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MiFID II/R - FAQ
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- **Extra-territorial Impacts for Non-EU/EEA Secondary Bond Market Participants**
- **Intra-territorial Impacts for EU/EEA Secondary Bond Market Participants**

MiFID II/R background

The Markets in Financial Instruments Directive (MiFID) is a European Union law that provides harmonized regulation for investment services across the 31 Member States of the European Economic Area. The Directive's main objectives are to increase competition and consumer protection in investment services. MiFID became effective in November 2007, and primarily related to equities markets. MiFID II (along with the Markets in Financial Instruments Regulation – MiFIR),[1] replaces MiFID, and broadens its scope to non-equities, including bonds. Among the key aspects of MiFID II/R are provisions covering: transaction reporting, market structure, pre-trade transparency requirements, post-trade reporting, best execution reporting, and conduct of business rules. MiFID II/R entered into force in July 2014 and **will apply in EU Member States from 3 January 2018**.[2]

The European Securities and Markets Authority (ESMA) was empowered to develop the numerous regulatory and implementing technical standards for MiFID II/R to support implementation, the majority of which having been adopted by the European Commission entered into law in early 2017.[3] ESMA is further publishing guidance and recommendations, in the form of "Q&As" (the "Level 3") on various aspects of MiFID II/R over the course of 2017 to support implementation.[4]

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[1] MiFID II is a Directive (that replaces MiFID), which is adapted and implemented at the Member State level. MiFIR is the Regulation that enforces MiFID II and applies at the EU level as it is. Elements of MiFID II may therefore vary slightly across different Member States (but not MiFIR).

[2] Originally MiFID II/R had been scheduled to be applied in January 2017, but was delayed for twelve months in light of the implementation challenges facing both industry and regulatory authorities.

[3] With respect to the MiFID II, Member States are expected to transpose the Directive into national law before 2018.

[4] These can be found on the ESMA website: https://www.esma.europa.eu/policy-rules/mifid-ii-and-mifir

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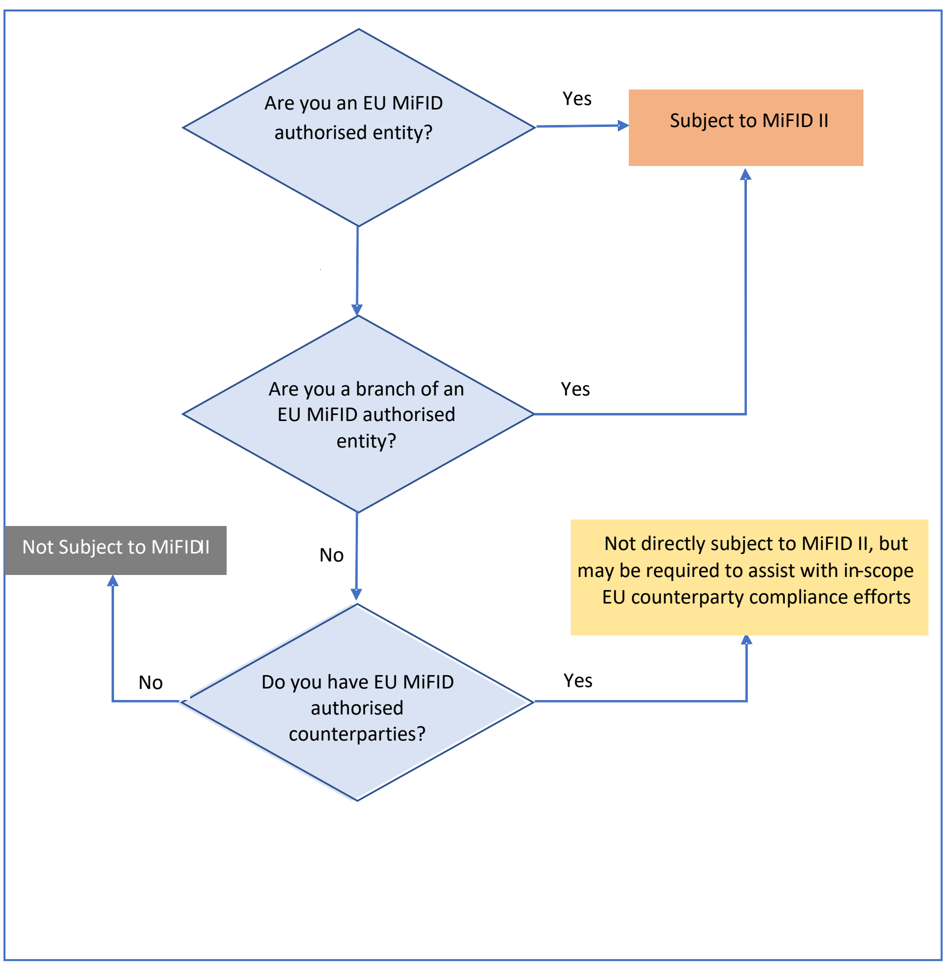
Non – EU/EEA Secondary Markets Participants (extra-territorial)

Q1. To which entities does MiFID II/R apply, and to what extent is it intentionally extra-territorial?

