

Financial institutions  
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# Ninth Annual Markets Infrastructure Group Seminar-MIFIR and MiFID II, Trade and Post Trade: Disruption?

12 July 2016



# Agenda

## MiFID II and MiFIR update

We will provide an update on MiFID II and MiFIR with a focus on:

- the trading environment of the future
- key post trade aspects
- wholesale conduct issues

## Refreshments break

## Brexit

We will share our views on the potential impact of Brexit from a market infrastructure perspective, including the possible forms an exit from the European Union may take and the impact on MiFID II, MiFIR and other market infrastructure legislation.

## Panel discussion

A discussion on how FinTech, including distributed ledger technologies and smart contracts, may further change the trade and post-trade picture and how regulatory issues may influence the shape of things to come.

**Chaired by** Imogen Garner | Partner | Norton Rose Fulbright

### **Panel members:**

David Harris | Head of Commercialisation, Global Technology Innovation | London Stock Exchange Group

Dr Lee Braine | Investment Bank CTO Office | Barclays

Jörn Tobias | Managing Director, EMEA Product Management | State Street

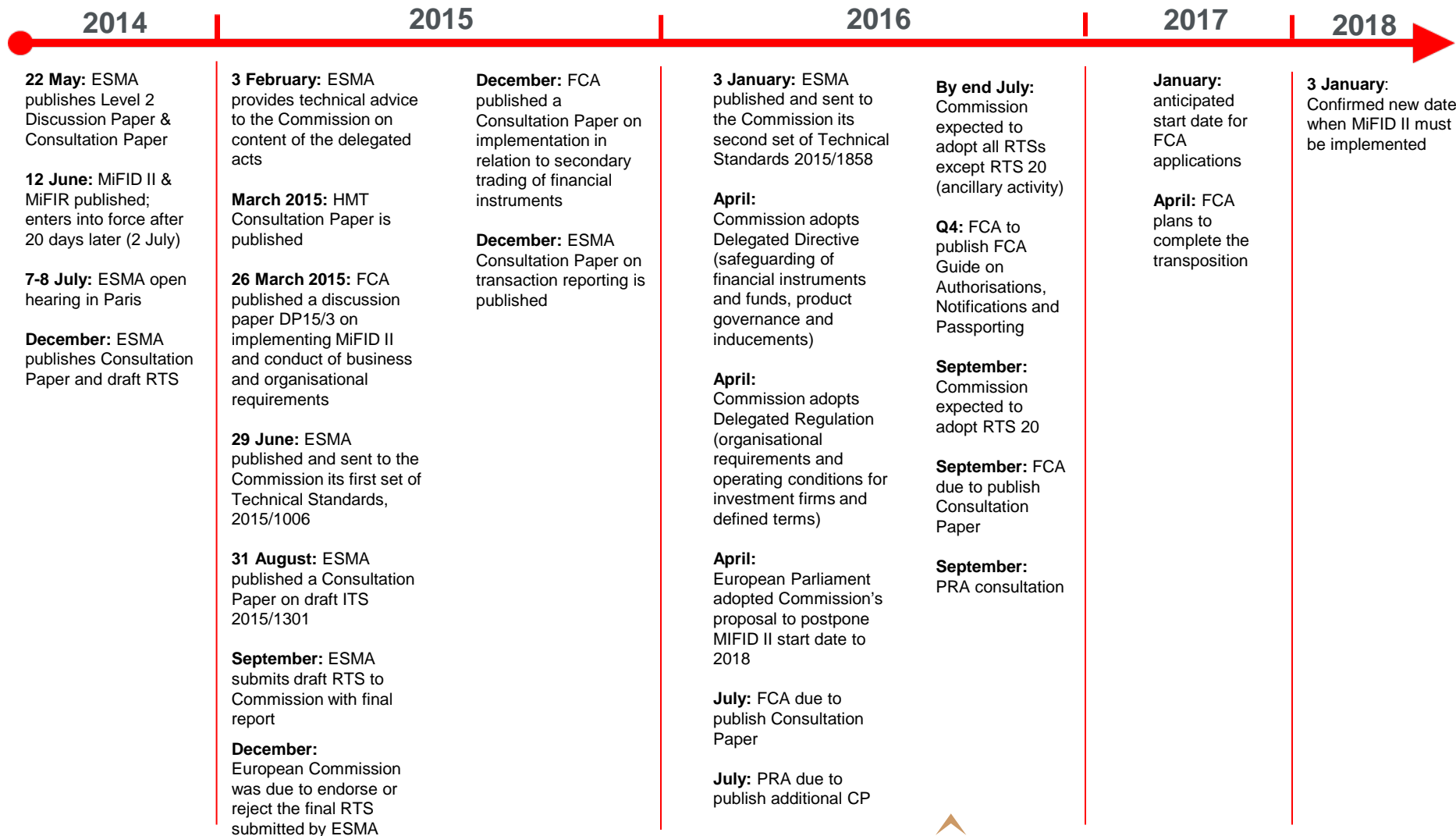
Simon Puleston Jones | Head of Europe | FIA

Seth Phillips | Lead Product Manager | itBit

## Networking and refreshments

# MiFID II/MiFIR: where are we up to?

# Timeline



# Pegasus tool: tracking the latest developments

## Directive 2014/65/EU (MiFID II) and Regulation (EU) No 600/2014 (MiFIR)

Publication | July 2016

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RTS/ITS	Legal Basis	Adoption by the European Commission	Links to the draft RTSs that are still not adopted by the European Commission	Links to the Acts as adopted by the European Commission	End of EP/Council scrutiny	Published in the Official Journal
<b>RTS 1:</b> Transparency requirements for trading venues and investment firms in respect of shares, depositary receipts, exchange-traded funds, certificates and other similar financial instruments	MiFIR Articles 4(6), 7 (2), 14 (7), 20 (3), 22 (4) and 23(3)		<a href="#">Draft RTS 1 + Annexes at page 4</a>			
<b>RTS 2:</b> Transparency requirements for trading venues and investment firms in respect of bonds, structured finance products, emission allowances and derivatives	MiFIR Articles 1(8), 9 (5), 11 (4), 21 (5) and 22(4)		<a href="#">Draft RTS 2 + Annexes at page 39</a>			

# Current trading issues

# Working with ambiguity and uncertainty

## Many unanswered questions

- Is further guidance forthcoming?
- What do you do where something is ambiguous?
- How can you retain flexibility while getting ready?

## Decisions to be made

- What are the key questions that drive everything else?
- When does it make sense to make them?
- Is it better to go first or follow others?

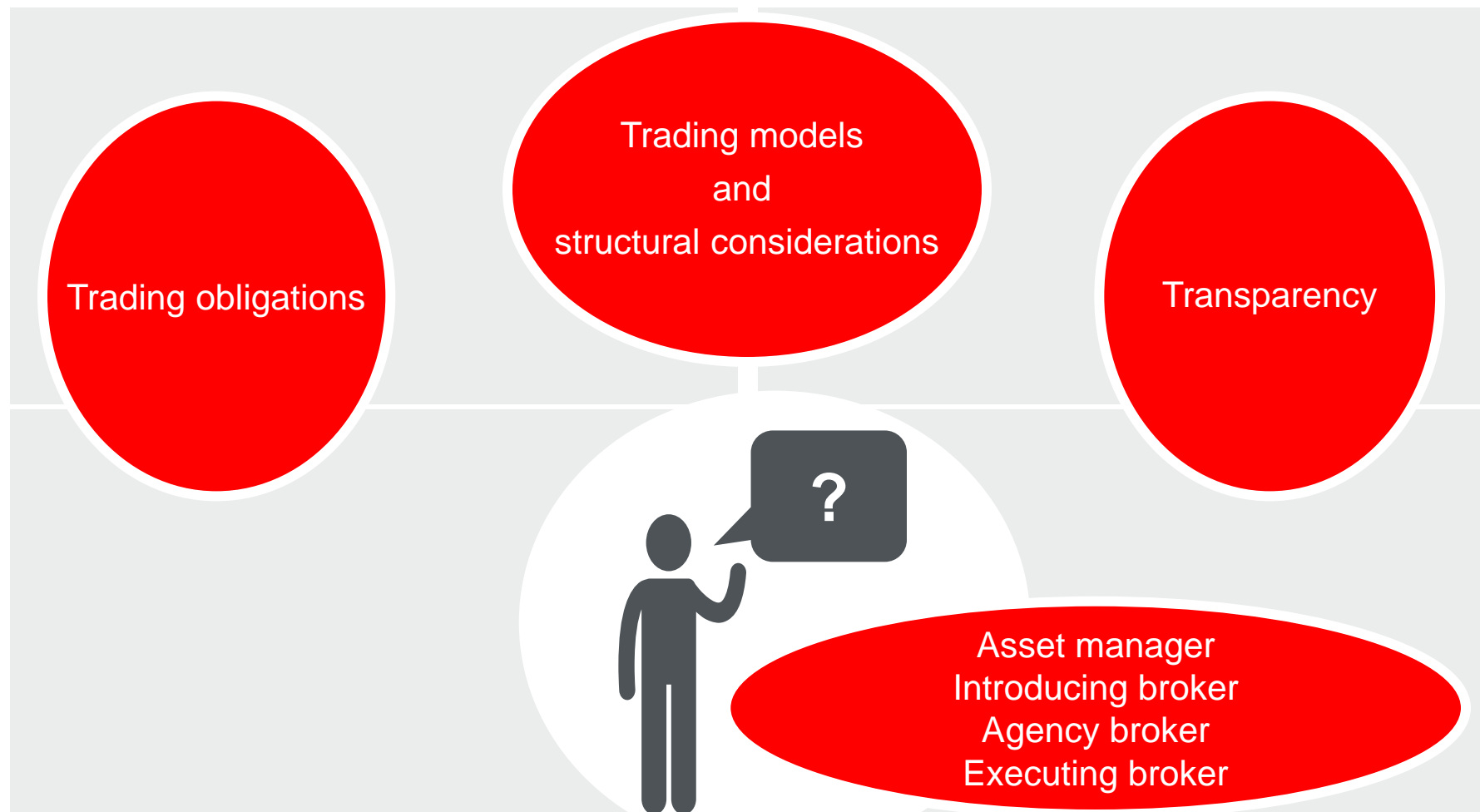
## Dependencies on others

- Where are you dependent on what others are doing?
- How can you find out what they will do?
- Is it better to go to market first or follow others?
- What will your clients need or want?

