The Investment Lawyer
Covering Legal and Regulatory Issues of Asset Management
VOL. 23, NO. 5 • MAY 2016

MiFID II: Key Considerations for US Asset Managers

By Christopher D. Christian and Dick Frase

In the wake of the financial crisis of 2008, the European Commission published a proposal to recast the European Union's Markets in Financial Instruments Directive (MiFID), which has been in force since November 1, 2007.[1] The proposal, which consists of two linked pieces of legislation – a revised MiFID[2] and the Markets in Financial Instruments Regulation (MiFIR)[3], is collectively referred to as MiFID II. MiFID II is one of the most ambitious and contentious legislative reform proposals to come out of Europe in decades.[4] It is a wide ranging piece of legislation that, depending on the business model of a US asset manager, could affect a wide range of functions, including trading, product development, client services, human resources, and IT infrastructure. This article examines the key regulatory considerations for US asset managers resulting from MiFID II based on the most common ways that US asset managers interact with Europe, including: (i) operating a portfolio management subsidiary in Europe; (ii) operating a marketing subsidiary in Europe to offer products and services to European investors and clients; (iii) managing assets on a cross-border basis from the United States directly for European clients; (iv) providing sub-advisory services from the United States to a MiFID investment manager or European fund; and (v) simply trading in European fixed income and equity markets.

I. Why Is MiFID Being Reformed?

MiFID came into force on November 1, 2007 as part of the European Single Market Programme to remove barriers to cross-border financial services within Europe, foster a competitive and level playing field between trading venues for financial instruments in the European Economic Area (EEA) and to improve investor protection across the EEA.[5] In the aftermath of the financial crisis of 2008, the European Commission launched a public consultation to revise MiFID.[6] It was perceived by the European Commission that the financial crisis exposed weaknesses in the functioning and transparency of financial markets which "can contribute to harmful socioeconomic effects."[7] The European Commission deemed it essential to revise MiFID to establish a "safer, sounder, more transparent and more responsible financial system working for the economy and society as a whole."[8] In addition, the European Commission noted that MiFID needed to be revised to: (i) regulate opaque parts of the financial system to improve the organization, transparency and oversight of certain market segments, including with respect to those instruments traded over-the-counter (OTC); (ii) support the original purpose of efficient and integrated financial markets and to take into account rapid changes in technological advancements; (iii) further strengthen investor protection throughout the EU; and (iv) minimize, where appropriate, discretion of national regulators in applying European law to the financial services sector.[9]

From this regulatory agenda, MiFID II was proposed in October 2011 as a "single rule book" for financial services in Europe.[10] Political agreement on the European Commission's proposals in a recast MiFID and a new MiFIR was reached on January 14 2014, after months of negotiations among EU legislatures, and finally adopted on July 2 2014.[11] Lengthy "Level 2" provisions, in the form of technical standards and delegated acts, have been under consultation since the adoption of MiFID II in 2014 and required to be transposed into national law by European Union Member States by July 2, 2016 with a full implementation date of January 3, 2017.[12] As of the date of this article, the implementation of MiFID II has been postponed until January 3, 2018.[13]

There are five key areas of reform in MiFID II: (i) internal organization and governance[14]; (ii) market structure[15]; (iii) market transparency[16]; (iv) investor protection[17]; and (v) reporting and market oversight,[18] as discussed more fully below in the context of their application to US asset managers.

II. Application of MiFID II to US Asset Managers

The impact of MiFID II on a US asset manager will be largely dependent on the business model of the US asset manager and the level of contact it has with the European Union. Generally, the fewer connections that a US asset manager has with Europe the less of an impact MiFID II will have on its overall business. As a result, US asset managers will wish to review their current business model and the connections their model has to Europe to understand the implications of MiFID and to, perhaps, avoid some of the more costly and burdensome implications of MiFID to the extent possible.

The following discussion examines the key regulatory considerations and their impact for US asset managers resulting from MiFID II based on the most common ways that US assets managers interact with Europe. We examine these considerations in order of impact that MiFID II may have on the activities that a US asset manager may undertake vis-à-vis Europe.

A. US Asset Manager Trading European Equities, Fixed Income, or Derivative Instruments

Generally, MiFID II established requirements in relation to: (i) the authorization of and operating conditions for investment firms; (ii) provision of investment services or activities by third-country firms through establishment of a branch; (iii) authorization and operation of EU regulated markets; (iv) authorization and operation of data reporting service providers; and (v) supervision, cooperation, and enforcement by EU competent authorities.[19] MiFID II, however, only applies to asset managers that have a physical presence in Europe that are operating under a MiFID permission and regulated by a European regulator.[20] As a result, US asset managers are not directly regulated by MiFID.

