MiFID 2 – impact on corporates and other entities who use financial markets

Introduction

The EU's revised Markets in Financial Instruments Directive and new Markets in Financial Instruments Regulation (***MiFID 2*** and ***MiFIR,*** together ***MiFID 2***) revise and replace the current Markets in Financial Instruments Directive (***MiFID***), which came into force in November 2007. The new Directive (as implemented by EU Member States) and MiFIR come into force across the EU on 3 January 2018.

MiFID 2 is designed to increase the transparency and safety of EU financial markets and to improve investor protection. In addition to a substantial impact on EU entities that are subject to MiFID 2 directly (referred to in this briefing as ***EU investment firms***), MiFID 2 will affect entities, such as corporates, who are not regulated under MiFID 2 and use financial markets both directly and indirectly, for example corporate entities in the context of their treasury operations or fundraising or who otherwise conduct business with EU investment firms.

This note sets out the impact of MiFID 2 on these entities who are not MiFID 2-regulated.

Legal entity identifiers (LEIs)

MiFID 2 imposes obligations on EU investment firms in relation to transparency (public reporting of trade data) and transaction reporting (private reporting of transaction details to national regulators).

Where an EU investment firm executes an in-scope transaction and is required to submit a transaction report to the national regulator, that report must include details of entities that the EU investment firm is trading with (i.e. the counterparty) and, where relevant, trading for (i.e. when executing a trade on behalf of a client), including the LEI of those entities. The obligation to provide an LEI applies regardless of where the counterparty is based and regardless of that entity's regulatory status.

LEIs are required already under a number of financial services rules and regulations, however MiFID 2 has brought them into focus since EU investment firms will not be permitted to trade with, or for, entities that do not have an LEI.

Therefore clients and counterparties of EU investment firms must obtain an LEI, so that EU investment firms can continue to provide them with financial services after 3 January 2018.

The European Securities and Markets Authority (***ESMA***) has issued guidance on LEIs, including information on who needs an LEI, who can apply for it, why it is important and how to obtain an LEI.

Client classification

EU investment firms regulated currently under MiFID must categorise a client as either a retail client, professional client or eligible counterparty. Classification is based on various qualitative and quantitative criteria. The MiFID conduct of business rules afford most protection to retail clients and least protection to eligible counterparties. MiFID 2 amends the conduct of business rules and the classification of certain entities.

Under MiFID 2, municipalities and local authorities will be classified as retail clients and may no longer be classified automatically as professional clients or eligible counterparties. If they satisfy opt-up criteria, clients may request in writing to opt-up to a higher classification.

Therefore EU investment firms may be contacting their clients to reconfirm their classifications and assess the appropriate level of client protection required under MiFID 2.

Client consents

MiFID 2 requires EU investment firms to obtain consent from clients for certain activities, either to enable the EU investment firm to comply with MiFID 2 or in order to modify the default application of MiFID 2.

By way of example, clients may be asked to provide their consent to:

- their orders being executed outside a trading venue;
- their unfilled limit orders not being made public automatically;
- the receipt of certain information via a website; and
- their EU investment firm's order execution policy and for orders to be executed in accordance with that policy (MiFID 2 has increased the existing requirements for execution policies and so many EU investment firms will be updating their existing execution policies).

New applications required to rely on the narrower own account dealing exemption

The exemption from MiFID for persons dealing on own account has been narrowed under MiFID 2 and entities that have relied on this exemption to date will need to review whether their activities remain exempt.

In addition, where the exemption still applies under MiFID 2 to those dealing in commodity derivatives, an annual application will need to be made to the relevant regulator in order to benefit from the exemption.

Costs and charges unbundling and research payment rules

MiFID 2 requires EU investment firms to unbundle and disclose the specific costs of each service and product that they provide to clients as a package. Consequently, EU investment firms will no longer be able to disclose only one bundled fee for execution services and research. Clients of EU investment firms can expect to receive more detailed costs disclosures under MiFID 2.

