

Impact of MiFID II & MiFIR on end users of financial markets

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I. Introduction

On 3 January 2018, the new Markets in Financial Instruments Directive¹ (“**MiFID II**”) and Markets in Financial Instruments Regulation² (“**MiFIR**”) (collectively the “**MiFID II package**”) will come into force across Europe³, with significant ramifications for users of European financial markets. This briefing summarises the major changes wrought by the MiFID II package on European financial markets as they affect end users⁴ of those markets and discusses some of the practical implications for such users.

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¹ 2014/65/EU repealing MiFID.

² Regulation 600/2014.

³ The MiFID II package will also apply in the European Economic Area member states which are not members of the EU (Iceland, Liechtenstein and Norway) in due course. For convenience we refer in this briefing to the EU.

⁴ Whilst the issues raised by this briefing will also be relevant to non-EU intermediaries accessing EU markets, other considerations will also arise for such firms.



Background

The original Markets in Financial Instruments Directive⁵ (“**MiFID**”) was implemented in 2007 and constitutes a key piece of the EU’s regulatory regime for financial markets. The MiFID regime sought to create a single market for investment services and activities and to ensure a high degree of harmonised protection for investors in financial instruments⁶.

In light of the financial crisis and the various developments in trading environment and practices, the European Union (“**EU**”) authorities opted to reform and strengthen the original MiFID regime, which resulted in the adoption of MiFID II and MiFIR on June 12, 2014. The MiFID II package will come into force on January 3, 2018⁷. The new regime is designed to improve the functioning of financial markets to make them more efficient, resilient and transparent. The reforms to be introduced by the MiFID II package include:

- the extension of licensing requirements to capture members of, and participants in, trading venues and algorithmic traders;
- the introduction of the “trading obligation”, which will result in volumes of OTC trading in shares and derivatives moving into transparent, on-venue trading;
- new requirements for trading venues, including extended pre-trade and post-trade transparency requirements for equity and non-equity markets (including derivatives) and extended transaction reporting obligations;
- harmonised rules designed to improve and strengthen investor protection for clients of EU investment firms; and

⁵ Directive 2004/39/EC.

⁶ Broadly: shares, bonds, fund units, money market instruments and derivatives.

⁷ MiFIR comes into effect on 3 January and will be directly applicable across the EU. MiFID II needs to be transposed into national law and brought into force by each EU member state by 3 January. In practice, some member states are likely to implement it late.

- some obligations which purport to apply to unregulated users of markets - in particular, commodity position limits.

Although the MiFID II package requirements will apply directly to EU investment firms and other EU market participants, the regime will also affect non-EU users trading on EU markets or with EU counterparties, or receiving investment services (such as investment advice or portfolio management) from EU investment firms.

Purpose

This briefing is designed to provide non-financial sector and/or non-EU end users of EU markets (“**Clients**”) that have trading relationships and/or other investment services agreements in place with EU banks and investment firms (“**EU Firms**”) or trading venues with a high-level overview of the main implications of the MiFID II package from a buy-side perspective.

For these purposes, we consider both the main reforms relating to market structure and trading activities and the key enhancements to investor protection, in each case, setting out brief details of the new requirements and headline legal and regulatory impacts for Clients. There will also be significant wider commercial ramifications of the new framework: we identify some commercial considerations below.

Structure

The remainder of this briefing is structured as follows:

- (a) Section II discusses issues relevant to Clients which are members of regulated markets or multilateral trading facilities (“**MTFs**”) or which engage in algorithmic trading on EU markets.
- (b) Sections III and IV summarise market infrastructure and investor protection changes under the MiFID II package, which will be relevant to all Clients.
- (c) Section V summarises the new commodity derivatives rules under MiFID II and will be relevant only to Clients which engage in commodities activities.

(d) Section VI sets out further steps Clients may wish to take in advance of implementation.

II. Access to trading venues; algorithmic trading

a. Licensing requirement for members/participants in and DEA users of regulated markets and MTFs and algorithmic traders

The current MiFID regime mandates each EU Member State to require licensing of “investment firms” — persons who provide investment services, or undertake investment activities, on a professional basis in the Member State. It does not address how Member States consider questions of extraterritoriality — i.e. the question of when a person undertaking activities from outside a Member State involving local counterparties, clients or markets is treated as carrying on that activity “in” the Member State. This has resulted in Member States taking different approaches to whether (and how) they regulate non-EU market participants and investment service providers.

MiFID contains exemptions from the licensing requirement for firms or other persons that trade on an own-account basis in MiFID financial instruments but without providing any other MiFID investment services. Clients that engage in proprietary trading on EU-regulated markets or MTFs are currently likely to be operating within the scope of this exemption. Under MiFID II, however, the parameters of this exemption will be narrowed, such that Clients that are participants of, or have direct market access or sponsored access to, an EU-regulated market or MTF will no longer be exempt (unless access is purely for hedging purposes). MiFID II also requires that firms engaging in high-frequency algorithmic trading⁸ have an EU licence.