While US asset managers are not directly in scope of the MiFID II authorization and operating conditions for firms, MiFID II introduces significant structural changes to EU financial markets that will have an impact on all asset managers, including those domiciled in the United States and registered with the US Securities and Exchange Commission. These market structure reforms are designed to improve transparency but may also increase the cost and complexity of trading and may reduce liquidity in the fixed income markets. The main provisions of MiFID II affecting market structure apply directly to the way sell side firms do business in the EU and indirectly to managers and other buy side firms who deal with or though EU sell side firms. The following is an overview of the market structure and transparency changes proposed by MiFID that could indirectly impact a US asset manager.

1. Changes to Market Structure

One of the overarching goals of MiFID I was to make EU markets more integrated, competitive and efficient.[21] Among other things, MiFID I introduced more EU competition among traditional exchanges/regulated markets (RMs) by introducing alternative trading venues or multilateral trading facilities (MTFs). While the introduction of MTFs brought increased competition, it also resulted in market fragmentation. A significant amount of fixed income securities and derivative instruments were also traded outside of organized venues on an OTC basis which provided, in the view of regulators, non-transparent risk to the financial system.[22] To address these perceived issues, all organized trading will now take place on regulated trading venues or by systematic internalisers (SIs).[23] In addition, a new category of venue, known as an organized trading facility (OTF) will be introduced for organized multilateral discretionary systems for non-equity order matching and agency crossing.[24] Derivatives contracts that are eligible for clearing under the European Market Infrastructure Regulation (EMIR)[25] by the European Securities Market Authority (ESMA) will be required to be traded on an RM, MTF, or OTF.[26]

Investment firms that operate internal matching systems to execute client orders in shares and other equity instruments may need to obtain extended authorization to carry on such activities and be subject to more detailed regulations. New operating requirements will be applied to trading venues, moving the regulation of MTFs and OTFs closer to the RM model.[27]

2. Impact on Equity and Fixed Income Financial Markets

All trading in shares must be carried out on RMs, MTFs, or SIs, or equivalent third country venues,[28] subject to certain exceptions. OTC trading of equities is likely to be substantially limited, with sell side broker-crossing networks effectively shut out of the market. Asset managers will need to check the impact of the new rules on their internal crossing systems.

Currently, pre-trade transparency requires the publication of real time orders and quotes (subject to certain exceptions). Post-trade transparency requires the immediate publication of the price and volume of executed transactions (with some deferred publication allowed). Currently under MiFID I these rules only apply to equities traded on an RM.

Under MiFID II, all trading venues (RMs, MTFs, and OTFs) must publish current bid and offer prices and depth of trading interest, on a continuous basis for equities and equity-like instruments such as depositary receipts, exchange-traded funds (ETFs), and certificates traded on RMs.[29] Pre-trade transparency requirements will be required for different types of trading systems, including book order, quote-driven and auction trading.[30] MiFIR will introduce a new pre- and post-trade transparency regime for certain non-equity instruments, including bonds, structured finance products traded on a RM or for which a prospectus is published, emissions allowances, and derivatives traded on an RM, MTF, or OTF.[31] In addition, SIs must make public firm quotes on a regular and continuous basis.[32]

The types of trade for which national regulators will be able to grant pre-trade transparency waivers is reduced to restrict dark pool trading.[33] A European consolidated tape for post-trade data will be introduced from 2019 giving the price, volume, and time of trades as close to real time as possible.[34]

3. Commodity Derivatives

National regulators will be able to set position limits for commodity derivatives traded on RMs, MTFs, and OTFs as well as economically equivalent OTC derivatives.[35] The limits will apply to investment funds as well as to clients of portfolio managers and are expected to be applied at the level of the fund rather than the manager. There will also be new reporting requirements for commodity derivatives. Trading venues will publish weekly reports on aggregate positions and firms trading OTC must make daily reports of their positions to the regulator.[36]

4. Practical Considerations

Based on the provisions noted above, the market may be impacted significantly by resulting in lower liquidity in the European fixed income market and additional costs associated with trading European equities. Position limits in commodities may have a direct impact on portfolio construction and product development for European funds. For US asset managers that manage European funds or US funds with EU counterparties, the position limits for derivatives also could have an impact on portfolio management for commodity related strategies.

B. US Asset Manager Providing Sub-Advisory Services

As a technical matter, US asset managers, which otherwise do not have a physical presence in the EU and are not regulated under a MiFID permission, are not within the scope of MiFID. Nevertheless, US asset managers may be indirectly impacted by MiFID II requirements where such US asset managers provide sub-advisory services to MiFID firms.