In addition, MiFID 2 prevents those EU investment firms who provide portfolio management services (or independent financial advice) from receiving research from third parties in relation to services provided to a client where the cost is bundled with execution commission. Portfolio managers must either pay directly for the research themselves or through a specific account set up for this purpose with the unbundled costs clearly disclosed to their clients.

Therefore, clients of portfolio managers where the portfolio manager currently receives research that is paid for by execution commission may start to see a specific cost being identified for research provided to the portfolio manager, unless the portfolio manager has decided to bear the costs of research itself (or to no longer receive the research).

These rules requiring the unbundling of research payments run counter to US rules which subject broker dealers and portfolio managers to fiduciary duty and compliance obligations under US legislation when research is paid for separately and not bundled with other services. In response to concerns raised by market participants and, in particular, the potential impact on the availability of research, the US Securities and Exchange Commission (***SEC***) has granted temporary relief to broker dealers and investment advisers from the obligations that would otherwise result under US legislation when accepting, in the case of broker dealers, or paying, in the case of investment managers, unbundled research payments. This relief will run from 3 January 2018 for 30 months and during that time the SEC will be assessing the impact of MiFID 2 and what it should do next. For further information about this SEC temporary relief, see our client alert.

Allocation justification in capital markets transactions

MiFID 2 requires EU investment firms who carry out underwriting and placement services in capital markets transactions to establish, implement and maintain an allocation policy that sets out the process of developing allocation recommendations. The allocation policy must be provided to issuer clients before agreeing to undertake any placing services.

Clients may be asked by their EU investment firms to specify any preferences regarding any specific names or the types of investor to whom an issue should be allocated. EU investment firms are likely to request client approval of the intended allocation strategy prior to transaction execution.

Product governance for capital markets transactions

MiFID 2 introduces a new product governance regime, which is broad enough to capture advisors to issuers in capital markets transactions – even where the financial instrument being issued is as simple as a share or corporate bond.

Where the advisor determines that it is caught, it is classified as a "manufacturer" under the product governance rules and must, among other things, determine a target market for the issue, regardless of where the target investors for that product are based. The product approval process will identify the target market for each product and ensure that relevant risks to that target market are assessed and that the intended distribution strategy is consistent with the identified target market. The target market and performance of products will be subject to periodic review.

Although this does not impose any direct obligations on a non-MiFID 2 regulated issuer, they may receive notification from their advisors that the advisor is a "manufacturer" of the securities being issued and will be determining a target market for the issue. As a result of these requirements, EU investment firms may require clients (including non-EU clients) to accept restrictions on distribution of financial instruments, such as restricting distributions to retail investors throughout the life of a bond.

Legends are likely to be included in certain new issue documents and communications in order to address MiFID 2 product governance requirements to provide distributors with information on (i) the product approval process, (ii) the target market assessment and (iii) appropriate channels for distribution. Where there are restrictions on distribution to reflect the target market, selling restrictions will likely be included in any prospectus.

Updates to terms of business and additional disclosures

As a result of the changes summarised above, many EU investment firms will update their client terms of business prior to 3 January 2018.

Around the same time as MiFID 2 updates are made, EU investment firms may update client terms to take account of the impact of other new EU legislation. For example, the General Data Protection Regulation comes into force on 25 May 2018 and replaces the EU's Data Protection Directive, imposing new EU-wide regulations for handling personal data. These include an obligation to demonstrate compliance. EU investment firms may update clients on their policies and procedures for handling client data and update their terms of business.

In addition to changes to terms of business, MiFID 2 increases the disclosure requirements for EU investment firms. Clients may receive updated order execution policies, risk disclosures, conflicts of interest disclosures and costs disclosures. In relation to costs disclosures, EU investment firms are required to disclose the costs and charges for any product or service that they sell both in good time before the sale of that product or service, and afterwards (however, the post-sale disclosures may form part of the regular reports provided by the EU investment firm to their clients).

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