MiFID II and Its Effects on US Advisers

By Cari Hopfensperger, Compliance Consultant

January 5, 2018

One of the largest global regulatory packages in the past ten years became effective January 3, 2018. The European Union’s Markets in Financial Instruments Directive, more commonly known as MiFID II, originated from the European Commission, and is meant to provide a European-wide legislative framework for regulating financial markets. The reforms have an extensive reach, applying to banks, fund managers, traders, brokers and stock exchanges, across the 28 European Union member states and Iceland, Lichtenstein and Norway. At the heart of this legislation is more detailed reporting of trades across a large range of assets classes, including equities, bonds, and derivatives, and the imposition of a “best execution” obligation on financial firms subject to MiFID II, and the unbundling of research and transaction costs.

This article is meant to provide US investment advisers with a summary overview of the potential effects of this new regulatory framework. Given the complexity of MiFID II, we recommend that advisers that provide advice to clients in the European Union (“EU”) or trade in European markets consult legal counsel for specifics on how to comply.

Background on MiFID

MiFID II describes the package of revisions to the EU Markets in Financial Instruments Directive (“MiFID”), which originally came into force in 2008. Broadly speaking, MiFID is viewed as a “cornerstone of European securities law and established the framework for EU legislation for investment intermediaries that provide services to clients around shares, bonds, units in collective investment schemes and derivatives (collectively known as ‘financial instruments’)”. MiFID (now called MiFID I) included objectives to increase transparency in and standardize disclosures required across EU financial markets.

In the wake of the global financial crisis in 2007/2008, the European Commission adopted a legislative proposal for the revision of MiFID on October 20, 2011. After more than two years of debate, the Directive on Markets in Financial Instruments repealed Directive 2004/39/EC and the Regulation on Markets in Financial Instruments, commonly referred to as MiFID II and MiFIR (together, MiFID II for the purpose of this article) were adopted by the European Parliament and the Council of the European Union. They were published in the EU Official Journal on June 12, 2014.

MiFID II

The primary goals of MiFID II are to further strengthen investor protection by “bolstering the transparency standards for venue-traded instruments in the EU (including bonds and swaps), beefing up
investor protection standards, implementing the G20 mandate on venue trading of swaps, introducing position limits for commodity futures, and broadening the scope of what has to be reported to regulators”. According to the European Securities and Markets Authority (“ESMA”), this new legislative framework will strengthen investor protection and improve the functioning of financial markets making them more efficient, resilient and transparent.

I am a US Adviser. Does MiFID II Affect Me?

The short answer, unfortunately, is “it depends”. Many of the new rules under MiFID II may impact US financial firms either directly or indirectly. Potential impacts of specific MiFID II requirements on US advisers are covered in greater detail below, but in general, activities that are more likely to give rise to compliance obligations under MiFID II include: (1) sub-advising for an EU fund manager, (2) having an EU subadvisor, (3) trading in EU securities on an EU regulated market, and (4) having an EU affiliate. At present, MiFID II does not apply to investment managers who purely carry out collective portfolio management of Alternative Investment Funds (“AIF”) and UCITS.

Subadvisors to EU managers and funds may be subject to MiFID II directly or indirectly. For example, a US subadvisor will be expected to cooperate by providing information needed by the MiFID-licensed firm to facilitate its compliance with MiFID II. EU managers may impose contractual obligations on their non-EU sub-advisers to ensure that they can comply with certain MiFID II requirements. US subadvisors should consult with their EU managers to determine the scope of the subadvisor’s obligations under MiFID II. Finally, US advisers seeking new business opportunities in the EU should expect new due diligence questions related to their ability to satisfy (or assist a prospective manager’s ability to satisfy) applicable MiFID II requirements.

What are the MiFID II Requirements?

1. Inducements & Unbundling Research

Arguably one of the most debated requirements under MiFID II is its prohibition on inducements (defined as “fees, commissions, or other monetary and non-monetary benefits that may induce a manager to trade with a particular counterparty”). Under U.S. regulation, “inducements” are more commonly known as “soft dollars”, and are permitted assuming that the adviser meets its obligation of best execution. MiFID II strictly curtails the use of “soft dollars” and requires the unbundling of research services from transaction costs. Specifically, EU investment managers can receive research only if they pay for that research (i) directly (out of their own funds) or (ii) from a research payment account (“RPA”) funded with client and with client approval (or a combination of both methods).

