

Top Ten Things  
every Fund  
Manager should  
know about  
MiFID2

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# Background

The EU's Markets in Financial Instruments Directive ([MiFID1](#)) established a pan European framework for the provision of investment services and the operation of markets. It has been in force since November 2007.

The existing MiFID1 framework is being substantially amended via legislation published in 2014, which splits MiFID1 into two parts. First, there is a "recast" MiFID1 (commonly referred to as "[MiFID2](#)") dealing primarily with authorisation, systems and conduct requirements in relation to investment business. Second, there is a Markets in Financial Instruments Regulation ("[MiFIR](#)") dealing with transparency, transaction reporting, clearing, and supervision of positions.

MiFID2 and MiFIR significantly increase the scope of MiFID1, in part, as a response to the financial crisis. Other key catalysts for the proposed revisions include: (i) technological developments, particularly around algorithmic trading and direct market access systems; (ii) perceived weaknesses in transparency in relation to investments other than shares; and (iii) a desire to enhance investor protection.

## Timing

MiFID2 and MiFIR were both originally due to come into force on 3 January 2017 although that implementation date is now subject to a one year delay until **3 January 2018**. Firms within scope of MiFID must, therefore, be ready to comply with MiFID2 by the revised deadline of 3 January 2018.

As a directive, MiFID2 will need to be implemented into national law by EU Member States before it can take effect. As a regulation, MiFIR will have direct effect without any need for national implementation. EU member states are required to adopt and publish measures to transpose the relevant parts of MiFID2 into national law. The original deadline for this was 3 July 2016 although (as with the one year delay for MiFID2 implementation) there is now a one year delay for national measures, to **3 July 2017**.

## Level 2 measures

MiFID2 and MiFIR will be supplemented by a number of pieces of so-called Level 2 legislation that will flesh out much of the practical detail. These will consist of delegated acts, regulatory technical standards ("[RTS](#)") and implementing technical standards ("[ITS](#)").

During 2014 and 2015, ESMA consulted on the Level 2 measures through Discussion Papers, Consultation Papers, and Final Reports, which included commentary and draft versions of the proposed Level 2 measures (please refer to our MiFID2 [Legislative Tracker](#) for more information on the consultation process). For much of 2014 and 2015, many in the asset management industry were frustrated by the lack of clarity on the scope of regulatory obligations under the Level 2 measures, with a resulting uncertainty about the full impact of MiFID2 on their businesses. However, the good news is that three significant publications in autumn 2015 and spring 2016 have provided some much-needed clarity on the Level 2 measures which are likely to be most important for asset managers:

- On 28 September 2015, ESMA published a third Final Report ("[FR3](#)") and its related [Annex](#), containing draft RTS on (among other issues) transaction reporting exemptions, post-trade transparency requirements, best execution and algorithmic trading.
- On 7 April 2016, the European Commission published a draft delegated act, which will take the form of a directive (the "[L2 Directive](#)"), providing more detail on product governance, inducements and investment research.

- On 25 April 2016, the European Commission published a second draft delegated act, which will take the form of a regulation (the "[L2 Regulation](#)") and its related [Annexes](#), providing more detail on organisational requirements and conduct obligations. Please refer to our separate [client briefing note](#) on the key issues arising out of the L2 Regulation.

These draft Level 2 measures are now expected to be adopted without material change.

## Brexit

On 23 June 2016, the UK voted in a national referendum to leave the EU, commonly referred to as "Brexit".

The UK government has not yet exercised its powers under Article 50 of the Treaty of the European Union to begin the two year process of negotiating the UK's exit from the EU. As such, the UK remains a member of the European Union and EU law continues to have full force and effect in the UK. The UK government has informally indicated that it expects to exercise Article 50 by late 2016 or early 2017, such that the UK's anticipated date of leaving the EU is late 2018 or early 2019 (in other words, *after* MiFID2 is due to come into force).

The UK Financial Conduct Authority ("[FCA](#)") issued in July 2016 its second consultation paper CP16/19 on MiFID2 implementation ("[UK CP2](#)"), which included for the first time the FCA's formal view on MiFID2 implementation following the Brexit vote. The FCA confirmed that MiFID2: *"is in the category of legislation that is still to come into effect. It is due to apply from 3 January 2018, so both firms and we need to continue with implementation plans."* UK firms within the scope of MiFID2 must, therefore, continue to prepare for MiFID2, notwithstanding the result of the Brexit referendum.

Please refer to our [Brexit microsite](#) for detailed information on the implications of Brexit.

## Scope of this briefing note

MiFID2 will have significant cost, infrastructure and headcount implications for EU based fund management firms. This briefing note sets out the top ten things that we think every such fund manager needs to know about MiFID2 and MiFIR.

This briefing note has been updated as at August 2016, to take account of the latest position following the publication of the draft L2 Directive and L2 Regulation, UK CP2 and the Brexit referendum result.

## Simmons & Simmons MiFID2 Manager

Simmons & Simmons MiFID2 Manager is the essential tool to stay on top of MiFID2 reform. The [MiFID2 Manager](#) focuses on the EU Level 1 and 2 text but also looks at local implementation/gold plating issues in the UK and other jurisdictions as local implementation takes off in 2016. It provides you with key information on how a particular MiFID2/MiFIR requirement applies: to your firm type, to particular services and activities, and to particular client types.

# 1 Will MiFID2 and MiFIR also apply to EU managers which are regulated under AIFMD and the UCITS Directive?

EU-based investment managers may be authorised under any of MiFID, AIFMD or the UCITS Directive, depending on the types of investment vehicles managed, the contractual structure, and the involvement of any other entities.

EU managers that are MiFID firms (and so not authorised as AIFMs or UCITS management companies) will be regulated under MiFID2 / MiFIR. By contrast, EU AIFMs and UCITS management companies are not subject to MiFID2 / MiFIR.

EU AIFMs and UCITS management companies which also carry on “top up” portfolio management and investment advisory activities (which fall outside the scope of their AIF / UCITS fund management and marketing activities) will be subject to certain specified parts of MiFID2 in respect of those top up activities. In addition, it is also possible that national regulators may “gold plate” the implementation of MiFID2 to extend it to AIFMs and UCITS management companies – in other words, extend it beyond its intended scope.

There are three EU regulatory regimes which are potentially applicable to an EU firm carrying on asset management activities. Which regime applies to an asset manager depends on the type of investment vehicle managed, and the manager’s role in the contractual structure.

- (i) **Alternative Investment Fund Managers Directive (AIFMD):** AIFMD applies to an EU-based alternative investment fund manager (AIFM) of an alternative investment fund (AIF), such as a hedge fund manager or private equity fund manager. An example of an EU AIFM would be a UK-headquartered investment manager of Cayman hedge funds. In addition, AIFMD permits AIFMs to seek authorisation to perform certain MiFID-style investment services (such as portfolio management for segregated managed account clients and investment advice) on a “top up” basis, in addition to acting as AIFM to AIFs. In the UK, such firms are referred to by the FCA as “collective portfolio management investment” (CPMI) firms.
- (ii) **Undertakings for Collective Investments in Transferable Securities Directive (UCITS):** UCITS funds are regulated EU investment funds, which are intended to be suitable for distribution to the public. The management company (ManCo) of a UCITS fund is subject to the UCITS Directive. Similarly to AIFMD, the UCITS Directive also permits UCITS ManCos to seek authorization to perform MiFID-style investment services (such as portfolio management for segregated managed account clients and investment advice) on a “top up” basis, in addition to acting as the ManCo of UCITS funds.  
  
In addition, a firm can be authorised as both a UCITS ManCo and an AIFM (a so-called **SuperManCo**), and a SuperManCo is subject to both AIFMD and the UCITS Directive. A SuperManCo can also obtain “top-up” permission to perform MiFID-style services.
- (iii) **MiFID:** The MiFID “investment firm” concept captures a wide range of participants in the financial services industry, including investment banks, broker dealers, certain asset managers, private wealth managers and financial advisers. In the asset management context, MiFID applies to firms which provide portfolio management services to their clients, including firms which act as the sub-investment manager to another firm which is an AIFM or UCITS ManCo. A common example of a MiFID investment firm is a UK based sub-investment manager within a global asset

management group, where the UK firm provides services to another group entity which is the AIFM to the group's fund vehicles.

The table below summarises how the various EU regulatory regimes apply to the different types of EU asset management structure.

