Markets in Financial Instruments Directive ("MiFID II"): Implications for U.S. Asset Managers

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AUTHORS

Henrietta de Salis  |  Rita M. Molesworth

What is MiFID II

MiFID II refers to a significant body of European legislation which sets out a revised regulatory framework governing the provision of financial and investment services across Europe.

It is extremely wide-ranging in scope and will impose rules with respect to:

- Authorization of investment firms and the ability to passport services throughout the EU
- Investor protection (including information and risk disclosure, best execution, conflicts of interest)
- Market infrastructure, such as trading venues
- Pre and post-trade transparency for equities and non-equities
- Transaction reporting and position limits
- Algorithmic trading, high-frequency trading and direct electronic access
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- Provision of investment services by non-EU firms to EU clients without establishing a branch

MiFID II does not cover the offering of pooled investment vehicles.

MiFID II will be implemented on January 3, 2018.

Objectives of MiFID II

MiFID II will replace MiFID I, the existing framework for regulation of investment services which came into effect in November 2007. The European Commission wanted to update and amend MiFID I following the financial crisis to further enhance investor protection, reflect developments in trading technology, increase the transparency of the markets by, for example, discouraging trading on dark pools, impose position limits on commodity derivatives and encourage trading on regulated trading venues rather than OTC.

Relevance to U.S. Asset Managers

This memo only considers those aspects of MiFID II which apply to U.S. asset managers. The extent of MiFID II’s impact on a manager will depend upon its business model and the way in which it interacts with the European markets, managers and/or clients in Europe.

This memo assumes that investment management services will be provided only to professional or institutional clients and not retail clients.

The following alternative business models are considered at a high level: (i) the U.S. manager provides investment management services from the United States to clients in Europe, (ii) the U.S. manager trades derivatives, equities and fixed income on European trading venues, (iii) the U.S. manager provides advisory services to a European investment manager, and (iv) the U.S. manager has a European subsidiary which provides portfolio management or other investment services in Europe.

i. U.S. Manager Markets Services to European Clients: Licensing Implications

Currently if a U.S. manager markets services such as managed accounts direct to European clients it will need to check in each European country where clients are based whether it requires a license to market and provide such services. Post MiFID II, a U.S. manager, as a “third-country” (i.e. non-EU) firm, will be able to provide such services to professional clients throughout the EU without obtaining specific authorization in each EU country provided that the United States is determined to meet “equivalence” requirements and the U.S. manager registers with the European Securities and Markets Authority (“ESMA”). An equivalence determination will mean that EU countries will not require individual managers to comply with specific ESMA rules, as it will be assumed that the compliance regime in the United States imposes similar standards. Once equivalence is determined for the United States, this should be beneficial for U.S. firms with European
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professional clients. However, it is not clear when equivalence will be granted. The process of assessing third-country equivalence for non-EU countries under the Alternative Investment Fund Managers Directive (“AIFMD”) and other financial regulation has been slow.

However, not all EU countries will implement this in the same way. In the UK, for example, the current “overseas” persons exemption will continue to apply to U.S. firms, so that the status quo will be maintained, allowing U.S. managers to provide cross-border services to UK clients without establishing a presence in the UK.

Managers potentially affected by this will need to analyze where they provide services to clients in the EU and what the nature of those services are (e.g. whether this is the provision of discretionary managed accounts and/or non-discretionary advisory services). Managers will also need to review the type of clients. There is a distinction in how the rules will apply to non-EU firms providing services to retail clients and non-EU firms providing services to institutional clients.

ii. U.S. Manager Trades Equities, Fixed Income or Derivatives on European Markets and Trading Venues: Implications for Portfolio Managers

Even though a U.S. manager may not have an office in Europe it is likely to be indirectly impacted by the MiFID II changes being made to European financial market infrastructure. These changes will directly affect EU firms. Changes relating to “market infrastructure” are very technical and complex but include extending rules that apply to trading venues such as regulated markets (“RMs”), multilateral trading facilities (“MTFs”) and Systematic Internalizers (“SIs”) to organized trading facilities (“OTFs”). An OTF will capture multilateral trading in non-equity instruments that do not take place on RMs or MTFs. OTFs are likely to include voice, voice/electronic hybrid and electronic brokerage platforms. Equities will not be traded on OTFs.

Pre- and post-transparency requirements will be extended to fixed income products in addition to equities on all trading venues. A concern with these requirements is the effect they may have on liquidity, particularly in the bond markets.

There will be an obligation to trade shares and mandatorily clearable derivatives on regulated trading venues. The aim of this is to push as much trading as possible onto more transparent trading venues, i.e. away from dark pools.

This may affect the choice of where products are traded and prompt a review of which trading venues are used for which products.

