



K&L GATES

MIFID II TOOLKIT FOR GLOBAL INVESTMENT MANAGERS

Changes to the MiFID II regulatory regime will impose new obligations on many global investment managers that, to date, have avoided substantive regulation in the European Union (“EU”).

While the precise scope of these obligations will depend, in many cases, on further regulatory guidance, it is clear that certain business practices that are common among global investment managers must be reassessed in light of the new regime.

This Toolkit summarizes several key aspects of MiFID II that may impact the trading activities and other operations of global investment managers with offices or clients in the EU. Its goal is to help global investment managers identify business practices that may be impacted by MiFID II, and to help reconcile the requirements of MiFID II with current market practice and the requirements of other regulatory regimes.¹



¹ This Toolkit reflects the European Securities and Markets Authority (“ESMA”) guidance as of July 10, 2017, and certain policy positions set forth in the UK Financial Conduct Authority’s (“FCA”) final Policy Statement on MiFID II, PS 17/14, published on July 3, 2017.

WHAT IS MIFID II? 4

WHEN WILL MIFID II TAKE EFFECT? 4

HOW WILL MIFID II APPLY TO GLOBAL INVESTMENT MANAGERS? 5

Global investment managers performing MiFID-covered activities in the EU5

Global investment managers acting as subadvisers to EU MiFID-licensed firms5

Global investment managers acting as subadvisers to EU UCITS management companies or AIFMD-licensed firms.....7

WHAT ARE THE KEY ASPECTS OF MIFID II FOR GLOBAL INVESTMENT MANAGERS? 8

Inducements and use of dealing commissions to obtain research8

Transaction reporting17

Recordkeeping and mandatory taping20

Best execution22

Position limits and reporting for commodity derivative trading.....23

HOW DOES MIFID II IMPACT THE REGULATORY TREATMENT OF FX SPOT TRANSACTIONS?..... 25

WHAT IS MiFID II?

MiFID II is a term widely used to describe the package of revisions to the current EU Markets in Financial Instruments Directive² (“**MiFID**”). At the heart of these revisions are a Recast Directive³ (the “**Directive**”) and a new EU Markets in Financial Instruments Regulation⁴ (“**MiFIR**”). MiFIR will be directly effective across the EU, whilst the Directive must be implemented in each individual EU member state (“**Member State**”). Consequently, certain aspects of MiFID II, including whether and how its requirements apply to the activities of global investment managers, will differ among Member States.

WHEN WILL MiFID II TAKE EFFECT?

The MiFID II implementation date is January 3, 2018. Presently, no general transitional relief is expected. However, the Directive portion of MiFID II is subject to local implementation in each Member State, and individual Member States may grant transitional relief in particular circumstances. It is also likely that some Member States will be late in bringing into effect the appropriate local implementing legislation.

The UK is expected to implement MiFID II on time on January 3, 2018, notwithstanding Brexit.



² Directive 2004/39/EC.

³ Directive 2014/65/EU.

⁴ Regulation (EU) No. 600/2014.

HOW WILL MiFID II APPLY TO GLOBAL INVESTMENT MANAGERS?

Determining which MiFID II provisions will apply to any given global investment manager will depend on the manager's particular circumstances.

GLOBAL INVESTMENT MANAGERS PERFORMING MIFID-COVERED ACTIVITIES IN THE EU

Authorization and associated conduct of business requirements under MiFID II will only apply directly to managers that perform investment services and activities, including discretionary and non-discretionary investment advice, in the EU.

Different Member States take different approaches as to whether an activity is deemed to be performed in the Member State. The UK has a relatively favorable "overseas persons exemption," which is expected to continue to be available after the MiFID II *implementation date of January 3, 2018*. That exemption permits the provision of certain investment services to UK persons by overseas managers with no physical UK establishment, provided that certain marketing rules are observed. However, some other Member States have stricter territorial tests that, for example, may impose local regulation under MiFID II if a manager has clients in the relevant

jurisdiction. For example, a manager that is not physically operating in Germany, but specifically targets German residents on a cross-border basis in its marketing, may be subject to local regulation under MiFID II.⁵



Global investment managers should assess the extent to which their activities may be considered to take place in the EU, in particular focusing on any places of business within the EU and EU-domiciled clients. Upon identifying relevant EU jurisdictions, global investment managers should review the extent to which MiFID II requirements might apply directly to them in those jurisdictions by reference to the jurisdiction's local implementation regulations.

GLOBAL INVESTMENT MANAGERS ACTING AS SUBADVISERS TO EU MIFID-LICENSED FIRMS

Global investment managers acting as subadvisers to EU MiFID-licensed firms may be subject to MiFID II directly as discussed above. If they are not directly subject to MiFID II, they may nevertheless bear certain MiFID II burdens indirectly because MiFID-licensed firms cannot contract out of their own obligations under MiFID II with

⁵ MiFID II also provides for bespoke registration and branch registration regimes. The bespoke registration regime is not generally applicable at this time, and will only become effective after an "equivalence decision" in relation to one or more non-EU countries has been made. The bespoke branch registration regime for non-EU firms who provide services to retail or elective professional EU clients is proposed in MiFID II as an option for Member States, and will not be generally applicable across the EU. For example, the UK has opted out, and Germany is not explicitly implementing the MiFID II branch registration regime as it already operates a similar regime under local law.

respect to their own activities that take place in the EU. At a minimum, non-EU subadvisers will be expected to cooperate in providing information needed by the MiFID-licensed firm to comply with mandatory **transaction reporting** and to perform other mandatory activities under MiFID II.

In addition, we expect that MiFID-licensed firms will seek to impose contractual obligations on subadvisers operating outside of the EU to comply with certain MiFID II requirements on a look-through basis, either in the interest of caution or because they have contracted with the underlying client to manage the account in accordance with MiFID II.