⁸ ‘High-frequency algorithmic trading technique’ means an algorithmic trading technique characterised by:

- (a) infrastructure intended to minimise network and other types of latencies, including at least one of the following facilities for algorithmic order entry: co-location, proximity hosting or high-speed direct electronic access;
- (b) system-determination of order initiation, generation,

In some EU Member States, Clients that fall within any of the above categories may benefit from national law exclusions from licensing requirements that could be relied upon, notwithstanding the narrowing of the MiFID exemptions in this area. In the UK and Ireland, for example, local law will permit non-EU Clients to trade on local venues without needing a licence, subject to certain conditions. It is also anticipated that the Netherlands’ implementing law will introduce an exemption from licensing requirements for non-EU users of Dutch venues. In other EU Member States, however, proprietary trading activity involving access to local venues or algorithmic trading with local counterparties may require a licence.

Client Impact

Clients that deal on own account other than for hedging purposes and:

- are a member of or have direct electronic access to EU-regulated markets or MTFs; and/or
- engage in high-frequency algorithmic trading in EU markets

will need to identify the EU Member States in which this activity takes place, to assess whether a licence may be required under local law, and where relevant apply for local licences⁹ or cease undertaking the relevant trading activity.

b. Transaction reporting for members of trading venues

MiFIR requires EU Firms executing transactions in financial instruments to report complete and accurate details of these transactions to national regulators. In

routing or execution without human intervention for individual trades or orders; and
(c) high message intraday rates which constitute orders, quotes or cancellations.

⁹ In practice, Clients attracting the licensing requirement across multiple Member States may consider establishing a subsidiary in the EU, which will be able to undertake activities across the EU under a single licence under the so-called ‘passport’ and transferring the licensable business to it, in preference to obtaining multiple licences.

order to enable the same level of data capture for transactions on regulated markets, MTFs and organised trading facilities (“OTFs”—a new category of trading venue under the MiFID II package discussed further in section III below) (collectively “**trading venues**”), MiFIR introduces a requirement for trading venues to undertake transaction reporting on behalf of any members or participants which are not EU Firms.

Accordingly, where a Client is, or becomes, a member of a trading venue, the operator of the trading venue will need to transaction report the Client’s transactions made over the venue as though the Client were an investment firm subject to MiFID II. The data required for transaction reporting purposes is extensive and will include details of the individuals at the Client responsible for trading decisions, and (where the Client deals as agent for, or as riskless principal with, a third party) details of the Client’s underlying client.

Client Impact

Clients, which are members of a regulated market, or participants in an MTF or OTF, will be required to provide detailed information to the trading venue in order to enable the venue to discharge its transaction reporting obligations, including information relating to their staff and underlying clients (if any). Many venues have begun to contact their members and participants in order to obtain this information.

Clients will need to assess whether they are prevented by legal or regulatory obligations from providing such information and whether such restrictions can be overcome in order to continue trading on-venue. Many non-EU members/participants have proven reluctant to provide the relevant information to trading venues. Where Clients are unable or unwilling to provide such information, it may be necessary to cease membership/participation and to access the venue through other means (for example, by way of sponsored access, if available), or deal elsewhere.

c. Direct electronic access

Clients that offer or receive sponsored access or direct market access (together “**direct electronic access**”) to EU trading venues will be subject to enhanced

diligence and monitoring requirements imposed on EU Firms and trading venues. Firms offering direct electronic access will need to have in place extensive systems and controls to, *inter alia*, ensure suitability of their clients, monitor transactions undertaken by their clients and ensure their clients comply with the requirements set out in the rules of the relevant trading venues and MiFID II. In addition, they will need to undertake due diligence assessments of their clients and put in place pre-trade and post-trade controls. Firms receiving direct electronic access services will be expected to be able to demonstrate adherence to the standards required of the EU Firm offering it.

Client Impact

Clients that have direct electronic access arrangements with EU firms will be requested to provide additional data for due diligence purposes and to cooperate with enhanced monitoring of trading activity by EU Firms in order to meet the new requirements. Clients can expect to be required to complete the FIA questionnaire¹⁰ or a similar document, requesting data on the Client’s legal and regulatory status, financial soundness, trading profile and strategies and internal governance and operational arrangements. Clients will need to assess whether they are restricted by legal or regulatory obligations from providing such information, and whether they have, or can put in place, the controls necessary to meet such requirements.

d. Algorithmic trading

MiFID II also imposes additional restrictions on algorithmic trading, which will apply where Clients engage in algorithmic trading with EU Firms and/or on EU trading venues. Trading venues will need to carry

¹⁰ The Futures Industry Association (“**FIA**”), in cooperation with other trade organisations, has produced a template of questions for use by providers of direct electronic access when conducting due diligence assessments of prospective clients. The template allows both providers of direct electronic access and their clients to use a standardised set of relevant/necessary checks. It is available at https://fia.org/sites/default/files/FIA%20DEA%20DDQ%20Template%20-%20No%20Annexes_FINAL.pdf.

out tests of algorithms and have various systems and controls in place, including systems to limit the ratio of unexecuted orders to transactions and to be able to slow down the flow of orders. EU Firms must also comply with more detailed systems and controls requirements associated with algorithmic trading.