<u>Type of firm</u>	<u>Does MiFID2 apply?</u>	<u>Does MiFIR apply?</u>	<u>Does AIFMD apply?</u>	<u>Does UCITS apply?</u>
MiFID investment firm	✓	✓	✗	✗
AIFM	✗	✗	✓	✗
AIFM (with top-up)	✓ *	✗ **	✓	✗
UCITS ManCo	✗	✗	✗	✓
UCITS ManCo (with top-up)	✓ *	✗ **	✗	✓
SuperManCo	✗	✗	✓	✓
SuperManCo (with top-up)	✓ *	✗ **	✓	✓

\* *MiFID2 does not directly apply, even in respect of portfolio management activities. Instead, each of the UCITS Directive and AIFMD currently specifies certain parts of the MiFID1 regime which apply to portfolio management activities. The MiFID2 regime updates those cross-references from MiFID1 to MiFID2 as necessary. The applicable rules are principally conduct of business rules and organisational rules.*

\*\* *Not directly applicable, but it remains possible that national regulators may gold-plate aspects of the MiFIR regime onto AIFMs or UCITS ManCos.*

The remainder of this briefing note assumes that the MiFID2 / MiFIR obligations described below are applicable to the relevant in-scope investment management firm.

### Possibility of gold-plating

There is some scope, via the implementation of MiFID2 into national law, for individual EU regulators to gold-plate the regime, by applying the MiFID2 requirements to EU AIFMs and UCITS management companies. The precise impact of the new requirements on EU AIFMs and UCITS management companies will, therefore, not be fully known until the national legislation and rules that implement MiFID2 have been published by the relevant national authorities (which they are required to publish by 3 July 2017).

Interestingly, the UK FCA has in its consultations published to-date on MiFID2 implementation generally indicated an intention not to gold plate MiFID2 requirements onto AIFMs and UCITS ManCos, including CPMI firms with top-up permissions. For example, in its first consultation CP15/43 published in December 2015 ("[UK CP1](#)"), the FCA expressly confirmed that it would not gold plate **transaction reporting obligations** onto AIFMs or UCITS ManCos, including CPMI firms in respect of their top-up portfolio management activities. In UK CP2, the FCA also proposes not to extend MiFID2 **remuneration requirements** onto

AIFMs or UCITS ManCos.

Additionally, in relation to some of the provisions of MiFID2 (for example, those relating to the use of dealing commissions to pay for research and the product governance rules) ESMA has suggested that the EU Commission should apply the relevant requirements to AIFMs and UCITS management companies; although this has not yet occurred.

### **Are there regulatory arbitrage opportunities?**

In advance of AIFMD coming into force in 2013, many fund management groups took active steps to ensure that their UK operations fell within the scope of MiFID and outside the scope of AIFMD, for example by identifying an offshore AIFM. This was typically motivated by a perception that AIFMD represented a more onerous regulatory regime than MiFID1.

However, MiFID2 introduces various new (and potentially onerous) obligations for MiFID investment firms, in particular in relation to transparency and reporting. These requirements do not apply to AIFMs, and so there may be an opportunity for hedge fund managers currently structured as EU MiFID investment firms to re-consider whether authorisation as an AIFM might be a more palatable structure, particularly if national regulators such as the UK FCA continue the approach of not gold-plating MiFID2 obligations onto AIFMs.

## 2 I've been told that MiFID2 will affect use of dealing commissions and the consumption of research by fund managers. Is that correct?

Yes, that is correct, as long as the EU manager is regulated under MiFID2 / MiFIR as per the above (or otherwise subject to home member state rules which regulate dealing commissions and research – like the UK's dealing commission rules). The use of dealing commissions and the consumption of research will be heavily restricted under MiFID2.

Currently, MiFID1 permits MiFID firms to pay or receive fees, commissions and non-monetary benefits (referred to as inducements) when acting as an investment manager, subject to satisfying certain conditions. MiFID2 provides that, when providing portfolio management services, MiFID firms shall not accept and retain fees, commissions or any monetary or non-monetary benefits paid or provided by, or on behalf of, a third party. The acceptance of minor non-monetary benefits is permitted provided that these are capable of enhancing the quality of service to the client and do not inhibit the firm from acting in the best interests of its client. Any permitted minor non-monetary benefits will also be subject to a disclosure obligation.

Since MiFID2 was finalised in 2014, the debate around the receipt of investment research, in the context of the broader MiFID2 inducements rules, has been one of the most controversial MiFID2 topics for fund managers. The Level 2 measures which provide the detail on the high-level inducements rule (described above) have gone through several iterations, and prompted much industry, press and even political commentary. The L2 Directive, published in April 2016, finally provides some much-needed clarity for fund managers on what will be the requirements around the consumption of investment research as from January 2018.

The L2 Directive adopts ESMA's proposal (raised during the 2014 consultation) that the receipt of investment research by an investment manager should, on the face of it, be treated as an inducement, and in particular research is deemed to be a "non-monetary benefit".

The L2 Directive also adopts the proposal that investment research can be received by a firm only if it is paid for either:

- directly by the investment manager out of its own resources, or
- from a separate research payment account (RPA) controlled by the investment manager, provided that various requirements are met relating to the operation and documentation of the account. We summarise these requirements below.

This approach means (as feared) that those EU managers which currently receive research on a "free" or bundled basis will need to move to a model of paying for that research either from own funds or via the establishment of RPAs. This may present a particular operational challenge for managers operating in the fixed income space, where the use of dealing commission to pay for research is not common.

The good news (and a divergence from the 2014 ESMA proposals) is that the L2 Directive acknowledges that the amount that will fund an RPA can be collected using a transaction-based research charge (provided that it is separate from the transaction commission). In other words, it will be possible to retain a model similar to the CSA model for payments for research, which is currently widely used within the equities space.



## What types of research are caught by the new rules?

The new requirements apply to research that relates to one or more financial instruments or one or more issuers or potential issuers, or is closely related to a specific industry or market such that it informs views on financial instruments or issuers within that sector which explicitly or implicitly recommends or suggests an investment strategy and provides a substantiated opinion as to the present or future value or price of such instruments or assets or otherwise contains analysis, original insights and conclusions based on new or existing information that could be used to inform an investment strategy and be relevant and capable of adding value to the investment firm's decisions on behalf of clients being charged for that research.

However, the L2 Directive excludes certain types of material from the new requirements. These include: written material from a third party that is commissioned and paid for by a corporate issuer to promote a new issuance by that company, or where the third party is contractually engaged and paid by the issuer to produce such material on an ongoing basis; and short term market commentary or information on upcoming releases or events containing a brief summary of the author's opinion that is not substantiated and does not include any substantive analysis (including the reiteration of an existing recommendation or an existing piece of research).

The remainder of the commentary in this section focuses on the use of RPAs to pay for research.

## Requirements for the use of RPAs

Detailed requirements will apply if a firm wishes to make use of RPAs, instead of paying for research from its own resources. These requirements fall within three principal areas.

**(1) RPA conditions:** there are four specific conditions which must be satisfied if an investment manager wants to make use of RPAs.

- *Condition (i) - the RPA must be funded by a specific research charge to the client:* In order to meet this condition, the specific research charge must be based on a research budget set by the investment manager for the purpose of establishing the need for third party research. In addition, the charge must not be linked to the volume or value of transactions executed on behalf of clients. The total amount of research charges received cannot exceed the research budget. However, the research charge is permitted to be collected "alongside a transaction commission" provided that the research charge is a separate line item from the dealing commission. The wording that prohibits the research charge from being "linked to the volume or value of transactions" could be interpreted as preventing the portion of the research charge that is collected alongside a transaction commission from being expressed as a percentage of the transaction's value (for example, it could be interpreted as requiring the charge to be expressed as a fixed monetary sum). However, we think that a transaction based research charge that is expressed as a percentage of the transaction value would be allowed, on the basis that the overall research charge is the total amount charged to the client for research. Consequently, provided the manager has set a budget for the period (see Condition (ii) below) and switches-off the research charge element of the transaction charges once the full budgeted amount for that period has been collected through such transaction charges, the overall research charge would not be linked to the volume or value of transactions.
- *Condition (ii) - the manager must set and regularly assess a research budget as an internal measure:* In order to meet this condition, the research budget must be managed solely by the investment manager, and must be based on a reasonable assessment of the need for third party research. The allocation of the research budget to purchase third

party research must be subject to appropriate controls and senior management oversight, to ensure that it is managed and used in the best interests of the firm's clients. Those controls must include a clear audit trail of payments made to research providers and how the amounts paid were determined with reference to the quality criteria referred to in condition (iv) below. In addition, investment managers must not use the research budget and RPA to fund internal research.

- *Condition (iii) - the manager will be held responsible for the RPA:* although the investment manager remains responsible, a degree of delegation is possible. In particular, the investment manager may delegate the administration of the RPA to a third party, provided that the arrangement facilitates the purchase of third party research and payments to research providers in the name of the investment manager.
- *Condition (iv) - the manager must regularly assess the quality of the research purchased, based on robust quality criteria and its ability to contribute to better investment decision:* In order to comply with this condition, the investment manager must establish a written policy which documents all elements of how it assess research quality, and provide it to their clients. That written policy must also address the extent to which research purchased through the RPA benefits clients' portfolios.