It is not presently clear that all MiFID II requirements must be imposed on a subadviser where noncompliance by the subadviser is consistent with the MiFID-licensed firm's compliance with MiFID II in relation to its own EU-based activities. In the UK, however, the FCA appears to support the view that the majority of MiFID II requirements must be imposed on subadvisers. In the context of rules relating to payments for research and

use of dealing commissions, the FCA has stated:

“We were concerned to see that some firms with overseas operations and those that delegated investment management services failed to implement controls and oversight structures to ensure the activities they outsourced complied with our rules.”⁶

There is an urgent need for ESMA and/or Member State regulators to clarify the scope of these requirements; however, neither ESMA nor the FCA provided any further clarification on the issue in July 2017 guidance updates.

NEXT STEPS:

Global investment managers that are engaged as subadvisers to EU-based firms should consider engaging their clients to determine both whether, and the extent to which, MiFID II will apply



⁶ FCA website, published March 3, 2017 (FCA summary of findings from a review analyzing dealing commission expenditure of 31 managers).

to those clients. Global investment managers with clients that seek to require MiFID II compliance on a look-through basis should seek clarity from their clients regarding which specific aspects of MiFID II will apply to the account, and the scope of the subadviser's obligations, keeping in mind that any obligations of such managers arising under MiFID II will be contractual in nature.

GLOBAL INVESTMENT MANAGERS ACTING AS SUBADVISERS TO EU UCITS MANAGEMENT COMPANIES OR AIFMD-LICENSED FIRMS

MiFID II does not apply directly to the investment services that UCITS management companies or AIFMD-licensed firms provide respectively to UCITS funds or alternative investment funds; these activities are regulated under the UCITS Directive⁷ or AIFMD.⁸ However, UCITS management companies and AIFMD-licensed firms may be subject to the requirements of MiFID II in respect of the management of separate account mandates. As a result, many large EU fund managers will likely be subject to MiFID II with respect to (at least) a portion of their activities.

Furthermore, Member States may choose to impose certain MiFID II requirements locally to UCITS management companies

and/or AIFMD-licensed firms. For example, in the UK the FCA confirmed in July 2017 that it will extend the MiFID II rules concerning **inducements relating to research** to AIFMD-licensed firms and UCITS management companies.⁹

NEXT STEPS:

Global investment managers acting as subadvisers to UCITS funds or alternative investment funds in the EU should analyze the extent to which MiFID II applies to these clients in relation to the services they are supplying and consider engaging the clients to ensure a common understanding. To the extent that clients seek to require MiFID II compliance on a look-through basis, managers should ensure that the scope of their obligations is limited to those imposed on their clients by local regulations.



⁷ Recast EU Directive Relating to Undertakings for Collective Investment in Transferable Securities (Directive 2009/65/EC). Each UCITS fund has a so-called UCITS management company which takes primary responsibility for the fund's activities and compliance with relevant UCITS rules. The UCITS management company may in turn delegate portfolio management to another firm, which can be licensed under MiFID rather than under the UCITS Directive. In this scenario, the portfolio manager may seek to impose MiFID II obligations on its subadviser.

⁸ EU Directive on Alternative Investment Fund Managers (Directive 2011/61/EU). This Directive regulates the managers of funds that do not qualify as UCITS, for example managers of hedge funds, private equity funds, infrastructure funds, and closed-ended funds in general.

⁹ PSA 17/14 pp. 51-53.

KEY ASPECTS OF MiFID II FOR GLOBAL INVESTMENT MANAGERS

MiFID II imposes several different substantive requirements that will impact the operations of global investment managers, including:

- **Inducements and Use of Dealing Commissions to Obtain Research**
- **Transaction Reporting**
- **Recordkeeping and Mandatory Taping**
- **Best Execution**
- **Position Limits and Reporting for Commodity Derivative Trading**

INDUCEMENTS AND USE OF DEALING COMMISSIONS TO OBTAIN RESEARCH

Background and current global practices

As used in MiFID II, the term “inducements” refers to fees, commissions, or other monetary and non-monetary benefits that may induce a manager to trade with a particular counterparty. Under MiFID, as under U.S. regulations and the regulations of

most other jurisdictions, inducements are generally permitted, provided that they do not impair compliance with the manager’s duty to act in the best interests of clients. The precise application of these standards can vary by jurisdiction, but global investment managers have generally continued to receive bundled services in exchange for client-funded brokerage commissions. However, in some jurisdictions such as the UK, the services that may lawfully be acquired in exchange for brokerage commissions have been progressively narrowed under specific local rules. As a result, the pre-MiFID II position in certain European jurisdictions is already quite restrictive, and the services that may be received in this fashion are generally limited to original and substantive research—not including corporate access—the receipt of which benefits the manager’s clients.

How will MiFID II change the treatment of inducements in the EU?

In short, MiFID II requires the unbundling of research spend from trading spend, in an effort to create a more transparent and normalized market for research in which research that is obtained is actually needed, is paid for by a separate charge, and is valuable to buy-side firm clients.



To this end, the application of the current MiFID inducements rule will be significantly tightened in the MiFID II revisions, and managers subject to MiFID II will be prohibited from receiving inducements from third parties such as brokers, unless they either:

- are so-called “minor non-monetary benefits”, or
- are paid for by managers out of their own funds or are funded out of a separate research payment account (“**RPA**”), in which case research can be received without amounting to a prohibited inducement under MiFID II.

Minor non-monetary benefits include certain kinds of generic research, such as “non-substantive material or services consisting of short term market commentary on the latest economic statistics or company results.”¹⁰ However, much of the research consumed by global investment managers is tailored to specific issuers or market opportunities and is expected to fall outside of the minor non-monetary benefit category. Consequently, most managers are seeking avail themselves of the research exemption. This exemption applies in only two circumstances.

The first is where the manager pays for research out of its own funds. This is an option that some large EU-based managers are taking, but it can significantly change a manager’s economic model. Predictably, the

managers adopting this approach typically have significant in-house research capability.