1. Indirect Impact – Sub-Advisory Contracts

It is expected that MiFID firms will attempt to delegate compliance with certain obligations of MiFID II via contract with US asset managers. As a practical matter, US asset managers providing sub-advisory services to MiFID firms will be required to comply with certain of the transparency and reporting obligations of MiFID firms since these requirements will be very difficult for a MiFID firm to comply with without the assistance of its US asset manager delegate. US asset managers will, however, be reluctant to adhere to other MiFID II conduct of business or internal organizational requirements (for example, telephone recording, best execution, dealing commission usage rules, *etc.*) discussed more fully herein.[37] These conduct of business rules could, in some cases, be directing contradictory to practices in the US and would have a direct impact on a US asset manager's business, including the way in which an asset manager trades for its client accounts.

With respect to pooled products, a US asset manager providing sub-advisory services to European Undertakings for Collective Investment in Transferable Securities (UCITS)[38] will not be subject to pass-through MiFID II requirements, for now. It remains to be seen whether national regulators at the urging of ESMA will introduce requirements to amend the UCITS Directive (or local implementing legislation) to implement certain MiFID II requirements at the product level. It should be noted that UCITS management companies will fall outside of scope of MiFID II when carrying out the activity of managing or marketing the UCITS funds for which they act as the management company.

2. Practical Considerations

US asset managers should consult with legal counsel to review any form of sub-investment management for a MiFID firm or a European fund to limit the potential collateral impacts of MiFID II on their organization.

C. US Manager Marketing Cross-Border Products and Services to European Clients

Many US asset managers attempt to raise assets from European clients by marketing products and services on a cross-border basis, including marketing "separately managed accounts" and pooled investment products.

1. Marketing Separately Managed Accounts to European Clients

Currently, to the extent that a US asset manager wishes to market its investment strategies and advisory services in the form of a "separately managed account" to potential clients in Europe and manage those accounts from the United States, the US asset manager must undertake to review the licensing regime in each jurisdiction in which a potential client resides to determine whether the manager is required to be licensed to manage the assets (or even market its investment advisory services to that potential client).[39]

MiFID II will introduce a new change with respect to a US investment manager's ability to market and manage separately managed accounts without having to establish a new EU subsidiary with a MiFID permission for portfolio management or obtaining direct licensing in the EU country in which the EU client or potential client resides.[40]

MiFID II goes some way towards harmonizing access to the EU markets for so-called "third-country firms" of which the United States is a member by virtue of not being in the European Union. The following will apply to any third-country firm providing MiFID services (such as investment advice or portfolio management) to an EU-based client.

a. Retail Clients

EU Member States will be able to require third country managers located outside the EU but providing portfolio management or other MiFID II services to EU retail and elective professional clients in their jurisdiction to establish a branch and obtain local authorization.[41] The branch will then be eligible for a passport to provide its services to professional clients in other EU jurisdictions, something not currently possible under the MiFID I passport regime.[42]

b. Professional Clients

A third-country firm providing portfolio management or other MiFID services to professional clients may do so if its home jurisdiction meets certain equivalence requirements and it registers with ESMA.[43] MiFID II also allows reverse solicitation by a third country firm without authorization or registration but defines this narrowly as being at the "exclusive initiative" of the client.[44]

2. Marketing Pooled Products

US asset managers that wish to offer pooled products to European clients whether directly or through an EU affiliate (or third-party) will need to consider the application of MiFID II to any marketing activity that takes place in Europe or that is directed at European clients, including both alternative investment funds (AIFs) and UCITS.

a. Offering Alternative Funds

US asset managers that wish to offer alternative investment funds (AIFs) for purposes of the Alternative Investment Fund Managers Directive (AIFMD)[45] that are not domiciled in the EU will not be impacted by MiFID II and will still need to comply with the provisions of the AIFMD, including any national private placement regime in the country in which any potential EU investor resides. A firm that has been authorized as an alternative investment fund manager (AIFM) under the AIFMD falls outside the scope of MiFID II when conducting the activities of managing or marketing the AIF for which it serves as AIFM. To the extent that an AIFM is authorized to conduct activities of a MiFID investment firm under Article 6(4) of the AIFMD (for example, authorized to conduct portfolio management of individual managed accounts), the AIFM will be in scope for MiFID II purposes.

b. Offering UCITS Funds

US managers offering UCITS directly to European institutional clients or through EU intermediaries will be indirectly impacted by the new investor protection regime described in Section D below, which will impact the design, offering disclosure, marketing, and distribution of UCITS.

As noted above, a UCITS management company falls outside of the scope of MiFID II when conducting the activities of managing or marketing the UCITS for which it serves as UCITS management company. To the extent that a UCITS is authorized to conduct activities of a MiFID investment firm, the UCITS management company will be in scope for MiFID II purposes.