**(2) Disclosure requirement if using RPAs:** The investment manager must also comply with an initial disclosure requirement, a separate ongoing disclosure requirement, and an ad-hoc disclosure requirement (on request from clients and regulators).

**(3) Express agreement with the client:** It will also be necessary for the investment manager to seek the client's express agreement to the use of RPAs. In particular, the investment manager must agree with clients (for example in the firm's investment management agreement or general terms of business) the research charge as budgeted by the firm and the frequency with which the specific research charge will be deducted from the resources of the client over the year (including, if applicable, where the research charge is to be collected alongside transaction commissions). Increases in the research budget may only take place after the provision of clear information to clients about such intended increases. If there is a surplus in the RPA at the end of a period, the firm must have a process to rebate those funds to the client or to offset it against the research budget and charge calculated for the following period.

The RPA solution is helpful for managers that participate in the cash equities market and other markets where commission based payments are typically made to brokers as it broadly preserves the status quo. The solution is less helpful in the fixed income markets and other markets where market participants have typically not made specific payments related to the research that they receive. Instead, brokers have typically funded their research departments through the bid / offer spread. Unless a research transaction charge can be separately added to such transactions to fund an RPA, managers who are active in such markets will either need to start paying for such research from their own balance sheets or will need to arrange for their fund clients to pre-fund the RPA through a (hard dollar) transfer of cash at the beginning of the relevant budget period. Either way, unless the bid offer spreads narrow, managers and / or their clients could end up paying twice for such research.

The L2 Directive is also silent on the issue of corporate access – specifically whether it constitutes a non-monetary benefit (the earlier ESMA consultation documents included commentary that it does) and, if it does, whether it could be paid for via the RPA solution. The language of the L2 Directive which explains the types of research that are eligible for payment via the RPA solution is inconsistent with the corporate access concept, suggesting very strongly that corporate access will now need to be paid for by managers from their own balance sheet (the “free receipt” model which currently prevails would no longer be allowed).

## Impact on sell-side firms

As a final requirement, the L2 Directive also imposes new express restrictions on the sell-side, around the pricing of execution and research services. An EU bank or broker providing execution services must identify separate charges for these services that only reflect the cost of executing the transaction. The provision of any other benefit or service (which would include investment research) by that bank / broker to EU-based investment firms must be subject to a separately identifiable charge. It is interesting to note that the L2 Directive expressly limits this rule to the situation where an EU bank / broker is dealing with another MiFID investment firm established in the EU (and so this pricing rule would not apply if dealing with non-EU investment managers, such as US firms). In addition, the L2 Directive states that the supply of and charges for those benefits or services must not be influenced or conditioned by levels of payment for execution services.

## Application to AIFMs and UCITS management companies

As mentioned above, the new rules (as proposed by ESMA) do not apply to AIFMs or to UCITS management companies when dealing on behalf of the AIFs and UCITS funds for which they act as AIFM / UCITS ManCo. However, ESMA has recommended that the EU Commission should adopt fresh legislation to apply these requirements to such firms. Additionally, given that the FCA has been the driving force behind this particular initiative, it seems likely that the FCA will gold-plate the MiFID2 requirements to apply the new inducements rule to UK AIFMs and UK UCITS management companies.

### 3 Will my firm be able to continue to rely on the MiFID1 transaction reporting exemptions?

Yes, but only in a more restricted way as the obligation to report is being expanded in scope and the available exemptions are more restrictive and less user friendly. Some firms which do not currently make transaction reports may find themselves required to report under the new (and expanded) reporting regime.

MiFID1 established an EU-wide transaction reporting regime. The regime required MiFID investment firms that execute transactions in financial instruments admitted to trading on EU regulated markets to report the salient details of the transactions to their EU local regulator within one business day of the trade date. The purpose of the regime was to facilitate EU regulators' attempts to detect and investigate potential market abuse and insider dealing. For UK firms, the FCA gold-plated the MiFID1 requirements by applying the reporting obligation to OTC derivatives that have an EU listed financial instrument as an underlier. The MiFID1 transaction reporting rules contained a carve-out from the reporting obligations for firms that rely on others to make transaction reports on their behalf. In the UK, the FCA interpreted this carve-out generously by permitting discretionary investment managers that enter into reportable transactions with other (sell side) EU MiFID investment firms to rely on the fact that those other firms would be making a transaction report naming the asset management firm in the "client" field to satisfy the discretionary investment manager's own reporting obligations. In some other EU jurisdictions, the local regulators took the view that only the entity directly facing the trading venue (i.e. the broker) is "executing" a transaction and, therefore, that only it has the reporting obligation.

MiFIR increases the scope of the transaction reporting regime so that it will apply to all transactions in financial instruments that are admitted to trading on regulated EU trading venues and any financial instruments (listed or OTC) where the underlying is a financial instrument that is admitted to trading on such an EU trading venue. The "trading venue" concept covers EU regulated markets (to which the existing MiFID1 transaction reporting regime applies) plus multilateral trading facilities and organised trading facilities.

ESMA has clarified that the obligation applies to portfolio managers (and is not limited to the entity that faces the trading venue). The timing for making reports remains the same as under MiFID1 (i.e. within 1 business day of the trade date).

#### Transmitting firms exemption

Notwithstanding that portfolio management firms will be subject to the reporting obligation, an exemption of sorts will continue to exist for so-called "transmitting firms":

- **What is a transmitting firm?** A transmitting firm is an investment firm which has transmitted an order where (a) the order was received from the firm's client or results from its decision to acquire or dispose of a financial instrument in accordance with a discretionary mandate; (b) the firm has transmitted certain specified information (see below) to another MiFID firm (the "receiving firm"); and (c) the receiving firm agrees either to report the transaction which results from the transmitted order or to transmit the order details to another investment firm. The "transmitting firm" concept will, therefore, include asset managers when they send orders to a broker for the broker to execute.
- **Information to be transmitted:** The transmitting firm will need to send the receiving firm details relating to the order which include: (1) an identifier for the underlying client or clients to which the order relates; (2) an identifier designation to identify a short sale; (3)

a unique ID code for the PM or algo that made the trading decision; and (4) where the order is an aggregated order relating to multiple clients, the information for each allocation.

- **Transmission agreement:** Additionally, the transmitting firm is required to have a transmission agreement in place with the firm to which it transmits the order that (a) specifies the timing by which the transmitting firm must provide the order details to the receiving firm; and (b) provides confirmation that receiving firm will validate the order details for obvious errors and omissions before it submits a transaction report.
- **Effect of exemption:** Where the above requirements are satisfied and the transmitting firm supplies the relevant details in the manner contemplated in the transmission agreement, the transmitting firm can rely on the report made by the receiving firm and does not have to make its own transaction report.

The requirements that need to be satisfied in order for a transmitting firm to rely on the exemption are more onerous than under the current UK exemption for discretionary asset managers. Managers will need to monitor physical sales by their clients of EU listed shares and EU sovereign debt instruments in order to ensure that they have appropriately flagged any short sales of such instruments to their brokers. Similarly where an order has been aggregated, the allocation between different underlying clients will need to be communicated to the receiving firm. This is traditionally something that asset managers have dealt with at primer broker / custodian level rather than something that has been communicated to executing brokers.

There are a number of situations in which an asset manager may be unable to rely on the exemption for transmitting firms. For example, an asset manager would be unable to rely on the exemption where it transmits an order relating to a reportable financial instrument to a non-EU broker. As mentioned above, the universe of financial instruments that will be subject to the reporting obligation is being significantly increased by MiFIR and so it will become more likely that transmitting firms will pass orders relating to some in-scope instruments to brokers from outside the EU. Additionally, given the narrowing of the exemption by ESMA in FR3, where an asset manager is not transmitting an order to a receiving firm for that receiving firm to execute but is, instead, executing a trade directly with that broker (for example, dealing on a request for quote basis with a market maker) it would appear that that the exemption will not be available in such a situation. FR3 does, however, clarify that the rules concerning the exemption apply to transmissions to DMA in the same way as for other entities, i.e. where a DMA user meets the transmission requirements referred to above, then the DMA provider would be able to report the details in the place of the DMA user.

In any event, even if asset management firms can avoid all situations where the exemption for transmitting firms does not apply, such firms will still need to consider whether they ought to plan for the contingency that they are unable to provide the requisite details to the relevant receiving firm, in which case, the transmitting firm will retain an obligation to make a transaction report.

### **Making transaction reports**

For those asset managers that do (or determine that they might) have an obligation to make transaction reports (whether regularly or occasionally), the detail contained in such reports will (if the draft RTS set out in FR3 are adopted by the Commission) significantly increase, with the number of fields within the reports increasing from the current 23 fields to 65 fields.