The second is where payments are made out of a separate RPA which is funded by a specific research charge to the client. Under this model, managers are required to set and disclose to clients a research budget on a periodic basis (which we would generally expect to be at least annually), track the cost of any research received, actually pay for that research out of clients’ RPAs, and fairly apportion the costs of research used in relation to multiple client accounts among the relevant accounts. To support the need to establish the cost of research, MiFID II also requires EU-licensed sell-side firms to identify separate charges for research and execution and prohibits these firms from allowing the supply of, and charges for, research to be “influenced or conditioned by levels of payment for execution services.”¹¹

Surplus funds in RPAs must be returned to clients periodically by reference to the period of the relevant research budget. Furthermore, Member State regulators will require the setting of realistic budgets and the application of good financial discipline—in clients’ interests—in relation to the agreement of prices for research, the determination that research will be of benefit to the client, and the allocation of research costs among clients. The FCA believes that the effect of these requirements, if

¹⁰ Recital 29 MiFID II Delegated Directive.

¹¹ Article 13(9) MiFID II Delegated Directive.

they work as intended, will be to reduce overall spend on research, and hence the cost passed on to clients, reduce the amount of unread research, and facilitate the development of more independent research providers.

Finally, although current EU rules relating to the use of brokerage commissions generally apply only to the execution of trades in equities and certain related derivatives, the MiFID II ban on inducements will apply to both equity and fixed income transactions.

How will the MiFID II changes impact corporate access?

ESMA has recently confirmed that so-called corporate access—the arranging of meetings with management of corporate issuers—does not “appear to be” research under MiFID II because it does not explicitly or implicitly recommend or suggest an investment strategy and provide a substantiated opinion as to the present or future value or price of a potential investment.



Consequently, corporate access can not be obtained through RPA access and will only be permitted when paid for by a manager out of its own resources or if the service is a minor non-monetary benefit (which will typically not be the case if the access is exclusive). Furthermore, ESMA has taken the position that this service must be priced at a commercially reasonable level, and that access itself must not be linked to or dependent upon either payments for research or execution volumes. In light of these prohibitions, the provision of corporate access by trading counterparties to global investment managers subject to MiFID II may well be reduced.

How may global investment managers outside of the EU be affected?

As noted above, [LINK] MiFID II may apply to global investment managers directly, and managers that act as subadvisers to EU-based managers are likely to face calls to agree contractually to comply with MiFID II standards in this area. Global investment managers may face several difficulties adapting their business models to ensure compliance with MiFID II. For example:

- Firms operating global brokerage models under which trades subject to MiFID II requirements are aggregated with trades of other accounts and executed outside the EU may face difficulties complying with MiFID II standards given local



market conditions, counterparty practices, and competing legal requirements. Some degree of disaggregation appears inevitable for managers seeking to adhere to their current trading practices outside of the EU.

- Sell-side firms outside the EU may not cooperate with calls for research and corporate access to be unbundled from execution costs, both through general inertia and because the current practice of bundled research services may be perceived as suiting their commercial interests. Furthermore, brokers may face the prospect of registering as investment advisers in the United States if they accept hard dollars for research, and we understand that some U.S. brokers have taken the position that they would sooner withdraw coverage for MiFID II-covered accounts than proceed with adviser registration. In July, the FCA acknowledged the issue without offering any solution, and reports emerged that U.S. Securities and Exchange Commission (“SEC”) staff are actively considering no-action relief or some other form of relief

to address the issue. However, until the contours of SEC relief (if any) are more clear, global investment managers can do little more than adhere to the FCA’s wait-and-see approach: “It is not yet clear whether this will provide a solution to the issues, so we will continue to monitor the situation and if necessary provide an update in due course.”¹²

- Global investment managers that share research and the benefits of corporate access throughout their organizations may need to consider “ring-fencing” trading activities for accounts subject to MiFID II and operating a gateway for the passage of research to and from these accounts. Specifically, a global manager would need to determine whether to accept certain research for the benefit of the MiFID II accounts and then effect an appropriate internal payment for the research. This in turn may implicate regulations outside the EU. For example, if the research was first obtained with client brokerage by a U.S.-registered manager, the manager must consider how to refund or otherwise use these payments

¹² PS 17/14 p. 63.

for the benefit of its clients; if the payments are redirected to pay for additional research, that research may not constitute eligible research and brokerage services under Section 28(e) of the U.S. Securities Exchange Act of 1934 (“**Section 28(e)**”). Global managers should also consider what disclosure or other obligations are owed to clients that contribute payments for research that benefits multiple affiliates if the clients of a MiFID-licensed affiliate do not make an equitable contribution to the common pool of research.

- Regardless of the trading model used, there are likely to be many difficult issues related to the pricing of research, particularly research that has previously been an unpriced add-on. With respect to the research produced by a single counterparty, aggregate pricing for an overall research service appears to be acceptable under MiFID II rules, which presents a partial solution. However, global investment managers will still need to grapple with the allocation of research costs among MiFID II-covered accounts and, potentially, the pricing of research passing through gateways.

How would the ban on inducements apply in some common fact scenarios?

- ***Global investment manager performing portfolio management and trading outside the EU on behalf of EU clients***—It will be key for a manager in this scenario to determine whether the EU jurisdictions in which the clients are resident consider the manager’s activities to be directly or indirectly subject to MiFID II’s ban on inducements. If the client is in the UK, for example, the manager would not need to be licensed under MiFID (provided that it does not perform advisory services through representatives who are physically in the UK). However, as noted above, **if the manager acts as a subadviser to a MiFID-licensed firm or to a UCITS management company and/or an AIFMD-licensed firm**, the manager may be asked to agree contractually to comply with the MiFID II ban on inducements with respect to such accounts.
- ***Global investment manager performing portfolio management outside the EU and executing trades through EU brokers***—The use of EU brokers would not impact a manager’s MiFID II obligations. EU-based brokers will be subject to MiFID II and will

generally be required to provide unbundled prices for execution and research. However, in the UK, per the FCA's most recent comments on the matter,¹³ brokers will not be required to provide execution-only prices to non-EU firms. Thus, it is possible that a manager in this scenario would not be impacted by MiFID II at all, depending on the location and character of its EU-based clients.