3. Practical Considerations

The determination of whether the United States is deemed "equivalent" for MiFID II purposes is likely to be fraught with politics. To the extent that the United States is granted equivalency, this may also impact on the availability of US asset managers to utilize the national private placement regimes under AIFMD in connection with the marketing, offer and sale of AIFs domiciled outside of Europe (for example, in Delaware or the Cayman Islands). If, as a result of equivalency, the EU concludes that the AIFMD passport should be extended to US managers, this could mean that national private placement regimes will no longer be available for US AIFMs offering non-EU products to EU investors, which may force more US managers to establish an onshore European presence to be effective in marketing AIF products to European investors.

The distribution of UCITS funds by US asset managers either directly or indirectly to European investors is also likely to be impacted by MiFID II irrespective of the fact MiFID II does not currently directly apply to the UCITS product itself. While the impact of MiFID II on UCITS distribution is difficult to predict, MiFID II provisions on investment advice, suitability and appropriateness, complex financial products and inducements are expected to have an impact on the market as described more fully below.

D. US Manager with EU Subsidiary for Marketing Only

MiFID II introduces new investor protection provisions that are directly applicable to MiFID investment firms, and also to alternative investment fund managers (AIFMs) and UCITS management companies when providing MiFID services. These provisions are indirectly applicable to any other managers or product providers–AIFMs, UCITS management companies or third country managers (for example, US asset managers)—to the extent that such firms use MiFID firms in their distribution network, as described more fully below.

1. Product Governance

MiFID firms that manufacture investment products[46] must:

- ensure those products are designed to meet the needs of an identified target market of end clients (in effect an appropriateness assessment at generic client level) and carry out a product scenario analysis including the risk of poor investor outcomes;
- ensure that the distribution strategy is compatible with that target market, take reasonable steps to ensure that the product is distributed to that target market; and
- make appropriate information available to distributors and carry out regular reviews of events that could affect the potential risk or return to the target market.[47]

MiFID firms that distribute such products and/or services must identify appropriate information on such products or services, have regard to the identified target market, give appropriate disclosures, and make appropriate assessments of clients' needs, regularly review the products they distribute and services they provide, and provide information to support the product manufacturer's product reviews.[48]

On its face, this new product governance regime resembles the regime applied under the FCA's "treating customers fairly" (TCF) initiative. However, it (i) does not extend to life assurance products; (ii) does not have any direct application to AIFMs or UCITS management companies when acting in that capacity (ESMA thinks the EC should extend the AIFMD and UCITS regimes to harmonize with this); (iii) extends in the case of distributors to services such as fund platforms; (iv) is referenced to clients rather than investors generally; (v) applies to professional clients as well as retail clients; (vi) applies to both primary and secondary market products; and (vi) is generally more detailed and prescriptive than TCF.

2. Disclosure Requirements

The MiFID I obligation on firms to provide clients with appropriate information on financial instruments and investment strategies is expanded in a number of respects. A firm providing an advisory service[49] must tell its clients:[50]

- the nature and type of advice it will provide;
- whether or not its advice will be "independent";
- how broad or restricted the range of that advice will be; and

- whether the service will include a periodic assessment and if so details of how this will be conducted.

Information on instruments and investment strategies must include:[51]

- appropriate risk warnings including how the client may exit the investment and any risks relating thereto;
- the functioning and performance of such instruments in different market conditions; and
- additional disclosures where an instrument is composed of two or more instruments or services.

Information on costs and charges must be provided to both professional and retail clients:[52]

- covering both investment and ancillary services including the cost of advice and where relevant the cost of the instrument recommended or marketed and how it will be paid for;
- separately identifying third party payments and rebates; and
- in the case of a service including an illustration showing the cumulative effect of costs on return.

The costs information must be aggregated to show the overall cost to the client.[53] Point of sale disclosure should be refreshed periodically when there is a continuing relationship with the client. Disclosure should include transaction costs, including costs embedded in a bid-ask spread and mark-ups and mark downs, and expressed as both a percentage and a monetary amount. The monetary amount may be based on an assumed investment rather than the precise amount the client is investing. Where precise information is not available, disclosure can be on a best efforts basis. Any assumptions on which an estimate is based should be explained.

ESMA would like the EU to extend these disclosure requirements to the UCITS regime and the retail disclosure regime to be introduced by the PRIPS Directive.[54] Meanwhile, where the information required to be disclosed is contained in a UCITS KIID (or when the PRIPS Directive comes into effect, a PRIPS KID) this does not need to be re-disclosed for MiFID II purposes.[55] However, information which is not included in the KIID (such as quantitative information on transaction costs, and a monetary as well as a percentage figure for costs) must be separately obtained and disclosed.