## Impact on markets

- Are you making decisions based on the current landscape or can you determine how it might change?
- Does this present any opportunities?

# What should I be thinking about?





# Trading obligations: shares and derivatives

## Shares

- **What?** Shares admitted to trading on a regulated market or traded on an MTF
- **Where?**
  - Regulated Market, MTF, Systematic Internaliser (SI)
  - Equivalent third country trading venue
- **Who?**
  - Investment Firms
  - Only Investment Firms can be direct members of trading venues

- **Trading obligation does not apply to trades that are:**
  - Non-systematic, ad hoc, irregular and infrequent;
  - Carried out between eligible and / or professional counterparties and do not contribute to price discovery;
  - In shares or equity instruments not admitted to trading on a regulated market or traded on an MTF; or
  - By non-Investment Firms (only)These parties / instruments can trade OTC

## Derivatives

- **What?** Derivatives that are traded on a trading venue that are sufficiently liquid and declared subject to the trading obligation
- **Where?**
  - Regulated Market, MTF, OTF
  - Equivalent third country trading venue
- **Who?** Transactions between:
  - An FC and another FC
  - An FC and an NFC+
  - An NFC+ and another NFC+(and third country entities that would be subject to clearing obligation in certain cases)

- **Trading obligation does not apply to:**
  - Non-equity instruments that have not been declared subject to the trading obligation
  - Any trade with an NFC- (including if it trades with an FC or NFC+)These parties / instruments can trade OTC or on an SI

# How will they decide which derivatives to mandate?



## To determine whether there is sufficient liquidity:

- ESMA must consider these criteria:
  - Average frequency and size of trades
  - Number and type of active market participants
  - Average size of spreads
  - Anticipated impact on liquidity
  - Impact on commercial activities of non-financial end users
- According to the final RTS, while ESMA will take into account whether a derivative class is liquid for transparency purposes, they will not automatically be deemed liquid for these purposes
- It proposes to retain flexibility and consult on:
  - Whether derivatives are only liquid below a certain size
  - How to deal with package transactions
- It also warns about moving trading into economically equivalent OTC contracts

# Traded / executed / concluded on a trading venue

Transaction reporting:  
- Financial instruments  
that are traded on a  
trading venue?  
- When a firm  
executes a transaction

When is a financial instrument traded / executed / concluded on a trading venue?

Do these words all mean the same?

Do you have to be the member or participant or does it also cover the contract between member / participant and client?

What if the transaction is subject to the rules of the trading venue but not traded on the central order book?

What about block trades and EFPs?

Will there be an equivalent of the ESMA Q&As on EMIR?

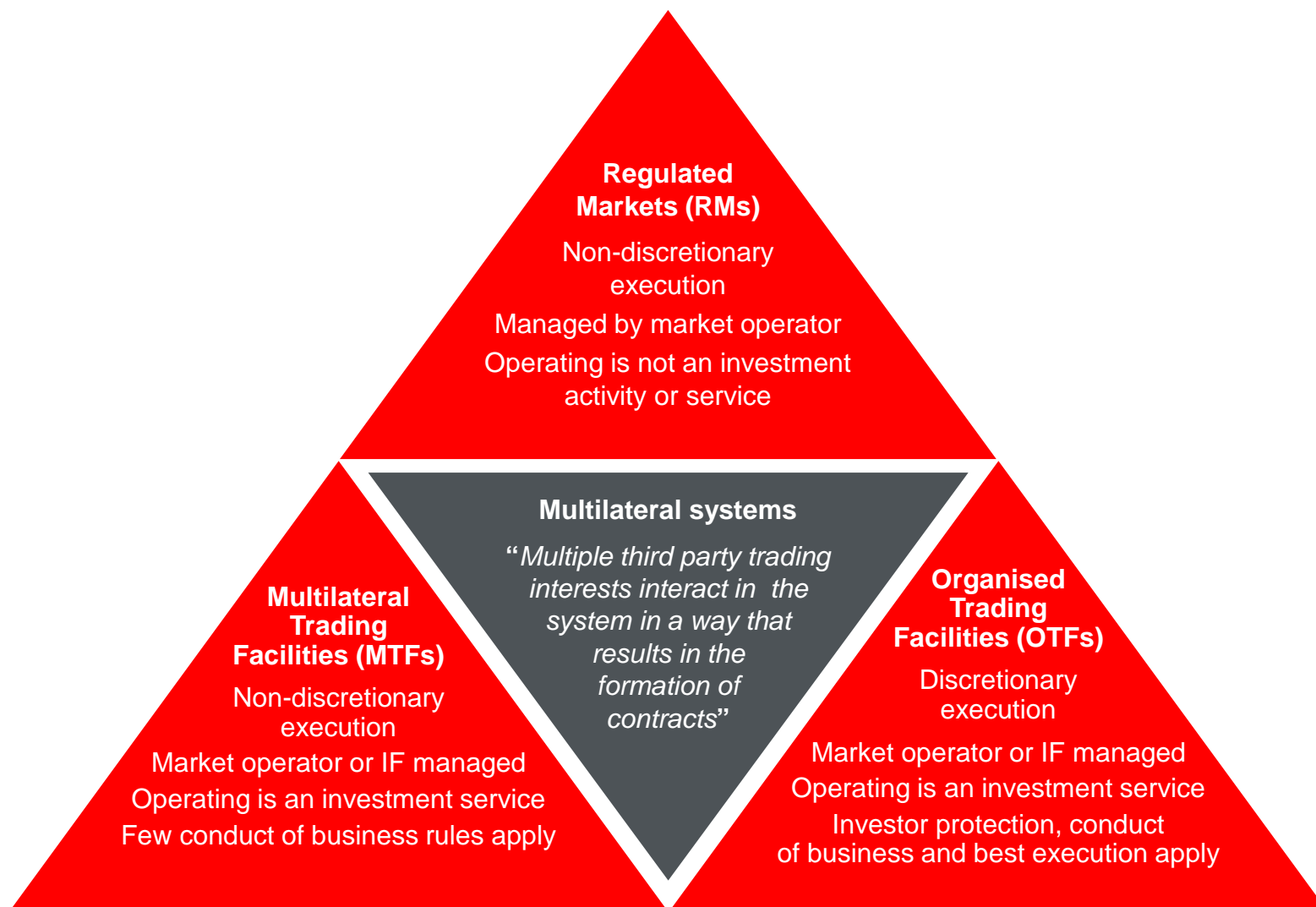
Can we use the ESMA Q&As by way of analogy?

Clearing obligation  
for derivatives  
concluded on a  
regulated market?  
- RTS refer to  
transactions  
executed on a  
trading venue

Trading obligation for  
derivatives – 'shall  
conclude  
transactions...on a  
trading venue'

What trading models will be available?

# Trading venues – new concepts and boundaries



MTFs

# Interesting questions on MTFs

**MTF:** "a *multilateral system*, operated by an investment firm or a market operator, which *brings together* multiple third-party buying and selling interests in financial instruments – in the system and in accordance with *non-discretionary rules* – in a way that *results in a contract*"

## Multilateral system

- Not bilateral: can't enter into every (any) trade on own account, even as riskless principal
- Multiple third party interests can interact
- Does every order need to interact with all other orders or can there be some segmentation?
- Non-discrimination
- Could it accommodate some 1:1 trades?

## Brings together multiple interests

- To be understood in broad sense
- Includes orders, quotes and indications of interest
- User ratification does not undermine this
- What is a firm quote or an indication of interest?

## In the system

- A set of rules - no need for a technical system for matching orders
- Includes systems where users can execute against multiple quotes requested
- Bring interests together under the rules, protocols or operating procedures
- Could some parts of the functionality fall outside the system?

## In accordance with non-discretionary rules

- Rules leave the operator with no discretion as to how interests may interact
- Limited development on this
- Users can have discretion

# MTFs and trading protocols (discretion)

**MTF:** "a *multilateral system*, operated by an investment firm or a market operator, which *brings together* multiple third-party buying and selling interests in financial instruments – in the system and in accordance with *non-discretionary rules* – in a way that *results in a contract*"

**Scenario #1:** A trading platform has multiple participants. These submit orders to an order book. Orders are matched (usually on a price-time basis) automatically by the platform. Neither the participant nor the platform operator can do anything after submission of the order that would affect whether or how orders are matched. ***Such a platform would quite clearly be an MTF. This is because:***

- 1) By having multiple participants able to interact in the order book it is "multilateral";
- 2) Orders are "brought together" by being able to interact directly in the order book;
- 3) Orders fall within "buying and selling interests";
- 4) The operator has no ability to force / prevent trades to occur so the rules are "non-discretionary"; and
- 5) Because the participant cannot make a choice after submitting an order whether or not to trade, the system "results in a contract".



# MTFs and trading protocols (RFQ and RFS)

**MTF:** "a *multilateral system*, operated by an investment firm or a market operator, which *brings together* multiple third-party buying and selling interests in financial instruments – in the system and in accordance with *non-discretionary rules* – in a way that *results in a contract*"

**Scenario #2: RFQ / RFS** permit quotes to be requested from discrete parties and *sent directly to the requestor*. Requestor must then choose which (if any) provider's quote to accept. The operator has no discretion (**so it cannot be an OTF**). This is **arguably not an MTF**:

1) Likely (although not certain) that it is “multilateral” as multiple parties are involved

**Counter-argument:** The *requestor interacts with each responder bilaterally* (this bilateral argument is more likely to hold if the requestor must accept / reject each quote individually rather than accepting one being sufficient to automatically reject the others)

2) Possible that buying & selling interests are “brought together” when quotes arrive at the requestor

**Counter-argument:** Quotes from *multiple parties* are not "brought together" as in a CLOB – the requestor's indication of interest is *brought together individually with separate quotes* (i.e. there is *no mass interaction of multiple requests with multiple responses*)

3) Arguable that the trade might not have occurred otherwise so the system “results in a contract”

**Counter-argument:** The *requestor elects* for a trade to occur. There is no certainty that a trade will occur on the basis of the quotes. Therefore it is not the system that "results in a contract" but instead the *system enables the requestor to take an action that will "result in a contract"*

OTFs

# Some thoughts on OTFs

**OTF:** "a *multilateral system...* in which *multiple third-party buying and selling interests* in bonds, structured finance products, emission allowances or derivatives are able to *interact in the system* in a way that *results in a contract* in accordance with Title II of MiFID II"

## Markets facing requirements

- Non-discrimination and transparency
- Conflicts management
- Monitoring compliance with the rules and orderly trading
- Market surveillance
- System resilience and tick sizes
- Position reporting

## Client facing obligations

- Clients' best interests
- Appropriate information requirements
- Suitability and appropriateness
- Best execution
- Prompt and fair execution of orders
- Publication of limit orders in shares

## Other differences from MTFs

- Only for non-equities
- Must exercise discretion by deciding to place or retract orders on the OTF and / or deciding not to match an order with other available orders at a given point in time
- May facilitate negotiation between clients
- Not subject to mandatory CCP clearing – will FCA allow a bit more flexibility?