Client Impact

Clients will need to assess whether their trading amounts to algorithmic trading under the new regime, and if it does identify the requirements to which they will be subject in order to continue to undertake algorithmic trading, put in place systems, controls, policies to meet the requirements and liaise with any EU Firms or trading venues to provide them with the necessary information to enable them to discharge their own obligations.

III. Market Structure and Trading Practices

a. Introduction of OTFs

The MiFID II package introduces a new type of trading venue, the OTF. This is designed to catch all types of organised executing and arranging of trades that do not currently take place on regulated markets and MTFs, such as broker crossing systems. Only non-equity instruments can be traded on OTFs¹¹ and, in contrast to MTFs and regulated markets, orders are executed on a discretionary basis. This is designed to ensure that systems where the operators have some discretion as to the manner in which orders are executed are brought within the scope of MiFID II. MiFID II requires all multilateral systems to be authorised as either regulated markets, MTFs or OTFs. The OTF category was introduced to ensure transparency requirements will apply to organised trading on all types of multilateral systems.

¹¹ One of the consequences of OTFs being permitted only to trade non-equity instruments is that broker crossing networks and other similar multilateral systems, which employ discretion, will no longer be available for trading equities (and equity-like instruments, including ETFs) in the EU.

In broad terms, OTFs are subject to requirements which are a hybrid of the markets regulation applicable to MTFs and investor protection regulation applicable to investment firms. OTFs will be “trading venues” for purposes of the transparency, trading and transaction reporting regimes but will also be required to meet best execution and other investor protection requirements under the regime.

Client Impact

A variety of EU Firms will be establishing OTFs in the run-up to MiFID II. Clients will need to diligence these to understand their commercial offering, legal terms and any conditions to being able to access them (including those discussed in Section II above).

b. Mandatory trading obligations

In an attempt to increase the volume of on-venue trading, MiFIR introduces a “trading obligation” for certain derivatives and shares. This will require EU Firms to trade shares and derivatives subject to the obligation on an EU or recognised non-EU regulated trading venue.

i. The trading obligation for derivatives

The trading obligation for derivatives in MiFIR requires certain counterparties to conclude new transactions in in-scope derivatives only on an EU regulated market, MTF or OTF or an equivalent non-EU trading venue. Existing swaps are unaffected.

The trading obligation only applies to certain classes of derivatives. These classes of derivatives are not listed in MiFID II but will be specified in separate regulatory technical standards. On September 29, 2017, the European Securities and Markets Authority (“ESMA”) submitted final draft regulatory technical standards to the European Commission for its endorsement. The final draft regulatory technical standards provide that fixed-to-float interest rate derivatives in EUR, USD and GBP and certain credit default swap indices (iTraxx Europe Main and iTraxx Europe Crossover) will be subject to the trading obligation. The European Commission has three months to endorse this final draft, but it is anticipated

to come into force on January 3rd in the form proposed in the final draft regulatory standards. ESMA will maintain a register of the classes of derivatives that will be subject to the trading obligation on its website.

While MiFIR does not directly impose requirements on non-EU firms, Clients may find themselves caught by the trading obligation for derivatives where they conclude transactions in in-scope derivatives with EU Firms or other “financial counterparties”¹² or with EU “non-financial counterparties that trade OTC derivatives above certain volume thresholds” (so-called “NFC+s”)¹³. These classifications are consistent with those applied under the European Market Infrastructure Regulation (“EMIR”¹⁴) and may already be familiar to Clients. In limited circumstances, the trading obligation may also apply to derivative contracts between two non-EU counterparties (for example, in cases where the

derivative is guaranteed by an EU financial counterparty).

To the extent that Clients are subject to trading obligations in their home jurisdiction, and unless equivalence is granted, the rule risks creating conflict between trading obligations applicable to the Client and its EU Firm counterparty. As yet, no equivalence decisions have been made. It is anticipated that an equivalence decision will be given for the US before January 3rd. For other jurisdictions with trading obligations, the requirement may impair continued trading in derivatives subject to dual trading obligations.