The details to be supplied include a unique ID code for the portfolio manager or investment committee that made the decision to deal and, if different, the individual executing the trade and/or, if the trade was generated or executed by a computer algorithm, the relevant identifier code for the relevant algorithm(s). This has cost implications as the management firm will need

to ensure that its IT system is capable of generating and submitting the relevant reports on time. There may be a need for additional headcount to oversee the reporting process and to check the accuracy of the reports.

For MiFID investment management firms that trade European listed equities on swap or CFD, the question of who will have the reporting obligation in respect of any cash market trade arranged by the manager between the swap counterparty and the executing broker to hedge the swap will need to be considered carefully. ESMA has proposed guidance on this issue in its draft [Level 3 transaction reporting guidelines](#), which clarifies that:

- **No obligation to report transactions when introducing without interposing:** Where an investment firm “brings together” two parties to a transaction, but is not a party to that transaction (and the other two firms agree the transaction between themselves), that firm does not have a transaction reporting obligation. It may therefore be inferred that, where the manager is merely obtaining indicative pricing from the executing broker for the swap counterparty (but no cash market hedge trade takes place until the swap counterparty and executing broker have confirmed the trade between themselves) the manager does not have a transaction reporting obligation in respect of the hedge. The manager will still need to report the swap.
- **Obligation to separately report both the equity hedge and the swap:** Where an investment firm both executes an equity hedge for a CFD provider, and enters into the CFD, it will have two separate transaction reporting obligations, one for the equity trade and one for the CFD trade. As such, it may be inferred that, where the manager acts as agent for the swap counterparty and executes the hedge trade on its behalf or effects a cash market trade between its fund clients and the executing broker which is later “given-up” (i.e. novated) to the swap counterparty, both the hedge transaction and the swap would be reportable.

### **Application to AIFMs and UCITS management companies**

The MIFIR transaction reporting requirements do not apply to EU AIFMs or UCITS management companies when carrying out portfolio management (and related execution) activities for the AIF or UCITS funds for which they act as AIFM/UCITS ManCo. It will be a matter of national implementation as to whether the transaction reporting requirements are extended to AIFMs or UCITS management companies in the context of managed account activities (including where trades resulting from orders for managed account clients have been aggregated with orders for AIFs/UCITS funds) or to their fund management activities.

Somewhat unexpectedly, the FCA proposed in UK CP1 that AIFMs and UCITS management companies should be entirely exempt from transaction reporting under MiFIR, even in respect of managed account business. This is contrary to what had been expected (the market was largely expecting gold-plating of all relevant MiFID2 and MiFIR obligations onto AIFMs and UCITS management companies, at least in respect of portfolio management activities). However, the FCA's proposal is clearly to exclude non-MIFID managers entirely from the scope of transaction reporting.



## 4 Does MiFID2 say anything about transaction record keeping including phone taping?

**Yes, MiFID2 significantly expands the transaction record keeping obligations under MiFID1 and it also introduces extensive rules on phone taping and electronic communications, including having to retain records for five years (or up to seven years upon request).**

MiFID2 contains a general obligation on the part of each MiFID firm to maintain sufficient records of all of its services, activities and transactions to enable its regulator to carry out its supervisory and enforcement responsibilities and, in particular, to ascertain whether the firm has complied with its obligations to clients/potential clients and to the integrity of the market.

### Transaction record keeping

The L2 Regulation implements new transaction record-keeping requirements that significantly expand those set out in the current MiFID1 Implementing Regulation (which is one of the existing Level 2 measures under MiFID1).

The record keeping requirements include an obligation to record certain details immediately following the decision to deal by the portfolio manager, or (as the case may be) algorithm ("Stage 1"), and, subsequently, when any resultant order that is intended to implement the dealing decision by the portfolio manager/algorithm is processed by the execution team ("Stage 2"). The precise record keeping requirements are specified in Section 1 and Section 2 respectively of Annex IV to the L2 Regulation.

- Details to be recorded at Stage 1 include the internal ID of the portfolio manager or the relevant algorithm that made the decision to deal and the "date and exact time" of the making of the decision to deal (recorded in accordance with synchronised clock methodology which will be prescribed in a separate MiFID2 RTS).

The requirement to record the date and time of the decision to deal is something that appears in the current MiFID1 Implementing Regulation – however it is an obligation that has often been avoided by industry participants by taking the view that no decision to deal is made until the resultant order(s) is/are submitted to a broker. The new emphasis on recording the exact time of the decision to deal (measured using the MiFID2 clock synchronisation methodology) indicates that the current favoured solution to avoid the obligation may no longer be viable.

- At Stage 2, Annex IV to the L2 Regulation requires 40 separate data items to be "immediately" recorded.

This implies that traditional "high touch" (i.e. voice-based) trading (whereby a member of the execution team passes an order to a broker on the phone and records the details of the order in a hand written blotter) will be administratively much more difficult under MiFID2 (because recording all 40 data items immediately will be a significant undertaking). At the very least it implies that each member of the execution team who wishes to continue to use a "high touch" approach may need a full-time desk assistant to help record the salient details of the relevant transaction. The likely practical implication is that a large proportion of trading will migrate to electronic order submission systems where the requisite data items can be automatically captured. Among the Stage 2 data items that must be captured is, in relation to physical sales of EU listed equities or EU sovereign debt, a flag if the sale is a short sale. This means that MiFID firms will need to develop systems that can ascertain, on a real-time basis, whether such sales are long or short sales.

## Electronic communications and telephone recording – application

In addition to the transaction record-keeping requirements described above, MiFID2 will require all MiFID firms to record telephone conversations and electronic communications relating to (as a minimum) transactions concluded when dealing on own account and the provision of “client order services that relate to the reception, transmission and execution of client orders”. The obligation applies to conversations and electronic communications relating to transactions that are concluded and to those which are intended to result in a concluded transaction (even if not ultimately concluded). The recording obligation is not, therefore, intended to capture general conversations about market conditions.

There is some ambiguity about whether the reference within the relevant provision of MiFID2 to “client order services that relate to the reception, transmission and execution of client orders” is intended to capture transmission and/or execution activities carried out by MiFID firms in the context of providing portfolio management services:

- Traditionally (i.e. under MiFID1), the MiFID investment service of “portfolio management” has been regarded as a stand-alone service that encompasses not only the research and investment decision-making process but also the implementation of the discretionary investment decision. References within the MiFID1 legislation that referred to “reception and transmission of orders” and “execution of client orders” have, therefore, traditionally been interpreted as not including the implementation (whether by transmission or by execution) by asset management firms of transactions generated by them as part of their discretionary portfolio management activities.
- However, the scope of the reference in MiFID2 to “client order services that relate to the reception, transmission and execution of client orders” is ambiguous and, arguably, given that one of the stated rationales for the new requirement is to help deter and detect market abuse, it seems logical for the requirement to be interpreted as applying to firms when they provide the MiFID service of portfolio management. In the UK, the FCA already has rules requiring the recording of phone conversations that result in or are intended to result in the conclusion of relevant transactions.
- If the correct interpretation of the MiFID2 provisions is that the requirement applies to portfolio management activities, then it will mean the end of the present exemptions under the FCA rules for discretionary portfolio managers (which currently permit such managers not to record otherwise recordable conversations where those conversations are with FCA- regulated brokers that have the obligation to record the conversation and where the remainder of their recordable conversations are de minimis in nature).
- Consistent with this interpretation, the FCA has stated in its discussion paper on the UK implementation of MiFID ([DP15/3](#)) published in March 2015, that it intends to remove the exemptions from the obligation to record telephone conversations for discretionary investment managers from its rulebook when it implements MiFID2.
- The L2 Regulation confirms that the obligation to record applies not just to conversations between a firm and third parties (for example, when the execution desk passes an order to a broker) but also internal or intra-group conversations relating to transactions that are concluded and to those which are intended to result in a concluded transaction. This means that conversations where a portfolio manager instructs his execution desk to execute a transaction would be captured, as would the situation where an overseas investment management affiliate makes use of the UK-based execution team by passing to them an order for them to execute.

Firms that do not have recording capability may now wish to start talking to potential suppliers sooner rather than later to avoid the rush and to ensure that the relevant systems can be



installed in time for when MiFID2 comes into force.

### **Electronic communications and telephone recording – scope**

The resultant records are required to be retained for a period of five years and to be made available to the relevant clients upon request. However, competent authorities may request that MiFID firms hold such records for up to seven years if necessary (i.e. for the purposes of an investigation).

MiFID2 requires that MiFID firms must inform clients that their telephone communications will be recorded before they are able to carry out any services that fall within the telephone recording requirement. In addition, where orders are placed by clients through other channels (e.g. face-to-face conversations, meetings), such orders are also subject to a record-keeping requirement which may be satisfied through the use, for example, of written minutes. Such orders will be treated as equivalent to orders received by telephone.