When an investment service is offered as a package (for example, portfolio management and custody) the firm must identify the cost of each component and any related risks, and advise whether the component parts can be obtained separately.[56]

3. Client Classification and Appropriateness Tests

Public and local authorities must be classified as retail clients rather than professional clients. New, more prescriptive tests will make it harder to classify retail clients as elective professional clients. When a firm sells to a retail client on a non-advised basis, the range of products for which the firm must carry out an appropriateness test[57] is being extended. Structured UCITS and non-UCITS funds (hedge funds, *etc.*) will automatically be classed as complex products.

4. New Sales Regime for Independent Advisers

A firm providing an advisory service must tell its clients whether or not it is acting as an independent adviser.[58] When it holds itself out as independent it must meet appropriate requirements as to the scope of its advice.[59] This bears a good deal of similarity to the old FSA packaged product polarization regime, abolished in the UK in 2002 as of no practical benefit.

An independent adviser will not be allowed to accept any payment or benefit from third party product providers for advised sales, but must charge its fees to the client directly. However, third party inducements may still be paid for non-advised sales and where products are distributed by a tied sales force or on a basis where the range of products advised on is insufficient to qualify as independent. This ban on third party payments was prefigured in the UK by the FSA's retail distribution review reforms (RDR), introduced in 2012, though RDR (i) only applies to advice given to retail investors and (ii) applies to all advised sales, not just sales by independent advisers.

5. Practical Considerations

Some UCITS funds and all AIFs are likely to be considered complex products under the new MiFID II regime. Retail clients that wish to allocate savings to these complex products must seek professional advice and bear the cost that it may entail. As a result of the limitations on financial advisors under the inducement provisions, many financial advisors may be unwilling to take on retail clients that may not generate significant fees considering the increased suitability and appropriateness checks that will be required under MiFID II.

From a consumer perspective, some retail investors may be unwilling to pay for investment advice that may be dictated by the inducements provisions of MiFID II. This is likely to lead to demand for execution-only platforms and, perhaps, a rise in the use of so-called "robo-advisors." MiFID II will likely change current distribution models for UCITS and may well have an impact on open-architecture.

E. US Manager with EU Subsidiary with Portfolio Management Permission

The asset management industry is global, and many US asset managers utilize operations within Europe to (among other things): (i) have greater access to and success in attracting European clients; (ii) conduct research within the same time zone; (iii) manage assets locally in Europe with full discretion; (iv) provide local trading and execution capability in a pass-the-book trading model; (v) improve the tax position of the enterprise and of the portfolio returns from investments; and (vi) to distribute or otherwise offer separately managed accounts services and/or pooled products to EU clients.

US asset managers that have organized subsidiaries in the EU and have those subsidiaries authorized by an EU regulator (for example, the UK Financial Conduct Authority) to provide discretionary portfolio management within the definition of a MiFID investment firm will be directly subject to all aspects of MiFID II in relation to its activities, including (i) internal organization and governance requirements; (ii) market structure changes; (iii) market transparency requirements; (iv) investor protection requirements; and (v) new recordkeeping and reporting requirements, as discussed more fully below.

1. Internal Organization and Governance Requirements

a. Inducements

MiFID subsidiaries with full portfolio management permissions will not be permitted to accept and retain fees, commissions or any monetary benefits from third parties such as issuers and product providers relating to the services provided to their clients.[60] This compares with the current MiFID I rules under which such payments or benefits may be received so long as they comply with the rule on inducements.

Under additional changes to the inducements rule,[61] the requirement for quality enhancement will be more strictly construed; disclosure on a generic basis will not be allowed; and the payment of placing fees is confirmed to be within the scope of the inducements regime.

b. Dealing Commissions

Probably the biggest single change in MiFID II is the proposed abolition of payment for research with dealing commissions. Although such payments are currently "unbundled" in the sense that they are separately identified and accounted for by managers, ESMA is proposing "full" unbundling under which managers must either (a) pay for research out of their own pockets or (b) agree with each client to a separate research payment account (RPA) with its own budget which will be directly paid by the client as its contribution to the manager's overall research budget. This is intended to decouple the manager's research spend from its clients' trading volumes and ensure that the manager only pays for research it actually wants.

If the manager has to pay for its own research this is expected to lead to a decline in the amount of research used, with a potential collateral negative impact on investment performance. If research is funded through RPAs, there will be significant client/client conflicts on matters such as how the research budget is allocated by the manager among its clients, how it is administered, what happens if one client does not accept its part of the budget, or if the size and number of a manager's client accounts changes during the period. UK managers will be potentially disadvantaged in competing with non-EU managers who are not bound by the new restrictions, while international firms running global soft dollar accounts will have to determine how to reconcile practice in the rest of the world with the new EU restrictions. For example, US asset managers may be required to unbundle MiFID accounts and execute those accounts similar to directed brokerage accounts behind US soft dollar accounts. To the extent that a US asset manager continues to bundle MiFID accounts with US accounts eligible to utilize "soft dollars" (for example, US mutual fund accounts), US accounts may question why certain accounts may be receiving a "free ride" on research utilized by a US asset manager for the benefit of all clients (but for which all clients are not bearing their allocable share of the cost). The effect of extending the new restrictions to the bond markets, where the FCA believes that a research cost is hidden in bid-offer spreads, is also very unclear. There have, however, been indications from the Commission that it will permit the continuation of existing arrangements with executing brokers to collect and administer the research payments using commission sharing agreements and a system of research credits.

