

## Financial Regulatory Alert

August 10, 2017

### UK Implementation of MiFID II (for Hong Kong and Other Asian Managers)

The release by the UK Financial Conduct Authority (FCA) on 3 July 2017 of its final rules on the implementation of the revised Markets in Financial Instruments Directive 2014/65/EU and the new Markets in Financial Instruments Regulation (EU) 600/2014 (together with the secondary legislation issued pursuant to the same, “MiFID II”) materially completed UK implementation of MiFID II.

When MiFID II takes effect on 3 January 2018, it will replace and materially expand the current framework for the regulation of financial markets and the provision of investment services in the European Union (EU).<sup>1</sup> MiFID II will push the EU significantly closer to the goal of harmonised regulation of the operation of financial markets. A number of the rules will be directly applicable across the EU. In an effort to bring about harmonised regulatory practice in respect of MiFID II requirements, the European Securities and Markets Authority (ESMA) has issued substantial guidance on the proper interpretation of key provisions. The FCA rules reflect ESMA's guidance.

However, a fully harmonised legal and regulatory framework has not been politically achievable. Consequently, the full impact of MiFID II implementation on firms will largely depend on who their “home regulator” is. Please see below for a summary overview of the FCA's rules in some key areas of MiFID II generally affecting investment managers.

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<sup>1</sup> MiFID II will also in due course be included in the Treaty of the European Economic Area (“EEA”) and apply as law in the EEA countries that are not part of the EU

## 1. Inducements and Research

<p><b>What are the key changes?</b></p>	<ul style="list-style-type: none"> <li>Managers will be prohibited from receiving any third-party inducements<sup>2</sup>, unless an exception applies.</li> <li>There is an exception for minor nonmonetary benefits that both are capable of enhancing the quality of service provided to a client and are of a scale and nature such that they could not be judged to impair compliance with the investment firm's duty to act in the best interest of the client (e.g., hospitality of a reasonable <i>de minimis</i> value during a business event, short-term market commentary and free trial periods for research of three months or less)</li> <li>Investment research, which is not an acceptable minor nonmonetary benefit, will have to be paid for out of the manager's own resources or otherwise from a research payment account ("RPA") controlled by the manager and funded through a specific research charge to the client based on a pre-agreed budget<sup>3</sup>.</li> <li>Where using an RPA to pay for research, managers will be required to (a) set and regularly assess a research budget and agree a research charge with the board of the fund (or its general partner), (b) adopt detailed procedures for valuing research, (c) disclose the research budget and estimated research charge to existing and potential investors, and (d) provide annual disclosures of research charges to investors.</li> </ul>
<p><b>Who will they affect?</b></p>	<ul style="list-style-type: none"> <li>UK firms carrying out collective portfolio management functions or those providing independent investment advice, including UK MiFID investment firms, UK AIFMs<sup>4</sup> and UK UCITS management companies.<sup>5</sup></li> <li>An exemption from prohibition when conducting private equity or venture</li> </ul>

<sup>2</sup> That is, any fee or commission, or any non-monetary benefit provided in connection with any investment service or ancillary service

<sup>3</sup> Articles 23 and 24 of Directive 2014/65/EU ("MiFID II") and Recitals 26 to 30 and Articles 11, 12 and 13 of the Commission Delegated Directive (EU) of 7.4.2016 C(2016) 2031 ("MiFID II Delegated Directive")

<sup>4</sup> Articles 23 and 24 of Directive 2014/65/EU ("MiFID II") and Recitals 26 to 30 and Articles 11, 12 and 13 of the Commission Delegated Directive (EU) of 7.4.2016 C(2016) 2031 ("MiFID II Delegated Directive").