In line with the current FCA regime, MiFID2 requires that MiFID firms take all reasonable steps to prevent employees and contractors from making, sending or receiving relevant telephone conversations and other relevant electronic communications on privately owned devices (i.e. private mobiles, office/employer supplied mobile devices) that cannot be recorded.

The L2 Regulation confirms that phone recordings and electronic communications must be kept in a “durable medium” which allows them to be replayed or copied, and must be retained in a format that does not allow the original record to be altered or deleted. Records must be “readily accessible” and available to clients on request. Firms also have to ensure the “quality, accuracy and completeness” of records. An investment manager which is engaging with external providers to supply technology to satisfy this rule should bear in mind these specific requirements.

### **Monitoring requirement**

Finally, in addition to the record keeping requirements, firms are also now subject to an express new requirement to periodically monitor the electronic records and also the recordings of telephone conversations. This monitoring must be “risk based and proportionate”.

Many investment managers already carry out spot-checks and key-word monitoring on email records and chatroom logs (so that aspect of the rule may not be unduly onerous) but the requirement to manually listen to even a small sample of telephone recordings could be a difficult burden for some investment managers. Firms may wish to start engaging now with the cost and headcount implications of this monitoring requirement.

### **Application to AIFMs and UCITS management companies**

The [transaction record-keeping requirements](#) will apply to AIFMs and UCITS management companies when they carry on “top-up” activities. Whether or not those record-keeping requirements will apply to orders and transactions that they place or execute for the AIFs and UCITS funds for which they act as AIFM or UCITS ManCo will depend on whether their home state gold-plates the core MiFID 2 requirements to apply them more widely. As a practical matter, it is likely to be easier for such firms to generate the relevant records for all clients rather than trying to distinguish between different client types, particularly if transactions are being executed on an aggregate basis for multiple clients some of which are AIFs and/or UCITS funds and others of which are clients to which the MiFID rules apply.

It is not yet clear whether the requirements relating to the recording of [telephone conversations](#) and [electronic communications](#) will apply to AIFMs and UCITS management companies when they carry on “top-up” activities. The drafting of the relevant “continuation”

provision within MiFID2 is ambiguous. This may ultimately be an issue that is clarified through national implementation, as will be the question of whether the requirements will be gold-plated to apply to all of the activities of AIFMs and UCITS management companies, rather than merely to their top-up activities. Again, it will be difficult as a practical matter for AIFMs and UCITS management companies to apply these requirements only to part of their activities.

## 5 What is happening to the MiFID1 post-trade transparency requirements?

In line with the general theme of MiFID2 and MiFIR, the post-trade transparency requirements under MiFID1 are expanded to a wider range of financial instruments, including a wider range of equity-like instruments and to non-equity instruments. Under the new rules, it may also be more difficult for fund managers to rely on the sell side to do the reporting (as there is a proposal to disapply the default reporting hierarchy).

MiFID1 established an obligation on MiFID firms that deal in EU listed shares on an OTC basis (rather than on a regulated market or a multilateral trading facility) to make certain details of the transaction public as close to real time as possible and (subject to certain limited exceptions) within three minutes of the trade. The details that are required to be made public are the trade date and time, the identifier (e.g. ISIN number) for the shares and the price, volume and venue for the trade. The exceptions to the requirement to publish the details within three minutes are for larger than average trades (measured by reference to the average daily turnover of the relevant share) where there is an ability to delay publication for up to four trading days – the larger the trade, the longer the permitted delay. Under the MiFID1 Implementing Regulation, there is a default hierarchy which determines (where there is more than one MiFID firm involved in the transaction) which of the relevant firms has the obligation to make the details of the trade public. The hierarchy is: (1) the seller, then (2) the seller's agent, then (3) the buyer's agent and finally (4) the buyer. However, the MiFID1 Implementing Regulation allowed MiFID firms, by agreement among themselves, to displace the default hierarchy so that, for example, two MiFID firms could agree that, whenever they deal with each other, a particular one of them will always make the details of the trade public (regardless of who is buying and who is selling). In practice, sell side MiFID firms have tended to agree with their investment manager clients (via their terms of business) that they (i.e. the sell side firms) alone will be responsible for any post trade transparency reporting. Consequently, buy side firms currently tend to lack the systems and infrastructure necessary to make such reports on a real-time basis.

Under MiFIR, the post-trade transparency requirements are being expanded to cover not just equities but equity-like instruments such as depositary receipts, ETFs, certificates and warrants, that have been admitted to trading on an EU trading venue ("Reportable Equity Instruments") and bonds, structured finance products, emissions allowances and derivatives that have been admitted to trading on an EU trading venue ("Reportable Non-equity Instruments").

The relevant draft RTS within FR3 requires that, for OTC transactions in Reportable Equity Instruments, the deadline for making the relevant trade details public will be one minute after the execution of the trade although, as is the case under MiFID1, there are exceptions that permit delayed publication for larger than average trades. However, under the draft RTS set out in FR3, publication may be delayed to the "end of the trading day" which means as close to real time as possible following the closing auction if the trade was executed more than two hours before the close of trading on the trading venue that is the most relevant market in terms of liquidity for the instrument in question, or, for transactions executed after that time, before noon on the next trading day in that jurisdiction. The details to be disclosed have also been changed in that there is now a requirement to flag in the report certain specific trade types such as agency crosses and algorithmic trades.

For OTC transactions in Reportable Non-equity Instruments, the relevant draft RTS within FR3 requires that the deadline for making the relevant trade details public will be fifteen minutes after the execution of the trade (reducing to five minutes with effect from January

2020). Again, delayed publication for larger than average trades is permitted. The maximum potential publication delay period for Reportable Non-equity Instruments is to 19:00 (7 pm) local time on the second working day after the date of the transaction.

### Impact on fixed income markets

The requirement to make public full details of OTC trades in EU listed bonds looks set to revolutionise the fixed income market (where the vast majority of trading is done on an OTC basis). Traditionally, the market has been opaque and price discovery has been achieved through the use of dealer runs or screen based, two-way prices from dealers. MiFID2 envisages a consolidated tape for fixed income products and (except for large trades) close to real time price transparency. For asset managers that pursue a credit strategy in Europe, it is important that their front office teams consider these changes and how they are likely to impact on the credit markets (particularly the trading opportunities and threats that they are likely to generate).

### Removal of default reporting hierarchy

The other major change to the existing post-trade transparency regime contained in the draft RTS under FR3 is that the ability (currently contained in the MiFID1 Implementing Regulation) to disapply the default reporting hierarchy will no longer be available.

Instead, the selling MiFID firm will always have the reporting obligation - unless the buyer is a so-called “systematic internaliser” in relation to the financial instrument in question and the seller is not, in which case the buyer will have the reporting obligation. (A “[systematic internaliser](#)” is defined in MiFID2 as an investment firm which, on an organised, frequent systematic and substantial basis, deals on own account when executing client orders outside a regulated market, a multilateral trading facility or an organised trading facility without operating a multilateral system. There are detailed rules within the draft Level 2 measures for determining whether a sell side firm is a systematic internaliser in relation to any particular financial instrument.)

The requirement that the seller is subject to the reporting obligation will mean that MiFID firms that are asset managers that sell, on an OTC basis, a Reportable Equity Instrument or Reportable Non-equity Instrument to another MiFID firm that is not a systematic internaliser in relation to that instrument will have the obligation to make the details of the trade public within the relevant timeframe. The firm will not be able to agree with its sell side counterparty that the sell side firm has the obligation instead. Similarly, if an asset manager that is a MiFID firm trades OTC or on a non-EU trading venue in a Reportable Equity Instrument or Reportable Non-equity Instrument with a firm that is not a MiFID firm, the asset manager will have the obligation to make the details of the trade public. This has significant potential cost and infrastructure implications for asset management firms who are, at present, generally not equipped to make such reports. One possible solution would be for MiFID asset management firms when selling Reportable Equity Instruments or Reportable Non-equity Instruments on an OTC basis, only to deal with MiFID firms that are systematic internalisers in relation to those instruments, although limiting their available trading counterparties in such a manner might conflict with their best execution obligations.

For firms for which that solution is not viable, it may be possible for them to agree, when dealing with a sell side MiFID firm that is not a systematic internaliser, to outsource their post trade publication obligations to the sell side firm. However, unlike the current situation where the default hierarchy can be disapplied, if the sell side firm did not do the reporting correctly, the buy side firm would remain responsible (from a regulatory perspective) for any errors. Also, this solution will not assist in a situation where the firm deals on an OTC basis in a Reportable Equity Instrument or Reportable Non-equity Instrument with a counterparty that is not a MiFID investment firm.