The final regime is likely to be copied over into the UCITS and AIFM Directives when they are next revised. National regulators such as the FCA may apply the new restrictions on a super-equivalent basis before then.

2. *Financial Collateral Arrangements*

A manager may not commit a retail client to any title transfer collateral arrangement (TTCA) (including stock lending or repos involving TTCAs) and must justify the use of any TTCAs for professional clients.[62]

a. Best Execution

Execution and order placing policies will need to contain more details of the venues and brokers used for particular classes of instrument (and selection criteria), and consider total costs associated with trading methods.

Firms that execute client orders will be required to publish annually the top five execution venues by trading volume they use for execution purposes. It is proposed to extend this through additional regulations to include disclosure of the number and volume of orders executed on each venue as a percentage of the firm's total executed orders.[63] For portfolio managers executing through brokers, the disclosure will relate to volumes at their top five brokerages.

b. Reporting to Clients

The frequency with which asset managers must provide clients with portfolio statements[64] will be increased from every six months to quarterly. The report must include valuations, if necessary on a best efforts basis, a review of activities and performance during the relevant period, any depreciation in the value of the portfolio that exceeds 10 percent, and certain prescribed information on ownership issues such as assets subject to title transfer or security arrangements.

c. Governance

MiFID firms will be subject to: (i) new formalized requirements for the composition and qualifications of a firm's management body,[65] and its responsibilities;[66] and (ii) new prescriptive rules on the organization and duties of internal compliance and its interaction with other business functions, reflecting ESMA's 2012 guidelines.[67]

3. Compliance

Prescriptive complaint handling rules will be extended to complaints by professional clients and potential clients. There will be a formal requirement to establish a complaints management policy and function, publish details of the policy, and provide reports to national regulators.[68] More detailed record keeping requirements will be introduced.[69] Records of decisions to deal will become more detailed with the initial decision covered by 16 fields and another 40 thereafter.

There will be enhanced record keeping requirements for telephonic and electronic-based communications relating to client orders. Records will include relevant internal communications and a new requirement for written records to be kept of face to face client meetings.[70] Certain exemptions under the existing UK regime will be discontinued and there will be a new requirement to monitor call recordings.

There will be new high level requirements on governance and design of remuneration policies, including balance between fixed and variable remuneration, applicable to all persons who can have a material impact, directly or indirectly, on the firm's services.[71]

4. Transaction Reporting

Under MiFID I, transaction reporting applies only to investments traded on RMs. Current UK rules extend this to investments traded on a UK prescribed market and any related derivatives. Under MiFID II the reporting requirement will be extended[72] to all instruments traded on RMs, MTFs or OTFs (or to which the underlying is so admitted), and the number of reporting fields will be increased from 23 to 65.

Under the current rules, reports may be made by third parties acting on behalf of a firm. Asset managers are covered by a general portfolio manager exemption where the broker or counterparty is itself subject to the reporting obligation. Under MiFID II this will be replaced by a narrower exemption for receiving and transmitting orders which (i) will not cover direct execution with counterparties; (ii) will require the manager to enter into an explicit reporting agreement with the broker that covers the responsibilities of both parties; (iii) still requires the manager to transmit certain detailed information to the broker; and (iv) still holds the manager responsible for the accuracy of the reported information.

When the manager delegates reporting responsibility to its brokers, it must still have new reporting arrangements in place in order to transmit relevant information to those brokers. This, together with related documentation and liability issues, and reporting experiences under EMIR may lead to more managers assuming direct responsibility for their own reporting rather than continuing to seek to rely on brokers.

5. Direct Electronic Access and Algorithmic Trading

Firms providing DEA to a trading venue will be required to ensure that their clients comply with applicable MiFID II requirements. Algorithmic traders pursuing a market making strategy must provide continuous prices.

Algorithmic trading is any trading where a computer algorithm automatically determines individual parameters of orders with no, or limited, human intervention. It covers decision making as well as execution algorithms. Any firm using an algorithmic strategy, including a manager, will be subject to new prescriptive organizational requirements;[73] and new regulatory notification, reporting, and record keeping requirements.[74]

6. Other

Other changes under MiFID II include amendments to the rules on client cash and custody, meaning of fair clear and not misleading in particular contexts, more prescriptive conflict management procedures, a formal requirement to provide suitability reports to advised retail clients, and new requirements for the content of client agreements.

