FOCUS ON

MIFID II ISSUES

Michelle Kirschner, of Macfarlanes, speaks to *HFMWeek* about the challenges posed by upcoming European hedge fund regulation

Michelle Kirschner has extensive experience in advising hedge fund managers on all aspects of their obligations under the regulatory system. She is heavily involved in the implementation of EU and UK regulatory developments, in particular under Emir and Mifid II.

The Mifid II legislative package comprises the recast Markets in Financial Instruments Directive (Mifid II) and the Markets in Financial Instruments Regulation (Mifir). Both Mifid II and Mifir were placed on the Official Journal of the European Union and are now in force. They will become effective on 3 January 2017. While we now have certainty as to what the legal framework will look like, much of the detail still remains to be finalised in the so-called 'level two measures' which the European Securities and Markets Authority (Esma) is currently working on. These level two measures will take the form of commission delegated acts and implementing/regulatory technical standards. It is expected that the level two measures will be finalised towards the end of 2015 and early 2016 respectively.

Mifid II and Mifir cover a broad range of issues relating to the authorisation and regulation of investment firms, investor protection, markets and market infrastructure, microstructural issues, trading issues and transparency requirements.

This article explores the trading obligations for shares and derivatives, the position limits regime for commodity derivatives and the proposals relating to payments for research.

Many hedge fund managers within the European Union will be alternative investment fund managers (AIFMs) under the Alternative Investment Fund Managers Directive (AIFMD). Firms which are authorised and regulated as such will not be subject to the authorisation requirements under Mifid II and therefore the conduct of business and investor protection requirements applicable to Mifid investment firms will generally not apply to them (unless they are carrying on the Mifid-like activities pursuant to Article 6(4) of the AIFMD). However, it is not yet clear to what extent the Financial Conduct Authority (FCA) in the UK and other national competent authorities elsewhere in the EU will impose Mifid standards on those firms which are authorised under the AIFMD and the Ucits Directive. Of course, it is also likely that the next iterations of the AIFMD and the Ucits Directive will align the requirements of those regimes with the requirements under Mifid II.

> "IT IS NOT YET COMPLETELY CLEAR WHICH CONTRACTS WILL BE SUBJECT TO THE EMIR CLEARING OBLIGATION"

KEY TRADING ISSUES FOR HEDGE FUND MANAGERS UNDER MIFID II/MIFIR?

Derivatives trading obligation: Mifir implements the G20 commitments given at Pittsburgh in 2009, by requiring standardised derivatives which have sufficient liquidity must be traded on a regulated trading venue. A regulated trading venue is a regulated market (RM), a multilateral trading facility (MTF) (e.g. Chi-X), an organised trading facility (OTF) (which is a new kind of trading venue introduced by Mifid II/Mifir) or equivalent third-country trading venues. The derivatives trading obligation will apply to those counterparties who are subject to the clearing obligation under Regulation 648/2012 (Emir).

The trading obligation can only apply to those derivative contracts which have been declared subject to the clearing obligation under Emir. Once a contract is declared subject to the clearing obligation it is then eligible to be considered for the trading obligation. A contract can only be declared subject to the trading obligation if the class of derivative (or a subset thereof) satisfies both the venue test (i.e. whether the contract is admitted to trading or traded on at least one trading venue) and the liquidity test (i.e. whether the derivative has sufficient liquidity).

It is not yet completely clear which contracts will be subject to the Emir clearing obligation and therefore it is not possible to say which contracts will be considered for the trading obligation. However, we expect that certain classes of over-the-counter interest rate and credit derivatives will be eligible for consideration.

As with Emir, the derivatives trading obligation applies directly to the underlying fund counterparty rather than to the hedge fund manager itself. Therefore, even where the fund is established in, for example, the Cayman Islands, the derivatives trading obligation will apply to it in the same way as the clearing obligation under Emir applies. In other words, the trading obligation will apply to the fund where the fund is a financial counterparty by virtue of its manager being authorised as an AIFM under the AIFMD or where the fund is a third country entity which would be a non-financial counterparty if it were established in the Union which is above the clearing threshold (i.e. an NFC+).