- ***Global investment manager performing portfolio management and trading in the EU***—MiFID II will apply, in full, to all activities of a manager in this scenario. This might occur where portfolio management and trading are conducted by an EU subsidiary or group company of a non-EU manager.

How might ring-fencing work in practice?

A global investment manager's specific ring-fencing needs will depend on the extent to which MiFID II applies to its accounts. However, we would generally expect a full ring-fencing solution to involve the following features:

- Intra-group payments for research received in exchange for brokerage outside the EU but consumed inside the EU;
- Decisions on broker choice made separately by EU and non-EU parts of firms;
- Broker voting mechanisms and other broker reviews used to ascertain the value of research would be organized on a regional basis, so that decisions in the EU on the procuring of research are made with reference only to surveys conducted among





EU-based staff who consume the research; and

- Disaggregated trade execution, such that trades for EU accounts are executed separately from trades for non-EU accounts.

Given the difficulties that global investment managers will face in trying to find practical ways to implement some or all of the elements of a full ring-fencing solution, some firms may instead prefer to conform their global practices to the MiFID II standards.

How will RPAs work in practice?

RPAs will not necessarily need to be administered by managers, and vendors are presently developing models for the receipt, maintenance, and payment of funds by RPAs. However, payments out of RPAs will need to be made in the name of the manager, the manager must retain full discretion and control over the RPA, and its instructions must be acted upon without delay.¹⁴ RPA funds must always be segregated from the funds of the manager and of the RPA administrator in a case where this role has been delegated.¹⁵ ESMA has expressed the opinion that an manager should align as much as possible the timing of research charges paid by the client with the expenditure on research paid from the RPA to the research provider. In the UK, the FCA has stated that research charges should be deducted from the RPA within 30 calendar days of being incurred. The FCA has also accepted the concept of multiple RPAs sharing the same research budget, administered through a “virtual” consolidated RPA; regulators of other Member States have not yet taken a final position on this issue. In some cases, this may result in very complicated operational processes.¹⁶

The actual ownership of RPA funds may prove vexing for global investment managers. ESMA has taken the position that client funds paid into an RPA belong

¹⁴ Article 13(7).

¹⁵ ESMA 35-43-349 (Part 7, Question 2).

¹⁶ The FCA has acknowledged this but is not particularly sympathetic, saying that the “complexity of a firm’s operational arrangements does not allow a dilution of these MiFID II obligations.” PS 17/14 p. 57.

to the manager, and in the UK, the FCA has confirmed that RPA funds do not need to be treated as client money. However, it is possible that the SEC would treat RPA funds as client assets for purposes of rule 206(4)-2 under the U.S. Investment Advisers Act of 1940. If this is the case, RPAs of U.S.-registered global advisers would need to be maintained by qualified custodians and would be subject to surprise examinations, among other consequences.

Must a global investment manager pay its affiliates to share research?

A manager must pay its affiliates for shared third party research (i.e., research that is not generated internally by the affiliates) where (i) the manager is subject to the MiFID inducements prohibition, but relies on the research carve-out, and (ii) the research would otherwise amount, directly or indirectly, to an inducement under MiFID II other than a minor non-monetary benefit.¹⁷ In this respect, third party research shared by an affiliate is no different from research received directly from an outside party and, in this situation, ESMA has indicated that “firms should pay particular attention to any potential conflicts of interest as well as their obligations to assess the quality of research and keep appropriate controls and oversight over the amounts paid with reference to [quality criteria].”¹⁸

Thus, third-party research obtained by a U.S. parent from brokers in exchange for brokerage commission would need to be paid for by an EU subsidiary on its own account or from RPAs to avoid “tainting” the EU firm with the receipt of research for which no explicit payment has been made.

By contrast, internal research may not be paid for out of RPAs.¹⁹ We believe it is likely that Member State regulators will apply this prohibition at a group level, such that internal research produced by an affiliate outside the EU and then distributed to an EU MiFID-licensed manager likewise could not be paid for out of RPAs. Furthermore, we understand the prevailing industry view to be that internally generated research can be freely distributed among group members, including EU MiFID-licensed managers, without payment.²⁰ Managers should, however, establish controls to ensure that only bona fide proprietary research is shared in this manner, and that internal research sharing is not used as a method to circumvent the MiFID II inducements rules, for example by repackaging third party research without the addition of original analysis that results in substantially a new document.



¹⁷ ESMA 35-43-349 (Part 7, Questions 3-5).

¹⁸ ESMA 35-43-349 (Part 7, Question 5).

¹⁹ Article 13(6) MiFID II Delegated Directive.

²⁰ The Investment Association, Frequently Asked Questions on Research under MiFID II, 28 April 2017, Questions 5.4 and 5.5.

Can research paid for out of RPAs be shared with other clients and investment teams?

Yes. Research paid for out of RPAs may be shared with clients and/or investment teams that did not contribute to payment for the research, but a fair apportionment of the cost of the research would need to be made among relevant RPAs and research budgets. As noted above, ESMA has stated that research budgets may be established across multiple portfolios:

“A firm is still required to identify a specific research charge for individual clients to fund the RPA, even where a budget is set for several portfolios. A firm will therefore need to have a transparent method for making a fair allocation of costs in such cases. This may involve the firm pro-rating the cost of the research budget across all client accounts benefitting from it based, for example, on the value

of each client’s portfolio, to establish a specific charge for individual clients.”²¹

How are execution-related brokerage services treated under MiFID II?