<sup>5</sup> Firms authorised by the FCA pursuant to the Alternative Investment Fund Managers Directive 2011/61/EU.

	capital business may be available.
<b>How will they affect Hong Kong and other Asian managers?</b>	<ul style="list-style-type: none"> <li>Rules will not apply to Hong Kong and other Asian investment managers (but will apply to UK subsidiaries or group entities).</li> <li>Controls may need to be put in place for research shared across a group, particularly where the group contains EU and Hong Kong and other Asian investment management firms.</li> </ul> <p>UK broker-dealers will be free to continue existing “soft dollar” arrangements with Hong Kong and other Asian investment managers; however, the rules may affect the price of investment research.</p>
<b>2. Best Execution</b>	
<b>What are the key changes?</b>	<ul style="list-style-type: none"> <li>The standard that a firm must meet has been raised from taking “all reasonable steps” to obtain best execution (under MiFID I), to taking “all sufficient steps.”<sup>6</sup></li> <li>The FCA has indicated that this change in the language sets a higher bar for compliance and is likely to involve the strengthening of the firm’s systems and controls and require that the firm reassess whether its execution policies and arrangements deliver the improved outcomes in line with the higher MiFID II standard.</li> <li>Firms will have to publish annually data of their top five execution venues and/or brokers for each class of financial instrument, including trading volume.<sup>7</sup></li> <li>Firms will also have to publish annually specific information on the quality of execution obtained from their execution venues and brokers, including an analysis of specific factors that might affect the investment firm’s execution behaviour (e.g., payments, discounts, rebates or nonmonetary benefits made and received over the previous year).<sup>8</sup></li> </ul>

<sup>6</sup> Firms authorised by the FCA pursuant to the Undertakings in Collective Investment in Transferable Securities 2009/65/EC.

<sup>7</sup> Article 27(6) of MiFID I, Article 65(6) of the MiFID II Delegated Regulation and Article 3 of Commission Delegated Regulation (EU) of 8.6.2016, C(2016) 3333 (“RTS 28”)

<sup>8</sup> Article 27(5) of MiFID II, Article 3(3) of RTS 28 and Article 65(6) of the MiFID II Delegated Regulation

	<ul style="list-style-type: none"> <li>Firms cannot receive payments for order flow that would result in a conflict of interest, or that would amount to a banned inducement.<sup>9</sup></li> <li>Where executing orders or taking a decision to deal in OTC products, firms will need to assess whether the price quoted to clients is “fair,” by developing systematic checks to undertake appropriate valuation and taking into account market data on comparable products (where available).<sup>10</sup></li> </ul>
<b>Who will they affect?</b>	<ul style="list-style-type: none"> <li>Rules will apply to all UK MiFID investment firms and UK UCITS management companies when executing client orders.</li> <li>Where UK UCITS management companies delegate portfolio management activities to MiFID portfolio managers, the burden of compliance with the best execution requirement will be borne by the delegate.<sup>11</sup></li> <li>UK AIFMs are exempt from the new rules.</li> </ul>
<b>How will they affect Hong Kong and other Asian managers?</b>	<ul style="list-style-type: none"> <li>Rules will not apply to Hong Kong and other Asian investment managers (but will apply to UK subsidiaries or group entities).</li> <li>Hong Kong and other Asian investment managers executing trades through UK broker-dealers will benefit from the higher best execution standard and new execution-related information.</li> </ul>
<b>3. Telephone Recording</b>	
<b>What are the key changes?</b>	<ul style="list-style-type: none"> <li>Firms will have to record telephone conversations and electronic communications relating to (or intended to relate to) transactions concluded when: <ul style="list-style-type: none"> <li>dealing on own account (proprietary trading);</li> <li>providing client order services that relate to the reception, transmission and execution of orders or</li> </ul> </li> </ul>

<sup>9</sup> Article 27(2) of MiFID II

<sup>10</sup> Article 64(4) of the MiFID II Delegated Regulation

<sup>11</sup> Page 94 of PS17/14: Markets in Financial Instruments Directive II Implementation – Policy Statement II, July 2017

	<ul style="list-style-type: none"> <li>○ performing investment management functions.</li> <li>• With respect to investment managers, the focus of the regime is on the transactional side of portfolio management, where conversations that relate to transactions undertaken, or intended to be undertaken, are required to be recorded.<sup>12</sup></li> </ul>
<b>Who will they affect?</b>	Rules will apply to all UK firms that execute, receive and transmit client orders and/or perform portfolio management functions (including UK MiFID investment firms, UK UCITS management companies, full-scope UK AIFMs and small authorised UK AIFMs).
<b>How will they affect Hong Kong and other Asian managers?</b>	<ul style="list-style-type: none"> <li>• Rules will not apply to Hong Kong and other Asian investment managers (but will apply to UK subsidiaries or group entities providing portfolio management services).</li> <li>• Calls between a Hong Kong and other Asian investment manager and its UK broker-dealer, or a Hong Kong and other Asian investment manager and a UK affiliate, during which an order is placed or a firm investment decision is made should be recorded</li> </ul>
<b>4. Transaction Reporting</b>	
<b>What are the key changes?</b>	<ul style="list-style-type: none"> <li>• The requirement to report certain transactions to the FCA (for the purpose of monitoring market abusive behaviour) has been broadened in scope and will apply to transactions in financial instruments admitted to trading or that are traded on any EU regulated trading venue, where the underlying is such a financial instrument or if the underlying is an index or a basket composed of such financial instruments.<sup>13</sup></li> <li>• The concept of an EU regulated trading venue has also been broadened in scope to include regulated markets, multilateral trading facilities and (as newly</li> </ul>