In the same way that MiFID is not intended to be deliberately extra-territorial in scope, MiFID II/R is only intended to apply to EU investment firms and activities undertaken in the EU. In other words, it does not matter where a financial instrument is listed or traded, or where the client is based; if the EU MiFID authorised firm is based in the EU, then it is in direct scope of MiFID II/R, and if it is based outside of the EU (including subsidiaries of EU firms), then it is not in direct scope. A notable and explicit exception is **non-EU branches of EU MiFID authorised entities**, which *are* in scope of MiFID II/R reporting requirements, wherever they are based.

However, while non-EU investment firms dealing with EU counterparties are not directly in scope of MiFID II/R, they may be indirectly impacted in a number of different areas that they will need to be aware of. With respect to secondary bond markets, important considerations when dealing with EU MiFID authorised counterparties will include providing information to support transaction reporting, the distribution of research, and product governance.



Q2. What are the obligations of non-EU firms for transaction reporting?

Branches of EU MiFID authorised investment firms are explicitly in scope of the transaction reporting requirements [RTS 22], even where the transaction is executed outside of the EU and regardless of where the instrument is listed. The reporting requirement will be to the Home State regulator of the EU parent entity.

For non-EU investment firms (including subsidiaries) that transact with an EU MiFID authorised counterparty, or on an EU venue, the transaction reporting obligation will be the responsibility of the EU counterparty or trading venue. However, the reporting venue or EU entity will be required to provide a significant amount of data (there are 65 separate reporting fields), including details relating to the counterparty. These will include the identification of the counterparty (in the form of its LEI code – see Q4), the name and date of birth of the executing trader, as well as the name and date of birth of the investment decision maker.

Q3. Are EU firms transacting on non-EU venues responsible for post-trade transparency?

MiFIR Articles 20 and 21 [RTS 2] require EU MiFID authorised firms to make public information on transactions through approved publication agreements (APAs), including transactions traded on a trading venue. In the case of trades executed on EU trading venues, the trading venue will provide this post-trade transparency. However, it is unclear as to whether EU firms are responsible for post-trade transparency in the case of executing trades on third-country (non-EU) trading venues.

ESMA has concluded that EU investment firms should not systematically republish information in the EU with respect to trades concluded on third-country trading venues that are subject to transparency provisions similar to those applicable to EU trading venues. Accordingly, ESMA is expected to publish a list of third-country trading venues that it considers meeting the criteria necessary for EU firms not to re-report trading information in the EU. It should be noted that third-country trading venues cannot apply directly to be on the ESMA list; rather EU firms are expected to nominate third-country trading venues for ESMA's assessment.

Q4. Are non-EU firms required to have LEIs?

While the transaction reporting requirements [RTS 22] fall on EU MiFID authorised entities and trading venues (see Q3), EU firms (and their non-EU branches) dealing with non-EU entities will be required to provide the Legal Entity Identifier (LEI)[5] of their counterparties, including non-EU counterparties.

[5] The Legal Entity Identifier is a unique 20-character, alpha-numeric code, that identifies a legal entity that engages in a financial transaction. LEIs are issued by Local Operating Units (LOUs) of the Global LEI system. LEIs are required for **each** separate legal entity.

Therefore, **non-EU firms that do not have an LEI by 3 January 2018 may find that EU counterparties are unable to transact with them**, or that they are unable to transact on EU trading venues.

Similarly, **issuers** of securities that are traded on EU venues (Regulated Markets, Multilateral Trading Facilities, Organised Trading Facilities, and Systematic Internalisers) will also need LEIs, as trading venues are required to provide these as part of the instrument reference data for all instruments admitted to trading [Article 27].

Q5. Are non-EU firms subject to pre-trade transparency obligations?

MiFIR Article 8 [RTS 2] requires a pre-trade transparency obligation for bonds that are classified as liquid, and which fall below specified size thresholds with respect to Large In Scale (LIS) and Size Specific To the Instrument (SSTI). This will apply to quotes on venues, and, in the case of OTC quotes, to Systematic Internalisers (SIs) for the relevant instrument.

With respect to quotes provided on EU venues, the trading venue will be responsible for complying with the pre-trade transparency obligations. In terms of OTC transactions, since non-EU entities cannot be SIs, non-EU entities are not in scope of any pre-trade transparency obligations.

Q6. Are non-EU firms subject to post-trade transparency obligations?

MiFIR Article 21 [RTS 2] requires a post-trade transparency obligation for bonds for EU MiFID authorised firms and EU trading venues. The obligation to make public trade details will fall on the trading venue, for on-venue trades, including SIs. For OTC trades (not with an SI), the obligation will fall to the selling counterparty. Where bonds are classified as liquid, and the transaction sizes fall under the LIS and SSTI thresholds, trade data will be reported close to real time (under 15 minutes). For bonds that are not classified as liquid, or are above the LIS and SSTI size thresholds, the publication of post trade information will be subject to a deferral of between 2 days and 4 weeks, as determined by the relevant EU Home Country regulator. The trade data is made public through an Approved Publication Arrangement (APA).