It is possible that brokerage services will be treated inconsistently among Member States. In the UK, the FCA offered some clarity on this issue in July, noting that MiFID inducements rules may apply to certain execution-related services other than research.²² The FCA stated that certain activities can be treated as “inherent to the provision of execution services and received by the underlying client in return for execution costs and changes.” These include services that occur between the point at which an order is received and executed by a broker and the final settlement of the order, such as working large orders, taking trades on risk, structuring derivatives trades, and transaction reporting offered as a standard service. U.S. practitioners may note with relief that this guidance is very similar to the “temporal standard” used by the SEC to assess eligible “brokerage” services under Section 28(e). The FCA also took the position that order transmission systems (e.g., FIX²³ connections) used by the broker do not appear to be provided

²¹ ESMA 35-43-349 (Part 7, Question 1).

²² PS 17/14 pp. 48-51.

²³ Financial Information eXchange (FIX®) Protocol.

either to the manager or its clients as a distinct benefit. We understand the effect of this observation to be that order transmission systems used by the broker are not inducements at all unless they are provided to the manager or its clients, a concept that, in this case, may be difficult to establish. The FCA also provided examples of ineligible brokerage-related services, including RPA administration services, a manager's internal order management system, and (contrary to Section 28(e)) the provision of third-party trade analytic tools. All of these would accordingly need to be paid for by the manager out of its own pocket unless exempted as minor non-monetary benefits.

NEXT STEPS:

The prohibition on inducements has proven to be a complicated issue for global investment managers, particularly those that do not divide portfolio management and trading activities by region. Impacted managers will likely need to choose among full compliance with MiFID II across all accounts (including those that are not otherwise subject to MiFID II) through the use of RPAs or manager payment for research, ring-fencing MiFID accounts, or a hybrid of these two options. In light of the significant impact that these options can have on a firm's trading practices and profitability, this decision in most cases will not be driven by legal and compliance professionals alone. At a minimum, managers should consider the potential expenses

associated with hard dollar payment for research, whether ring-fencing is a practical option, the appointment of an internal group to spearhead the valuation and apportionment of research costs, and whether client agreements will need to be adjusted under different scenarios.

TRANSACTION REPORTING

A manager's obligations to report certain transactions to applicable EU regulators under MiFID II are significantly wider in scope and more prescriptive than under MiFID. These obligations are contained within MiFIR, and as such are directly applicable in each Member State.

Which financial instruments are subject to the transaction reporting obligation?

Managers subject to MiFID II will be required to report on all financial instruments admitted to trading or traded on any of the regulated EU trading venues (which have been expanded from traditional regulated markets to also include multilateral trading facilities ("**MTFs**") and organized trading facilities ("**OTFs**") for non-equities). The reporting obligation has also been extended to include derivative financial instruments where the underlying financial instrument is traded on a regulated trading venue, thus capturing all OTC²⁴ transactions in such instruments.

Furthermore, financial instruments that reference an index or basket comprising

²⁴ Over-the-counter, i.e. generally, off-exchange, and on a bilateral basis.

financial instruments that trade on a regulated trading venue are also subject to the reporting obligation. This could mean, for example, that a financial instrument investing in an index that includes just one in-scope financial instrument would be subject to the reporting requirement.

MiFID II transaction reporting obligations will apply to in-scope managers without regard to the jurisdiction or market in which an asset was actually traded. For example, a derivative transaction that references an underlying asset traded on an EU trading venue would be reportable even if the derivative itself is traded outside the EU.

What information needs to be reported?

Managers subject to transaction reporting will be required to file prescribed information in a specific format. The amount of information required in each transaction report is also increasing materially—MiFID II has 81 reporting fields for each transaction. Notably, managers will (among other things) need to identify the client facing the member of the trading venue, using the client's legal entity identifier (“**LEI**”) if the client is eligible for one, as well as the individual or algorithm responsible for the investment decision. Other required information includes whether a transaction in shares or sovereign bonds is a short sale, and whether a transaction was made in reliance on an applicable waiver (for example, transactions that do not feed into public current bid and

offer prices when certain conditions are satisfied). Managers will also be required to identify themselves by their LEI and to provide a range of other information including buyer and seller details (including dates of birth for each) and additional details of the individual portfolio manager and/or algorithm primarily responsible for the activity, including date of birth in the case of an individual.

Who makes the reports?

Reports can be submitted by the manager, by an approved reporting mechanism (“**ARM**”)

authorized under the Directive to report details of transactions to Member State regulators or ESMA on behalf of managers, or by the operator of a trading venue through whose system the transaction was completed. In all cases, transactions must be reported no later than the close of business on the working day following the date of execution. When a manager that is directly subject to the reporting obligation



(that is, managers authorized under the Directive) relies on an ARM or trading venue to report transactions on its behalf, it must take reasonable steps to verify the accuracy, completeness and timeliness of the reports made for it.



A manager may also rely on its broker to report transactions on its behalf, if certain conditions are met. To rely on this “transmission exemption,” the manager must send certain detailed information to the executing broker and must enter into an explicit reporting agreement

under which the executing broker agrees to report transactions on the manager’s behalf. Further, the transmitting manager must have systems and controls to ensure accurate and complete reports. Managers that have previously relied on brokers to report transactions will need to reassess whether such reliance will remain commercially practical under the MiFID II regime.

How may transaction reporting apply to non-EU managers?

The reporting requirement applies directly to managers licensed under MiFID II and their branches (even if the branch is outside the EU) that trade in-scope financial instruments (as explained above). Non-EU branches of EU managers must submit transaction reports to the primary Member State regulator responsible for the manager. EU branches of non-EU firms must report to the regulator which authorized the branch.

Non-EU managers without an EU branch are outside the scope of the reporting obligation. However, if a non-EU manager transacts on an EU trading venue, the operator of the venue itself will need to report the transaction.²⁵ Trading venues may therefore demand additional information from the manager to satisfy their own MiFID II obligations, and the manager may in turn need to obtain relevant data from its clients.

