The “butterfly effect” - why MiFID2 is relevant to US and other non-EU fund managers

This note summarises the Top 10 issues arising from MiFID2 which have a potential impact on the business of US and other non-EU investment managers.

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The EU 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 by new legislation (MiFID2) which comes into force in the EU with effect from 03 January 2018. In the UK, MiFID2 will still come into full force and effect, notwithstanding the Brexit vote to leave the EU.

There has been much attention given to the impact of the forthcoming MIFID2 regime on investment managers established in the EU. What is perhaps less appreciated, however, is that MiFID2 will also indirectly impact investment managers which are established outside of the EU (including US managers), if they fall within one or more of the four key trigger points for MiFID2 becoming relevant to a non-EU entity. In summary, MiFID2 will be indirectly applicable to non-EU investment managers which:

- trade on European trading venues
- trade with (or are clients of) European counterparties
- market their funds and other products through European distributors, or
- provide investment management services directly to clients in the EU.

This note is a very high level summary of the Top 10 issues arising from MiFID2 which have a potential impact on the business of US and other non-EU investment managers.

Trading on EU trading venues

The first set of indirect MiFID2 issues arise as a result of a non-EU firm trading in financial instruments which are admitted to trading on an EU trading venue (a regulated market, a multilateral trading facility or an organised trading facility).

Increased transparency on non-equity markets

MiFID1 already contains a requirement for EU trading venues to disclose pre-trade and post-trade information on prices for equities trading, along with a parallel obligation on EU investment firms to immediately print to the market details of off-exchange or Over-The-Counter (OTC) trading in listed equities. The obligation does not (under MiFID1) extend to equity-like instruments, nor to non-equities. Such markets are therefore relatively opaque at present, as compared to equities markets.

Under MiFID2, the pre- and post-trade transparency requirements are being expanded:

- Wider range of instruments in scope: a wider range of equity-like instruments will be within scope of the price transparency regime, and non-equity instruments are also brought within scope of the regime, including bonds, derivatives, and structured finance products, where they are admitted to trading on an EU trading venue.
- Wider range of trading venues in scope: MiFID2 newly regulates a wider range of trading venues, known as organised trading facilities (OTFs). OTFs include trading platforms such as broker-crossing networks and swap execution facilities.

A non-EU investment manager will not be directly subject to any pre- or post-trade reporting obligations under MiFID2. However, there are certain key indirect impacts to note. There will be a significantly wider range of instruments and markets within scope of the EU transparency rules. In particular, currently opaque markets such as fixed income markets will, once MiFID2 comes into force, be transparent / lit markets. This could have an impact on price discovery and trading patterns on those markets. In addition, if a non-EU firm is trading OTC in EU-listed financial instruments with an EU regulated counterparty, the non-EU firm should note that the EU counterparty will have to make a post-trade report to print details of the trade to the market.

Dark pools - double volume cap restrictions

MiFID1 contains a regime to allow dark pools to operate outside of the pre-trade price transparency rules for equities, effectively allowing dark pools to operate on an “unlit” basis, by means of a waiver from the pre-trade transparency rules. MiFID2 contains a regime which limits the ability of dark pools to make use of a waiver from the pre-trade price transparency rules, if two new volume cap restrictions are breached (the double volume cap):

- If the EU trading volumes in a particular equity instrument that are transacted on a particular dark pool during any rolling 12 month period 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 specific equity for a six month period.
- If the EU trading volumes in a particular equity instrument that are transacted in aggregate across all EU dark pools during any rolling 12 month period 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 specific equity, again for a six month period.

(There are certain exemptions for large-in-scale orders.)

The possibility of dark pool waivers being suspended for six 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. As the relevant change affects the functioning of equity dark pools generally, non-EU investment managers which currently trade via EU dark pools will be impacted if a particular dark pool loses the benefit of a transparency waiver.

Commodity derivatives - position limits and reporting

MiFID2 introduces two parallel regimes relating to commodity derivatives trading: position limits, and a position reporting regime. Unlike the majority of the provisions in MiFID2, these new regimes apply to all persons globally (in other words, they are not limited to EU regulated firms). As such, a non-EU investment manager trading in commodity derivatives will be directly subject to these new rules.

In respect of position limits, each EU regulator must impose limits on the size of a net position which a person can hold in commodity derivatives trading on a trading venue (or in economically equivalent OTC contracts). The baseline figure for calculating the position limits is 25% of the deliverable supply (although national regulators may amend this to a maximum of 35% or a minimum of 5%). In addition, trading venue operators will be empowered with position management controls which will enable them to monitor and manage positions, for example by requiring a person to terminate or reduce their positions. As noted, a non-EU investment manager will be directly subject to these position limits, and so - if a non-EU manager trades in EU commodity derivatives - it should consider how the position limits will impact on its business and update trading systems accordingly.

