LATHAM & WATKINS LLP

1 November 2017

Financial Regulation Monthly Breakfast Seminar

Overview

- SEC No Action Letters on MiFID Research
- Brexit
- EU Benchmarks Regulation – Update
- Recent Enforcement Cases

LATHAM & WATKINS LLP

SEC No Action Letters on MiFID Research

Dana Fleischman

MiFID II Rules on Inducements

- MiFID II prohibits the receipt of inducements by EU MiFID firms providing independent investment advice or portfolio management services ("EU Managers") to clients
- EU Managers must not accept or retain any fees, commissions, or monetary or non-monetary benefits paid or provided by any third party (or a person acting on behalf of a third party) in relation to the provision of the relevant service to clients
- UK has extended to certain UK-based non-MiFID managers
- Research (as defined) will not be considered an inducement if it is "unbundled" and paid for:
  - Out of the EU Manager's own resources ("P&L")
  - Through a separate RPA controlled by the EU Manager

Impact on US Broker-Dealers

- The MiFID II inducements rules have indirect extraterritorial effect on US broker-dealers that provide research to EU Managers
- While US broker-dealers are not directly subject to MiFID II (and thus not required to comply with the EU rules on inducements), EU Managers must still comply with the ban on receiving inducements, even if such inducements are provided by a non-EU firm
- Effectively, this means that US broker-dealers wishing to continue sending research to EU Managers must be able to value and price research separately
- However, if a US broker-dealer receives “hard dollars” or a specifically definable payment for research from an EU Manager, the exemption typically relied on by broker-dealers from the definition of “investment adviser” under the US Investment Advisers Act of 1940 may no longer be available (which carries with it fiduciary responsibilities, certain principal trading restrictions and other obligations)

SEC Action

- The SEC issued on October 26, 2017 a series of “no-action” letters addressing the definitional question as well as certain ancillary issues raised by MiFID II
- According to a statement by the SEC, “the no-action relief provides a path for market participants to comply with the research requirements of MiFID II in a manner that is consistent with the U.S. federal securities laws. More specifically, and subject to various terms and conditions: (1) broker-dealers, on a temporary basis, may receive research payments from money managers in hard dollars or from advisory clients' research payment accounts; (2) money managers may continue to aggregate orders for mutual funds and other clients; and (3) money managers may continue to rely on an existing safe harbor when paying broker-dealers for research and brokerage”

SEC Division of Investment Management – Advisers Act Regulation

- The Staff of the SEC's Division of Investment Management issued a letter to SIFMA stating that it would not recommend that the SEC take enforcement action for failure to comply with the Advisers Act against a broker-dealer that provides research services to an EU Manager that is required under MiFID II (directly or by contractual obligation) to pay for such research services "from its own money, from a separate RPA funded with its clients' money, or a combination of the two…."
  - No-action relief is temporary and expires 30 months after January 3 2018
  - During the 30-month period, the Staff will "monitor and assess the impact of MiFID II's requirements on the research marketplace…in order to ascertain whether more tailored or different action is necessary"
- The letter does not provide no-action relief to broker-dealers that receive payments from firms not subject to MiFID II

SEC Division of Trading and Markets – Section 28(e)

- Section 28(e) of the US Securities Exchange Act of 1934 provides a "safe harbor" that allows a money manager to use client commissions to purchase (through a single payment) "brokerage and research services" (essentially by paying a higher cost for trade execution) without breaching its fiduciary duty to obtain best execution for its clients
- Under MiFID II, EU Managers that pay for research out of client assets must separate the order execution charge from the research charge and the executing broker-dealer must transmit the payments for research into an RPA

SEC Division of Trading and Markets – Section 28(e) (cont)

- The Staff of the Division of Trading and Markets provided relief to allow continued reliance on the safe harbor if the money manager makes payments for research to an executing broker-dealer out of client assets alongside payments for execution through the use of an RPA that conforms to the requirements for RPAs in MiFID II, provided that all other applicable conditions of Section 28(e) are met (including, e.g., that the research payments are for services eligible for the safe harbor and the executing broker is legally obligated by contract with the money manager to pay for research through the use of an RPA in connection with a client commission arrangement)

SEC Division of Investment Management -- Trade Aggregation

- The Staff of the SEC's Division of Investment Management also provided no-action relief under the Advisers Act and the US Investment Company Act of 1940 to permit investment advisers to continue to aggregate client orders for purchases and sales of securities, even though (as a result of MiFID II requirements), some clients may pay different amounts for research, but all clients will continue to receive the same average price for the security and execution costs
- The SEC states that this relief provides "clarity and consistency to investment advisers by permitting the continued aggregation of orders while addressing the differing arrangements regarding the payment for research that will be required by MiFID II"

European Commission Statement

- Third country broker/dealer may receive combined payments for research and execution as a single commission…as long as the payment attributable to research can be identified
  - The MiFID II Portfolio Manager must be able to identify to its clients the amount spent on research with such a third country broker/dealer
- Third country broker/dealer need not produce a separate research invoice
  - Where this is so, the MiFID II Portfolio Manager may consult with third parties including that broker/dealer to determine the charge attributable to the research provided
- EC guidance also frequently refers to "or its Third Country Sub-Advisor"
  - AIMA letter with Stephen Hanks of FCA

