MiFID II and MiFIR

Q&A with Schulte Roth & Zabel's London office

HAMLIN LOVELL, CONTRIBUTING EDITOR, IN CONVERSATION WITH ANNA MALEVA-OTTO, PARTNER, SCHULTE ROTH & ZABEL

Hamlin Lovell: Regulators are under no illusion about the magnitude of the challenges ahead. MiFID II has already been delayed, and ESMA is well aware that firms may need to spend substantial amounts of money on new technology and additional staff. Why is MiFID II so onerous for asset managers?

Anna Maleva-Otto: MiFID regulates investment firms and market infrastructure. As a result, many of MiFID II provisions are designed with sell-side firms in mind. Asset managers that are authorised as MiFID firms will be subject to MiFID II in the same way as sell-side firms, although they may not necessarily have the infrastructure and resources to comply with, for instance, transaction and trade reporting requirements. Managers authorised under AIFMD are technically out of scope, except for certain provisions that apply to their MiFID (e.g. managed account) services (if they provide such services). However, the FCA has decided to gold-plate MiFID II and apply some MiFID II provisions (such as telephone taping, best execution transparency and inducements rules) to AIFMs.

HL: MiFID impacts multiple areas, including technology hardware and software, call recording and time-stamping trades, human resources, client reporting, and the investment process. A wide variety of experts are advising hedge funds and others in the ecosystem. Where do the lawyers fit in and which other service providers are helping to ready clients for MiFID?

AMO: Lawyers can add value in interpreting the rules – such as what rules will apply to which activities, and what is in scope of the new rules; for instance: what is an inducement, what qualifies as research, and what structures will work under the new rules. There are also questions about what firms and activities are exempt from MiFID II. One example is whether proprietary trading vehicles will need to be licensed as MiFID firms, especially in the context of systematic trading. On the operational side, prime brokers are a good source of information for lists of providers of operational solutions, such as telephone recording software and transaction reporting.

Commission and research

HL: Will it become completely impossible to use commission sharing agreements (CSAs) to remunerate independent research providers? Or are there safe harbours carved out such as *de minimis* exemptions or allowable categories of research?

AMO: The Research Payment Account (RPA) model can be described as a halfway house solution, but cannot technically be called a CSA because MiFID II mandates full unbundling of dealing commission from other services. From an operational stand-point, the RPA model is not dissimilar to how CSAs work now. It involves amounts being swept from the fund's account to pay for commission and for research. The key difference is that there must be a separate charge for research, based on annual budgets pre-agreed with fund boards, but whoever administers the RPA can allocate these research payments to various research providers.

HL: How much regulatory guidance exists on the definition of "research" and inducements?

AMO: MiFID II contains definitions of "research" and "minor non-monetary benefit" and, for the most part, it [makes] clear what research is. The UK already has the concept of "substantive research", and the MiFID II definition is not dissimilar. What is trickier is other services that managers receive, such as consulting, capital introduction, varying levels of corporate access, conferences, talent search, and bespoke execution algorithms, to name a few. It remains to be determined which of these additional services are in fact inducements (which cannot be received), and which of them are "minor non-monetary benefits" (which are allowed). ESMA is due to publish another Q&A in March, which will hopefully provide greater clarity on these concepts. Two particularly contentious areas at the moment are macroeconomic (as opposed to company-specific) research, and corporate access. The FCA is toeing its hard line that corporate access is an inducement and cannot be bundled with research. The French AMF takes the somewhat more pragmatic view that some types of corporate access research are "minor non-monetary benefits".

HL: Will research become a new line item in audit reports and a component of ongoing charge ratios?

AMO: Yes, research will be a separate charge disclosed to investors.

HL: Many hedge funds, and particularly systematic and quantitative ones, take pride in all of their research being in-house. Do they also need to apportion management fees between research, and non-research, activities – or is it only external research costs that need to be identified?

AMO: The RPA model is only intended for third-party research. Research budgets may not be used to fund internal research. That being said, there is no requirement to apportion the management fees between research and other investment management activities.

HL: How will external research costs be shared between investment vehicles, such as funds or managed accounts, and fund managers?

AMO: Research can be charged either to the manager or to the fund. But very few will pick it up as a manager expense. Managers are required to ensure that the costs of research are allocated between their managed accounts and funds fairly.

HL: In equity markets commissions are transparent, but MiFID II also covers other markets such as OTC markets, where the commission is in effect embedded in the bid/

offer spread. This commission pays for both execution and research. Do you expect spreads will compress to accommodate the need to charge for research?

AMO: You would think so, but from what we are hearing, the spreads may not in fact be narrowed following unbundling. ESMA is expected to comment on the application of the MiFID II inducements regime to fixed-income research in its Q&A to be published in March.

Best execution

HL: Defining best execution always seems subjective, as multiple weightings could be applied to myriad factors and in turn measured against a variety of benchmarks such as VWAP, TWAP, implementation shortfall, etc. Does MiFID make the process any more or less subjective? Will a consolidated tape make it easier to gauge best execution?

AMO: A consolidated tape bringing more transparency is in theory a good thing, but somebody needs to rise to the challenge of being the commercial provider. MiFID II requires a lot of information on execution quality to be published by investment firms and trading venues but it remains to be seen how comparable and helpful it will be in post-trade analysis.

HL: Is public disclosure of the top five trading counterparties likely to result in commercially sensitive or confidential information around OTC counterparty agreements becoming public?