Client Impact

Clients which have been categorised as NFC+ entities by reference to the trading volume thresholds footnoted above will be subject to the derivatives trading obligation when trading with EU Firms. NFC+ Clients’ EU Firms will likely contact them (if they have not already) to put in place the necessary documentation supporting on-venue trading for derivatives subject to the trading obligation (such as fixed-to-float EUR interest rate swaps).

Where Clients are already subject to trading obligations in their home jurisdiction, and no equivalence assessment has been made for the home jurisdiction, trading may have to cease unless the home jurisdiction trading obligation accommodates trading on EU venues.

Some Clients have historically permitted themselves to be categorised as NFC+s as it was easier to do so than to undertake the diligence to determine NFC- status. The increased costs associated with on-venue trading may be a spur to revisit categorisation under EMIR for such firms.

ii. The trading obligation for shares

The trading obligation for shares will affect Clients where they trade shares that are admitted to trading on EU-regulated markets or MTFs (“EU traded shares”: this includes dual listed shares) with an EU Firm.

¹² I.e. investment firms, credit institutions, insurance undertakings, assurance undertakings, reinsurance undertakings, UCITS funds and their managers, Institutions for occupational retirement provisions (IORPS) and alternative investment funds.

¹³ A non-financial counterparty will qualify as an NFC+ broadly where taking into account all the OTC derivative contracts entered into by it and by other non-financial entities within its group (whether established within or outside the EEA), but excluding those OTC derivative contracts entered into for hedging purposes, the following thresholds are crossed:

- a) EUR 1 billion in gross notional value for OTC credit derivative contracts;
- b) EUR 1 billion in gross notional value for OTC equity derivative contracts;
- c) EUR 3 billion in gross notional value for OTC interest rate derivative contracts;
- d) EUR 3 billion in gross notional value for OTC foreign exchange derivative contracts;
- e) EUR 3 billion in gross notional value for OTC commodity derivative contracts and other OTC derivative contracts not provided for under points (a) to (d).

¹⁴ Regulation 648/2012.

The trading obligation obliges an EU Firm to execute trades in EU traded shares on EU-regulated markets or MTFs, or through EU “systematic internalisers”¹⁵ (“SIs”), or on an equivalent non-EU trading venue¹⁶.

Trading in EU traded shares with EU Firms will therefore need to occur on EU or non-EU equivalent venues or SIs. This may affect EU brokers’ ability to be competitive in shares which are both listed outside the EU and traded on an EU venue, at least pending equivalence decisions for non-EU trading venues. EU brokers may seek to work around this constraint by routing orders to non-EU brokers.

Client Impact

Whilst there is no immediate legal or regulatory impact of the requirement for non-EU Clients, pricing and/or liquidity offered by EU Firms in dual-listed shares could be adversely affected by the obligation. In particular, Clients which undertake trades through EU brokers and are subject to best execution (or similar fiduciary or quasi-fiduciary) obligations will need to consider whether arrangements for trading such shares will need to change to avoid the impact of the obligation.

c. Indirect clearing

MiFIR introduces a requirement for exchange-traded derivative transactions (“ETDs”) to be cleared by a CCP. This will essentially align the position for ETDs in Europe with that of OTC derivatives subject to the

¹⁵ An investment firm will qualify as a “systematic internaliser” where it, on an organised, frequent systematic and substantial basis, deals on own account when executing client orders outside a trading venue without operating a multilateral system. Different criteria apply with respect to different financial instruments in establishing whether an investment firm deals in a frequent systematic and substantial basis in a particular financial instrument.

¹⁶ A non-EU trading venue will be equivalent where the European Commission has issued a positive equivalence determination in relation to the trading venue. No equivalence decisions have yet been issued by the European Commission. It remains unclear whether any non-EU venues will have been declared to be equivalent by January 3rd.

clearing obligation under EMIR, and broadly represents no change to market practice across the EU markets (as ETDs are generally already cleared by CCPs). MiFIR will also align indirect clearing arrangements for ETDs with the parallel requirements under EMIR for cleared OTC derivatives, to ensure that indirect clearing arrangements do not increase counterparty risk.

Specific requirements in relation to documentation and segregation under indirect clearing arrangements have been introduced to ensure that arrangements for ETDs offer adequate protection to clients and markets, consistent with the EMIR requirements for cleared OTC derivatives. As with the EMIR rules, indirect clearing arrangements must provide for segregation of client assets and positions under (at minimum) a net omnibus account model and/or a gross (non-offsetting) omnibus account model. Clearing members that facilitate indirect clearing must have robust default management procedures to ensure that ETDs under indirect clearing arrangements can be promptly and effectively liquidated or transferred in a default scenario.

Client Impact

The new requirements on documentation of indirect clearing arrangements will drive some changes for EU Firms offering indirect clearing to Clients.