## Questions without answers (yet)

- Who might become an OTF?
- What will OTF rules look like?
- How much discretion will clients accept?

# OTFs and trading protocols (discretion)

**OTF:** "a multilateral system which is not a regulated market or an MTF and in which multiple third-party buying and selling interests in bonds, structured finance products, emission allowances or derivatives are able to interact in the system in a way that results in a contract"

**Scenario #3:** Exactly the same situation as **Scenario 1**, however, *now the platform operator has discretion* as to:

- a) If / when orders should be placed on the platform; and / or
- b) What orders to match against each other (i.e. follows best execution requirements - these do not necessarily equate to a price-time matching algo).

**Such a platform would quite clearly be an OTF under MiFID II.** This is because of the reasons below except that reason (4) is now that the operator has the requisite type of discretion for the platform to be "discretionary":

- 1) by having multiple participants able to interact in the order book it is "multilateral";
- 2) orders are "brought together" by being able to interact directly in the system;
- 3) orders fall within "buying and selling interests";
- 4) the operator has the requisite type of discretion for the platform to be "discretionary";** and
- 5) because the participant cannot make a choice after submitting an order whether or not to trade, the system "results in a contract".

# Structural considerations

## If you operate an MTF

- You can't execute client orders against proprietary capital or engage in matched principal trading – how far this goes is unclear – at least 3 interpretations
- It looks like you can operate an OTF as well
- If you're the operator of a regulated market, you can operate an MTF and an OTF
- There are examples in the market of firms operating an MTF and a non-regulated platform side by side in the same legal entity
- It looks like you can order route to other MTFs, OTFs and SIs, although query whether this is part of the MTF functionality

## If you operate an OTF

- You can't execute client orders against proprietary capital – extent is unclear
- But you can deal on own account in non-liquid sovereign bonds
- You can't engage in matched principal trading in the same entity save for instruments other than mandatory traded derivatives but only with the client's consent
- You can't execute client orders against the proprietary capital of another member of the group – i.e. other members of the group can't act as market makers
- Orders cannot connect to or interact with orders in an SI or another OTF – so you cannot order route to SIs and OTFs
- It looks like you can operate an MTF as well (and if you're the operator of a regulated market, you can operate an MTF and OTF)

# Systematic Internalisers

# Systematic Internalisers

## Definition:

“An investment firm which, on an organised, frequent, systematic and substantial basis deals on own account by executing client orders outside a RM, MTF or OTF ”

## Quantitative tests and opt in:

- Firms exceeding both thresholds are caught but others can opt into the regime
- Must notify competent authority

		Equities	Bonds	Structured Finance Products	Derivatives	Emission allowances
Frequent and systematic basis threshold (liquid instruments) OR	Number of transactions executed by the investment firm on own account OTC / total number of transaction in the same financial instrument in the EU	Equal to or more than 0.4% and daily	2.5% and at least once a week	4% and at least once a week	2.5% and at least once a week	4% and at least once a week
Frequent and systematic basis threshold (illiquid instruments) AND	Minimum trading frequency (average during last 6 months)	Daily	At least once a week	At least once a week	At least once a week	At least once a week
Substantial basis threshold criteria 1 OR	Number of OTC trades by investment firm in a financial instrument on own account when executing client orders of equal to or larger than in comparison to the number / nominal amount traded in that financial instrument and executed  This is on own account or on behalf of clients executed on a trading venue or OTC	15%	25%	30%	25%	30%
Substantial basis threshold criteria 2	Number of OTC trades by investment firm in a financial instrument on own account when executing client orders/ total volume / nominal amount in financial instrument executed in the EU with or on a trading venue or OTC	0.4%	1%	2.25%	1%	2.25%

# Pre-trade transparency for Systematic Internalisers

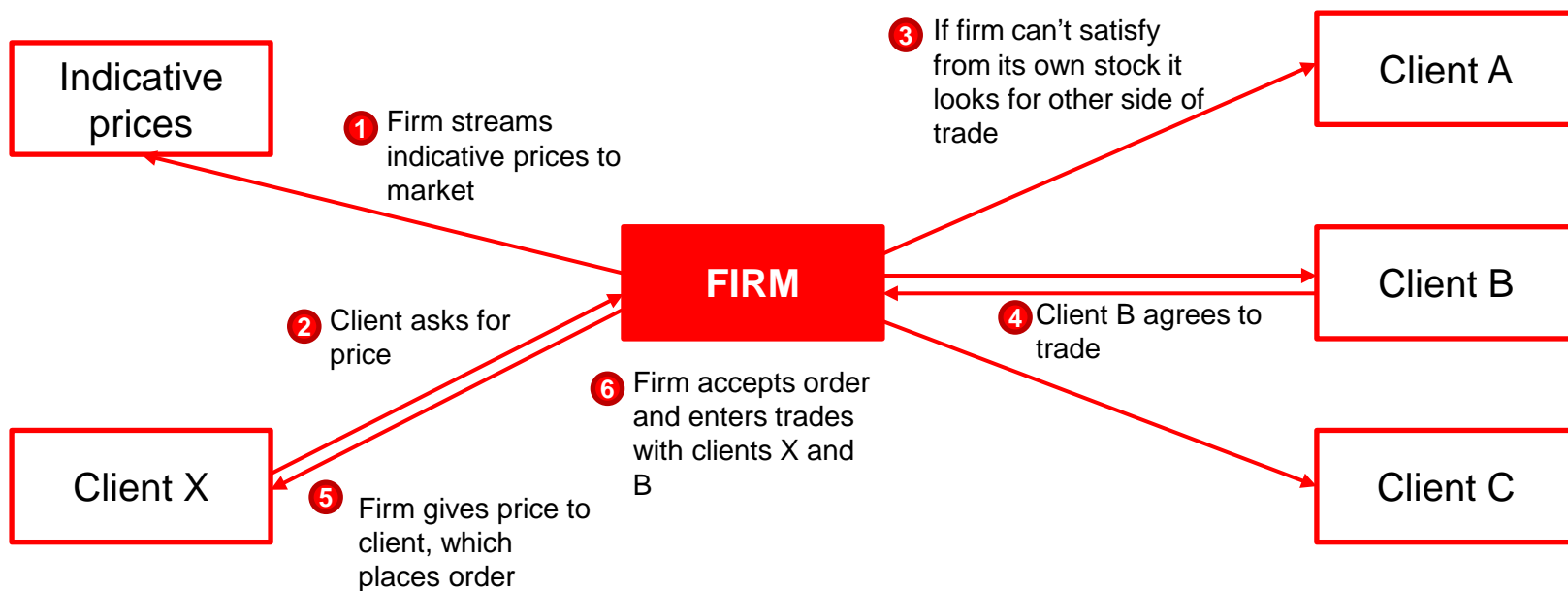
	Equity like instruments	Non-equity like instruments
Make public quotes for liquid instruments	On a regular and continuous basis during normal trading hours	<ul style="list-style-type: none"> <li>- When prompted by client</li> <li>- When agreed to provide a quote and, if illiquid, on request from the client if they agree to provide a quote</li> </ul>
Quotes requirements	Must achieve best execution and reflect prevailing market conditions	
Update / withdraw	Can update any time but can only withdraw in exceptional conditions. Article 14 Delegated Regulation 18/5/2016 details when exceptional conditions are deemed to exist	
Access to quotes	Must make available to other clients but can have commercial policy on access provided objective and non-discriminatory	
Obligation	Execute at quoted price in sizes up to standard market size – minimum quote size	Enter transactions under published conditions if at or below size specific to instrument
Acceptable limits	Number of trades with same client and total trades at same time provided non-discriminatory and transparent	Number of trades at any quote provided non-discriminatory and transparent
Price improvement	Same but carve out for professional clients where several securities in one trade	Only in justified cases if it falls within public range close to market conditions



# The future for equities broker crossing networks

- 3 choices for an equities broker crossing network?
  - **MTF**: must be an MTF if operated on a multilateral basis
  - **SI**: must be an SI if not multilateral and exceeds SI thresholds
  - **Neither?**: if multilateral but exercise discretion, i.e. OTF or if deal on own account but below thresholds and don't opt in to SI regime – for use by exempt persons
- An Investment Firm that operates an internal matching system on a multilateral basis should be authorised as an MTF
- Single dealer platform (where trading is always against one firm) v multi-dealer platform, with multiple dealers interacting for same financial instrument
- How bilateral do SIs need to be?
  - Dealing on own account when executing client orders includes matching on a matched principal basis but, Recital 19 of Delegated Regulation 25/4/2016 provide that firms entering into matched principal transactions on a “regular and not occasional” basis should not be considered SIs
  - Does this mean that an SI for non-equities (other than derivatives subject to mandatory trading) could look very similar to an OTF?
- SIs may have more control over access to flow and fewer markets obligations (inc. transparency) but quoting obligations are onerous except in relation to illiquids, where waivers largely remove obligations to publish firm quotes (i.e. pre trade transparency obligations)

# What would this bond arrangement be?



## Could it be an SI?

- Are orders executed outside a trading venue?
- Does firm deal on own account when executing client orders?
- Is it bilateral / a single dealer platform?
- Is it on an organised, frequent, systematic and substantial basis?