Non-EU subadvisers to managers subject to MiFID should engage at the earliest opportunity with those firms to determine the allocation of responsibility for transaction reporting, understanding that the reporting requirement from a regulatory perspective under MiFID II normally rests with the manager and not the subadviser (a point that should be addressed in any subadvisory agreements. Regardless of which party is responsible for submission (or ensuring the submission via a third party) of

²⁵ MiFIR Article 26.

transaction reports, all parties concerned should understand the required information flows and implement processes to allow the sharing of relevant information.

NEXT STEPS:

Global investment managers should first determine whether the financial instruments that they trade are subject to MiFID reporting. A manager with direct or indirect exposure to MiFID II regulation may nevertheless have no reporting obligations if they are not active in financial instruments that are traded on an EU trading venue or that reference instruments traded on an EU trading venue. Managers that do trade covered instruments should consider reaching out to trading venues and other financial intermediaries to determine if they are prepared to provide trade reporting services and at what cost. These entities should also have the capacity to guide global investment managers through the new reporting process and provide test files to assist with implementation. Subadvisers to MiFID-covered accounts should discuss and clearly document the allocation of reporting obligations with their clients. Finally, managers should ensure that they have LEIs

and other relevant information for all affected accounts, and that investment management agreements authorize the manager to report the necessary information on behalf of their clients.

RECORDKEEPING AND MANDATORY TAPING

MiFID II enhances existing MiFID record-keeping requirements and introduces new requirements regarding the recording of telephone conversations and electronic communications.

Recordkeeping

MiFID II requires MiFID-licensed managers to arrange for the creation and retention of records regarding all services, activities, and transactions sufficient to enable the manager's Member State regulator to fulfil its supervisory tasks and to pursue enforcement actions. These specifically include records relating to: (i) information provided to clients (e.g., information regarding the firm, services, proposed investment strategies, costs, and charges); (ii) client agreements; (iii) assessments of suitability and appropriateness; (iv) client order-

handling; (v) client orders and decision to deal; and (vi) transactions and order processing. Records must be accessible and made readily available to the relevant



regulator and to clients upon request. Recordkeeping periods can vary by Member State; in the UK, records required by MiFID II must be retained for at least 5 years.

Taping

MiFID II introduces a mandatory obligation for firms to record telephone conversations and maintain electronic communications that resulted in, or might result in, transactions.

The MiFID II taping provisions are stricter than under MiFID, which gave Member States discretion as to whether managers are required to record such communications. Most managers were historically able to operate under an exemption, often relying on their brokerage firms to create such records, but this exemption will disappear on MiFID II implementation.

The MiFID II requirements will apply to MiFID-licensed managers providing “client order services that relate to the reception, transmission and execution of client orders,” and also when these managers deal on their own account. The requirements therefore encompass any receipt of trading instructions from clients/investors, and the communication of trade orders with brokers and other trading counterparties (whether or not they are EU persons).

Notably, “reception and transmission” is a distinct activity from “execution” under MiFID, and ESMA has recently clarified that the recording requirement will apply

to communication channels used for the reception and transmission of orders irrespective of whether the execution and transmission of orders is also allowed over a communication channel.²⁶

MiFID-licensed managers are required to establish and maintain a taping policy that complies with MiFID II, maintain records of staff with firm devices and approved personal devices, and periodically monitor compliance. Specifically, managers must periodically monitor, in a risk-based and proportionate manner, the records of transactions and orders subject to these requirements. The arrangements in place must be appropriate to the nature, size, and complexity of the manager’s business, although this guidance does not introduce flexibility as to the types of communications that are required to be recorded. At a minimum, monitoring programs should be designed to ensure that the records are readily accessible and that a manager can accurately reconstruct the audit trail of a transaction.

How may this apply to non-EU managers?

The record-keeping and taping requirements under MiFID II are not directly applicable to non-EU managers. However, **as explained on page 7**, where a manager is appointed as a subadviser by an EU firm that is subject to MiFID II, the EU firm may require the manager to comply with such requirements to enable or assist its compliance with the obligations to which it is subject.

²⁶ ESMA 35-43-349 (Part 3, Question 12).

The extent to which this occurs can vary by Member State. Also as noted above, the UK is proposing to extend certain MiFID II requirements (including taping) to UCITS management companies and AIFMD-licensed firms. Thus, a non-EU manager acting as delegate of a UCITS management company in the UK may be required (by contract) to maintain additional records (particularly relating to the execution of transactions, including taping) and either provide or make these records available to the EU manager.

NEXT STEPS:

As with other requirements, global investment managers should first analyze the extent of their direct and indirect contractual exposure to MiFID II. When acting as subadvisers to EU firms that are themselves subject to MiFID II requirements and that seek to apply taping requirements to a manager on a look-through basis, managers should consider not only the technical implementation of taping, but also confidentiality and privacy protections that should be built into applicable agreements.

BEST EXECUTION

MiFID already imposes certain best execution obligations on in-scope managers. These obligations will be enhanced in several respects under MiFID II.

Managers subject to MiFID II must now take “all sufficient steps” as opposed to “all reasonable steps” to obtain best execution for client transactions. In addition, firms will need to publish their

top five execution venues, based on trading volumes for orders, on an annual basis, as well as specific information relating to the quality of transactions.

In an effort to address concerns about managers’ execution policies being too generic, MiFID II requires firms to ensure that their execution policies are clear and sufficiently detailed, allowing clients to easily understand how their orders will be executed. Firms must also demonstrate their efforts to achieve best execution to Member State regulators, when requested, as well as to clients. Significantly, MiFID II provides that “any firm routing client orders to a particular trading venue or execution venue shall not receive any remuneration, discount or non-monetary benefit.” The effect of this provision is that payments for order flow between brokers and market makers have been explicitly banned. In light of these expanded requirements, greater care may be required when drafting execution policies, and caution should be taken when implementing them.

How may these changes apply to non-EU managers?