If a manager has direct access to an EU trading venue, it is likely that the trading venue will develop additional criteria as to continued access or information as to systems and controls surrounding access to trading, in particular regarding use of algorithms.
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Commodity Derivatives

In line with G20 commitments, MiFID II will contain position limits for commodity derivatives traded on RMs, MTFs and OTFs as well as “economically equivalent” OTC derivatives. These limits will apply extraterritorially and may therefore be relevant to U.S. investment funds with affected positions in addition to EU managers. Local regulators will monitor market participants’ positions and may restrict the size of an investor’s position. Such firms will need to look at these provisions in more detail and assess the impact they may have on their trading strategy. They will also need to put in place procedures for monitoring the announced position limits for relevant trading venues.

It should be noted that the definition of a commodity derivative in the EU is complex and wide in scope, and is different from other financial derivatives such as interest rate derivatives. In general it covers options, futures, swaps, forwards and other derivative contracts relating to physical commodities. Commodities are goods of a fungible nature that are capable of being delivered, including metals and their ores and alloys, agricultural products and energy such as electricity. Commodity derivatives also include some cash settled derivatives which do not have a tangible underlying such as climatic variables, freight rates and inflation rates.

i. U.S. Asset Manager Providing Sub-Advisory Services to EU Firm

Where an EU firm appoints a U.S. manager as a sub-advisor, as part of those delegation arrangements, it may seek to impose some requirements under MiFID II that it is subject to onto the U.S. manager, thereby indirectly impacting the U.S. firm. This will be a matter of commercial negotiation between the EU firm and the U.S. manager as to the extent to which it will agree to comply with EU conduct of business rules which may conflict with U.S. rules or impact its operational processes. Later in 2017, U.S. firms may start to receive new sub-investment management or advisory agreements reflecting new requirements on the EU firm which will need to be reviewed carefully.

ii. European Authorized Subsidiary

EU authorized investment managers will be directly impacted by MiFID II and will have substantial changes that they will need to make prior to implementation in January 2018. In addition to the changes in market infrastructure, some of the key issues that EU firms must implement relate to:

- Inducements and payment for research
- Transaction reporting
- Best execution
- Product governance
- Reclassification of local and public authorities from professional clients to retail clients
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- Algorithmic trading, high frequency trading direct electronic access
- Telephone recording

Payments for Research

EU investment managers will no longer be able to pay for research with dealing commission. Firms either must pay for the costs of research themselves, or agree with each client on a research budget and for each client to agree to make a payment towards the firm’s overall research budget. Some large investment managers in the UK including M & G, Baillie Gifford and Jupiter have already made public that they will bear the costs of research themselves. Others are deciding whether they will be able to charge these costs to clients. If research is to be paid for by clients, there are detailed requirements that must be followed which will be onerous from a compliance perspective and may look uncompetitive.

ESMA published a Q&A on April 4 which gives additional guidance on the operation of the rules on payment for research. These provisions will also apply to research in respect of bonds. It is less clear how this will be paid for as currently the costs of research in the fixed income markets are contained as part of the bid-offer spread. Theoretically, the FCA in the UK has suggested that if research is currently a material part of a broker’s costs it might expect to see a narrowing of spreads. Negotiations will be required, with brokers providing investment research as to how it should be valued.

ESMA has maintained in its Q&A that for research related to fixed income firms should either pay for the research themselves or charge it to the client. ESMA envisages that it may be possible to develop a subscription agreement, provided the firm can demonstrate how the pricing structure has been developed. Alternatively, ESMA suggested the research providers make the research available to the public, in which case it may be treated as a minor non-monetary benefit.

Where those brokers are in the United States, receipt of payment for research in “hard dollars” may create tensions under the U.S. Securities laws, including the Investment Advisers Act which otherwise allow a broker to receive “soft dollar” payments for research without being registered as an investment adviser. Brokers and/or U.S. investment advisors may be asked by EU managers to alter their use of soft dollars for brokerage services.

To the extent analysts notes are not sufficiently tailored or bespoke in content or rationed in how they are distributed or accessed, they might not amount to “research.” Such notes may be allowable as “minor non-monetary benefits” and not prevented by the rules relating to inducements.