On October 26, 2017 the SEC issued three temporary no-action letters providing U.S. broker-dealers and investment advisers relief when conducting business with entities subject to MiFID II. (For a summary of these letters, see our Regulatory Update November 2017.) The no action relief provided by the SEC was designed in conjunction with European regulators and confirms that money managers and broker-dealers can continue rely on the safe harbor in Section 28(e) of the Securities and Exchange Act of 1934, and will not be in breach of U.S. federal securities laws when complying with MiFID II unbundling requirements. The relief also allows EU asset managers to continue to have access to research from U.S. broker-dealers. The European Commission issued its FAQ at the same time to provide guidance to EU investment firms on how to deal with non-EU brokers that provide research.
In a letter addressed to Securities Industry and Financial Markets Association’s Asset Management Group, the SEC addresses the Section 28(e) safe harbor. As stated by the SEC in its press release, the no action relief allows investment advisers to continue to comply with the Section 28(e) safe harbor as long as the adviser makes payments for research to an executing broker-dealer out of client assets alongside payments for execution using an RPA that conforms to the requirements in MiFID II, and the executing broker-dealer is legally obligated to pay for the research. All other applicable conditions of Section 28(e) must continue to be met.

**Potential impacts to US advisers**

A US manager that trades with EU broker dealers or acts as a subadvisor to an EU manager may be indirectly impacted, since research costs will be unbundled and separately invoiced from execution services. It may also result in its contractual arrangements, such as commission sharing agreements, with such counterparties being revisited and amended accordingly.

Managers registered under both the SEC and EU regimes can pay hard dollars for research services from U.S. research providers. The thornier question is how global managers will handle the issue. For example, a global manager may decide to continue paying for research using soft dollars in the U.S., and using hard dollars to pay for research in the EU. In this situation, the global manager may have to create a “fire wall” (or “ring fence”) to prevent sharing of research, or the EU firm may have to make a separate payment to its U.S. affiliate for the research. Creating a “ring fence” would require having separate trading desks for EU and non-EU accounts, and having separate groups make decisions affecting trading activity (i.e., broker reviews, broker approvals) for EU and non-EU divisions.

**Special Concerns related to inducements and unbundling:**

- **RPAs and Operational Complexity.** There are a host of operational requirements associated with using RPAs to pay for research. These include client disclosure, budget maintenance, tracking the cost of any research received, arranging for payment of research out of each client’s RPA and fairly allocating the costs of research across multiple and relevant accounts. Check out KL Gates MiFID II Toolkit for Global Investment Managers, available here.

- **Fixed income unbundling.** MiFID II’s prohibition on inducements applies to both equity and fixed income transactions. This may not have much effect on US managers, since fixed income transactions have not historically been used to generate soft dollars. This reason is, in part, because the dealer’s compensation is part of the bid/ask spread as opposed to being charged as a commission as with exchange-traded equities, i.e., the majority of fixed income trades are executed on a non-agency, or principal, basis. Principal trades are not covered by the Section 28(e) safe harbor.

- **Firms serving EU and Non-EU clients.** Firms with MiFID and non-MiFID clients have a decision: (1) implement full compliance with MiFID II across all accounts (even those that are not otherwise subject to MiFID II) through the use of RPAs or hard payments for research, or (2) implement “ring-fencing” for their MiFID accounts as described above. Firms that “ring fence” will also face the challenge of allocating research costs to one group of clients but not the other if the research helps the firm serve all of its clients. For more
details on this, check out the KL Gates MiFID II Toolkit for Global Investment Managers, available here.

- **Corporate access.** Under US regulations, corporate access is considered a legitimate research expense meeting the criteria for research services under the Section 28(e) safe harbor. ESMA takes the opposite view, noting that with corporate access, “there is no implicit or explicit recommendation or suggestions of an investment strategy or opinion” regarding the current or future value of securities. ESMA expects investment firms subject to MiFID II “to carefully assess whether corporate access services such as field trips, conferences and individual meetings involving a corporate issuer and facilitated by an investment firm are material benefits, or alternatively could qualify as an acceptable minor non-monetary benefit”. Conversely, ESMA indicates that ‘road shows’ to support a capital raising event that are freely and publicly open to analysts from investment firms and other investors could qualify as acceptable minor non-monetary benefits.

2. **Transaction Reporting**

MiFID II requires managers to report on an expansive list of financial instruments, including depository receipts and exchange-traded funds; certificates and similar instruments trading on a venue; bonds and structured products trading on a regulated market or with a published prospectus; emission allowances; and derivatives. The reporting obligation generally falls to brokers, since investment managers are subject to a “transmission exemption.” However, in order to rely on this exemption, the investment manager must provide certain details of the trade to the executing broker and have an explicit reporting agreement where the broker is obligated to report transactions on the manager’s behalf.

**Potential Impacts to US Advisers**

US investment advisers without an EU branch are generally not subject to the transaction reporting obligation. However, US investment advisers trading on EU venues will probably need to provide additional information to that venue, including certain data about its clients. Managers should obtain Legal Entity Identifiers (“LEI”) and other relevant information from all affected accounts to meet these obligations. (See sidebar on LEIs) Funds and managed accounts will require an LEI.

Advisers may want to revise their investment management agreements to get client approval to provide the necessary data points to the broker needed for reporting.