Although certain aspects of MiFID II are likely to be applied to subadvisers on a look-through basis, there is no clear guidance as to whether MiFID II rules regarding best execution need to be applied at the subadviser level. Although industry commentators have espoused the position that the applicable execution rules should be those that apply in the jurisdiction where execution takes place, the best execution obligations

of a non-EU subadviser to an in-scope manager are presently unclear. Another situation some global investment managers are considering is whether, when an EU manager subject to MiFID II sends a trade order to a non-EU affiliate for execution, the affiliate should be subject to the specific best execution requirements of MiFID II.

NEXT STEPS: Managers that are directly subject to MiFID II should review their best execution policies and consider which changes will be necessary to meet the best execution requirements of MiFID II. Subadvisers to accounts with EU-based managers will need to assess whether, and the extent to which, those firms are themselves subject to MiFID II requirements and discuss with these clients whether they expect to impose any additional best execution requirements.

POSITION LIMITS AND REPORTING FOR COMMODITY DERIVATIVE TRADING

MiFID II mandates that Member State regulators set and apply position limits, based on ESMA methodologies, on the net position that any person can hold in commodity derivatives traded on regulated trading venues in the EU (i.e., EU regulated markets, MTFs and OTFs), as well as economically equivalent OTC contracts. Although the levels at which those limits will be set have not yet been determined, we have not yet seen any indications that the imposition of commodity derivative position limits

will be delayed beyond January 2018. Nonfinancial firms using commodity derivatives for hedging purposes, including those based outside the EU, may apply for an exemption from the position limits.

One aspect of these rules that may need particularly close attention relates to aggregation across corporate groups and the exemptions from those rules for managers operating independently within a group. The basic position is that holdings of commodity derivative positions need to be aggregated across corporate groups.²⁷ Q&A guidance issued on July 7, 2017 by ESMA²⁸ discusses the particular issues affecting asset management groups and indicates in particular that the parent or holding company of a manager should conduct a self-assessment exercise to determine whether it exercises any influence on investment decisions by the manager, taking into account “any relevant circumstances” of the corporate relationship.

MiFID II also introduces commodity derivative position reporting obligations applicable to trading venues and to the members and participants of those venues. MiFID-licensed firms which trade commodity derivatives outside trading venues also have an obligation to report those trades to the trading venue on which the relevant derivatives are traded. Members and participants of EU trading venues will also need to report client positions. These reporting requirements

²⁷ Commission Delegated Regulation (EU) 2017/591, Articles 3 and 4.

²⁸ ESMA70-872942901-28 (“Questions and Answers on MiFID II and MiFIR commodity derivatives topics”), Part 4, Question 6.

are separate from, and additional to, any overlapping reporting requirements under the European Markets Infrastructure Regulation²⁹ (“**EMIR**”), relate only to commodity derivatives and derivatives of emissions allowances, and require a “complete breakdown” of relevant positions.

How will commodity derivative position limits impact non-EU managers?

The position limits regime will extend beyond MiFID-licensed managers to any person holding a position in commodity derivatives subject to a limit, regardless of location or jurisdiction. Thus, global investment managers will need to pay the same attention to relevant position limits under MiFID II as similarly affected EU-domiciled firms. Where global investment managers are members and/or participants of EU trading venues, they will be directly subject to commodity derivative reporting obligations as noted above.

Global investment managers should also note that ESMA has been considering whether commodity derivatives traded on a non-EU venue should be considered as traded OTC for the purposes of the position limits regime under MiFID II. ESMA has stated its position³⁰ that contracts in commodity derivatives traded on a non-EU facility that is considered as a trading venue should not be regarded

as OTC and, therefore, the positions resulting from trading those contracts should not count towards the EU position limit regime. This position, in turn, requires the identification of recognized non-EU trading venues. ESMA has stated that these venues should have features similar to those common to all EU trading venues and has specified several objective criteria that a third-country trading facility would need to meet to be considered a recognized trading venue for the purposes of the MiFID II position limit regime. ESMA is expected to publish a list of recognized non-EU trading venues for this purpose.



Global investment managers should review the scope of their trading in commodity derivatives on EU trading venues, and compare their historic volumes with the new position limits, once they are published. They will also need to consider whether trading in relevant commodity derivatives, or economically equivalent OTC derivatives, outside the EU takes place outside of recognized non-EU trading venues, in which case MiFID II position limits will apply to these trades as well. Global investment managers should also review ESMA guidance regarding the aggregation of positions across affiliated companies and determine well in advance of January 2018 whether they will need to comply with MiFID II position limits on an individual or aggregate basis.

²⁹ Regulation (EU) No. 648/2012.

³⁰ ESMA opinion on third-country trading venues for the purpose of position limits under MiFID II (ESMA70-156-112), published on 31 May 2017. The purpose of this opinion is to promote consistent supervisory practices across the EU, so, whilst the opinion does not have the force of law, it is likely that Member State regulators will follow it.

HOW DOES MiFID II IMPACT THE REGULATORY TREATMENT OF FX SPOT TRANSACTIONS?

MiFID II will also provide welcome clarity on an issue that has become unnecessarily complicated: the distinction between a foreign exchange spot contract and a foreign exchange forward under EU regulation. This distinction is important because FX³¹ forwards are financial instruments potentially subject to the reporting and margin requirements of EMIR, whereas FX spot transactions are exempt from these requirements. A lack of definitional clarity in MiFID has resulted in inconsistent scope of transaction reporting required under EMIR across Member States. In response to a request from ESMA for clarity on this topic, the EU Commission in its delegated regulation of March 25, 2016 offered a revised definition of spot FX that will become effective with MiFID II: FX spot is a contract for the exchange of one currency against another currency, under the terms of which delivery is scheduled to be made within the longer of the following periods:

- where the contract currencies are both “major currencies,”³² two trading days;
- where at least one of the

contract currencies is not a “major currency,” the longer of two trading days or the period generally accepted in the market for that currency pair as the standard delivery period; and/or

- where the contract is entered into in connection with the purchase or sale of a transferable security, the period generally accepted in the market for the settlement of that transferable security, or five trading days (whichever is shorter).