## Application to AIFMs and UCITS management companies

The MiFIR post-trade transparency requirements do not apply to EU AIFMs or UCITS management companies when carrying out portfolio management (and related execution) activities for the AIF or UCITS funds for which they act as AIFM/UCITS ManCo. It will be a matter of national implementation as to whether the post-trade transparency requirements are extended to AIFMs or UCITS management companies in the context of managed account activities (including where trades resulting from orders for managed account clients have been aggregated with orders for AIFs/UCITS funds) or to their AIF/UCITS fund management activities.

In UK CP1, the FCA proposed draft language for the UK rules that will reflect the post-trade transparency requirements of MiFIR. That draft language did not propose or suggest that the FCA was proposing to apply the MiFIR post-trade transparency requirements to AIFMs and UCITS management companies, even in respect of managed account business (and so we may infer from this that the FCA will not impose MiFIR post-trade transparency obligations on AIFMs or UCITS ManCos, even in respect of top-up activities such as segregated portfolio management).

## 6 Will the obligations relating to best execution of orders be changing?

**Yes, the obligations will be expanded – in particular firms will be required to include more details in their execution policies (in particular, with a significant expansion to the number of instrument classes covered) and also to ‘publish’ on an annual basis their top five execution venues.**

Regulated firms which execute client orders, or which receive and transmit orders, are currently subject to a best execution obligation under MiFID1. Under MiFID1, MiFID firms are required to ensure that their order execution policies differentiate between five broad instrument classes (equities, debt instruments, exchange-traded derivatives, OTC derivatives and funds). For each instrument class the firm is required to set out the execution factors that the firm is permitted to take into account in deciding where to place trades (and the relative importance to be ascribed to those factors) and a list of the execution venues and brokers on, or through, which trades in the relevant instrument class are permitted to be executed (based on the firm’s assessment of which venues/brokers have consistently demonstrated that they are capable of delivering the best possible result).

Under MiFID2, the conduct obligations relating to best execution will be expanded, such that firms will be required to give a more detailed execution policy summary to clients. ESMA has proposed in its RTS (as set out in FR3) that, under MiFID2, the number of instrument classes and sub-classes that will potentially need to be differentiated within each firm’s order execution policy will be expanded from the current 5, increasing to 22. To the extent that firms do or might trade in instruments falling within each relevant sub-class, the policy will need to set out, in respect of that sub-class, the execution factors that the firm is permitted to take into account, the relative importance to be ascribed to those execution factors and the list of permitted venues/brokers for executing trades in instruments within the sub-class.

Additionally, each MiFID firm (including fund managers) will be required to produce and make public an annual disclosure setting out, for each sub-class of financial instrument, its top five execution venues in terms of trading volumes over the preceding year for all executed client orders for (a) retail clients and (b) professional clients as well as information on the quality of execution obtained. In order to preserve some element of protection from disclosing commercially sensitive information, ESMA has provided that the volume of execution and number of executed orders is to be expressed as a percentage of the investment firm’s total execution volumes and number of executed orders in the relevant class of financial instrument. This means that firms will need to gather data for each sub-class of financial instruments on their trading volumes with different counterparties and on different venues and that they will also need to develop a methodology for monitoring the execution performance of those execution venues. “Execution venues” for these purposes include not just exchanges, multilateral trading facilities and organised trading facilities but also systematic internalisers, market makers and other liquidity providers with whom the firm has traded.

The information to be published will need to differentiate between passive and aggressive orders and disclose the existence of any links or conflicts of interest between the firm and the relevant venue and the amount of fees paid to the relevant venue (which, as mentioned above, may include brokers with whom the firm has dealt). The disclosure will need to include a summary of the steps taken by the firm to monitor execution quality for each instrument sub-class including quantitative performance data obtained from the relevant venue. The obligation to “publish” this information requires the firm to make this information available to the market at large on its website “in a machine-readable electronic format, available for downloading by the public”. This obligation is, therefore, likely to require firms to put into the public domain information that is commercially extremely sensitive (for example, where one or more of a firm’s top five venues is a broker with whom it has dealt, information about the volume of

trades done with the broker and the amount of fees paid to that broker, which would then be accessible to other brokerage counterparties). It also seems likely that the preparation of the annual disclosure will require considerable effort and administrative time and may, therefore, have headcount and other cost implications.

### **Application to AIFMs and UCITS management companies**

The MiFID 2 best execution requirements do not apply to AIFMs and UCITS management companies when they carry on “top-up” activities. It will be a matter of national implementation as to whether the best execution requirements are extended to AIFMs or UCITS management companies in the context of managed account activities (including where trades resulting from orders for managed account clients have been aggregated with orders for AIFs/UCITS funds) or to their AIF/UCITS fund management activities.



## 7 I'm hearing that MiFID2 is going to affect my ability to trade on dark pools – what are the issues?

**Correct – MiFIR contains a provision that will effectively require EU based dark pools to cease to permit trading in equity and equity-like instruments that are admitted to trading on a European trading venue if volumes on a single EU dark pool or on EU dark pools collectively exceed certain levels.**

Article 5 of MiFIR contains a “volume cap mechanism” which is intended to limit dark pool activity in relation to equities and equity-like instruments within Europe. Under MiFID1, EU-based dark pools can apply to their local competent authority for, and obtain, a waiver from the usual pre-trade transparency requirements that would normally apply to orders for equities that are admitted to trading on an EU regulated market. The availability of such waivers means that orders submitted to such dark pools do not have to be publicised on a pre-trade basis, effectively enabling those dark pools to operate on an “unlit” basis.

Under MiFIR, the MiFID1 pre-trade transparency requirements that currently apply only to equities that have been admitted to trading on an EU regulated market will be expanded to cover equities admitted to trading on any EU trading venue and other equity like instruments that have been admitted to trading on an EU trading venue such as depositary receipts, ETFs and certificates (“Relevant Equity Instruments”). The ability for dark pools to obtain waivers from those pre-trade transparency requirements has been preserved. However, as a result of concerns among European legislators about the migration of trading volumes from EU regulated markets to dark pools since MiFID1 came into force, Article 5 of MiFIR includes a provision that will withdraw those waivers under certain circumstances.

Article 5 provides that, if the trading volumes in a particular Relevant Equity Instrument that are transacted on a particular dark pool during any rolling 12 month period (as calculated by ESMA as at the end of each calendar month) exceed 4% of overall trading volumes in that instrument during that period, the dark pool in question will immediately lose the benefit of its pre-trade transparency waiver in relation to that Relevant Equity Instrument for a six month period.

Article 5 also provides that, if the trading volumes in a particular Relevant Equity Instrument that are transacted in aggregate across all EU dark pools during any rolling 12 month period (again, as calculated by ESMA as at the end of each calendar month) exceed 8% of overall trading volumes in that instrument during that period, all EU dark pools will immediately lose the benefit of their pre-trade transparency waivers in relation to that Relevant Equity Instrument, again for a six month period.

The numerator calculation for the 4% and 8% limits does not take into account orders that are excluded from the pre-trade transparency requirements on the basis that they benefit from a separate waiver as a result of being “large in scale compared with average market size” and dark pools that rely on such waivers should be able to continue to rely on them even if they become subject to a 6-month ban on relying on the other types of available waiver. The methodology for determining whether an order is large in scale compared with average market size is set out in Annex II of RTS 1 (as recently published in FR3). For example, for an equity that has average daily turnover in excess of EUR 100 million a transaction value in excess of EUR 650,000 would be “large in scale compared with average market size” and, therefore, potentially unaffected by a waiver suspension.

Notwithstanding the possible exemption for orders that are “large in scale compared with



average market size” the possibility of dark pool waivers being suspended for 6 months is likely to have a profound impact on the manner in which EU equities markets function and the way that asset managers execute their equities trades. A recent study conducted by the London Stock Exchange concluded that, of the 100 stocks in the FTSE 100 index, 99 of them would, based on 2014 trading volume data, be subject to the six month dark pool ban had it been operational as at the start of 2015.

The dark pool volume caps are set out in MiFIR (i.e. within the Level 1 text) and so are not subject to further change. It is important that front office teams (and in particular execution staff) are made aware that, with effect from January 2018, their ability to execute orders via European dark pools may be significantly constrained, so that they can plan accordingly.

#### **Application to AIFMs and UCITS management companies**

As the new rules regulate the activities of dark pools, the impact on MiFID asset managers and on AIFMs/UCITS management companies should be identical.

## 8 Will MiFID2 affect how sell side firms allocate IPOs and placings among their clients?

Yes, under MiFID2 sell side firms will be required to comply with more extensive conflict of interest management obligations in the context of allocations – including having written allocation policies. Fund managers may, therefore, find that the manner in which IPOs and secondary issuances are allocated to them by their sell side service providers changes significantly once MiFID2 has come into force.