FCA's Statement and VAT position

- "Arrangements in which a UK asset manager pays the EU entity of a broker for global research content…"
  - Ignores transfer pricing impact
- "…or research is circulated within a buy-side group, can also be an acceptable way…"
  - Internal or external?
- HMRC now clear that VAT is payable

LATHAM & WATKINS LLP

Brexit

Axel Schiemann

EBA Opinion on issues related to Brexit

On 12 October 2017, EBA published an Opinion on Brexit-related issues to ensure consistent applications of EU legislation to businesses seeking to establish or enhance their EU27 presence in order to retain access to the EU Single Market

- The opinion is based on assumption that after Brexit UK will be a third country (without prejudice to any specific arrangements that may be reached between the UK and the EU)

EBA Opinion on issues related to Brexit (cont)

- Topics addressed in the Opinion include:
  - Authorisations
  - Prudential regulation and supervision
  - Internal models
  - Outsourcing
  - Internal governance
  - Risk transfers via back-to-back and intragroup operations
  - Resolution and deposit guarantee schemes
- EBA emphasizes the maintenance of existing authorization standards and the importance of substance for the EU27 institution

Authorisations

The competent authorities shall apply existing authorisation standards without any derogations or exemptions and shall not rely on mere confirmations or existing authorisation decisions

- Key questions to be addressed in application are set forth in Annex to EBA Opinion
- Competent authorities shall refuse authorisation where factors such as the geographical distribution of activities indicate clearly that an applicant has opted for the legal system of one member state to evade stricter standards in force in another member state within whose territory it carries out a greater part of its activities
- EBA deems equivalence access under MiFID II/MiFIR for third country firms to be “suboptimal” from a prudential perspective
- The EBA opinion contains no statement on recognition of EU passport for services provided by EU institutions via UK branch

Substance of institutions – Internal Governance

The EU27 institution must have a sound and effective governance requiring local management and steer

- The management body and key function holders must effectively perform its functions in the member state of establishment
- Members of the management body must be suitable and commit sufficient time to perform their function
- The number of local members of the management body must be adequate (minimum 2) and its composition appropriate
- The management body must retain responsibility for establishing and monitoring the adequacy and effectiveness of the internal control framework, processes and mechanisms, and for overseeing all business lines and internal units
- It is not sufficient if management and steer is provided by the parent undertaking

Substance of institutions – Outsourcing

Competent Authorities should not allow institutions to outsource activities to such an extent that they operate as “empty shell” companies

- Outsourcing may not be used with the intention of stripping the institution’s corporate substance and of setting up a legal vehicle with the sole purpose of benefiting from an EU passport
- Outsourced activities must be sufficiently monitored and managed by the outsourcing institution
- Risks must be assessed and monitored by the EU27 institution
- It must be ensured that there are no obstacles which may prevent the effective exercise of supervisory functions (access to information, inspection rights of the competent supervisory authority – this would apply in particular to outsourcing to third countries)

Substance of institutions – Back-to Back transactions

Back-to-back transactions must not threaten the continuity of the EU27 entity in the event of the failure of the institution to which the risks have been transferred

- Challenges identified by EBA in the case of a default of the institution to which the risks have been transferred:
  - Potential losses from exposures with the institution
  - Sudden jump of capital requirements as a result of the unhedged portfolio
  - Operational / risk management issues due to the need to manage the open book

Substance of institutions – Back-to Back transactions (cont)

- The EU27 entity must have enough capital in excess of the pillar 1 minimum requirement as well as in-house risk management and operational capabilities to be able to cover any material risks stemming from the unhedged portfolio, manage it actively and wind down the positions (pillar 2 SREP requirement)
- Back-to-back transactions must be appropriately reflected in the market and credit risk strategies as well as the management of large exposures of the EU27 institution

LATHAM & WATKINS LLP

EU Benchmarks Regulation – Update

Nicola Higgs

LATHAM & WATKINS LLP

Recent Enforcement Cases

Rob Moulton

Rio Tinto

- Impairment provision on asset
- Decided not to announce
  - Lack of clarity over next steps meant re-evaluation was “premature”
  - Fear of misleading market
- Fine £27,385,400
  - Further issues in the US

Merrill Lynch International

Overview

- Fined £34,524,000 for failing to report 68.5 million exchange traded derivatives over a two-year period
- Breach of Article 9 EMIR, and Principle 3 of the FCA's Principles for Businesses
- First FCA enforcement action for breach of the transaction reporting requirements under EMIR

Merrill Lynch International

Specific failings

- Failed to have in place adequate oversight arrangements in relation to its reporting obligations under EMIR
- Failed to undertake testing to ensure the completeness and accuracy of the reports it was submitting
- Failed to allocate adequate and sufficient human resource to undertake its reporting obligations under EMIR
- Failed to address issues it had identified within the risk management systems applying to the reporting requirement in a timely manner

Compounded by the fact that the firm has already been fined twice for transaction reporting failings

Merrill Lynch International

Lessons learned

- Some key takeaways for regulatory change implementation projects
- Take heed of Mark Steward's warning:

  "*Effective market oversight depends on accurate and timely reporting of transactions. The obligations under EMIR, as with MiFID, are key aspects of such oversight. It is vital that reporting firms ensure their transaction reporting systems are tested as fit for purpose, adequately resourced and perform properly. There needs to be a line in the sand. We will continue to take appropriate action against any firm that fails to meet requirements*"

LATHAM & WATKINS LLP

Questions?