<sup>12</sup> Page 127 of PS17/14: Markets in Financial Instruments Directive II Implementation – Policy Statement II, July 2017

<sup>13</sup> Article 26(2) of Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012 (“**MiFIR**”)

	<p>introduced by MiFID II) organised trading facilities.</p> <ul style="list-style-type: none"> <li>• Reports shall be made to the FCA either by the investment firm itself, an ARM acting on its behalf or by the trading venue through whose system the transaction was completed.<sup>14</sup></li> <li>• The current reporting exemption for UK firms trading with or through a UK/EU broker firm will no longer apply (UK firms will be exempt from the reporting requirement only if the broker agrees to include the relevant information in its own report or otherwise to pass such information to another firm that would make the report).<sup>15</sup></li> <li>• Firms will be required to retain transaction reports for five years.</li> </ul>
<b>Who will they affect?</b>	<ul style="list-style-type: none"> <li>• UK MiFID investment firms executing orders or carrying out collective portfolio management functions.</li> <li>• Rules will not apply to AIFMs or UCITS management companies.</li> </ul>
<b>How will they affect Hong Kong and other Asian managers?</b>	<ul style="list-style-type: none"> <li>• Rules will not apply directly to Hong Kong and other Asian investment managers (but will apply to UK subsidiaries or group entities dealing as agent or as principal).</li> <li>• Hong Kong and other Asian investment managers may be required to provide transaction information to EU trading venues or Direct Electronic Access providers.</li> </ul>
<b>5. Trade Reporting</b>	
<b>What are the key changes?</b>	<ul style="list-style-type: none"> <li>• The requirement to publish details of certain transactions (for the purpose of promoting market transparency) has been broadened in scope and will apply to transactions in financial instruments admitted to trading or that are traded on any EU regulated trading venue.<sup>16</sup></li> <li>• Details of the transaction (including its volume, price and time of conclusion) will have to be published through an Approved Publication Arrangement. There</li> </ul>

<sup>14</sup> Article 26(7) of MiFIR and Article 11 of Commission Delegated Regulation (EU) of 2.6.2016 C(2016) 3201 ("RTS 13")

<sup>15</sup> Article 26(4) of MiFIR and Article 4 of Commission Delegated Regulation (EU) 2017/590 ("RTS 22")

<sup>16</sup> Article 20 and 21 of the MiFID Delegated Regulation

	is an exemption from the reporting requirement where the firm is trading with (i) a systematic internaliser, or (ii) an MiFID investment firm and such counterparty is the seller. <sup>17</sup>
<b>Who will they affect?</b>	<ul style="list-style-type: none"> <li>• UK MiFID investment firms executing transactions in financial instruments admitted to trading or that are traded on any EU regulated trading venue.</li> <li>• Rules will not apply to AIFMs or UCITS management companies.</li> </ul>
<b>How will they affect Hong Kong and other Asian managers?</b>	<ul style="list-style-type: none"> <li>• Rules do not apply to Hong Kong and other Asian managers (but will apply to UK subsidiaries or group entities that may need to put in place transaction reporting arrangements for reporting OTC trades).</li> <li>• Hong Kong and other Asian managers will benefit from greater market transparency with respect to financial instruments traded within the EU.</li> </ul>
<b>6. Disclosure</b>	
<b>What are the key changes?</b>	<ul style="list-style-type: none"> <li>• Enhanced disclosure requirements for firms carrying on investment business that is MiFID business, (e.g., in relation to information disclosure, timing, costs and charges).</li> <li>• With respect to costs, firms will have to provide a client with information on costs and associated charges, including, as applicable, the total price to be paid by the client in connection with the designated investment or the designated investment business, including all related fees, commissions, charges and expenses.<sup>18</sup></li> </ul>
<b>Who will they affect?</b>	<ul style="list-style-type: none"> <li>• UK firms that carry on MiFID investment business.</li> <li>• UK firms conducting non-MiFID business have been instructed by the FCA to consider an approach that involves complying with the MiFID disclosure requirements in relation to both the MiFID and non-MiFID aspects of their business.</li> </ul>