AMO: The FCA is planning to extend the publication requirements in respect of top five execution venues/counterparties to AIFMs (and not just MiFID managers). Many managers do worry about it, as their relationships with brokers may be based on the managers' assurances that most of their order flow goes to that counterparty. If they have to publish a detailed breakdown on their websites (as required under MiFID II), the counterparties can see how much business is going to each of them. You would think, in the context of fund managers, that the relevant stakeholders that need to know this information are investors, not the public at large.

Recording communications

HL: Over what range of media do communications need to be recorded? Clearly, fixed, mobile and internet telephony must be included? What about messaging systems (which some hedge funds preclude certain staff from using), such as social media chat, e.g. Facebook, Twitter, Messenger, WeChat, Snapchat, etc.?

AMO: All relevant electronic communications and telephone calls will need to be recorded, regardless of what medium is used. If the firm is not able to record, it will need to prohibit its staff from using the relevant method of communication. There is also an affirmative duty to monitor communications. Larger managers are better resourced and already have procedures in place to monitor calls. The rules are subject to proportionality but still mean that the average manager needs to allocate resource to such monitoring on a regular basis, whether it is done as part of post-trade surveillance or through reviewing samples of calls.

HL: What special challenges are you hearing from clients?

AMO: Multilingual staff create an extra problem, as it is hard to monitor calls if compliance are not proficient with the language and might not understand nuances. Solutions exist, such as software that recognises and flags certain words or phrases, but someone will actually need to take time to review the flagged messages and calls. There is also a question of how effective these automated solutions are and how much customisation is required to make them useful.

HL: Are only communications over electronic media covered?

AMO: All surrounding communications could be relevant so there is much talk about this. You certainly need to record electronic conversations relating to specific trades. Then if there is a face-to-face meeting between analysts and PMs to discuss the relevant investment thesis, you may also need to record that as part of transaction record-keeping obligations (which are separate from telephone taping). We do not expect microphones to be installed in coffee machines, however!

Transaction reporting

HL: Will some additional reporting fields lead to disclosure of equity ownership stakes before the currently prevailing thresholds are reached, e.g. 3% in the UK? Will this imply wider disclosure of short positions?

AMO: No and no. MiFID transaction reporting is done to the regulator and will not be made public.

Position limits

HL: Larger fund managers seem to periodically breach position limits for commodity derivatives, on a number of US exchanges. Are limits under MiFID II likely to be higher or lower than for other exchanges, and can the limits be circumvented via OTC swaps or by spreading positions across multiple exchanges?

AMO: MiFID II provides a framework for commodity derivatives position limits and position management powers. ESMA has produced technical standards for how position limits should be determined but it is for the national regulators to set limits based on ESMA's methodology. We do not yet have much information on what the limits will be, as no EU regulator has published a list of position limits.

Scope of MiFID II and exemptions from MiFID

HL: Does MiFID also widen the scope of the Market Abuse Regulation (MAR)?

AMO: Yes, it introduces a new concept of organised trading facilities (OTFs). Financial instruments traded on OTFs are in scope of MAR.

HL: Do the labels regulated market (RM), multilateral trading facility (MTF), organised trading facility (OTF) and systematic internaliser (SI) cover all possible venues and financial instruments?

AMO: The MiFID II trading obligation applies to shares and derivatives, which must be traded on a regulated trading venue or (in the case of shares) with systematic internalisers. Derivatives are subject to the trading obligation, but it is likely to take effect on a staggered basis.

HL: How about instruments with lookalike markets outside the EU?

AMO: There is also the concept of "equivalent" markets located in third countries (i.e. non-EU countries). This is important for dually-listed shares because of the trading obligation. Apparently, the Commission intends to have equivalence assessments in place by 2018, but the experience of equivalence assessments under other EU legislation (such AIFMD) has shown that this can be a protracted and highly political process.

HL: Will any types of hedge fund managers within the EU remain outside the scope of MiFID?

AMO: MiFID is meant to apply to MiFID investment firms. Most hedge fund managers in London are authorised as AIFMs and not MiFID firms. Theoretically, they might have been out of scope, but as the FCA gold-plated and extended certain provisions of MiFID II to AIFMs, there is no way to avoid it altogether. AIFMs will escape some of the more onerous operational aspects such as transaction and post-trade reporting, however.

MiFID's reach inside and outside the EU

HL: Like EMIR, MiFID has some extra-territorial reach. What determines whether those outside the EU do, or do not, need to comply?

AMO: Non-EU managers may be impacted if they get direct access to EU trading venues, as it brings them into the scope of the client due diligence obligations applicable to EU brokers that provide "direct electronic access".

Non-EU brokers providing research will need to ensure that their model for charging for research and execution sits within what their EU clients are required to do.

HL: Managed accounts under MiFID can be an alternative to AIFMD compliance, for non-EU managers seeking to raise capital in the EU. Will this change?

AMO: US managers providing managed account services to EU clients will find it harder to offer the services in some EU jurisdictions after MiFID II. The UK will keep its "overseas persons" exemption for managed account services but it will become harder in other EU countries because MiFID II regulates third-country services.

HL: Post-Brexit, could the UK have a dual regime with some participants MiFID compliant and others not?

AMO: This is possible, but remember that many parts of MiFID II, including unbundling of research, resulted from the FCA's agenda leading the drafting of the EU regulation. I don't think realistically the UK can be selective in retaining constructive parts of EU rules and removing the unhelpful parts. A wholesale review of regulation would likely be required and could take many years if it happened. **THFJ**

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