In addition, MiFID2 also introduces a new reporting regime for commodity derivatives. Under this regime, members or participants of EU trading venues must report their own commodity derivatives positions to the trading venue at least daily. A non-EU investment manager that is a direct member of or participant in an EU trading venue will be directly subject to this position reporting regime, if trading in-scope commodity derivatives. Again, a non-EU firm directly subject to this regime should consider how the reporting requirement impacts on its business and how it will satisfy the reporting requirement.

Trading with EU counterparties

The second set of indirect MiFID2 issues arise as a result of a non-EU firm having a trading relationship with, or being the client of, an EU broker, bank or trading counterparty. These issues arise principally as a result of the regulated status of that EU counterparty.

Equities - mandatory on-exchange trading

MiFID2 introduces a new requirement that an EU regulated firm may execute an equity trade only if it is on an EU trading venue (or with a firm which is a systematic internaliser or an equivalent venue in a third country). The instruments in scope for this requirement are any equities admitted to trading on any EU trading venue, including those with only a secondary listing in the EU (as is the case for a large proportion of the most liquid internationally traded stocks).

A non-EU firm will not be directly subject to this requirement. However, whenever a non-EU firm trades with an EU bank or broker, that trading counterparty will be subject to the rule, and so there will be an indirect impact on the non-EU firm (due to the constraints on its counterparty). The effect of this rule is to introduce a substantial limit on the possibility of trading off-exchange or OTC in EU listed equities with EU counterparties. It will be important for non-EU firms to ensure that their investment professionals are aware of this forthcoming constraint when trading with EU firms. (The requirement will not be applicable where two non-EU firms trade with each other).

Re-papering and new terms of business, including conflicts rules

All EU regulated banks and brokers will (once MiFID2 comes into force) be subject to a range of revised and updated conduct of business and organisational requirements. This includes revised rules relating to best execution, conflicts of interest and disclosures of costs and charges. Certain of these organisational and conduct rules will require the relevant bank or broker to make new disclosures to its clients and obtain new consents from clients. We anticipate that, in many cases, EU banks and brokers will document this by repapering clients, for example by issuing updated Terms of Business (TOBs) or new client agreements.

Where a non-EU investment manager has a trading relationship with, or is a client of, EU banks and brokers, those banks and brokers will, therefore, need to re-paper the manager in advance of MiFID2 coming into force, for example by seeking to agree revised TOBs. A non-EU manager which receives updated TOBs will need to consider whether it wishes to accept those updated TOBs, or whether it wishes to engage in a broader review and negotiation of the revised documentation.

In parallel, investment managers which are clients of EU banks and brokers may wish to consider preparing and issuing a standard “MiFID2 side letter”, similar to that implemented in 2007 for MiFID1. Such a side letter may include the investment manager’s baseline requirements or requests to EU counterparties, in areas where MiFID2 affords the EU firm a degree of discretion or choice in its conduct (including for example as to client classification).

One of the key changes to the conduct rules, to which an EU broker is subject, relates to conflicts of interest. MiFID2 clarifies what is expected of sell side firms - from a conflicts perspective - when underwriting or placing Initial Public Offerings (IPO) or secondary issuances. MiFID2 prohibits sell side firms from allocating issuances to clients either (a) to incentivise the payment of a large amount of fees for unrelated services provided by the EU firm or (b) which is conditional on the receipt of future orders or the purchase of any other service from the investment firm by a client. In practice, some European sell side firms have historically used IPO and secondary allocations as a way of rewarding their most valued buy side clients (in terms of trading volumes or commissions) for the business that they have given to the firm previously or to incentivise future business. The new MiFID2 requirements effectively outlaw such behaviour. Non-EU investment managers may 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.

Use of direct market access provided by EU broker

MiFID2 introduces new requirements on an EU bank or broker which offers direct market access (DMA) software, to allow its clients to trade on EU trading venues via its trading systems. Non-EU managers will be indirectly impacted by these requirements to the extent that they make use of DMA software offered by EU brokers.

EU DMA providers will be required to impose trading and credit thresholds on their clients, and to have the benefit of monitoring rights. It will also be necessary for the broker to enter into a binding written agreement with the client, which deals with compliance with MiFID2, market abuse rules, and the trading venue rules. Non-EU clients of an EU broker should therefore anticipate the EU broker seeking to enter into a DMA agreement, and also seeking to impose the relevant threshold and rights.

In addition, EU trading venues which permit 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. Again, we note that these rules will be of indirect relevant to a non-EU investment manager trading on such a trading venue using DMA.

Transaction reporting by EU firms

MiFID1 already contains an obligation on EU firms to report transactions in EU listed instruments to the local regulator (reporting privately to the national regulator on a T+1 basis). MiFID2 is extending the transaction reporting requirement to capture a wider range of instruments and trading venues, and also to increase the number of reporting fields, and the level of detail to be reported in a transaction report.

A non-EU investment manager is not currently subject to the transaction reporting requirement, and will continue not to be subject to the requirement once MiFID2 comes into force.