MiFID2 mirrors the requirement in MiFID1 that MiFID firms must maintain and operate effective organisational and administrative arrangements with a view to taking steps designed to prevent conflicts of interest from adversely affecting the interests of their clients.

The L2 Regulation clarifies what is expected of sell side firms (in terms of the management of conflicts of interest) when underwriting or placing IPOs or secondary issuances. This includes a requirement on sell side firms to adopt measures that prevent placing recommendations that MiFID firms make to their issuer clients from being inappropriately influenced by existing or future relationships and a requirement to prevent staff responsible for providing services to a MiFID firm's general brokerage clients (such as equity sales personnel) from being directly involved in decisions about allocation recommendations.

The L2 Regulation identifies that the following practices should be considered abusive contrary to the requirements of MiFID2 concerning the management of conflicts of interest:

- an allocation made to incentivise the payment of a large amount of fees for unrelated services provided by the investment firm (known as “laddering”). For example, very high rates of commissions paid to the investment firm by an investment client, or an investment client providing very high volumes of business at normal levels of commission, as compensation for receiving an allocation of the issue;
- an allocation that is expressly or implicitly conditional on the receipt of future orders or the purchase of any other service from the investment firm by an investment client.

In addition, the L2 Regulation requires sell side firms to have in place a written allocation policy that sets out the process for developing allocation recommendations and that, when acting for an issuer on an IPO or placing, a copy of the policy should be provided to the client and that it should include the proposed allocation methodology for the relevant issuance. The L2 Regulation also requires that the sell side firm should involve the issuer in the discussions about the allocation process, for example, by asking the issuer to agree to the proposed allocations to different client types.

It is no secret that, in the past, sell side firms have used IPO and secondary allocations as a way of rewarding their most valued clients (in terms of trading volumes/commissions) for the business that they have given to the firm previously or to incentivise future business. The new requirements outlaw such behaviour. The requirement that the sell side firm would have to adopt a written allocation policy that sets out the proposed allocation methodology appears to make it much harder for sell side firms to indulge in such practices going forward, as, presumably, any allocations would need to be consistent with the allocation methodology set out in the policy. Fund managers may, therefore, find that the manner in which IPOs and secondary issuances are allocated to them by their sell side service providers changes significantly once MiFID2 has come into force.

### Application to AIFMs and UCITS management companies

As the new requirements regulate the activities of sell side firms, the impact on MiFID asset managers and on AIFMs/UCITS management companies should be identical.

## 9 I've heard that MiFID2 will affect algorithmic trading as well as firms which trade using a DMA system. Is this true?

Yes, it is true. MiFID2 significantly alters the way in which algorithmic trading is regulated in the EU. There will be new regulation of persons involved in this type of trading, extensive requirements on firms that engage in algorithmic trading (including disclosure of trading models) and changes to the way the markets regulate this activity.

Furthermore, banks and brokerage firms that permit their clients to make use of their Direct Market Access (DMA) systems to trade directly on trading venues will, under MiFID2, be subject to a number of organisational and conduct requirements, some of which are required to be passed on contractually to fund managers that use the banks' or brokers' DMA systems.

### Algo trading

Algorithmic trading is one of the prime targets for additional regulation under MiFID2 and so fund managers that use such systems will have to comply with several new requirements. The EU is keen to avoid a repeat of the "flash crash" of 2010, and to curtail the possibility that algorithmic trading can be used for market abuse.

Under MiFID2, algorithmic trading is widely defined as *"trading in financial instruments where a computer algorithm automatically determines individual parameters of orders such as whether to initiate the order, the timing, price or quantity of the order or how to manage the order after its submission, with limited or no human intervention, and does not include any system that is only used for the purpose of routing orders to one or more trading venues or for the processing of orders involving no determination of any trading parameters or for the confirmation of orders or the post-trade processing of executed transactions"*. The L2 Regulation further clarifies that "no or limited human intervention" means that an automated system makes decisions at any stages of initiating, generating, routing or executing orders or quotes according to pre-determined parameters.

The definition goes well beyond high frequency trading and effectively captures any trading activity where a computer is responsible for generating the relevant orders (although order routing systems are excluded).

Under MiFID2 and ESMA's proposed Level 2 measures, regulated firms that engage in algorithmic trading will be subject to new requirements that include requirements to:

- implement appropriate governance arrangements for algo trading, including an express role for compliance staff and new outsourcing rules;
- have effective systems and risk controls suitable to the business they operate, to ensure that their trading systems are resilient and have sufficient capacity, are subject to appropriate thresholds/limits and prevent the sending of erroneous orders or the systems otherwise functioning in a way that may create or contribute to a disorderly market;
- ensure that algorithmic systems cannot be used for any purposes contrary to market abuse laws or contrary to the rules of a trading venue;
- notify the relevant competent authority that they are engaging in algorithmic trading (and the competent authority may require them to provide, on a regular or ad-hoc basis, a description of the nature of their algorithmic trading – including a description of their algorithmic trading strategies, details of the trading parameters or limits to which the

system is subject, the key compliance and risk controls they have in place and details of the testing of their systems) – see below;

- where the algorithmic trading strategy is a high frequency algorithmic trading strategy, store, in an approved form accurate and time sequenced records of all their placed orders, including cancelled orders, executed orders and quotations on trading venues and make these available to the competent authority on request. A “high frequency algorithmic trading strategy” is defined in MiFID2 as *“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, routing or execution without human intervention for individual trades or orders; and (c) high message intraday rates which constitute orders, quotes or cancellation”*;
- comply with quasi-market making obligations if they engage in algorithmic trading specifically to pursue a market making strategy;
- conduct non-live testing in non-live testing environments, segregated from the firm’s production environments and used specifically for the testing and development of trading algorithms and trading. In response to industry feedback, ESMA’s proposed rules on testing in RTS 6, appended to FR3, now distinguish between pure investment decision algos – which are exempt from certain of the more onerous testing requirements – and order execution algos – which are subject to all of the testing requirements. Where required, such testing will include conformance testing, stress testing, controlled deployment rules as well as annual review requirements.); and
- conduct real-time monitoring of all of their algorithmic trading activity for signs of disorderly trading and monitoring for signs of market abuse. The disorderly trading monitoring should be carried out by both the relevant algorithm’s responsible trader and an independent risk control function. The monitoring systems for both disorderly trading and market abuse must include automated alerts and the staff responsible for monitoring must have the authority to withdraw orders. The trading system functionality must include a “kill” function that allows the firm (including the compliance function) to cancel immediately all or a specific subset of the firm’s unexecuted orders.

The latest draft RTS on algo trading (see RTS 6 appended to FR3) remains silent on the controversial issue of provision of details of the algo system to national regulators. It, therefore, remains unclear whether firms operating on algo will be required to disclose commercially sensitive details (such as formulae, source code, etc.) and this may – in the absence of definitive rules in the final RTS – boil down to a question of how individual regulators implement Article 17(2) of MiFID2 into their national law.

In addition, under MiFID2, regulated markets will be subject to new systems resilience and “circuit breaker” requirements that may have an impact on fund managers trading on those markets. Regulated markets will need to have in place effective systems, procedures and arrangements in order to ensure:

- their trading systems are resilient
- they can deal with peak order and message volumes
- they are able to reject orders that exceed pre-determined volume and price thresholds or are clearly erroneous
- they can ensure orderly trading under conditions of severe market stress;
- they can, where necessary, halt or constrain trading; and
- they require members/participants to carry out appropriate testing of algorithms.

## Using DMA systems

Firms trading using a DMA system (referred to as Direct Electronic Access, or DEA, in MiFID2) will also be impacted by MiFID2. In particular, DMA providers will be required to conduct an assessment and review of their fund manager clients (to ensure they are suitable to use their DMA systems).

DMA providers will be required to impose trading and credit thresholds and monitoring rights. It will also be necessary for the DMA provider to require fund manager clients using DMA systems to enter into a binding written agreement dealing with compliance with MiFID2, market abuse rules and the trading venue's rules. MiFID2 will prohibit DMA access unless the foregoing controls are in place – and DMA providers may be requested by competent authorities to provide (on a regular or ad hoc basis) a description of the systems and controls that they have in place. We, therefore, anticipate that fund managers can expect to be subject to fairly onerous regulatory representations and warranties in these types of agreements – especially since the DMA provider is ultimately responsible for its clients' compliance with MiFID2 and the rules of the trading venue.

The system resilience rules for regulated markets mentioned above will also impact on DMA access to markets. Any regulated market that permits DMA will be required to ensure that market participants are only permitted to provide DMA services if they set appropriate standards as to the suitability of DMA traders, set risk controls and trading thresholds for DMA and have the powers to stop trading. Additionally, regulated markets will be required to have arrangements to suspend or terminate the provision of DMA access to market participants for non-compliance.