US investment advisers trading on EU venues are also required to provide more specific information about individuals involved in the trade, including a passport number or national client identifier for:

- the individual making the decision to buy or sell a reportable financial instrument (e.g., the portfolio manager)
- the trader responsible for executing a transaction or unique ID for automated processes, such as an automated routing rule within an OMS, and
- The client or individual acting on their behalf.
Additionally, US subadvisers to EU managers will need to provide the required information so that the EU manager can meet its MiFID II transaction reporting obligations. Finally, a US adviser that is a branch of an investment firm subject to MiFID II must provide transaction reporting to the EU regulator that authorized the branch.

3. Best Execution

Managers subject to MiFID II are required to take “all sufficient steps” to obtain best execution for client transactions. Additionally, firms will need to provide annual disclosure of top execution venues for each subclass of financial instrument traded, along with additional execution information related to pricing, commissions, execution costs and research-related expenses. Finally, trading venues will be required to publish additional data related to execution quality free-of-charge.

Potential Impacts to US Advisers

There may be little impact on US subadvisors to EU managers, since it is not clear whether MiFID II rules on best execution apply at the subadviser level. Sub-advisers to EU managers should talk to those managers to see whether they intend to impose any additional best execution requirements.

4. Telephone recording & recordkeeping

MiFID II contains new recordkeeping requirements, including that firms must record telephone conversations and electronic communications relating to client orders and to keep such records for five years.

Potential Impacts to US Advisers:

Although the requirement is not directly applicable to non EU managers, US subadvisors to EU managers may once again be indirectly vulnerable to this new requirement in order to ensure their EU manager’s compliance.

5. Investor Protection

New suitability requirements will apply to EU firms under MiFID II, including classification of institutional and retail investors and establishing different suitability requirements for each. With respect to retail investors, expect enhanced suitability documentation requirements. For EU fund managers, there are new requirements for categorical disclosure of fund expenses to promote greater transparency in fees. Platform sponsors and distributors will also bear new requirements, the latter will need to consider a fund’s target market alongside their overarching suitability obligations.

While most of these requirements will apply just to fund managers – as the producers of funds – they also have significant implications for distributors, including fund platforms, discretionary wealth managers, multi-asset funds, asset allocators, fund buyers, investment advisers and financial advisers. Check out FT Adviser’s Guide to MiFID II Implementation for more on this topic.

Potential Impacts to US Advisers
Even if requirements are not applicable at this time, US advisers active in Europe should consider monitoring developments on these topics carefully in the coming months. US advisers using European distributors to offer products and services to EU investors may be indirectly impacted by MiFID II requirements. MiFID II requires EU distributors to have product governance procedures in place to ensure that products are being marketed to the appropriate audience and fit the needs of the client. US adviser may be asked to provide product information to EU distributors to help them meet their obligations.

References

1. Paul Weiss: MiFID II Unbundling Rules: Implications for Asset Managers and Broker-Dealers in the United States
2. KL Gates MiFID II Toolkit for Global Investment Managers
3. International Capital Market Association’s Briefing Note on ESMA Q&A on MiFID II Inducements Rule (Research)
4. FT Adviser’s Guide to MiFID II Implementation
5. Thomson Reuters MiFID II Handbook
6. GFMA Legal Entity Identifier Webinar – MiFID II and Other Important LEI Matters 10/31/17.

Closing

As we forge ahead into MiFID II’s effectiveness in early 2018, US managers dealing with EU entities are advised to evaluate the potential direct and indirect applicability of MiFID II requirements to their business. We are here to help your firm navigate this regulatory challenge and assist in monitoring MiFID II’s post-effective impact across the industry. Do not hesitate to contact us.
**Side Bar on LEIs:**

**What is an LEI?** The LEI (Legal Entity Identifier) is a free-to-use standard entity identifier that uniquely identifies parties to global financial transactions across jurisdictions. LEIs were designed to help regulators measure and monitor systemic risk by identifying parties to financial transactions quickly and consistently, and obtaining an accurate view of their global exposures.

**Why is one needed for MiFID II reporting?** Beginning January 3, 2018, firms subject to MiFID II transaction reporting requirements will need to ensure that any client eligible for an LEI has one before a trade may be executed on its behalf.

**How do I obtain an LEI?** LEIs are issued by organizations called Local Operating Units (“LOUs”). In the US for example, LEI’s can be obtained from Bloomberg (see Bloomberg LEI) and the Global Market Entity Identifier (“GMEI”) Utility Portal (available here), which is operated by DTCC.

**What information is required to apply to an LEI?** Information required includes the entity’s legal name, address, headquarters address, registration authority/number, entity type and legal form, in addition to other identifying data. Applicants are also required to provide parent relationship information, such as parent LEI and other parent reference data.

**Is obtaining an LEI a one-time process?** No, LEI’s must be renewed annually.

**How quickly can I obtain an LEI?** According to the GEMI utility, it can take between 48 to 72 hours. Same day LEI service is also available for an additional fee.

For more information, check out the following websites:

- https://www.gmeiutility.org/mifid2/