Corporate access is not research and managers will also need to review whether they will have to pay for the service (so that it is not an “inducement”) or whether it can be treated as a “minor non-monetary benefit.” This will be fact-specific, so will require internal monitoring procedures.
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Transaction Reporting

The objective of the rules on transaction reporting is to enable EU regulators to monitor transactions for market abuse. Under MiFID I, transaction reporting applied only to equities and, provided a trade was reported by sell-side firms, a manager was exempt. MiFID II has considerably broadened the scope of transaction reporting to cover a wider range of products to encompass all financial instruments – whether equities, bonds or derivatives traded on any of the extended range of trading venues. The data required for the reports is also to be significantly expanded in scope. Although a manager that transmits orders to an EU broker could appoint that broker to report on its behalf, an agreement would need to be put in place meeting specified requirements. In essence the manager would have to supply the broker with the same extensive data as if the manager were to report for itself. We have heard anecdotally that some large portfolio managers are developing systems themselves to report relevant transactions. Self-reporting will also ensure that the manager is able to report its transactions where it has a non-EU broker, where the manager will remain responsible for the reporting. This is a significant operational and IT cost for EU firms. Some smaller firms are able to outsource to service providers.

Best Execution

EU investment managers must take “all sufficient” steps to obtain the best possible result for their clients when placing or transmitting orders. Firms must monitor the quality of execution services by the brokers with whom they place orders for execution. In addition, where managers execute orders directly on a trading venue such as an MTF they must apply best execution to such trades. U.S. brokers may receive requests for detailed information from EU firms to enable the EU firms to meet their best execution requirements.

Compliance with the more stringent requirements under MiFID II will require detailed review by EU firms. Changes may be necessary in respect of procedures for disclosing order execution arrangements and may be necessary in respect of order execution policies to make them more detailed. For example, managers must publish annually their top five execution venues for each class of financial instrument traded in their portfolios. To monitor and review execution quality will require ensuring that relevant data can be captured. Best execution applies to a wide range of asset classes in scope including listed derivatives and fixed income instruments. This is likely to represent another significant area of IT spend and continuing compliance involvement.

Product Governance

MiFID II introduces a new product governance regime as part of its investor protection framework. This will affect product manufacturers (e.g., fund sponsors) and product distributors. The aim of the rules is to ensure products sold by investment firms are sold to an appropriately identified target market. In relation to asset management, this will apply to investment funds sold to investors even where such investors are professionals.
The product governance regime contains a number of detailed rules and principles relating to the internal governance arrangements in a firm. For example, the product approval process of a manufacturer of financial instruments (e.g. funds) must:

(i) identify a “target” market for the relevant product or service;

(ii) ensure that all risks are assessed for that target market; and

(iii) ensure that the distribution strategy is consistent with the identified target market. Firms involved in either the distribution or manufacture of products will need to review their internal governance and approval arrangements and review their distribution agreements. We expect distribution agreements between manufacturers and distributors to include provision of relevant information between the parties to ensure each party is aware of its ongoing responsibilities.

U.S. asset managers are likely to be indirectly affected by these rules where, for example, their products are sold in the EU. The governance regime is separate from other EU legislation governing the content and disclosure requirements of offer documents.

**Algorithmic Trading, HFT and Direct Electronic Access ("DEA")**

MiFID II introduces a detailed framework of organizational and systems requirements for EU firms that engage in algorithmic trading or apply a ‘high frequency trading technique’ (which is a subset of algorithmic trading).

These rules will not apply to an investment manager that transmits orders to a broker which separately uses algorithmic trading. However, if the manager uses an algorithm which does more than merely route orders, it is likely to be in scope of the rules.

Such firms will need to comply with detailed systems and controls requirements and notify their regulator.

Firms which use DEA will find that the providers of DEA will impose enhanced due diligence and information requirements on them.

**Telephone Recording**

The current rules on telephone recording and record keeping are being extended. EU firms will be required to record all telephone conversations or other electronic communications that lead to or are likely to lead to transactions in equity and non-equity instruments whether dealing on their own account or when executing, receiving or transmitting orders. The scope extends to internal conversations. Where the rules apply, records must be kept for at least five years –

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1 E.g. where the algorithm determines what to trade and when to submit orders.
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considerably longer than the six month requirement which applies now. This is another area which will result in IT and compliance costs for firms.

Summary

The above is a very high level indication of some of the key areas that are likely to have the most significant impact for U.S. asset managers. MiFID II is extremely wide-ranging and complex. It is not yet clear the extent to which MiFID II will affect the way in which products are traded or their liquidity or the extent to which brokers may reduce the amount of research provided, amongst other implications. It does require a GAP analysis of each business affected to ensure steps can be taken to implement required changes.

If you have any questions regarding this memorandum, please contact Henrietta de Salis (+44 203 580 4710, hdesalis@willkie.com), Rita M. Molesworth (212-728-8727, rmolesworth@willkie.com) or the Willkie attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is an international law firm with offices in New York, Washington, Houston, Paris, London, Frankfurt, Brussels, Milan and Rome. The firm is headquartered at 787 Seventh Avenue, New York, NY 10019-6099. Our telephone number is (212) 728-8000 and our fax number is (212) 728-8111. Our website is located at www.willkie.com.

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