## Application to AIFMs and UCITS management companies

The MiFID2 algorithmic trading rules do not apply to AIFMs and UCITS management companies when they carry on “top-up” activities. It will be a matter of national implementation as to whether the transaction reporting requirements are extended to AIFMs or UCITS management companies in the context of managed account activities (including where trades resulting from orders for managed account clients have been aggregated with orders for AIFs/UCITS funds) or to their AIF/UCITS fund management activities.

In relation to the new DMA rules, as the new requirements regulate the activities of DMA providers (including their interactions with their own clients), the impact on MiFID asset managers and on AIFMs/UCITS management companies should be identical.

## 10 Will the product governance provisions affect fund managers?

Yes, the product governance provisions will impact fund managers caught by MiFID as they apply to the manufacturing and distribution of all financial instruments – including funds. The new obligations are extensive and will require additional process and policies for managers and distributors.

MiFID2 introduces a new regime in relation to a firm's product governance arrangements and the manufacture and distribution of products and services (including funds and related management services) to end clients. These requirements are not currently included in MiFID1. These requirements implement, to a large extent, the UK FCA's current "Responsibilities of Providers and Distributors for the Fair Treatment of Customers" ("RPPD") regulatory regime, although the MiFID2 requirements extend the application to professional clients and a wider range of products.

The key product governance obligations under MiFID2 distinguish principally between obligations on manufacturers and on distributors in respect of manufacturing and distributing financial instruments. For these purposes, units in a fund will be a financial instrument, and so the following summary focuses on fund units as the relevant financial instrument (although will of course apply more broadly if a firm is manufacturing or distributing other financial instruments).

### Manufacturers

The L2 Directive clarifies that the manufacturer rules are intended to apply to the **creation, development, issuance and/or design** of financial instruments (including funds). In practice, it is going to be important for all asset management groups to identify which entities within the structure are "manufacturers" and whether the EU MiFID investment firm is a manufacturer. Industry practice is still developing around issues such as whether an offshore fund can properly be understood to be the "manufacturer" of the fund as an investment product.

Where a MiFID firm is acting as a manufacturer of financial instruments (including funds) for sale to clients, it must implement a process for the **approval** of each fund (and significant adaptations of existing funds) before that fund is marketed or distributed to clients. A further key facet of the product governance rules is managing **conflicts of interest**. The L2 Directive introduces an important proportionality principle to the manufacturer rules, such that firms must comply with the rules in a way that is appropriate and proportionate, taking into account the nature of the fund, the service and the target market for the product. The key rules are:

- **Target market:** The product approval process must specify an identified target market of end clients for the fund, and must ensure that all relevant risks to the identified target market are assessed. The intended distribution strategy must be consistent with the identified target market. The L2 Directive clarifies that, in practice, firms must identify at a sufficiently granular level the potential target market and specify the types of client for whose "*needs, characteristics and objectives*" the fund is compatible. As part of this process, the firm must also identify any groups of clients for whose needs, characteristics and objectives the fund is not compatible. Firms will be required to determine whether a fund meets the identified "needs, characteristics and objectives" of the target market, by examining (for example) whether the fund's risk / reward profile is consistent with the target market; and whether the fund's design is driven by features that benefit the client (and not by a business model that relies on poor client outcomes to be profitable). As part of this, manufacturer firms will also need to conduct scenario analysis and assessments of the fund under negative conditions.



In practice, the concept of “target market” may be a significant shift in commercial mindset for certain asset managers, particularly hedge funds and other alternative funds (although existing retail managers may be more familiar with the concept, if they are already subject to RPPD in the UK, for example). Hedge fund managers would not typically describe themselves as product providers, and the process of identifying the needs and objectives of a target market for a potentially complex and high-risk hedge fund will be a potential challenge.

- **Conflicts of interest:** Manufacturer firms must have procedures to ensure the manufacturing of funds complies with the requirements on proper management of conflicts of interest, including remuneration. Firms will need to analyse potential conflicts of interest each time they manufacture a fund (including whether clients will end up with an exposure which is opposite an exposure held by the firm itself). In particular, firms manufacturing funds shall ensure that the design of the fund (including its features) does not adversely affect end clients and does not lead to market integrity issues.
- **Charging structure:** Firms must also consider the charging structure which is proposed for the fund, including by examining whether the costs and charges are compatible with the needs of the target market, whether the charges could undermine the returns of the fund, and whether the charging structure is appropriately transparent.
- **Regular review:** A manufacturer firm must also regularly review the funds which it offers or markets, taking into account any event that could materially affect the potential risk to the identified target market, to assess (at a minimum) whether each fund remains consistent with the needs of the identified target market and whether the intended distribution strategy remains appropriate.
- **Making materials available to distributors:** A manufacturer firm must make available to any distributor all appropriate information on the fund and the product approval process, including the identified target market for the fund. The L2 Directive clarifies that this information includes information about the appropriate channels for distribution of the fund, the product approval process and the target market assessment. This must enable distributors to understand and recommend or sell the fund properly.
- **Agreements with third parties:** The L2 Directive introduces an express requirement that, where a firm collaborates with another firm (whether EU regulated or not) to create, develop, issue and/or design a product, that both firms must enter into a written agreement to outline their mutual responsibilities.

## Distributors

The second part of the MiFID2 product governance rules applies to a firm acting as distributor. A distributor is defined as a firm which offers or recommends financial instruments which it does not manufacture. As discussed above, many EU sub-investment managers within broader asset management groups are MiFID firms, and these firms are likely to be “distributors” if they have a role in marketing the funds originated by other group members.

Where an investment firm acts as a distributor, MiFID2 states that it must have in place adequate arrangements to **obtain appropriate information** on the fund and the product approval process, including the **identified target market** for the fund (and, as with the manufacturer rules, these requirements are subject to a proportionality principle). The distributor must understand the characteristics and identified target market of each fund.

- **Focus on needs of target market:** Distributor firms must implement product governance arrangements to ensure that products and services they intend to offer or recommend are compatible with the needs, characteristics, and objectives of an

identified target market and that the intended distribution strategy is consistent with the identified target market. Distributor firms must also appropriately identify and assess the circumstances and needs of the clients they intend to focus on, so as to ensure that clients' interests are not compromised as a result of commercial or funding pressures. As part of this process, firms shall identify any groups of clients for whose needs, characteristics and objectives the product or service is not compatible.

Distributors must also comply with the MiFID2 distribution rules when offering or recommending funds manufactured by entities that are not subject to MiFID2. Distributor firms must determine the target market for the respective fund, even if the target market was not defined by the manufacturer.

- **Obtaining information from manufacturers:** Distributor firms must obtain from manufactures (which are subject to MiFID2) information to gain the necessary understanding and knowledge of the products they intend to recommend or sell in order to ensure that these products will be distributed in accordance with the needs, characteristics and objectives of the identified target market. In addition, distributor firms must take all reasonable steps to ensure they also obtain adequate and reliable information from manufacturers not subject to MiFID2, to ensure that products will be distributed in accordance with the characteristics, objectives and needs of the target market. Where relevant information is not publicly available, the distributor must take all reasonable steps to obtain such relevant information from the manufacturer or its agent.
- **Regular review:** Distributor firms must review the investment products they offer or recommend and the services they provide on a regular basis, taking into account any event that could materially affect the potential risk to the identified target market. Distributors must assess at least whether the product or service remains consistent with the needs, characteristics and objectives of the identified target market and whether the intended distribution strategy remains appropriate.
- **Provision of information to manufacturers:** Distributor firms must provide manufacturers with information on sales and, where appropriate, information on the above reviews to support product reviews carried out by manufacturers.
- **Distribution chains:** The L2 Directive also addresses the split of responsibility between multiple firms in a distribution chain. Where different firms work together in the distribution of a product or service, the L2 Directive requires that the investment firm with the direct client relationship has ultimate responsibility to meet the product governance obligations. However, intermediary investment firms still have certain responsibilities, including to: (a) ensure that relevant product information is passed from the manufacturer to the final distributor in the chain; (b) if the manufacturer requires information on product sales in order to comply with their own product governance obligations, enable them to obtain it; and (c) apply the product governance obligations for manufacturers, as relevant, in relation to the service they provide.

MiFID firms which are within scope of the distributor rules will need to ensure that all fund marketing procedures and distribution arrangements are appropriately updated, to reflect the new requirements.

### **Application to AIFMs and UCITS management companies**

The MiFID2 product governance provisions are not directly applicable to EU AIFMs and UCITS management companies when carrying out the activities of managing (or marketing) an AIF for which they act as an AIFM or a UCITS for which they act as the UCITS ManCo. However, a MiFID firm acting as distributor on behalf of an AIFM or UCITS ManCo will be subject to these rules and will need to obtain information from the AIFM or UCITS ManCo in order to comply with its own obligations (including about the target market).



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