Clients that trade ETDs with EU firms under indirect clearing arrangements can expect to receive revised terms governing ETD trading, updated to take account of MiFIR. It is likely that the revised terms will offer a choice of net or gross omnibus account segregation options (individually segregated accounts may also be offered). While these changes will offer additional protection to Clients, it is possible that the costs of clearing EU ETDs could increase.

Clients should be aware that the existence of indirect clearing arrangements with EU Firms may not always be immediately apparent to Clients. Clients may receive clearing services from a non-EU counterparty, such as a US bank; however, many US banks will operate back-to-back clearing arrangements with its EU affiliates in circumstances where the clearing

services cover derivatives traded on EU exchanges. In this scenario, the MiFIR requirements on documentation and segregation will apply.

d. Transparency requirements

In an attempt to increase transparency of EU markets, MiFIR introduces enhanced pre-trade transparency requirements for EU trading venues and SIs and post-trade transparency requirements for EU trading venues and investment firms.

Pre-trade transparency requires EU trading venues to publish current bids and offer prices and the depth of trading interests at those prices, which are advertised through their systems. Similarly, SIs will be required in certain circumstances to publish firm quotes. Post-trade transparency requires EU trading venues to publish the price, volume and time of transactions executed on the venue as close to real time as is technically possible. Similarly, all EU trading venues and EU Firms which conclude transactions, either on own account or on behalf of clients, will be required to publish the volume and price of those transactions and the time at which they were concluded as close to real time as is technically possible.

Such pre-trade and post-trade transparency requirements apply, *inter alia*, with respect to bonds, structured finance products and derivatives. Waivers for pre-trade transparency and deferrals for post-trade transparency are available in principle for certain types of financial instruments and may be granted by national supervisors to trading venues.

Client Impact

Whilst there is no direct client impact, the transparency requirements may influence the willingness of market participants to commit capital to EU markets and venues, resulting in some migration of liquidity.

e. Transaction reporting and record keeping

As indicated in Section II, MiFIR requires EU Firms executing transactions in financial instruments to report complete and accurate details of these transactions to national regulators. In addition, MiFID

II also requires EU firms to maintain records of the transactions they have carried out for at least five years, including the identity of counterparties.

Client Impact

Clients will need to provide a legal entity identification number (“**LEI**”) and other data (including the national ID of the person or algorithm responsible for investment decisions and/or for execution) to EU Firms, to enable them to meet their transaction reporting and record keeping obligations under MiFIR.

Clients will need to assess whether they are in any way restricted by other legal obligations from providing such information and whether such restrictions can be overcome in order to continue trading on EU markets.

IV. Investor protection reforms

a. Enhanced conduct of business disclosures for investment services

The current MiFID regime already obliges EU Firms to categorise clients (as retail, professional or eligible counterparty) and to provide various mandatory disclosures to clients, depending on their classification and the nature of the services provided. We would expect most Clients to have been categorised as professional clients under the current MiFID regime. This is unlikely to change under MiFID II, although MiFID II will increase the scope of disclosures required to be made by EU Firms, including in dealings with professional clients. These will include extended basic information on the specific services provided to the Client, the financial instruments covered and the associated risks. EU Firms will also need to update their policies relating to conflicts of interest, best execution and client assets and to provide updated summary disclosures and/or policies to Clients.

MiFID II also mandates detailed disclosure to Clients of information on costs and charges associated with the investment services provided, including “unbundling” of costs for bundled services or products, details of third-party payments or charges

and details of marketing and sales costs. Clients must be provided with an aggregated composite figure and (if requested) an itemised breakdown. EU Firms are permitted to contract out of some of the detailed disclosure requirements in dealings with professional clients (except in connection with investment advice and portfolio management services and for instruments that embed a derivative).

Additional service-specific mandatory disclosure requirements are also introduced for certain investment activities, including:

- Custody: disclosure of level of protection/segregation offered (omnibus vs. individual etc.) and associated risks; risks associated with use of third parties and/or non-EU jurisdictions; risks associated with title transfer collateral arrangements and rehypothecation under securities financing transactions.
- Investment advice: disclosure of whether advice is “independent” or “restricted” (wholesale market advice is more likely to be the latter due to the additional limitations attached to independent advice); details of affiliate or contractual relationships connected with advised products/markets; clarification of whether periodic suitability assessments will be provided.
- Portfolio management; portfolio eligibility requirements/limitations; benchmarks for assessing performance, delegation arrangements.

Client Impact

Clients can expect to receive and be requested to execute revised MiFID II-compliant terms of business, including acknowledging receipt of updated policies and contracting with EU Firms to agree to a more limited application of certain MiFID II requirements (such as certain costs and charges information).

Clients should ensure that they are content with the disclosure of this information and understand the practical implications for the ongoing relationship (for example: portfolio management delegation arrangements; level of protection offered for custody

assets; arrangements for ongoing reporting or communications). Clients should consider, in particular whether they are prepared to accept any purported limitations to the extent of disclosure and if there are any areas on which further information may be requested (such as in relation to costs and charges).