<sup>17</sup> Article 7(2) of MiFIR and Article 12(5) of Commission Delegated Regulation (EU) 2017/587 ("RTS 1")

<sup>18</sup> COBS 6.1.9R (1): Information about costs and associated charges

<b>How will they affect Hong Kong and other Asian managers?</b>	<ul style="list-style-type: none"> <li>Rules will not apply to non-EU investment managers (but will apply to UK subsidiaries or group entities – in some instances intra-group payments made by the UK firm may have to be disclosed).</li> <li>Hong Kong and other Asian managers will benefit from enhanced disclosures when receiving investment services from UK authorised firms.</li> </ul>
<b>7. Conflicts of Interest</b>	
<b>What are the key changes?</b>	<ul style="list-style-type: none"> <li>Firms will be required to consider all risks, rather than just “material risk” as is currently the case under MiFID.<sup>19</sup></li> <li>A firm’s conflicts-of-interest policy will have to specify procedures to be followed and measures to be adopted in order to prevent, as well as manage, conflicts of interest.<sup>20</sup></li> <li>Firms will have to ensure that disclosure to clients of conflicts is a “measure of last resort” that can be used only when the firm’s organisational and administrative arrangements cannot adequately manage conflicts.</li> <li>Where disclosure is made, it will be subject to additional mandatory requirements (including the fact that the firm’s organisational and administrative arrangements were inadequate to manage the conflict).<sup>21</sup></li> <li>Senior management will be required to receive written reports on a frequent basis and at least annually on the situations in which there is a conflict of interest entailing a risk of damage to the interests of one or more clients.<sup>22</sup></li> </ul>
<b>Who will they affect?</b>	<ul style="list-style-type: none"> <li>UK MiFID investment firms, UK AIFMs and UK UCITS management companies when carrying out MiFID investment services or ancillary activities.</li> </ul>
<b>How will they affect</b>	<ul style="list-style-type: none"> <li>Rules do not apply to Hong Kong and other Asian managers (but will apply to UK subsidiaries or group entities that may need to boost internal conflicts</li> </ul>

<sup>19</sup> Article 34(2)(a), Article 34(3) and Article 35 of the MiFID II Delegated Regulation

<sup>20</sup> Article 34(2)(B) of the MiFID II Delegated Regulation

<sup>21</sup> Article 34(4) and (5) of the MiFID Delegated Regulation

<sup>22</sup> Article 35 of the MiFID Delegated Regulation



<b>Hong Kong and other Asian managers?</b>	<p>processes).</p> <ul style="list-style-type: none"> <li>Hong Kong and other Asian managers will benefit from higher standards when receiving investment services from UK authorised firms.</li> </ul>
<b>8. Commodity Derivative Position Limits and Reporting</b>	
<b>What are the key changes?</b>	<ul style="list-style-type: none"> <li>National regulators will establish and apply position limits on the size of a net position that a person (in aggregate with its parent undertaking) can hold at all times in commodity derivatives traded on EU trading venues and economically equivalent OTC contracts.<sup>23</sup></li> <li>Position limits will not apply to positions held by or on behalf of a nonfinancial entity and that are objectively measurable as reducing risks directly relating to the commercial activity of that nonfinancial entity.</li> <li>Members or participants of EU trading venues will be required to report to such trading venue operator details of their own positions held through contracts traded on such trading venue at least on a daily basis, as well as those of their clients and the clients of those clients until the end client is reached.<sup>24</sup></li> <li>A firm trading OTC commodity derivatives or emission allowances/related derivatives trading on an EU trading venue will have to provide the regulator of the relevant trading venue with a daily breakdown of its position in such instrument.</li> <li>The reporting requirement also extends to cover the positions of the firm's clients and the clients of those clients until the end client is reached (where there are multiple venues, notification will have to be made to the regulator of the venue on which the largest volume of trading occurs).<sup>25</sup></li> </ul>
<b>Who will they affect?</b>	<ul style="list-style-type: none"> <li>All firms (wherever established) trading in commodity derivatives or emission allowances/related derivatives admitted to trading on an EU trading venue will</li> </ul>