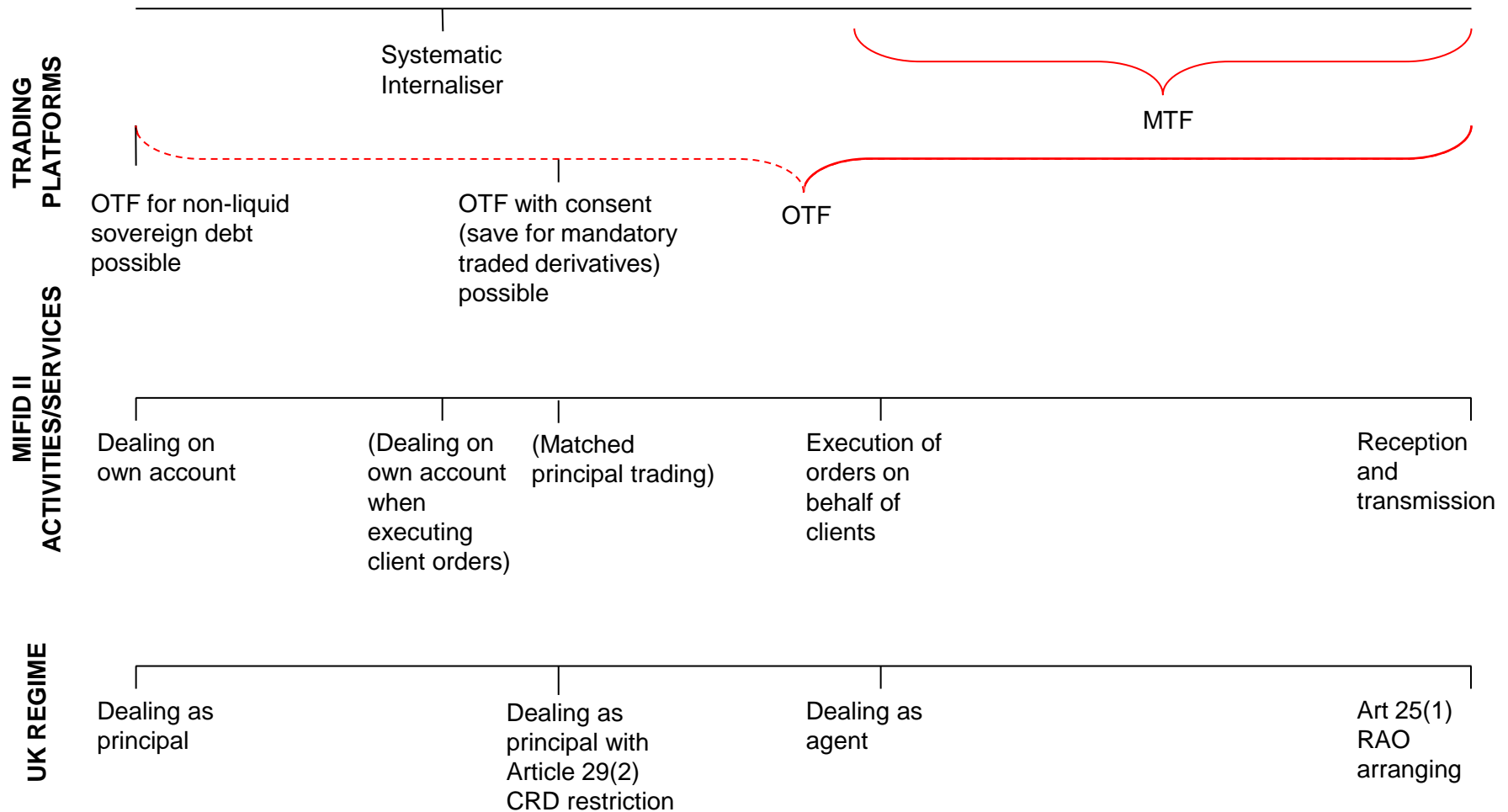
## Could it be an OTF?

- Is it multilateral?
- Does it bring together multiple buying and selling interests / is a multi-dealer platform?
- Is there a system?
- Do they interact in a system in a way that results in a contract?

# MTF v OTF v SI v SEF:

	MTF	OTF	SI	SEF
Assets	All financial instruments	Non-equities only	All financial instruments (but OTC only)	Swaps only
Matching System	Non-discretionary CLOB, RFQ, RFS	Discretionary CLOB, RFQ, RFS	Full discretion (bilateral) RFQ, RFS	Discretionary CLOB, RFQ, RFS
Restrictions on Multilateral trading	Cannot execute client orders against own capital and no matched principal trading	Matched principal is allowed if client consents Market makers must be independent	Cannot operate a multilateral trading system	Permits limited matched principal trading
Other Restrictions	Cannot operate an SI (we don't think) but can connect to one	Cannot operate an SI and cannot connect to another OTF	Cannot operate an OTF	Limit on dealer ownership
Participants	Regulated only (save for commodity derivatives)	Can be unregulated subject to certain criteria	Clients only	Eligible Contract Participants
Investor Protection	Very few COB rules	Full COB rules apply including best execution	Full COB rules apply including best execution	Core principles apply; SEF has discretion to examine best practices and regulations
Resilience	Various requirements (mainly HFT focus)	Various requirements (mainly HFT focus)	Limited requirements (mainly HFT focus)	Detailed requirements
Purpose of new rules	Requirements have been aligned with those of RMs in order to create a more level playing field and replace broker crossing	Create new venue on which derivatives can be traded and replace broker crossing networks in non-equities	Alternative to replace broker crossing networks	Replace broker crossing networks, as well as regulate secondary markets for swaps

# Mapping out the brokerage world



Map is an attempt to show correlations between different concepts in MiFID II. It should not be understood to mean that an MTF or OTF requires separate permissions for providing investment activities and services – this remains to be seen.

# Transparency and dark pools

# Transparency for equity instruments

**Pre-trade**                      **Post-trade**

**Trading venues**

Equity instruments:

- shares
- depositary receipts
- ETFs
- certificates
- similar financial instruments

that are traded on a trading venue

**Investment firms**

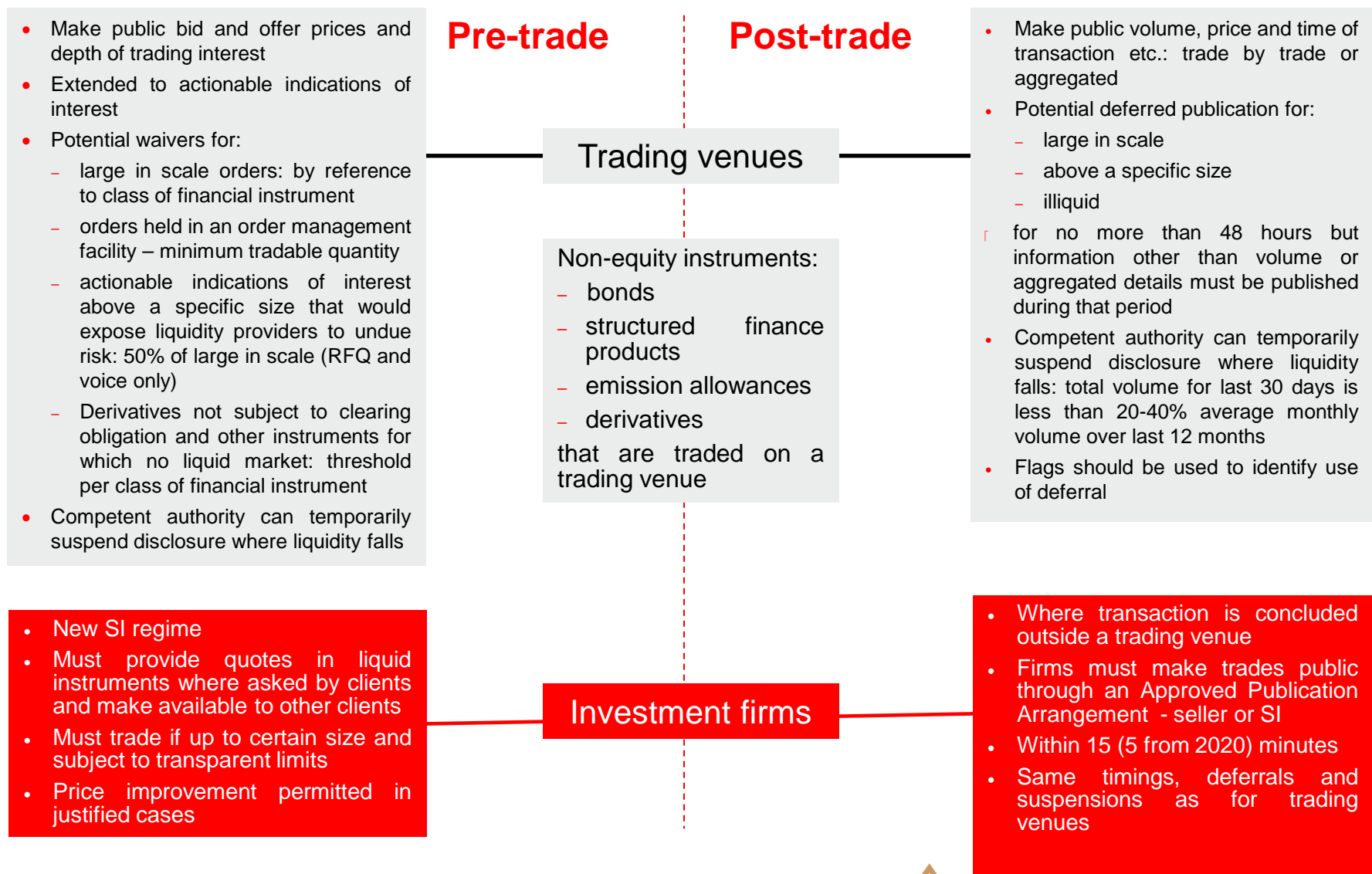
- Make public bid and offer prices and depth of trading interest
- Extended to actionable indications of interest
- Competent authorities permitted to grant waivers including orders that are large in scale but ESMA will opine on use of waivers before their use and has powers to oppose them
- Volume cap limit on use of referential price and (for liquid shares) negotiated transaction waivers: 4% per trading venue and 8% across all trading venues of overall EU trading in instrument
- Existing waivers to be reviewed against new requirements by Jan 2019