Many EU Firms will use the repapering requirements under MiFID II as an opportunity to revise their general terms and conditions to protect their legal position—for example by limiting liability, providing for indemnity protections, providing rights to the transfer and use of data etc. Consideration should be given to the preferred response to incoming terms of business, portfolio management agreements and other agreements which purport merely to address MiFID II requirements, but which affect the Clients’ legal position.

b. Inducements restrictions and investment research

The current MiFID regime already contains limitations on the acceptance by EU firms of payments or other “inducements” from third parties other than clients. While MiFID II strengthens the requirements in this area for all investment services, it goes a step further for portfolio managers and independent advisers in imposing an outright ban on inducements in connection with these services. The practical impact of these changes is likely to be most acute for Clients of EU portfolio managers, as some EU portfolio managers may no longer receive “soft dollar” benefits, including investment research and will therefore face the choice of funding research in-house or transferring the costs to clients through a separate research payment account structure.

Client Impact

In addition to driving disclosures to Clients (in particular where EU Firms offer research payment accounts), the new rules may lead to the introduction of new pricing structures between EU Firms and Clients, including allocation of costs currently borne by EU Firms to expenses borne by Clients in order to offset the impact of the inducements ban. Clients

should monitor changes to the economic terms on which portfolio and fund management are provided.

c. **Best Execution**

The current MiFID regime imposes best execution obligations on EU firms that execute Client orders (under trading and/or portfolio management relationships) and/or receive and transmit Client orders to other firms or trading venues for execution. The core requirement is currently expressed as an obligation on EU firms to “*take all reasonable steps to obtain, when executing orders, the best possible result for their clients taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order.*” Under MiFID II, “reasonable steps”, will be replaced with “sufficient steps”, resulting in a slightly higher standard. Broker firms are also restricted from receiving inducements for routing orders to particular venues. MiFID II also introduces a new requirement for EU firms to publish the top five execution venues in terms of trading volumes for all executed client orders, for each class of financial instrument.

Execution venues (which includes trading venues, SIs, market makers and other liquidity providers) must also publish additional data on execution quality, including reporting details on price, costs, speed and likelihood of execution for individual financial instruments.

Client Impact

Clients can expect to receive more transparency on EU Firms’ best execution practices and venues through EU Firms’ updated policies and the execution quality data published by execution venues. Consistent with the current rules, Clients will need to consent to the execution of orders outside of a trading venue, although as OTFs are a trading venue for non-equities only, consent will not be required in order for EU Firms to execute Client trades via an OTF.

More generally, the MiFID II package will result in significantly greater data flows enabling Clients to monitor execution quality by EU Firms. Clients may

wish to consider whether to change their execution monitoring arrangements.

d. **Telephone Taping**

MiFID II introduces a common requirement for recording of telephone calls, in-person meetings and electronic conversations between firms and their clients relating to client orders and heightened record-keeping requirements for investment advice. EU firms will therefore need to ensure that relevant Client calls are recorded (to the extent not already the case) and to make notes of in-person meetings in which trading investment decisions or recommendations are communicated.

Client Impact

Clients should be aware that some or all of their communications with EU Firms will generally be recorded. As with the current regime, records would not be expected to be published but may be used by national regulators for supervision and enforcement purposes.

V. **Commodity derivatives**

a. **position limits, management and reporting**

MiFID II introduces new requirements in relation to trading of commodity derivatives¹⁷, which are designed to counter concerns regarding market abuse, pricing volatility and the need for orderly settlement. Unlike the majority of the MiFID II requirements, the obligations in this area will apply to unregulated market participants, including non-EU entities which trade commodity derivatives that are admitted to trading on EU trading venues. The new commodity derivatives regime comprises quantitative position limits, position reporting requirements and position management and enforcement powers for EU regulators and ESMA. Non-financial entities may apply for exemptions from the regime with respect to commodity derivatives that are executed for hedging

¹⁷ This would include most energy and utilities derivatives, weather derivatives, metal derivatives, agricultural and other food derivatives, whether physically or cash settled.

purposes related to the commercial activities of the business.

Position limits¹⁸ will be established by national regulators with respect to different classes of commodity derivatives that are traded on local trading venues. The quantitative limits will vary according to the instrument type¹⁹ and will apply to restrict the maximum net position that may be held by a person or group in specific commodity derivatives, whether the position is held through derivatives traded on EU venues or in OTC derivatives that are “economically equivalent”²⁰.

Trading venues will also have powers to monitor open interest in commodity derivatives (including by requiring access to information on positions and any third party beneficial owners) and to enforce the limits by (among others) requiring participants to reduce or terminate positions. National regulators will also have wide powers to enforce and sanction breaches of the position limits regime, which would in principle extend to unregulated non-EU entities.

