Linklaters

July 2012

MiFID II.
Key interactions between MiFID/MiFIR II and other EU and US financial services legislation.

Introduction

MiFID is often described as the corner stone of financial services regulation in Europe, and not surprisingly, given the breadth of financial services activities that it regulates, it overlaps considerably with a number of other EU financial services directives, and also significant non-EU legislative initiatives. When conducting its review of MiFID, the European Commission (the "**Commission**") should be mindful of the consequences that changes to MiFID will have for such overlapping legislation. These overlaps result in some cases in conflicting obligations that are impossible to comply with, and in others in duplication of efforts on the part of market participants to satisfy slightly differing obligations under two different directives, something which the regulators have been keen to emphasise they want to avoid. It is clearly not an easy task to co-ordinate the drafting of MiFID with other legislation on which it might have an impact, and this is undoubtedly compounded by the silos in which the Commission staff work and also the complexity of the legislation itself. However, this is an important issue to avoid unnecessary disruption to the markets, and the Commission will need to devote considerable resource to ensuring that all potential significant difficulties are resolved.

This note highlights some of the key areas of overlap between the proposals to amend MiFID under the MiFID review ("**MiFID II**"), and other key financial services directive, including:

> The European Markets Infrastructure Directive ("**EMIR**");

> Undertakings for Collective Investment in Transferable Securities ("**UCITS**");

> Regulation on Energy market integrity and transparency ("**REMIT**");

> Alternative Investment Fund Managers Directive ("**AIFMD**");

> Market Abuse Directive ("**MAD**");

> Prospectus Directive ("**PD**");

> Securities Law Directive ("**SLD**");

Contents

1. Undertakings for Collective Investment in Transferable Securities ("UCITS"). 2

2. European Markets Infrastructure Regulation ("EMIR") 2

3. Regulation on "Energy market integrity and transparency" ("REMIT")... 3

4. Alternative Investment Fund Managers Directive ("AIFMD") 3

5. Market Abuse Regulation ("MAR") 4

6. Securities Law Directive ("SLD") 5

7. Prospectus Directive/Codified Listing Directive ("PD") 5

8. Capital Requirements Directive ("CRD") 6

9. US - Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") 6

> Capital Requirements Directive ("**CRD**");

> US - Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank**").

1. Undertakings for Collective Investment in Transferable Securities ("UCITS").

The objective of the UCITS directive is to create a level playing field for the marketing and selling of open-ended retail investment funds, known as UCITS, at the same time as ensuring high standards of investor protection. The UCITS directive contains rules relating to the authorisation, supervision and activities of UCITS that are established in the EU, as well as rules on information that UCITS should make available to retail investors. Similar to the MiFID passport for investment firms, UCITS that are authorised in their home state can be offered and sold to retail investors in other member states on the basis of a passport under the directive.

The key point at which MiFID and the UCITS directive overlap concerns the regulation of the sale of UCITS, since MiFID's conduct of business rules includes within their scope the sale of UCITS.

MiFID II, in the Commission's draft proposal, splits UCITS between "complex" and "non-complex". The significance of this distinction under MiFID is that only financial instruments that are non-complex can be sold to customers on an execution only basis without first having to assess the appropriateness of the instrument for the customer. This contrasts with the UCITS directive under which all UCITS are specifically identified as suitable for retail investment, and are heavily regulated under the UCITS Directive. There is therefore a clear conflict in policy between the MiFID and UCITS directives, with MiFID providing that certain "complex" UCITS cannot be sold to customers on an execution only basis without complying with the appropriateness obligation, and the UCITS directive, which provides that they can be more freely sold to retail. There has been pushback from the industry to this proposal on the basis that as UCITS are already heavily regulated under the UCITS directive, they should all be treated as non-complex. These concerns have filtered through to the European Parliament, with certain MEPs proposing to amend the Commission's proposals to remove the UCITS/non-UCITS distinction.

2. European Markets Infrastructure Regulation ("EMIR")

As well as providing for mandatory clearing of eligible OTC derivatives, EMIR also requires all derivatives to be reported to authorised trade repositories. The main area of interaction between MiFID and EMIR concerns reporting obligations in respect of derivatives transactions.

Whilst the Commission proposed in its legislative proposal in respect of MiFID II to waive the MiFID reporting obligation on an investment firm that has already reported an OTC contract to a trade repository or competent authority under EMIR, this will only work if data content standards for the two forms of

reporting are consistent. If standards of data between the two forms of reporting differ, the efficiencies gained by avoiding duplication of reporting under MiFID and EMIR will be entirely lost.

However, some doubt has been thrown on the practicalities of achieving consistent reporting regimes in respect of derivatives by ESMA in its consultation paper of 25 June 2012 on EMIR. Although ESMA does acknowledge that this is a key issue under EMIR and MiFID II, ESMA is of the view that it is not possible to align the data that is required under EMIR with MiFID completely, since EMIR's reporting obligations are more extensive. ESMA does go on to state in the consultation paper, however, that it will continue working towards the objective of a common reporting mechanism and will discuss any differences with the trade repositories and the national regulators.