7. Practical Considerations

US asset managers may wish to analyze the implications of MiFID II on their business model in Europe and re-examine the need for full portfolio management permissions and/or an execution desk in Europe. The recording of telephone calls for the required recordkeeping period of five years with hundreds of thousands of trades could prove very expensive as well as the other recordkeeping and transparency provisions. To the extent that no portfolio management is carried out in Europe (only retaining trade execution and research capabilities), a US manager could potentially side-step the inducements ban and the uncertain impact on its global soft dollar programme.

US managers with affiliates in scope will have to deal with: (i) transaction reporting agreements; (ii) point of sale disclosure materials; (ii) ongoing disclosure materials (services, strategies, costs, best execution, *etc*); (iv) revised client agreements; and (v) new policies and procedures generally. Specifically, MiFID II will require a host of new policies and procedures, including (i) Board level governance; (ii) telephone monitoring and recordkeeping; (iii) client categorization; (iv) product governance; (v) range and independence of investment advice; (vi) complaints handling; (vii) periodic reviews of products and services; and (viii) title transfer collateral arrangements. In addition, MiFID firm will have to make amendments to current recordkeeping procedures to deal with the enhanced requirements noted above.

III. Conclusion

MiFID II is 18 months way. While many issues are still uncertain, US asset managers need to begin assessing the potential impact on their businesses now and plan for how they will deal with the impact. This will include reviewing: (i) internal processes and procedures; (ii) distribution strategies; and (iii) relationships with clients and other third parties. US asset managers must then decide what course of action will be best for their own organizations based on their current business model. This may require sacrifices in either absorbing additional costs relating to increased infrastructure and trading costs or limitations on the ability of the organization to fully deploy its strategy in Europe. More to come!

Mr. Christian and **Mr. Frase** are partners in the Financial Services Group of Dechert LLP. The views expressed herein are based on the legislation in force as of the date of this Article.

NOTES

1 MiFID originally comprised three main pieces of legislation: the Level 1 Directive 2004/39/EC, the Level 2 Directive 2006/73/EC and Regulation 1287/2006 (collectively referred to herein as MiFID or MiFID I).

2 EU Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (MiFID Level 1 Directive).

3 EU Regulation No. 600/2014 Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (MiFIR).

4 *See* Brunsden, Jim and Stafford, Phillip, "What is a 'Mifid' and Why Care About its Delay?": *Financial Times, London*, Nov. 10, 2015.

5 *See generally* MiFID I, *supra* n.2.

6 *See* European Commission, Public Consultation, Review of the Markets in Financial Instruments Directive (MiFID), December 8, 2010 (MiFD I Consultation Paper).

7 *See* MiFIR, Recital 1; *see also* MiFID II Level 1 Directive at Recital 1.

8 MiFID I Consultation Paper at 6*; see* also Communication by the European Commission dated June 2, 2010 on Regulating Financial Services For Sustainable Growth (COM (2010), 301).

9 *See* MiFID I Consultation Paper at 6-7.

10 *See id.* at 7.

11 *See* European Securities Market Authority (ESMA), *Final Report: ESMA Technical Advice to the Commission on MiFID and MiFIR* (pub. avail. Dec 19, 2014) at 10.

12 *See ESMA, Final Report: Draft Regulatory and Implementing Technical Standards MiFID II/MiFIR* (pub. avail. 28 Sept. 2015) at 14 and 168.

13 European Commission - Press release, "Commission extends by one year the application date for the MiFID II package" Brussels, February 10, 2016.

14 *See* MiFID II, Recitals 52, 57, 71 and Article 16 on internal organizational and governance requirements, including new requirements for product approvals, information security, recording of telephone conversations and electronic communications, and custody of client assets.

15 *See* Recitals 13, 14, 112, Articles 4(1)(22), 4(1)(23), 18-1 and Recitals 7-9 and Article 23 of MiFIR regarding the introduction of organized trading facilities (OTFs) and multi-lateral trading facilities; *see also* MiFID II, Recitals 125-131, Articles 57, 58, 69(2)(J), (O), (P) and MiFIR, Recitals 30, 31 and Articles 44, 45 for commodity derivative position limits and reporting; *see also* MiFIR, Recitals 28, 37-40, Articles 35-38, 52, 54, 55 with respect to proposals aimed to promote competition by mandating open access to the central counterparties (CCPs), trading venues, and benchmarks; *see also* MiFIR, Article 23 for new trading rules for equity instruments; *see also* MiFID II, Recitals 59-68, Articles 18(5), 49, 49, 50 for new requirements for trading venues, circuit breakers, and electronic trading, including for (among others) trading halts, market making, and synchronization of business clocks; *see also* MiFID II, Recitals 59-68 and Article 17 with respect to more restrictive regime for high-frequency and algorithmic trading.