MiFID II also introduces position reporting rules for EU Firms and trading venues, which will be obliged both to report daily details of all positions in commodity derivatives (including OTC trades, in the case of EU Firms) to national regulators, including positions held on behalf of underlying clients. EU Firms that are members of EU trading venues will also need to report to trading venues and trading venues

¹⁸ Contracts will be subject to two different position limits: one for the spot month and one for all other months.

¹⁹ National regulators are required to apply detailed calculation methodology that takes into account certain mandatory factors, including maturity, deliverable supply, overall open interest in the contract and other instruments with the same underlying, market volatility and liquidity and characteristics of underlying spot markets.

²⁰ An OTC derivative shall be considered economically equivalent to a commodity derivative traded on a trading venue where it has identical contractual specifications, terms and conditions, excluding different lot size specifications, delivery dates diverging by less than one calendar day and different post trade risk management arrangements.

must also publish weekly reports with aggregated position data.

Client Impact

Clients will need to assess whether or not they trade in commodity derivatives that are traded on EU trading venues—including OTC trading²¹ of such instruments and trades executed through portfolio managers, for example. Where this is the case, Clients will need to assess:

- whether or not the trades are for hedging risks related to the Client’s commercial business;
- the EU trading venues on which the commodity derivatives are traded and the relevant national regulators²²; and
- the applicable position limits imposed by national regulators.

The exemption for hedging derivatives, where available, is not automatic and must instead be obtained through an application to national regulators.

Clients will not be subject to any direct obligation to monitor or report their positions but will need to provide contract and position data to EU Firms on commodity derivatives that are admitted to trading on EU trading venues and are traded with EU Firms (whether on-venue or OTC and whether the EU Firm acts as principal or agent on the Client’s behalf), to enable EU Firms to comply with their own reporting obligations to national regulators and trading venues.

Data that may be required for Client positions will include details on the position (for example: date; trading venue; type of commodity derivative, maturity, hedging status or otherwise) and the Client or other

²¹ ESMA has clarified that commodity derivatives traded on non-EU trading venues meeting certain conditions will not be considered to be traded OTC.

²² Where the same commodity derivative is traded in significant volumes on trading venues in more than one jurisdiction, the applicable regulator will be based on the Member State of the trading venue in which the largest trading volume takes place.

position holder (including Client LEI number and parent LEI number and email addresses for position management notifications from regulators - in case of a breach of an applicable limit, for example). There is some ambiguity over the extent to which Clients will need to report details of their underlying clients' positions (if any), although it is likely that this information will be requested by EU Firms in order to report as accurately as possible. Positions held by Clients on behalf of third parties will not count towards the Client's own position limits.

b. Removal of outright exemption for commodity derivatives dealers

The changes to the scope of the MiFID regime and the available exemptions will also be relevant for firms that deal on a proprietary basis in commodity derivatives. While the current MiFID regime provides for a complete exemption for persons whose main business consists of dealing on own account in commodities and/or commodity derivatives, this will be removed under MiFID II and replaced with a narrower and non-automatic exemption, which requires an evaluation of the relative and absolute size of a group's commodity derivatives activity.

Under the revised regime, commodity derivatives dealers will only be able to remain exempt provided that:

- the entity/group's commodity derivatives activity is "ancillary to the main business" of the entity and/or group;
- the entity/group's business is not the provision of investment services – *i.e.* a commodities dealer that is part of an investment management group could not avail itself of the revised exemption for purposes of its commodity derivatives trading (and the exemption will also be unavailable where the own-account dealing is for purposes of executing client orders on a riskless principal basis²³);

²³ ESMA has indicated that the execution of orders directly between two non-financial entities on an ancillary basis should amount to "dealing on own account when executing client orders".

- the entity/group does not engage in high-frequency algorithmic trading; and
- each affected commodity derivatives dealer entity notifies relevant EU regulators annually to confirm reliance on the exemption.

The question of whether an entity/group's commodity derivatives activity qualifies as "ancillary to its main business" must be determined by applying a combination of two cumulative tests (the second of which contains two alternative components)²⁴.

The tests are as follows:

1. The size of the group's commodity derivatives activity in the EU relative to the overall EU market trading activity must fall below certain thresholds:
 - Thresholds are assessed on a per asset class basis for a list of specified asset classes²⁵ with percentage thresholds ranging from 3%-20%.
 - The group's activity must be calculated by aggregating the gross notional value of all EU-traded contracts within the relevant asset class to which a group entity is party (but disregarding any contracts entered into by authorised EU investment firms within the group – if any) and assessing these numbers relative to the gross notional value of all derivatives traded on EU trading venues and OTC derivatives traded by EU entities²⁶.
 - the calculations should exclude commodity derivatives entered into for hedging business risks related to the group's commercial

²⁴ In accordance with Commission Delegated Regulation (EU) 2017/592.