However, if a non-EU investment manager trades in EU instruments with an EU-regulated bank or broker, the non-EU manager should be aware that the broker will need to report the relevant trade to the local regulator (whether it has traded on- or off-exchange). The EU counterparty will also need to obtain certain information from the non-EU manager in order to complete the transaction report, including potentially the manager’s LEI code and a short position flag. Non-EU firms may wish to open a discussion with EU counterparties as to what information will be required to enable the counterparty to satisfy this requirement.

Use of EU distributors

The third set of indirect MiFID2 issues arise as a result of a non-EU firm appointing an EU distributor to market units or shares in its funds.

Product governance - use of EU distributor

MiFID2 introduces a new product governance regime which impacts EU “distributors” of investment products, such as third party introducers, selling agents, private banks, wealth managers, or financial advisers. The distributor rules apply to such EU firms which offer and/or recommend investment products and services to clients, including offering and selling fund units in alternative funds.

The relevant EU distributor firms will need to have in place explicit product governance arrangements, including an understanding of the financial instruments being offered or recommended, an assessment of the compatibility of the financial instruments with the needs of their clients, and will need to ensure that the financial instruments are offered or recommended only where it is in the interests of the client. Where investment products are “manufactured” by non-MiFID firms such as US managers, such distributors must take all reasonable steps to ensure that the level of product information from the non-MiFID firm is of a reliable and adequate standard to be distributed in accordance with the distributor’s target market and, where such information is not publicly available, to require the entry into a suitable written agreement to provide all relevant information.

A non-EU investment manager will not be directly subject to the product governance rules as a manufacturer, but will be indirectly impacted by any relationship with EU distributors. This will require a non-EU investment manager to respond appropriately to requests for information and documentation, to enter into discussions around “target market” definitions, and to negotiate updated distribution agreements which enable the distributor to comply with MiFID2.

Inducements rules - payments of commission

MiFID1 already contains a set of rules, known as the “inducements” rules, which limit the situations in which an EU firm can receive payments and non-monetary benefits from third parties other than its client. MiFID2 significantly enhances the inducements rules, particularly in respect of independent financial advisers and portfolio managers.

A non-EU investment manager will not be directly subject to these rules, but will be indirectly impacted if and to the extent that it wishes to make payments to third parties which are EU MiFID firms, particularly in the context of distributors which offer independent advice to their underlying clients (such as an independent financial adviser or a private bank). This may impact on a non-EU manager if an EU distributor is required to re-negotiate distribution agreements in respect of commission payments, trail payments, retrocession payments, or similar.

Additionally, in connection with the prohibition on EU based managers receiving investment research for which they do not pay, EU research providers that are MiFID firms will be obliged to price their research services separately from their execution services. It remains to be seen whether some of those research providers might seek to impose that pricing model on their investment manager clients globally, rather than just applying it to their clients in the EU.

Providing services to clients in the EU

The fourth and final set of indirect MiFID2 issues arise as a result of a non-EU firm providing investment services to clients located in the EU, which could include clients within the same corporate group.

Providing services to EU firms - outsourcing and third country rules

Certain non-EU firms may provide services to an EU firm under a delegation / outsourcing agreement (for example, where an EU firm is the primary investment manager on a client mandate, and then delegates sub-investment management functions to a non-EU affiliate). MiFID1 already contains outsourcing rules which govern this type of arrangement, and MiFID2 is updating those rules. As such, the relevant EU firm will likely need to update the relevant services agreement for compliance with the MiFID2 outsourcing rules. In addition, where certain obligations are passed on contractually to the non-EU firm, the compliance procedures around those processes will need to be reviewed and updated - for example to execute orders to the best execution specified in MiFID2. Additionally, in order to provide investment management services to an EU based MiFID firm on an outsourced basis, the EU based investment management firm will need to satisfy itself that there is a co-operation agreement in place between its EU regulator and the non-EU regulator that regulates the activities of the non-EU manager to which portfolio management activities have been delegated.

Under MiFID2, EU member states may require non-EU firms which intend to provide investment services or perform investment activities to retail and elective professional clients in the EU to establish a branch in that member state. In contrast, for services provided to per se professional clients and eligible counterparties, MiFID2 creates a regime whereby the third country firm must register with ESMA (subject to ESMA first adopting an equivalence decision and with certain other conditions being met). In each case, there is a “reverse enquiry” exemption (though this is different from that under AIFMD with which some non-EU fund managers may be familiar). The requirements will also be subject to any “grand-fathering” provisions which member states may adopt. Non-EU managers which provide investment services to clients based in the EU should monitor the situation closely.

Next steps

Investment managers which are, or think they may be, affected by the changes being introduced by the new regime should contact their EU brokers, counterparties and distributors, as well as analyse at a more macro level how these changes might impact their firm’s overall strategy. It may also be necessary to make changes to trading and other information systems. Simmons & Simmons can provide legal advice as needed.

Simmons & Simmons MiFID2 Manager is an online service which provides key information on how MiFID2 applies to particular firm types, the services and activities it provides/performs and to what sort of clients, analysing the requirements and producing a list of action points which may form the basis of an implementation project plan.

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