Since the post-trade transparency requirements fall on EU trading venues (including SIs) or EU investment firms, non-EU entities are not required to make public post-trade information.

Q7. If non-EU firms are not subject to pre- or post-trade reporting requirements, could they still be affected?

While the obligation to provide pre-trade transparency will fall on the EU trading venue (including SIs), a non-EU firm will need to be aware that any quote they receive from an SI (including non-EU branches) will be subject to pre-trade transparency requirements, and so will be publicly disseminated.

Similarly, while the post-trade transparency reporting obligation will not fall on a non-EU entity, in the event that the trade is executed on an EU venue, or is booked with an EU entity (or its non-EU branch), then the trade will be subject to the post-trade reporting requirements, and will be publicly reported.

The non-EU entity may therefore need to take into consideration which EU Home Country reporting deferral regime is applicable in the case of large trades, or trades in illiquid securities, since this could impact pricing and liquidity.

Q8. Can non-EU firms become Systematic Internalisers?

The Systematic Internaliser (SI) regime is intended to extend the pre- and post-trade transparency obligations into the OTC space for non-equities (including bonds). EU MiFID authorised investment firms will be classified as SIs for a financial instrument where they deal on their own account, OTC, on an organised, frequent and systematic, and substantial basis in that instrument ("frequent and systematic" and "substantial" are defined quantifiable thresholds). Firms can also "opt in" to becoming designated SIs for particular financial instruments.

The broad understanding is that only EU domiciled entities can be designated SIs, so non-EU entities can neither qualify nor elect to be SIs. This includes the EU branches of non-EU entities.

However, the trading activity of non-EU branches of EU entities will be in scope of the "frequent and systematic" and "substantial" tests for the SI designation of the EU entity.

Q9. Are non-EU firms subject to best execution requirements?

Article 27 [RTS 27 and 28] requires EU MiFID authorised investment firms to take "all sufficient steps" to ensure best execution for their clients, and are required to disclose their best execution policy. Furthermore, EU execution venues (which include trading venues, SIs, market makers, and other liquidity providers) are required to make publicly available, on a regular basis, at no cost, extensive and highly detailed information to illustrate quality of execution. Investment firms are also required to publish annually information on the quality of education obtained for client orders on their top five execution venues.

The understanding is that the best execution requirements (including the related reporting obligations) do not apply to non-EU firms, nor to the non-EU branches of EU firms, even when trading with an EU entity, and that the local best execution requirements of the relevant regulatory authority will apply.

However, it may be the case that EU firms dealing with non-EU entities request their best execution policies, and expect that these are in line with the policies generally adopted by EU investment firms.

Furthermore, non-EU entities may be asked for data points on transactions from their EU counterparts, because EU firms need such data to fulfil their top 5 execution venue reporting obligations under Article 27(6) (further specified in RTS 28).

Q10. What are the implications of research unbundling for non-EU firms?

MiFID II introduces new rules related to “inducements” and prohibits EU MiFID authorised firms[6] from receiving certain inducements, including free research. Therefore, EU firms are required to pay for research received, which, in the case of fixed income research, can be either from their own P&L or through the establishment of a Research Payment Account (RPA) which is funded by a direct charge to clients.

While this does not directly apply to non-EU firms, this has implications with respect to the provision and receipt of research, particularly for jurisdictions with different rules to the EU. It may be difficult for a non-EU firm to provide research to an EU firm since the EU firm will be obliged to pay for it. Non-EU research providers may therefore need to charge their EU counterparties for research that they currently provide for free. Furthermore, global EU MiFID authorised firms headquartered in the EU receiving research may decide to start paying for research outside Europe as well. These developments could present a particular problem for US entities, for example, since it is unlawful in the US for firms to charge for research without being registered as an investment advisor.[7]

In future, non-EU firms who have received research from EU firms in the past for free, may find that EU firms who have started charging for research for their EU clients, may start charging all their clients for research.

EU/EEA Secondary Markets Participants (intra-territorial)

Q11. Which EU National Competent Authority has jurisdiction over the trading activities and practices of a branch entity of an EU/EEA MiFID authorised firm?

The Competent Authority of the Member State where the branch is located assumes responsibility for ensuring that the services provided within its territory comply with MiFID II/R provisions: eg The deferral regime of the host Member State for that branch will apply (Branch of UK firm in Sweden: Swedish FSA MiFID II/R interpreted rules apply, *not* UK FCA interpreted rules).

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[6] Note that some EU jurisdictions, such as the UK, are extending application from EU MiFID authorised firms to most UCITS and AIF funds registered in the UK, but this is not true for all jurisdictions.
[7] At the time of writing, the SEC is understood to be looking at the possibility of creating a “carve out” to avoid this inherent conflict with MiFID II requirements.