²⁵ Metals, oil/oil products, coal, gas, power, agricultural, freight, emission allowances and certain "other" contracts.

²⁶ Indicative EU market size data has been provided for these purposes by ESMA: https://www.esma.europa.eu/sites/default/files/library/esma7-0-156-165_opinion_on_market_size_calculation.pdf

activity, or for intra-group liquidity or risk management purposes²⁷.

2. The group's commodity derivatives trading activity must constitute a "minority" of overall activities at group level. "Minority" for these purposes refers to a base 10% threshold, which must be calculated in accordance with either or both of the following alternative tests:
 - Size of the group's commodity derivatives trading activity, relative to total size of the group's trading activity:
 - the former is calculated using similar methodology to the first test, although without the express carve-out for hedging derivatives;
 - the latter is calculated by reference to the gross notional value of the underlyings of the group's commodity derivatives activity, as an ostensible proxy for overall trading activity.
 - Estimated capital employed within the group for commodity derivatives activity, relative to total capital employed for carrying out the group's main business:
 - the former is calculated by reference to the estimated capital that a non-financial group would need to hold against market risk arising from positions in commodity derivatives (in line with specified net and gross thresholds and in this case excluding hedging derivatives, etc.);
 - the total capital figure is based on the sum of total group assets minus short-term debt.

The applicable methodologies for calculating the "minority of activities at group level" test(s) and their

²⁷ Specified in more detail in Regulation (EU) 2017/592.

interaction with the "share of trading activity" test are complex and the asset class thresholds in the first test are adjustable downwards for groups whose proportion of activity exceeds 10% under the "minority of group activities test". The calculations should be based on a three-year rolling average²⁸.

Commodity derivatives dealers seeking to rely on the "ancillary activities" exemption are required to make annual notifications to relevant national regulators for this purpose²⁹. The first notification must be made by 3 January 2018. The notification does not need to explain the calculations underlying the exemption unless requested by national regulators.

Client Impact

Clients that trade commodity derivatives in EU markets should assess their eligibility for the ancillary activities exemption by reference to the tests above. In simple terms, Clients' commodity derivatives trading activity will be out of scope of the MiFID II licensing requirements if it is entered into to hedge commercial activities (or for intra-group liquidity/risk management purposes) and amounts to less than 10% of total trading activities.

If this is not the case, or the answer is unclear, Clients will need to examine the nature and extent of their EU commodity derivatives trading activity in more detail by reference to the tests outlined above, in order to assess whether it is reasonable to rely on the exemption.

Clients that are eligible for the exemption will nonetheless need to make the annual notification(s) to relevant national regulators, confirming reliance on the exemption.

VI. Action points for Clients

²⁸ Except in specified cases of material decline in activity, in which the most recent calculation period may be substituted for reference purposes.

²⁹ Relevant national regulator(s) will be the authority/ies in the jurisdiction(s) in which the firm would, absent the exemption, need to be licensed to carry on the relevant activity.

The precise effects of the MiFID II reforms will depend on the nature and extent of a Client's EU markets activity and relationships with EU Firms.

In broad terms, however, Clients should be prepared to consider at least some of the following issues:

- **Licensing:** for Clients which are members of or have direct electronic access to trading venues and/or engage in algorithmic trading (see Section II) or substantial commodity derivatives trading (see Section V), consider obtaining legal advice on licensing requirements in relevant jurisdictions and consider temporary workarounds (on the basis that, as licences generally take six months to obtain, Clients which have not already commenced applications will be unlikely to obtain them by January 3rd).
- **Technical requirements for direct electronic access and algorithmic trading:** Clients which provide or use direct electronic access or algorithmic trading, commence working through the technical requirements under MiFID II and the diligence required by trading venues and EU Firms: this may require changes to algorithms, technology, systems, controls and procedures.
- **Trading obligations:** for Clients which engage in OTC trading activity with EU firms in derivatives and/or shares, consider the ramifications of the move to on-venue trading and (for derivatives) whether categorisation as an NFC+ should be reappraised.
- **Data:** Clients are likely to be asked by EU firms and/or trading venues to provide substantial amounts of data, in order to enable EU market participants to fulfil their reporting and disclosure obligations under MiFID II: Clients should assess the extent of any legal restrictions on their ability to provide this data and whether these can be overcome. For Clients which are members of regulated markets or MTFs, commence analysis on transaction reporting data needs of trading venues with a view to decision-taking on whether to continue membership or participation.
- **Legal documentation:** Clients can expect to receive considerable volumes of revised legal

documentation from trading venues and EU Firms. Consider how to manage dealing with documentation.

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