Experience in the US with the mandatory trading obligation there has generally been that trading is largely unaffected, with the implementation of the obligation being more of an operational issue than a front office trading issue. We would expect much the same experience in the Union with the trading obligation under Mifir.

Equities trading obligation: the equities trading obligation will apply to Mifid investment firms by requiring them to execute trades in shares which are admitted to trading on an RM, MTF systematic internaliser or equivalent non-EU trading venue, subject to some limited exceptions for transactions which do not contribute to the price formation process and trades which are 'non-systematic, ad hoc, irregular and infrequent'. This requirement will restrict the ability for hedge fund managers to buy and sell

EU-listed and traded shares on an over-the-counter basis with their brokers.

Commodity derivatives position limits: Mifir imposes position limit, position reporting and position management powers for trading venues, national competent authorities and Esma. In terms of impact on trading, the position limit requirements will impose restrictions on the size of exposures to commodity derivatives that hedge funds may have at any one time. These position limits will apply to exchange traded and 'economically equivalent' over-the-counter commodity derivative contracts traded on trading venues in the Union. These limits will apply regardless of where the fund is located.

Esma is currently working on the methodology which will be utilised by each national competent authority in setting the limits on the size of the net position which a person can hold in commodity derivatives which are traded on trading venues in their jurisdiction. We will not know for some time yet where the limits will be set by national competent authorities. However, any funds which have large exposures to commodity derivatives will need to assess whether they meet the position limits and monitor these on an ongoing basis.

WHAT ARE THE NEW RULES ON PAYMENTS FOR RESEARCH?

Mifid II prohibits a firm carrying on the investment service of portfolio management from accepting and retaining third-party fees, commissions or any monetary or non-monetary benefits except certain minor non-monetary benefits. Esma's view is that all research with the exception of publicly available, generic research is an inducement when it is received by a portfolio manager from a broker with whom it executes orders on behalf of its clients and therefore gives rise to a conflict of interest. Esma's proposed solution to this issue is to decouple the execution of trades from the provision of research by requiring portfolio managers to pay 'hard' for research or to utilise a client funded ring fenced research account which is based on a research budget and is not linked to the volume and/or value of transactions executed.

How individual national competent authorities will implement these requirements (if the Esma advice is accepted by the commission) is not clear at this stage. However, it is likely that differences will arise between member states of the EU, giving rise to potential competitive issues and regulatory arbitrage. The wider global issue is whether these requirements will put European managers at a competitive disadvantage to their counterparts elsewhere in the world. At a more practical level, there will clearly be a commercial decision for hedge fund managers to make as to whether to pay hard for research (which may lead to an increase in management fees) or whether to take the ring fence research account route and negotiate this with individual clients. It is open to debate whether the commission sharing arrangements currently in place will be capable of remaining or whether there will be a more fundamental change in the market. It seems clear from the FCA's perspective that it does not consider that commission sharing arrangements are compatible with the current Esma proposals in their current form.

One interesting issue with these rules in the context of hedge fund managers is how these rules will apply to AIFMs. AIFMs are not investment firms and therefore are not subject to the Mifid II inducement rules (except in relation to the Article 6(4) Mifid-like activities that hedge fund managers may be carrying on in respect of managed accounts and/or funds that they manage under delegation).

Esma has recommended to the commission in its technical advice that it should consider how these rules should apply to AIFMs (and Ucits managers). The FCA has indicated that it is likely to extend these rules to AIFMs in order to create a level playing field.

Finally, when assessing the impact of these requirements on the business, hedge fund managers must not forget that these rules impact no only equities research because they are agnostic as to asset class. The impact on fixed income research is yet to be fully analysed and discussed at European and national level. ■