16 *See* MiFIR, Recitals 1, 5, 10, 12-18, 22, 23, 26, Articles 3-22 and MiFID II, Recitals 117-119, Articles 64, 65 for new pre- and post-trade transparency requirements, including for pre-trade transparency requirements, publication of post trade information and a European consolidated tape.

17 *See, e.g.*, MiFID II, Recitals 70-106 and Articles 24-30 on proposals for investor protection, including those on inducements, independent advice, suitability and appropriateness, tied agents, best execution and enhanced client disclosure obligations.

18 *See* MiFIR, Recitals 32-36, Articles 24-27 and MiFID, Article 66 for new increased regulatory reporting and recordkeeping requirements; *see also supra* n.16.

19 *See* MiFID II, Article 1.2.

20 *See* MiFID II, Article 1.1, "This Directive shall apply to investment firms, market operators, data reporting service providers and third-country firms providing investment services or performing investment activities through the establishment of a branch in the Union."

21 *See* MiFID I, *supra,* n.1.

22 *See* MiFID I Consultation Paper at 5 and 9.

23 Under MiFID II, the definition of an SI will be more strictly applied, as will the obligations of an SI to publish firm quotes.

24 *See* Recitals 13, 14, 112, Articles 4(1)(22), 4(1)(23), 18-1 and Rectials 7-9 and Article 23 of MiFIR regarding the introduction of OTFs and multi-lateral trading facilities.

25 EMIR is a European Union regulation designed to increase the stability of the over-the-counter (OTC) derivative markets throughout the EU states. It is designated Regulation (EU) 648/2012, and it entered into force on August 16, 2012.

26 MiFIR, Article 28.

27 MiFID II, Articles 18-20.

28 MiFID II, Article 23.

29 MiFIR, Article 3.

30 MiFIR, Article 3.

31 MiFIR, Article 8.

32 MiFIR, Articles 14, 15 and 18.

33 *See supra* n.16.

34 *Id.*

35 MiFID II, Article 57.

36 MiFID II, Article 58.

37 *See generally* MiFID II, Recitals 70-106 and Articles 24-30 on proposals for investor protection, including those on inducements and best execution.

38 UCITS or "undertakings for the collective investment in transferable securities" are investment funds regulated on a European Union level. The legislative

instrument covering these European funds is E.U. Directive 2014/91/EU. On July 23, 2014, the European Union adopted Directive 2014/91/EU on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards depositary functions, remuneration policies and sanctions. EU Directive 2014/91/EU amends the current Directive 2009/65/EC (the UCITS IV Directive).

39 It should be noted that certain European clients are prohibited from contracting with a firm that is not otherwise licensed under MiFID. To access capital from these types of clients, many US asset managers establish a subsidiary in Europe that is regulated to provide portfolio management services under MiFID and delegate actual portfolio management for any mandate back to its US asset manage affiliate via Article 14 of MiFID.

40 *See generally*, MiFID II, Recitals 109–111, Articles 39-43.

41 MiFID II, Article 39(1) & (2).

42 MiFID II, Articles 34 & 35.

43 MiFIR, Article 46 & 47.

44 MiFID II, Article 42.

45 *See* EU Directive 2011/61/EU of the European Parliament and of the Council of June 8, 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010.

46 Investment products include shares, bonds, and structured deposits, as well as more complicated structured products.

47 MiFID II, Article 24(2) & 16(3).

48 *Id.*

49 Investment advice means offering or recommending investment products or services to clients on a personalized basis.

50 MiFID II, Article 24(4)(a).

51 MiFID II, Article 24(4)(b).

52 MiFID II, Article 24(4)(c).

53 MiFID II, Article 24(4).

54 The proposed directive for the marketing of "packaged retail and insurance-based investment products."

55 MiFID II, Article 24(64).

56 MiFID II, Article 24(11).

57 MiFID II, Article 25(3) 7 (4).

58 MiFID II, Article 24(4)(a)(i).

59 MiFID II, Article 24(7).

60 MiFID II, Article 24(8).

61 MiFID II, Article 24(9).

62 MiFID II, Article 16(10).

63 MiFID II, Article 27(6).

64 MiFID II, Article 25(6).

65 MiFID II, Article 9 cross referencing Article 91 of CRD IV.

66 MiFID II, Article 9 cross referencing Article 88 of CRD IV.

67 MiFID II, Article 16(2).

68 MiFID II, Article 75.

69 MiFID II, Article 16(6).

70 MiFID II, Article 16(7).

71 MiFID II, Articles 16(3) and 24(10).

72 MiFIR, Article 26.

73 MiFID II, Article 17(1).

74 MiFID II, Article 17(2).