- Make public price, volume and time of trades as close to real time as possible: within 1 minute of trade
- Deferred publication for large in scale transactions where authorised by competent authority: delays are shortened to 60 mins, 120 mins or EOD depending on size of trade and thresholds are increased – minimum qualifying size and one party must be an investment firm dealing on own account but not matched principal
- New flags to identify trades executed under waivers

- Some amendments to SI regime including minimum 10% quote size, two way quotes and price improvement for retail as well as professional clients

- Firms must make public trades through an Approved Publication Arrangement – seller or SI
- Applies in respect of instruments traded OTC
- Same timings and deferrals as for trading venues
- Make public volume, price and time of transaction

# Transparency for non-equity instruments



# Transparency waivers / deferrals for equities

Exception Type	Instruments Covered	Pre-trade Waiver	Post-trade Deferral
Large-in-scale	All	Yes	Yes
Order management facility	All	Yes	No
Price reference	Equities & equity-like	Yes	No
Negotiated transactions	Equities & equity-like	Yes	No
Size specific to instrument	Non-equities	RFQ & voice trading systems only	Yes (all trading systems)
Illiquid instruments	Non-equities	Yes	Yes

- **Large in scale (LIS)**: for ETFs, an order is LIS if over €1m. Other equity and equity-like instruments are set against a scale measured in average daily turnover in the EU
- **Order management facility**: orders for order management facility may not be smaller than the minimum tradable quantity (as set in the trading venue's rules) and reserve orders may not be smaller than €10,000 at any stage during their lifetime
- **Price reference**: either the price for that instrument from the trading venue where the instrument was first admitted to trading, or the 'most relevant market in terms of liquidity' (market with the highest turnover in the EU in the preceding calendar year (excluding transactions concluded under a pre-trade transparency waiver))
- **Negotiated transactions**: ESMA has prescribed the scope of transactions falling within this waiver by merit of being subject to conditions other than market price (which are closely aligned with the transactions that do not contribute to price discovery, such as give-ups or give-ins): catch all category of price taking trades



# Transparency waivers / deferrals for non-equities

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Large-in-scale	All	Yes	Yes
Order management facility	All	Yes	No
Price reference	Equities & equity-like	Yes	No
Negotiated transactions	Equities & equity-like	Yes	No
Size specific to instrument	Non-equities	RFQ & voice trading systems only	Yes (all trading systems)
Illiquid instruments	Non-equities	Yes	Yes

- **RFQ:** ESMA permits all submitted quotes to be published at the same time but rejected average price argument
- **LIS:** ESMA has set restrictive thresholds for block trades – set against either fixed or periodically recalculated thresholds depending on the type of instrument: note treatment of stubs in iceberg situation
- **Order management facility:** orders for order management facility may not be smaller than the minimum tradable quantity (as set in the trading venue's rules) and reserve orders may not be smaller than €10,000 at any stage during their lifetime
- **Size-specific-to-instrument (SSTI):** applicable only to actionable IOIs in RFQ and voice operated trading systems that are at or above a set threshold, where publication would expose liquidity providers to undue risk. Thresholds are a fixed or percentile value lower than the LIS threshold
- **Illiquid instruments:** encompasses all derivatives which are not subject to MiFIR's trading obligation; also applies to other instruments (including derivatives that are subject to the trading obligation) that ESMA has deemed at Level 2 are not sufficiently liquid to be subject to pre-trade transparency

# Update from the Level 2 consultations

## Criticism responded to

- Not enough granularity in categories of instrument
- Static liquidity thresholds not able to adapt to changing markets
- Significant misclassification of liquidity for derivatives caused by:
  - Inadequate data
  - Insufficiently granular instrument classes
- Liquidity thresholds too low
- LIS and SSTI thresholds too high
- SSTI methodology inappropriate: 50% link to LIS too high

## Liquid market definition

- More granular classes of financial instruments approach (COFIA) for derivatives
- Assessment of liquidity for derivatives will now occur annually rather than being static and liquidity thresholds have been raised in general
- Bonds to follow an instrument by instrument approach (IBIA) rather than COFIA to allow more granular treatment
- All FX derivatives classed as illiquid until better data can be collected
- Nearly all types of equity derivatives deemed liquid

## Equities waivers/ deferrals

- Increase in number of liquidity bands in general: asset class, sub-asset class and sub-class analysis
- New threshold for shares with ADT below €50,00 added to promote liquidity in SME shares
- Proposed single pre-trade LIS threshold of €1,000,000 for all ETFs regardless of underlying kept
- New post-trade deferral thresholds for ETFs set at €10m and 50m.
- Proposed cut from three to one minute delay to post-trade publication where no deferral applies kept

## Non-equities waivers/ deferrals

- Pre-trade thresholds lower than post-trade (previously equal)
- Thresholds raised in general
- SSTI no longer half of LIS; instead a lower trade percentile
- Equity derivatives methodology changed; no longer trade percentile but based on ADT (i.e. like equities)
- Four-year phase-in for bonds (30 – 60%)
- Deferral period now T+2BD rather than T+48h
- Supplemental deferral regime of up to 4 weeks remains with 1 week delay in aggregated reporting

# Remaining Level 2 issues

## Liquid market definition

- Buy side would prefer COFIA for bonds
- ESMA suggests that it is unclear whether proposed phase-in for bond liquidity definition will allow for meaningful transparency in the bond market
- ESMA to conduct an annual assessment of liquidity levels, however the scope, granularity and extent of this remains unclear

## Bond thresholds

- For bonds, trades under €100,000 are excluded when measuring trade percentiles
- ESMA argues this is necessary as a large number of small trades can bias the measure and risk loss of transparency for retail investors
- Argument that many institutional trades are under €100,000 and should not be excluded otherwise thresholds biased against professional investors

## Package trades

- Examples are swap spreads or EFP
- MiFIR provides for post-trade transparency for package trades but not pre-trade
- Concern that showing quotes for each leg of a package transaction separately could be misleading: recognition that deferral to longest period of one element of package is permitted
- ESMA recognises problem but says can only be fixed at Level 1
- Level 1 can't be amended before introduction of pre-trade requirements

## Cross border convergence

- 'LIS' v 'Block' regimes; LIS thresholds generally lower
- Divergence of approaches between EU and US – fundamental scope issues remain
- Systems and monitoring convergence/ updates required
- Deferral regime and NCA discretion under Article 11 MiFIR may lead to regulatory arbitrage
- Trading obligation; 'sufficiently liquid test' should be applied at a more granular level
- BUT alignment with EMIR is welcomed

# Draft RTS on transparency requirements re bonds, structured finance products, emission allowances and derivatives

## Issue

- Determining a bond (ISIN) as liquid on the basis of two trades per day might not reflect the existence of continuous buying and selling interest and might identify too many bonds as liquid instruments

## Approach

- Commission requested that ESMA phase-in the trades per day element of the liquidity definition to mitigate possible liquidity risks to bond markets accordingly:
  - Year 1: 15 trades per day
  - Year 2: 10 trades per day
  - Year 3: 7 trades per day
  - Year 4: 2 trades per day
- ESMA opposed the Commission's proposed approach for implementing a phase in, considering the proposed annual amendments to the RTS overly burdensome
- ESMA suggests instead having an annual transition to the next stage included in the RTS and monitoring of impact of the pre-trade transparency regime, publishing proposed amendments to the RTS for consultation if risks are identified
- ESMA noted it was unclear whether the earlier phases in particular would allow for meaningful transparency, noting that for derivatives in most classes 10-15 trades per day constitutes a liquid market

# Draft RTS on transparency requirements re bonds, structured finance products, emission allowances

## Testing

- ESMA would be obliged to assess liquidity in all classes of bond markets annually – this would include:
  - verification that the intended ISIN coverage ratio emerges once officially reported data under MiFID II becomes available
  - trading volumes and number of trades
- It would not be possible to move to the next threshold if trading volumes have declined
- ESMA has raised a number of practical questions concerning the scope of the assessment; e.g. what reference period or periods should be considered and when should the first assessment be carried out, considering that the data will only be available after MiFID II/ MiFIR apply

## SSTI thresholds

- Commission is also concerned that the proposed SSTI thresholds might expose liquidity providers to undue risk and also suggests a more cautious, phased in approach for both bonds and other non-equity asset classes that currently use the 60<sup>th</sup> percentile:
  - Year 1: 30<sup>th</sup> percentile
  - Year 2: 40<sup>th</sup> percentile
  - Year 3: 50<sup>th</sup> percentile
  - Year 4: 60<sup>th</sup> percentile
- All current cash floors would stay in place during the phase-in period
- Again, ESMA would need to regularly assess the operation of liquidity providers to ensure the increases do not pose undue risks

# What does this all mean for dark pool trading?

## Shares

- Dark pools continue in theory but volume caps will make unlit trading unpredictable in practice for all but block trades
- Moving to another dark pool could result in a market wide suspension
- Scope for trading elsewhere is limited by trading obligation but could SIs be an alternative?
- Venues and firms will need to be ready to “light up” – will they be expected to have arrangements in place?