<sup>23</sup> Article 57(1) of MiFID II

<sup>24</sup> Article 58(3) of MiFID II

<sup>25</sup> Article 58(2) of MiFID II

	<p>be subject to the position limits.</p> <ul style="list-style-type: none"> <li>• Trades in commodity derivatives that take place on a trading venue will be reported by the trading venue.</li> <li>• The position reporting requirements apply to MiFID investment managers in respect of OTC contracts.</li> </ul>
<b>How they affect Hong Kong and other Asian managers?</b>	<ul style="list-style-type: none"> <li>• Position limits will directly apply to Hong Kong and other Asian managers to the extent they trade in commodity derivatives or emission allowances/related derivatives admitted to trading on an EU trading venue.</li> <li>• Hong Kong and other Asian managers will be required to monitor the aggregate positions of the funds they manage, including positions in economically equivalent OTC contracts.</li> <li>• Trading venues will apply position management measures. In addition, if a fund managed by a Hong Kong or other Asian manager exceeds the applicable position limit, it must reduce its position accordingly. The FCA may instruct Hong Kong and other Asian managers to reduce their/the relevant fund's position.</li> <li>• Commodity derivative positions of funds managed by non-EU managers will be reported to the relevant trading venue, generally through the EU broker used.</li> </ul>
<b>9. Product Governance</b>	
<b>What are the key changes?</b>	<ul style="list-style-type: none"> <li>• A new Sourcebook (PROD) will be introduced that sets out the FCA's product governance requirements for manufacturers and distributors.</li> <li>• UK firms, when manufacturing financial instruments or deciding on the range of financial instruments and investment services that they intend to distribute to clients, will have to take into account the nature of the financial instrument or investment service and the target market for the financial instrument.</li> <li>• UK firms will have to identify a target market of end clients, ensure that any distribution strategy instrument is compatible with the identified target market and take reasonable steps to ensure that the relevant instrument or product is distributed to only the identified target market.</li> </ul>

	<ul style="list-style-type: none"> <li>• UK firms distributing financial instruments or providing portfolio management services must understand such financial instruments and assess the compatibility of the financial instrument or the portfolio management service with the needs of the clients.</li> <li>• With respect to financial instruments, it must do so taking into account the manufacturer's identified target market of end clients and ensure that financial instruments are distributed only when this is in the best interests of the client.</li> <li>• UK firms manufacturing and/or distributing financial instruments, or providing portfolio management services, will have to put in place relevant systems and procedures to meet these regulatory obligations, including a product governance policy.</li> </ul>
<b>Who will they affect?</b>	<ul style="list-style-type: none"> <li>• They will affect UK MiFID investment firms, including those providing portfolio management services to professional clients (on a proportionate basis).</li> <li>• UK AIFMs and UK UCITS management companies that manufacture and/or distribute financial instruments should regard the rules as guidance and apply them proportionately.</li> </ul>
<b>How will they affect Hong Kong and other Asian managers?</b>	<ul style="list-style-type: none"> <li>• Rules will not apply directly to Hong Kong and other Asian investment managers (but will apply to UK subsidiaries or group entities marketing funds managed by a Hong Kong and other Asian manager, or the portfolio management services of a Hong Kong and other Asian manager).</li> <li>• UK firms appointed to market/distribute funds on behalf of a Hong Kong and other Asian investment manager may request further information about the product/target market from the Hong Kong and other Asian manager in order to comply with their own regulatory obligations.</li> </ul>

**Contact Information**

If you have any questions about the matters addressed in this alert, please contact the following Akin Gump authors or your regular contact at Akin Gump.

**Helen Marshall**[helen.marshall@akingump.com](mailto:helen.marshall@akingump.com)

+44 20.7661.5378

London

**Ezra Zahabi**[ezra.zahabi@akingump.com](mailto:ezra.zahabi@akingump.com)

+44 20.7661.5367

London