 provides that transactions in a combination of financial instruments (*i.e.*, packages) must be reported separately and must include a unique identifier that links the reports together.

Identification Requirements

RTS 22 clarifies that clients should be identified in transaction reports either via an LEI (for entities) or the full name and date of birth (for natural persons). In addition, where a person other than the client or an algorithm makes a trading decision of the Trading Venue or Investment Firm to which an order is submitted, such person or algorithm must be identified in the report using a consistent identifier. Where multiple persons/algorithms are involved in such decisions, the firm submitting the report must identify the person/algorithm with primary decision-making responsibility.

Short Sales

Short sales must be flagged as such in transaction reports whether the transactions are full or partial shorts. Note that these flags are separate from, and in addition to, any reporting required of net short positions under the Short Selling Regulation.[49]

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[48] The agreement between the Transmitting Firm and the Receiving Firm must provide a time limit for the relevant order details to be sent and require the Receiving Firm to verify whether such details contain any obvious errors or omissions before submitting the transaction report or transmitting the order to another firm.

[49] Regulation (EU) No 236/2012 of the European Parliament and of the Council of 14 March 2012 on short selling and certain aspects of credit default swaps.

Resources

MiFIR: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R0600&from=EN

RTS 22: http://ec.europa.eu/finance/securities/docs/isd/mifid/rts/160728-rts-22_en.pdf

RTS 22 Annex: http://ec.europa.eu/finance/securities/docs/isd/mifid/rts/160728-rts-22-annex_en.pdf

For capitalised terms not otherwise defined herein, please refer to the Glossary.

TRANSACTION REPORTING – ANNEX

LIST OF DATA FIELDS

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 MiFIR, in comparison to the FCA Handbook - SUP 17 – Annex I

11. CLOCK SYNCHRONISATION

Takeaway: 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.

Overview

MiFID II requires Trading Venues (*i.e.*, Regulated Markets, MTFs and OTFs), and their members or participants, to synchronise their business clocks to record the date and time of reportable events.

Synchronisation Requirements

In General

Trading Venues and their members/participants must synchronise their business clocks with Universal Coordinated Time ("**UTC**") either:

- as issued and maintained by timing centres listed in the BIPM's Annual Report on Time Activities (*e.g.*, NIST in Boulder, CO); or
- as disseminated by a satellite system (*e.g.*, GPS) but only where any offset from UTC is accounted for and removed from the timestamp.

"Traceability"

Members and participants of Trading Venues need to be able to demonstrate "traceability to UTC," which means documenting the system design, functioning and specifications of their synchronisation arrangements, including identifying the exact point where a timestamp is applied and demonstrating that such timestamp remains consistent over time.

These traceability requirements must be reviewed at least annually.

Time Stamp Accuracy

Members or participants of a Trading Venue must meet the following standards of accuracy in respect of each type of trading in which they are engaged on Trading Venues.[50]

Type of Trading	Max. Divergence from UTC	Granularity of Timestamp
High-frequency algorithmic	100 microseconds	1 microsecond (or better)
Voice	1 second	1 second (or better)
RFQ with human intervention (or non-algorithmic)	1 second	1 second (or better)

[50] These requirements are set out in Table 2 of the Annex to RTS 25. Separate requirements apply in respect of negotiated trades in equity products which are not included in this Briefing Note.

Other	1 millisecond	1 millisecond (or better)

Reportable Events

The term "reportable event" is not expressly defined for purposes of the clock synchronisation rules; however, ESMA has provided guidance regarding the types of events that it considers reportable events for these purposes. The list of events is reproduced in an Annex to this Briefing Note.

Resources

MiFID II: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R0600&from=EN

RTS 24: http://ec.europa.eu/finance/securities/docs/isd/mifid/rts/160624-rts-24_en.pdf

RTS 24 Annex: http://ec.europa.eu/finance/securities/docs/isd/mifid/rts/160624-rts-24-annex_en.pdf

RTS 25: http://ec.europa.eu/finance/securities/docs/isd/mifid/rts/160607-rts-25_en.pdf

RTS 25 Annex: http://ec.europa.eu/finance/securities/docs/isd/mifid/rts/160607-rts-25-annex_en.pdf

ESMA has also published guidelines on transaction reporting, including a section dedicated to clock synchronisation, which is available at: https://www.esma.europa.eu/sites/default/files/library/2016-1452_guidelines_mifid_ii_transaction_reporting.pdf

For capitalised terms not otherwise defined herein, please refer to the Glossary.

CLOCK SYNCHRONISATION – ANNEX

LIST OF "REPORTABLE EVENTS" – DERIVATIVES

ESMA has clarified that a "reportable event" for a derivative transaction executed on a Trading Venue includes any of the following obligations.

Obligation	Description
Annex II of Table 1b of RTS 2	Transparency requirements for non-equity instruments
Field 28 of Table 2 of the Annex to RTS 22	Date and time when the transaction was executed
Article 25(1) of MiFIR and Article 16(6) of MiFID II	Events affecting all orders and transactions carried out by an Investment Firm and the records kept relating to an Investment Firm's services, activities and transactions
Field 27 of Table 2 and Fields 23, 24 and 33 of Table 3 of Annex II to RTS 6	Exact date and time of the receipt of an order or decision to deal; exact date and time of submission of an order to the Trading Venue; exact date and time of any message transmitted to and received from the Trading Venue in relation to such order; and the time when the order becomes effective or is removed from the order book
Fields 9, 12, and 13 of Table 2 of the Annex to RTS 24	The date and time of any "events affecting an order" (*e.g.*, new order, triggered order, replaced order, change of status, cancelled order, rejected order, expired order, partial fill, filled); the trading phases during which an order is active in the order book as well as indicative auction prices and indicative auction volumes; the time on which an order becomes active or is removed from the order book; and the time the priority of an order changes