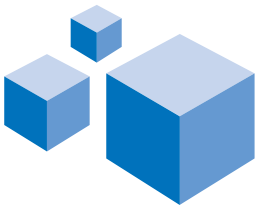

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MiFID II: current UK legal and regulatory issues for US managers – part 1

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Introduction

The two major topics for US managers wishing to manage or market funds in the UK from a legal and regulatory perspective are currently MiFID II and the AIFMD. Although the rules of both Directives generally apply to EU managers based in the EU, they are likely to affect a non-EU manager wishing to provide investment services to EU clients or who has EU counterparties.

This is the first part of a two-part series dealing with the impact of MiFID II and AIFMD on US managers. This first part will provide a brief overview of the key issues raised by MiFID II, due to come into effect on 3 January 2018, while the second part will focus on the AIFMD, which is already in force.

What is MiFID II?

The MiFID II Directive and the Markets in Financial Instruments Regulation (MiFIR) will repeal and recast MiFID with effect from 3 January 2018. Together, the MiFID II Directive and MiFIR ("MiFID II") will form the legal framework governing the requirements applicable to investment firms, trading venues, data reporting service providers and third-country firms providing investment services or activities in the EU.

Currently, the provision of investment services by non-EU, or third country, firms is largely subject to national law in each EU Member State which has led to varying rules, requirements and exclusions. MiFID II aims to harmonise to some extent the rules for authorisation and conduct of business for third country firms, but full harmonisation is not possible, as some of the provisions are optional, including those relating to establishing a branch in the relevant Member State (the "Article 39 Regime").

The UK has decided not to implement the Article 39 Regime and UK domestic laws will continue to apply in this respect, which means third country firms who establish branches in the UK will not be able to benefit from the MiFID II branch passport, but will have to establish a legal subsidiary with appropriate MiFID authorisations.

US firms which have established a full subsidiary in the UK which is authorised and regulated as a MiFID firm by the FCA will be subject to compliance with all aspects of MiFID II regulation in respect of such subsidiary. The scope of this note does not extend to discussion of MiFID II in relation to such managers, but focuses on US managers operating outside of the UK only.

How does MiFID II affect US managers?

Under the present MiFID rules, a US manager which does not have a place of business in the UK may operate within the UK without falling within scope of MiFID; this position will generally remain the same under MiFID II. However, new rules introduced by MiFID II relating to, for example, inducements and research, best execution, recording, market transparency and algorithmic trading may impact third country firms, either directly or indirectly.

The following provides a brief overview of those key issues which may affect US managers operating, but not regulated, in the UK.

Unbundling of research

As part of its aim to enhance investor protection, MiFID II will make changes to the current method of bundling research into transaction costs under MiFID, as this is considered to amount to a material inducement. EU investment firms providing portfolio management or investment advice will now need to make explicit payments for investment research so as to demonstrate that there is no inducement to trade.

Under MiFID II, research may only be received if it is paid for either by the investment firm itself or from a separate research payment account ("RPA") that is funded by a specific charge to the firm's clients and operated in accordance with certain criteria. The new requirements will not apply to any inducement considered to be a minor, non-monetary benefit.

An EU investment firm which offers execution of orders and research services will therefore be required to price and supply these services separately to ensure transparency in the market and to allow it to better demonstrate its compliance with the inducements requirements and wider conflicts of interest provisions.

The UK's FCA is also proposing to gold-plate or enhance the new rules on unbundling research by applying them to all investment managers, including AIFMs and UCITS management companies, with the effect that sub-managers are likely to be expected to comply with the new requirements, regardless of their jurisdiction, in order to ensure compliance by the investment manager.

Thus, a US manager which uses EU broker dealers or which acts as a sub-manager to a UK investment manager may be indirectly impacted in that its research costs will be unbundled and separately invoiced. It may also result in its contractual arrangements, such as commission sharing agreements, with such counterparties being revisited and amended accordingly.

Where an investment firm opts to make a direct payment for research, this could create further issues for a US firm providing research in relation to payment in 'hard dollars' as opposed to 'soft dollar' compensation. The payment in hard dollars could affect the US firm's regulation, in that it could be deemed an investment adviser, as opposed to a research provider, and therefore subject to the regulatory obligations and related rules such status necessarily entails.