3. Regulation on "Energy market integrity and transparency" ("REMIT")

REMIT is intended to address a gap in the EU regulation of financial energy markets since currently the Market Abuse Directive and MiFID only cover exchange traded energy derivatives, rather than all wholesale energy markets.

REMIT imposes a framework for monitoring wholesale energy markets, with the objective of ensuring the transparency of those markets, and to detect abusive conduct in these markets.

There is therefore an overlap between REMIT and MiFID, since they both apply market monitoring and reporting provisions to wholesale energy products that are financial instruments for the purposes of MiFID. Care should therefore be taken to ensure that these obligations are made consistent and do not duplicate one another.

4. Alternative Investment Fund Managers Directive ("AIFMD")

The AIFMD's objective is to create a common regulatory framework across the EU for EU-established managers of alternative investment funds. MiFID and the AIFMD overlap, since they are directives that both address to some extent the regulation of investment management. There are several areas with potential for overlap, with both directives for example, making some provision for the following requirements:

- Authorisation obligation for investment managers;
- Capital requirements for investment managers – an own funds requirement plus capital requirements under the CRD;
- Conduct of business and investor protection provisions;
- Outsourcing/delegation requirements;
- Organisational requirements; and

> Third country equivalence provisions.

While an AIFM is outside the scope of MiFID, we anticipate that, as with UCITS, much of the investor management activity of alternative investment funds will in fact take place in investment firms that are covered by MiFID. Alternatively, a manager will manage funds that are caught by both MiFID and the AIFMD, and will therefore have to comply with both directives. There is therefore no sense in making fine distinctions between the two directives.

It is therefore imperative that the following approach should be adopted when developing MiFID II, including:

> To avoid duplication between the two directives;

> Where duplication is unavoidable, the provision of clear guidance as to which directive should be followed or will prevail – or a clear indication that the more strict requirements will apply;

> To make direct reference to both UCITS and AIFM Directives where relevant so that the areas of overlap and how they are reconciled is expressly dealt with on the face of the directive.

5. Market Abuse Regulation ("MAR")

The proposed new market abuse regulation ("**MAR**") that is intended to replace the existing Market Abuse Directive ("**MAD**") as part of the MAD review has as one of its objectives making the scope of MAR consistent with the scope of MiFID. The scope of the MAR regime is to be extended to cover all financial instruments covered by MiFID, and to those traded on an MTF as well as a regulated market. However, in a few instances, this produces legislation that runs a high risk of being unclear in its application.

The MiFID II process will include development of the OTF definition. Putting aside any issues as to the appropriate perimeter for this, it should be borne in mind that this will be picked up and used as the perimeter of the market abuse regime. Consideration should therefore be given as to whether the breadth of what is covered by the OTF regime is appropriate for that purpose too.

For example, the latest EU Council compromise draft of the proposed MAD legislation extends the scope of the insider dealing and market manipulation rules to any financial instrument admitted to trading on a MTF or OTF, as defined under MiFID. Given the breadth of the definition of OTF, this has the potential to bring within the scope of the MAD a vast number of trading venues, and an even larger number of instruments traded on those venues. The EU Parliament rapporteur's draft report on the proposed MAD legislation takes a slightly more limited approach to scope, and proposes including financial instruments traded on MTFs or any other trading (over-the-counter or otherwise) that could have an effect on a financial instrument traded on a regulated market or MTF. Given that even now it can be difficult for market participants to identify instruments that are traded on regulated markets, this

problem will be exacerbated by the extension of the regime as proposed by the EU Council and the draft EU Parliament report. Market participants will have little certainty as to whether the MAD regime applies to them in their daily dealings in diverse instruments.

A further example is the use of the definition of “algorithmic trading” from MiFID to provide examples in the MAR regime of behaviour that manipulates the market. When developing this definition as part of the MIFID II process, consideration should be given to its use in the proposed MAR legislation.

6. Securities Law Directive (“SLD”)

The interaction between the Securities Law Directive (“**SLD**”) and MiFID relates to the provisions in the SLD proposals that seek to regulate securities account providers. The SLD proposals provide for account providers to be brought within the scope of MiFID by making the service of providing and maintaining securities accounts a core investment service under MiFID (currently it is regulated as an “ancillary service” under MiFID, which means that it can be provided without authorisation provided that the provider is not providing a core investment service regulated under MiFID in connection with the service). The MiFID II draft legislation provides for the service of providing and maintaining securities accounts to be a core investment service.

However, currently there are concerns whether all account providers in the EU will be brought within the scope of MiFID without exception. It is unclear which provisions of MiFID will apply to account providers, since not all MiFID requirements will be appropriate. The Commission should ensure that it provides some clarity on these issues.

7. Prospectus Directive/Codified Listing Directive (“PD”)

The PD uses MiFID definitions to define the scope of the PD. For example, the application of the main PD obligation not to make an offer of transferable securities to the public unless an approved prospectus has been made available to the public before the offer is made, partly depends on the MiFID defined term “transferable securities”. Likewise, the PD prohibition on requesting admission to trading on a regulated market before a prospectus has been made refers to the MiFID definition of “regulated market”.