## Derivatives that are mandated for trading and other liquid non-equities

- Subject to transparency for first time
- Dark pools can exist if trading venues get waivers
- No volume cap
- If transparency drops, competent authorities can suspend pre-trade transparency obligations for up to 3 months but extendable

Whenever instruments are executed on trading venues

## Other equity instruments

- Subject to transparency for first time and waivers are subject to volume caps
- Volume caps do not apply to negotiated transactions in these instruments for which there is no liquid market in certain cases

## Other derivatives and non-liquid financial instruments

- Waiver from pre-trade transparency so this can remain dark
- Competent authorities can withdraw waivers where they think they are being abused

# Conclusions

# Conclusions: what will it mean?

## Many unanswered questions

- Further guidance may be limited, it may take such time and it may not resolve all issues
- Take sensible interpretations to avoid having to completely re-do the work
- But be a bit flexible and track views

## Decisions to be made

- Work backwards to determine when they need to be made
- Be aware of the information you don't yet have and review when it arrives
- Allow some wiggle room if possible

## Dependencies on others

- Tricky because everyone is in the same boat
- But no harm in talking to key suppliers / relationships
- Talking to clients about the changes and their needs may be a positive

## Impact on markets

- Involves some crystal ball gazing
- However, worth considering because investment needed for MiFID II needs to last a while
- And there may well be opportunities
- Again, keep ideas under review



# Update on post-trade issues: Transaction Reporting

# Transaction Reporting: scope

- Applicable to an **investment firm and its (non) EU branches**: It does not matter where the counterparty to a transaction or the client on whose behalf the transaction is executed is located - it would need to be reported even if they are outside the EU
- The obligation applies to an **EU branch of a third country firm** which is authorised pursuant to MiFID II

# Transaction reporting for investment firms

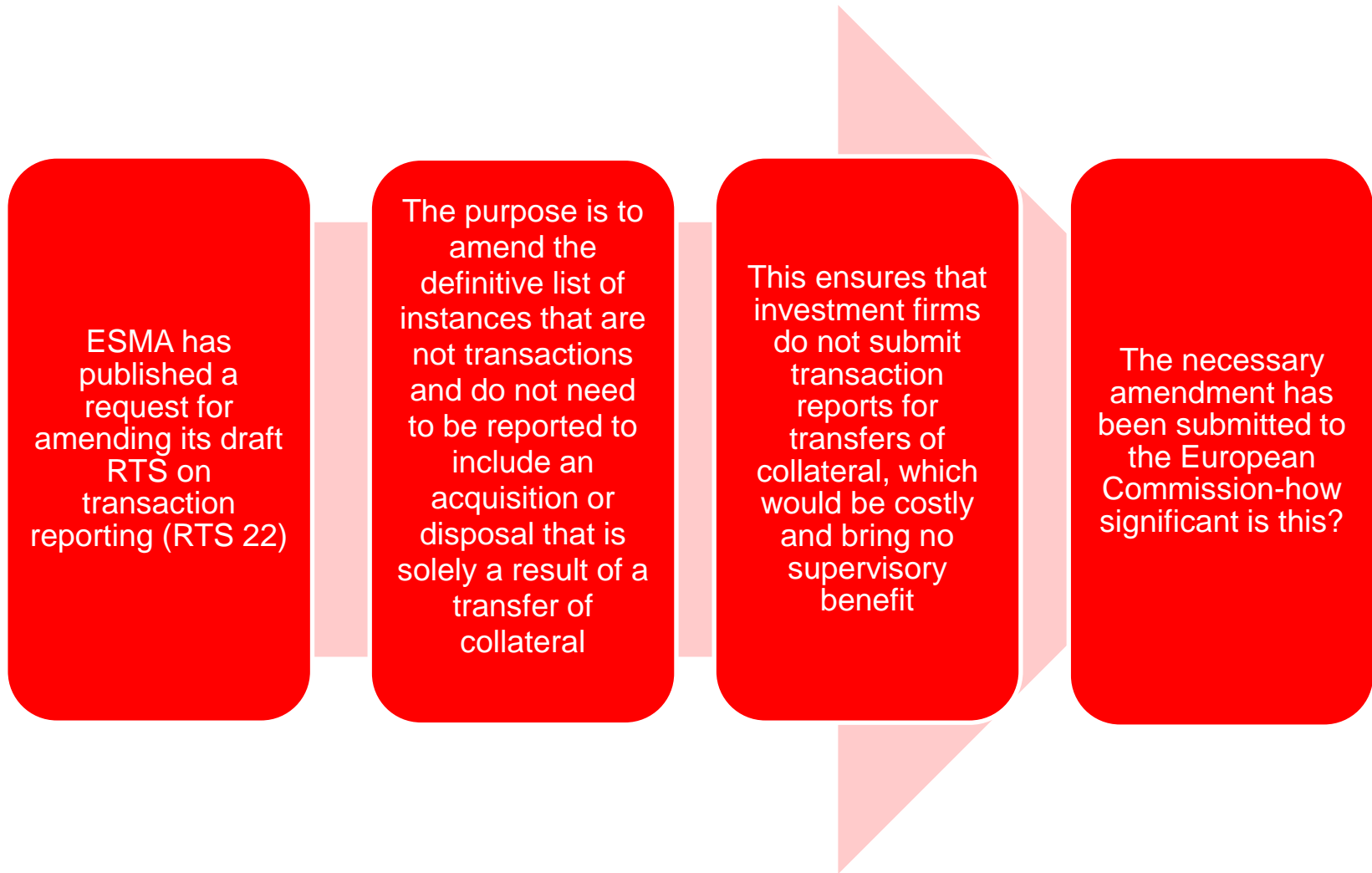
<b>Which trades?</b>	<ul style="list-style-type: none"> <li>• Investment firms that execute transactions in financial instruments close of T + 1:             <ul style="list-style-type: none"> <li>- that are admitted to trading or traded on a trading venue or for which a request has been made</li> <li>- where the underlying is a financial instrument traded on a trading venue</li> <li>- where the underlying is an index or basket of financial instruments traded on a trading venue</li> </ul> </li> </ul>
<b>Transactions and execution</b>	<ul style="list-style-type: none"> <li>• Transaction means an acquisition, disposal or modification subject to various exceptions</li> <li>• Execute means any action that results in a transaction if it is sufficiently important that without it, the transaction would not have taken place</li> <li>• A firm that transmits orders can enter a transmission agreement under which receiving firm will report but, if it doesn't transmit all required information, it must report trades itself</li> </ul>
<b>Which information?</b>	<ul style="list-style-type: none"> <li>• ESMA has attempted to simplify the reports – <b>65 fields</b></li> <li>• New fields include client ID, IDs of person or committee that make decision to trade and also responsible for decision and execution</li> <li>• Legal entities to be identified by LEI codes, simplified concatenation for individuals</li> <li>• Codes for algos and committees must be unique, consistent and persistent</li> <li>• Various new designations – eg. waivers, short sales</li> </ul>
<b>How?</b>	<ul style="list-style-type: none"> <li>• Firms can report themselves or through an ARM or trading venue – they must take reasonable steps to ensure compliance where they don't report themselves and remain responsible</li> <li>• Trading venues will report trades executed by firms <b>not subject to</b> reporting obligation</li> </ul>
<b>To whom and by when?</b>	<ul style="list-style-type: none"> <li>• Home competent authority of firm, even where a branch executes the transaction</li> <li>• As quickly as possible and <b>no later than end of next working day</b></li> </ul>
<b>Link to EMIR?</b>	<ul style="list-style-type: none"> <li>• Transactions reported to a trade repository under EMIR count provided:             <ul style="list-style-type: none"> <li>- that trade repository is also an ARM</li> <li>- the report contains all the required details</li> <li>- trade repository transmits information to competent authority</li> </ul> </li> </ul>

# Transaction

- Transaction: acquisition or disposal
  - Acquisition: purchase, entering into derivative, increase in notional amount
  - Disposal: sale, closing out of derivative, decrease in notional amount
- RTS 22 includes exhaustive list of ‘non-transactions’
- Execution of transaction:
  - Reception and transmission of orders in relation to one or more financial instruments;
  - Execution of orders on behalf of clients;
  - Dealing on own account;
  - Making an investment decision in accordance with a discretionary mandate given by a client; and
  - Transfer of financial instruments to or from accounts.

Not deemed execution: transmission of an order

# Draft RTS on transaction reporting



# Important points

## Branches

Single report to home member state unless agreed otherwise with host

Branch code to be included where it:

- receives order or makes decision,
- has supervisory responsibility for person responsible for decision or execution or
- transaction is executed on trading venue outside EU using branch membership

Branch of a third country firm submits to competent authority that authorised it – where there is more than one, they agree

## LEIs

To be used for all legal entities

Must not provide service before obtaining LEI

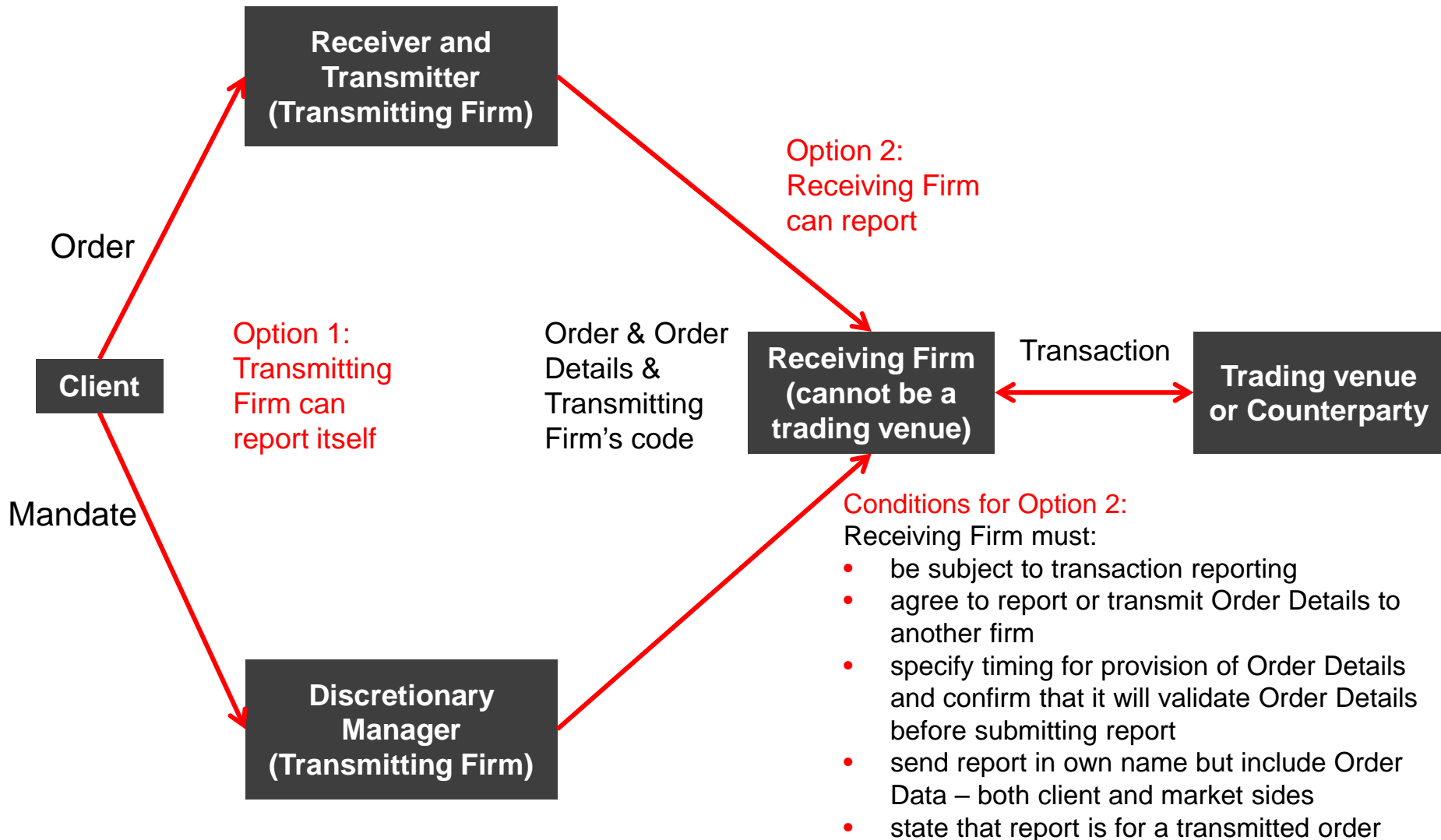
Validate against Global LEI website at onboarding, rather than transaction by transaction