Best execution

Best execution requires firms within scope to publicly disclose execution data relating to pricing structures and information on commissions, execution costs and research-related expenses. The current MiFID rules on best execution will remain, but a higher compliance standard is required under MiFID II, namely to take all sufficient steps, rather than all reasonable steps, to obtain best execution. Further, the FCA has gold-plated the new requirements by applying them to all investment managers, including AIFMs and UCITS management companies.

A US manager which uses EU broker dealers or which acts as a sub-manager to a UK investment manager is likely to be impacted in that its contractual arrangements with such counterparties may need to be amended to provide for the new execution policy accordingly and it may be subject to compliance with the new requirements in order to ensure compliance by the investment manager.

Taping and Recording Obligations

MiFID II enhances record keeping requirements, such that firms are required to record telephone conversations or electronic communications relating to client orders and to keep such records for five years. The FCA has extended this requirement to cover all discretionary investment managers.

Once again, this is likely to impact US managers acting as sub-investment managers, who could be expected to comply with the new requirements in order to ensure compliance by the investment manager.

The MiFID II taping rules also raise potential issues in relation to employment law, as they require an investment firm to take all reasonable steps to prevent an employee or contractor from making, sending or receiving relevant telephone conversations and electronic communications on privately-owned equipment which the investment firm is unable to record or copy.

Product Governance

MiFID II introduces new product governance rules, which require investment firms that manufacture (i.e. issue) or distribute financial instruments or services to clients to: (i) ensure

those products are designed to meet the needs of the identified target market; (ii) ensure that the distribution strategy is compatible with the target market; and (iii) make appropriate information available to distributors and placement agents.

Although the product governance requirements do not extend to AIFMs and UCITS management companies, a distributor marketing or distributing an AIF or UCITS on behalf of the manager is likely to be subject to these rules.

A US manager may be indirectly impacted by these rules in the event that it is marketing an AIF or UCITS on behalf of an EU distributor or in the event that its own product is being marketed by an EU distributor, as it may be required to enter into arrangements which enable the EU distributor to fulfil its obligations under MiFID II and to provide MiFID II compliant information regarding an AIF or UCITS or the US manager's own product(s).

Transparency and reporting obligations

Currently, the trade reporting regime under MiFID applies only to equities trading on regulated markets, which includes a multilateral trading facility (MTF). MiFID II considerably broadens the scope of financial instruments subject to the trade reporting obligation, as well as including a new trading venue, the organised trading facility (OTF). MiFID II requires details of such trading to be publicly disclosed, both pre- and post-trade. Further, the exemption extended to portfolio managers, whereby a manager could rely on an EU investment firm to report on its behalf, has been replaced by a narrower exemption and the manager will generally be responsible for complying with this obligation under MiFID II, regardless of any delegated transaction reporting agreed with a third party.

The enhanced reporting obligation could affect a US manager acting as sub-manager to an EU manager in that it is likely that the US manager will be required to comply with some or all of the obligations, as it would be difficult for the EU manager to ensure compliance without the assistance of its US sub-manager.

Algorithmic trading

MiFID II permits Member States to require funds that engage in algorithmic trading to be regulated within the Member State. However, the UK is not proposing to implement the requirement and a US manager which operates on a UK exchange outside the UK is unlikely to have to be authorised by the FCA, but can rely on the 'overseas person' exemption set out in the UK's domestic legislation.

Next steps

In the second and final Legal Long in this series, we shall be looking in more detail at the AIFMD and how you might make use of the AIFMD to develop your business in the UK.

In the meantime, should you wish to discuss any of the issues raised in this paper, please contact Claire Cummings at claire.cummings@cummingslaw.com.

How can we help?

As set out above, we anticipate that US managers may need to amend, or be required to agree to amend, their fund documentation, including offering memoranda, investment and/or sub-investment management agreements, distribution agreements and brokerage agreements. The relevant amendments will differ depending on the firm's business and a gap analysis is likely to be required by the firm to analyse how its documentation will be impacted by MiFID II.

We are able to assist US managers to carry out a gap analysis by providing advice on MiFID II, reviewing a firm's contractual arrangements currently in place and by helping to re-draft or negotiate revised documentation accordingly. If you would like our assistance in this respect, please contact Claire Cummings at claire.cummings@cummingslaw.com.

We have taken great care to ensure the accuracy of this document. However, it is written in general terms, is for general guidance and does not constitute advice in any form. You are strongly recommended to seek specific advice before taking any action based on the information it contains.

No responsibility can be taken for any loss arising from, action taken or refrained from on the basis of this publication.

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