A consistency issue for MiFID across other EU directives, including PD, MAR and REMIT, relates to the definitions and use of terms “admission to trading” and “admission to official list”. This is a work stream that was identified by ESME in 2007[1], where it identified as an issue the importance of bringing clarity on how the notions of admission to official listing on a stock exchange, admission to trading on a regulated market and trading on an MTF relate to each other.

The Commission’s draft MiFID II legislative proposals makes reference to admission to official stock exchange listing.[2] Likewise, a number of MiFID

[1] See http://ec.europa.eu/internal_market/securities/docs/esme/05122007_mifid_report_en.pdf
[2] Recital 81 of the Commission’s October draft of recast MiFID Directive

obligations refer to admission to trading- e.g. client limit order rule, appropriateness regime etc. Although this workstream does not appear as yet to have been progressed, the Commission needs to ensure that its use of these terms is consistent with their use in other directives such as the PD, MAR and REMIT.

8. Capital Requirements Directive ("CRD")

The CRD applies to firms by reference to activities that are defined in MiFID. For example, a key interaction between MiFID and the CRD relates to the capital treatment of certain commodities firms. Commodities firms whose activities consist exclusively of the provision of investment services or activities in relation to financial instruments set out in C5, 6, 7, 9 and 10 of Annex 1 of MiFID are subject to MiFID, but enjoy an exemption from the capital requirements in the CRD (although are subject to certain risk management and systems and controls requirements). The Commission announced in July 2011 that it will report to the Parliament and Council by 31 December 2014 on an appropriate prudential regime for such firms. No publicly available progress on this work stream has been made to date.

The Commission is proposing in its draft MiFID II legislation to narrow the scope of exemptions enjoyed by certain commodities firms, specifically firms that deal on own account in financial instruments or provide investment services in commodity derivatives on an ancillary basis as part of their main business and when they are not subsidiaries of financial groups (article 2 1(i) and (k) of MiFID).

9. US - Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank")

Dodd-Frank and MiFID cover the same ground where they are implementing the same G20 derived principles. The equivalent US legislation should also be taken into account when developing MiFID, to avoid making the compliance burden for global firms greater, and also to prevent opportunities for regulatory arbitrage.

Both Dodd-Frank and MiFID II contain similar requirements for OTC derivatives to be traded on exchange, originating from the G20 requirements. The MiFID II proposals provide that the on-market obligation will apply to all derivatives identified by ESMA as subject to the trading obligation, and shall be eligible for trading on any trading venue on a non-exclusive basis. Dodd-Frank, on the other hand, provides that a mandatory trading obligation only applies to a derivatives contract if a swap execution facility, stock exchange or designated contract market makes it available to trade.

Dodd-Frank and MiFID also contain similar requirements requiring the reporting of OTC derivative transactions to trade repositories. Under proposed guidance on the extraterritorial reach of the Dodd-Frank Act, transactions involving a U.S. counterparty (and some involving only non-U.S.parties) could be subject to many of "transaction-level" requirements of the U.S. regime, including a requirement that trades be reported to a data

repository. This could require trade reporting in both the United States and the European Union, something which in practice withwould result in greater compliance costs and duplicative (and potentially misleading) transaction reporting.

Linklaters

Author: Kirsty Gibson

This publication is intended merely to highlight issues and not to be comprehensive, nor to provide legal advice. Should you have any questions on issues reported here or on other areas of law, please contact one of your regular contacts, or contact the editors.

© Linklaters LLP. All Rights reserved 2012

Linklaters LLP is a limited liability partnership registered in England and Wales with registered number OC326345. It is a law firm authorised and regulated by the Solicitors Regulation Authority. The term partner in relation to Linklaters LLP is used to refer to a member of Linklaters LLP or an employee or consultant of Linklaters LLP or any of its affiliated firms or entities with equivalent standing and qualifications. A list of the names of the members of Linklaters LLP together with a list of those non-members who are designated as partners and their professional qualifications is open to inspection at its registered office, One Silk Street, London EC2Y 8HQ or on www.linklaters.com and such persons are either solicitors, registered foreign lawyers or European lawyers.
Please refer to www.linklaters.com/regulation for important information on our regulatory position.

We currently hold your contact details, which we use to send you newsletters such as this and for other marketing and business communications.

We use your contact details for our own internal purposes only. This information is available to our offices worldwide and to those of our associated firms.

If any of your details are incorrect or have recently changed, or if you no longer wish to receive this newsletter or other marketing communications, please let us know by emailing us at marketing.database@linklaters.com.

Contacts

For further information please contact:

Peter Bevan
Partner

(+44) 207 456 3776

peter.bevan@linklaters.com

Nadia Swann
Partner

(+44) 207 456 5232

nadia.swann@linklaters.com

Carl Fernandes
Partner

(+44) 207 456 3002

carl.fernandes@linklaters.com

Sarah Parkhouse
Partner

(+44) 207 456 2674

sarah.parkhouse@linklaters.com

Harry Eddis
Partner

(+44) 207 456 3724

harry.eddis@linklaters.com

One Silk Street

London EC2Y 8HQ

Telephone (+44) 20 7456 2000
Facsimile (+44) 20 7456 2222

Linklaters.com