## ESMA Guidelines

ESMA still plans to replace existing framework with buyer / seller fields and a separate trading capacity field

Further instructions may be provided in ESMA Guidelines

# Transmission of orders



# Transmission agreements: what might they contain?

Beyond conditions on previous slide, ESMA suggests that commercial terms should be for negotiation between parties

## Liability

Responsibility presumably lies with Receiving Firm if conditions for transmission are satisfied but:

- What if there is a mistake in the transmission information provided by Receiving Firm? Transmitting Firm must validate order details for obvious errors and omissions but this won't capture everything
- Contractual consequences need not necessarily be limited to regulatory responsibility
- Will Transmitting Firms seek to recover some of their risk of fines or costs of other disciplinary action and back reporting?

## Monitoring

- Obligation to notify competent authority of errors, omissions and failures it notices – presumably also on Receiving Firm but will it report anything the Transmitting Firm notices?
- How much monitoring and reconciliations can/ should the Receiving Firm do? Should this include the Art 15(3) and (4) RTS 22 obligations? And should Receiving Firm have to tell Transmitting Firm about anything it sees?

## Compensation

- Is this a service that the buy-side / smaller brokers will pay for?



# How MiFIR matches up with EMIR

## When does an EMIR report count for MiFIR also?

- Trade repository must also be approved as an ARM
- Report must contain all details required under MiFIR
- Trade repository must transmit report to relevant competent authority no later than close of following working day

# Potential problems with EMIR/ MiFIR reporting

EMIR	MiFIR
<b>Two parties report each transaction</b>	Multiple parties may report same transaction – they won't all be the counterparties
<b>In their capacity as principal</b>	Many persons other than the counterparties have a reporting obligation
<b>Some counterparties have delegated reporting</b>	This cannot be done under MiFIR – can counterparties establish a relationship with the trade repository for these purposes?
<b>There is no equivalent of transmission</b>	If a counterparty wants to use its EMIR reports, can it perform obligations as a Receiving Firm?
<b>EMIR reports don't contain all the necessary reporting fields for MiFIR and even where they do, the notations can be different</b>	Can existing EMIR information be reorganised and any missing information be collected in addition?

# Top 5 conduct issues for market players

# Why conduct matters to the wholesale market?

## Communication

What extra communications will you have to make at what points in the relationship?

How will those communications need to change?

## Information/ analytics

Where will you get the information you need?

What will you need to do with it?

How will you do that?

How will you record that information?

## Systems and controls

Which obligations will impact on your systems and controls?

How will you account for continuing changes – eg. in the services or clients' preferences?

## Product life cycle

Do you design or sell a product? What will you need to consider as a result – at what stages of the life cycle?

When and how can the regulators intervene?

# 1: Dealing with eligible counterparties

Depending on FCA conclusions, only investment firms and large undertakings will be able to **opt up**

Client must request; firm must provide written warning of consequences and client must confirm request in writing

## **Act honestly, fairly and professionally**

What changes will firms have to make to evidence this?

Most **information** needs to be provided to ECPs including information about terms of agreement and risks

But firms can agree to provide less information on costs and charges save where firm intends to offer financial instruments which embed a derivative to their clients

## **Reporting requirements**

for retail and professional clients apply unless firm agrees reduced content and timing of reports

Do your opt up **policies and procedures** need to be updated?

How will staff know whether a client has opted up generally or for certain products/ services/ trades?

## **Communicate in a way which is fair, clear and not misleading**

But Delegated Regulation provisions do not apply so what does this mean in practice?

## **Wider set of principles to apply to MiFID ECP business**

6 on treating them fairly and 7 on communication

1 on integrity and 2 on skill, care and diligence

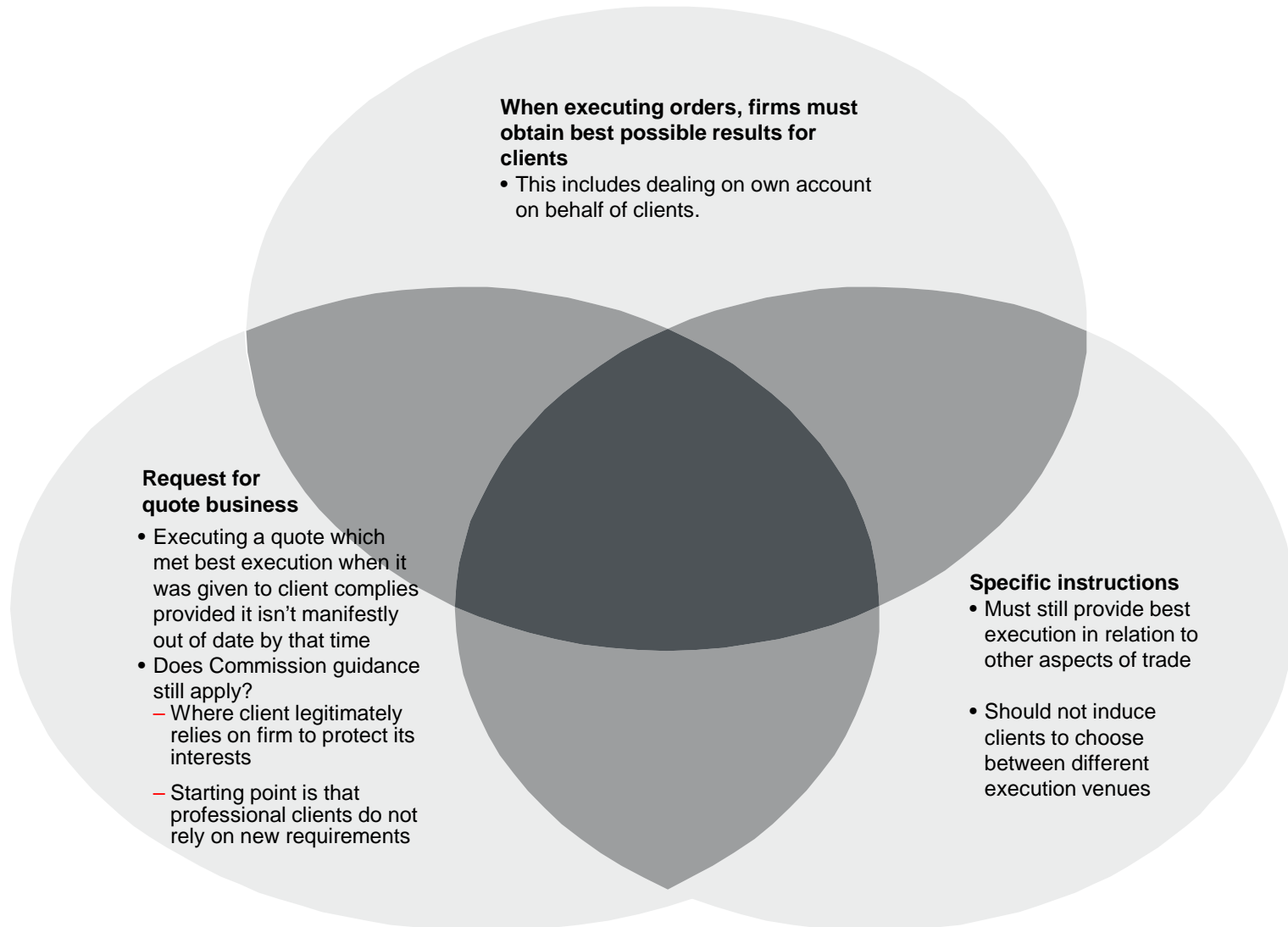
8 on managing conflicts

1 on integrity and 2 on

Will it be simpler to apply same **standards for professional clients** and eligible counterparties?

What are the main differences?

## 2: Best execution (1)



## 2: Best execution (2)

Firms must summarise and publish annually their **top five execution venues by trading volume** for each class of financial instrument, as well as **information on the quality of execution obtained**

Trading venues and Systematic Internalisers must publish annually information on **quality of execution so that firms can compare and analyse it**

**'All sufficient steps'** to be taken to obtain best execution

**Material changes** to a firm's policy to be notified in an ongoing relationship

Answer reasonable requests for **more information** with a reasonable time estimate and best execution to be **demonstrated to NCAs** on request

Order execution policies to be **clear, easily comprehensible and sufficiently detailed** – specific requirements in delegated regulation

Check **fairness of OTC product** price by gathering market data and comparison with similar products



### 3: Conflicts of interest (1)

Reassess potential conflicts – do they include any situations where firm/ relevant person/ person linked by control:

- Is likely to make a financial gain or avoid a financial loss at expense of client
- Has an interest in outcome of service provided that is distinct from client's
- Has a financial or other incentive to favour another client's interests
- Carries on same business as client
- Gets an inducement in relation to service provided to client – monetary or otherwise?