The EU Commission further noted that a contract will not be considered an FX spot where there is an understanding between the parties that delivery is to be postponed or not performed within the relevant period above. Additionally, under the delegated regulation, rolling spot contracts are expressly included within the definition of “derivative.”

In addition to providing much needed clarity and harmonization among Member States, the revised definition of FX spot also more closely aligns the European regulatory scheme with that of the U.S. Commodity Futures Trading Commission.³³

³¹ Foreign exchange.

³² The “major currencies” are: the U.S. dollar, Euro, Japanese yen, Pound sterling, Australian dollar, Swiss franc, Canadian dollar, Hong Kong dollar, Swedish krona, New Zealand dollar, Singapore dollar, Norwegian krone, Mexican peso, Croatian kuna, Bulgarian lev, Czech koruna, Danish krone, Hungarian forint, Polish zloty and Romanian leu.

³³ See 77 Fed. Reg. 48257 (Aug. 13, 2012) <http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2012-18003a.pdf>

A GLOBAL PERSPECTIVE

Our broad global platform allows us to guide clients through the legal challenges of the ever-changing international landscape. With fully integrated offices on five continents, the deep latticework of relationships across our offices and practices enables our clients to respond to diverse legal issues and risks through the services of one law firm, with one communication. K&L Gates has more than 150 lawyers in 24 offices across the globe who focus their practice on providing legal services to the investment management and professional investor communities.



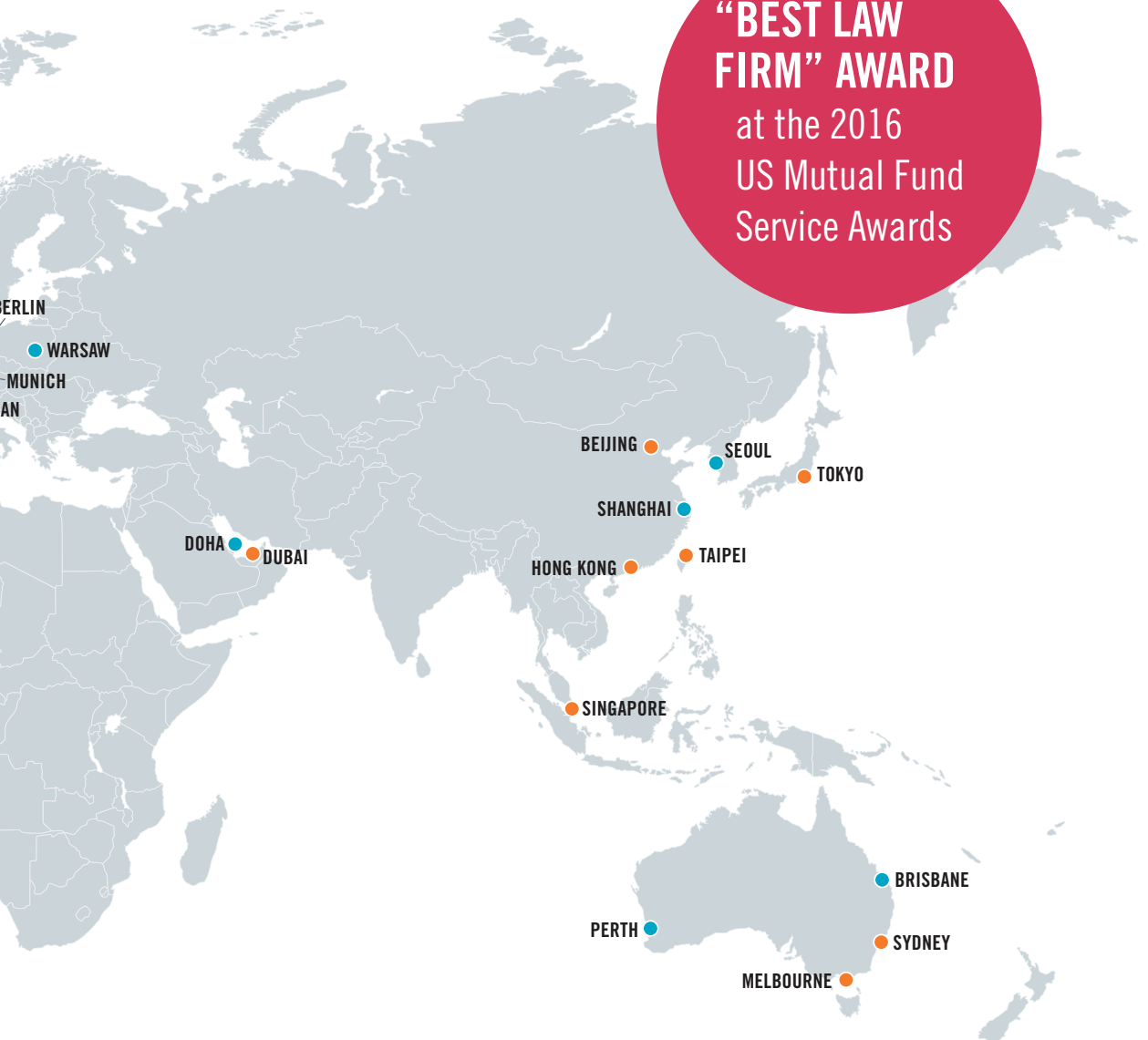
K&L Gates’ “outstanding” group has “**unparalleled depth and breadth of expertise;**” according to one client, it is “**the best I have ever worked with.**”

—*The Legal 500*

**“An effective team with a global reach,
providing real expertise in a cost-effective
manner. A highly regarded global investment
practice, with an innovative approach to deals.”**

—Chambers and Partners

**“BEST LAW
FIRM” AWARD**
at the 2016
US Mutual Fund
Service Awards



Visit **KLGATESHUB.COM** for comprehensive industry-based digital content at the intersection of legal and business issues.