Make sure written conflicts policy specifying measures to manage conflicts includes at least measures to:

- Prevent or control exchange of information
- Separate supervision of persons who represent conflicting interests
- Remove direct links between persons engaged on one activity and revenues generated by a conflicting activity
- Prevent inappropriate influence
- Prevent involvement of a person in activities that may impair proper conflicts management
- These should also apply to investment recommendations and research

### 3: Conflicts of interest (2)

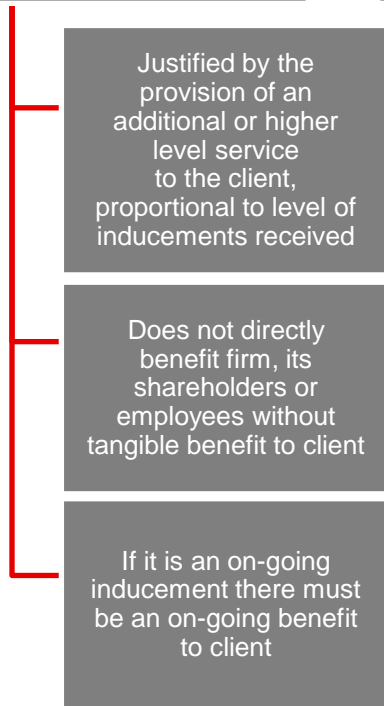
Check you are using disclosure as a last resort only – to be used where risk of damage to clients can't be prevented

In addition:

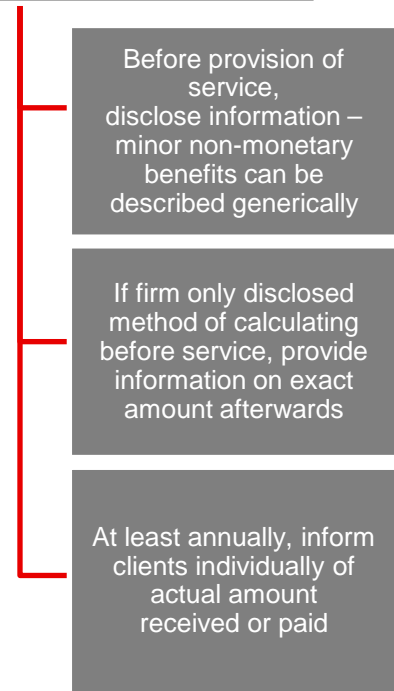
- Consider how this ties into fiduciary duties on conflicts
  - Check your disclosures contain required content
  - Presume that conflicts policy is deficient if firm is over-relying on disclosure
  - Regularly update a record of the kinds of activity where a conflict entailing a risk of damage to clients has arisen and provide a written report to senior management at least annually
- Don't forget special requirements for firms that produce investment research or underwrite or place
  - Research recommendations must state that they are not prepared in accordance with investment research standards
  - Also consider best execution, inducements and product governance requirements

# 4: Inducements (1)

If firm pays or is paid any fee or commission or provides or is provided with any non-monetary benefit in connection with an investment or ancillary service to or by any person other than the client or someone acting on its behalf



Custody costs, settlement and exchange fees, regulatory or legal fees are exempt



Why is this relevant?

- Considerable detail at level 2
- Qualitative v quantitative evidence of enhancement of quality
- How will you demonstrate it?

## 4: Inducements for investment advice and portfolio management (2)

- Must not accept and retain fees, commissions and non-monetary benefits
- Return to clients ASAP after receipt
- Policy to ensure that amounts are allocated and transferred
- Inform clients through periodic statements

- Cannot accept non-monetary benefits other than acceptable minor non-monetary benefits
- Must be reasonable and proportionate and of a scale that is unlikely to influence firm's behaviour to detriment of client's interests
- Must disclose before providing service

### **Acceptable minor non-monetary benefits:**

- (a) Information or documentation generic in nature or personalised
- (b) Issuer commissioned third party new issuance material provided relationship disclosed and made available at the same time to any investment firms or general public
- (c) Participation in conferences, seminars and other training events
- (d) Hospitality of a reasonable de minimis value
- (e) Other minor non-monetary benefits which a Member State deems capable of enhancing the quality of service and are of a scale and nature that are unlikely to impair compliance with duty to act in client's best interest

### Why is this relevant?

- Full price unbundling mandated
- No reference to execution-related services
- Where does this leave current permissible services?
- How will the FCA exercise its power?

# 4: Inducements relating to research (3)

Provision of research is not an inducement if firm pays through:

**Its own resources**

**OR**

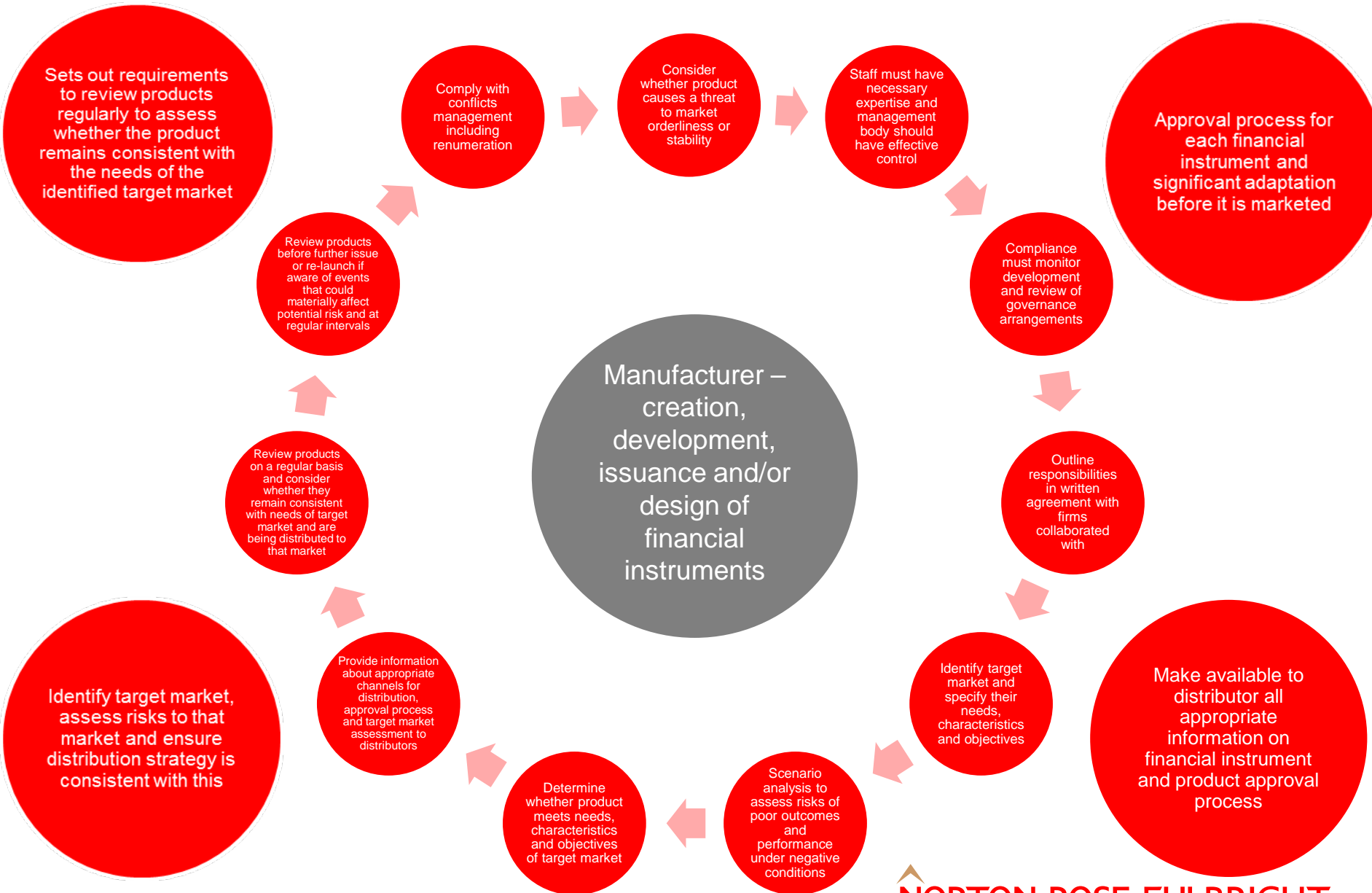
**A research payment account:**

- Funded by a specific research charge to client
- Set and regularly assess a research budget
- Firm is responsible for research payment account
- Firm regularly assess quality of research and its ability to contribute to better investment decisions
- Before providing service, tell clients of budgeted amount and charge and agree research charge and frequency in terms and conditions
- Provide annual information on total costs incurred by client for research
- If required by client or competent authority, provide further information
- All operational arrangements must identify research charge separately
- Tell clients about any increase in advance
- Any surplus at end of period must be rebated or offset against research budget for following period
- Allocation of budget is subject to appropriate controls and senior management oversight
- Cannot use to fund internal research
- Firm providing execution services must identify separate charges that only identify execution costs

Why is this relevant?

- Where does it leave the CSA model?
- How do you make a research payment account work?
- Client money account implications
- Shutting off nil value service agreement

# 5: Product governance



# Conclusion

# Conclusion

## Use of key terminology

- Do the same words mean the same things?
- Do different words mean the same thing?
  - Traded
  - Executed
  - Concluded
  - Undertaken

## How wide is MiFID II?

- When does a non-EU firm provide investment services/activities in the EU?
- How does this apply to trading on an EU exchange?
- Will current Member State arrangements fall away on equivalence?
- Which obligations are intended to apply?

## Organised trading platforms

- Continuing uncertainties on scope of MTF and OTF
- Drive to create an OTF for C6 trades
- Relevance of systematic internalisers for derivatives
- Proposed new PERG answer on multilateral system

## Best execution questions

- What does it really mean for ETD and OTC derivatives?
- Can you still use specific instructions?
- Is the client/counterparty relying on you for best execution?
- Duty to act in best interests of clients extended to eligible counterparties



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- Phoenix - Our guide to UK regulatory reform
- The UK Corporate Governance Portal - access to the latest corporate governance developments
- Blockchain, distributed ledgers, smart contracts and cryptocurrencies

## Pegasus

### Preparing for MiFID II









MiFID II and MiFIR (together 'MiFID II') will underpin the provision of investment services across and into Europe, both in terms of how trading is carried on and how firms organise and conduct themselves. They will affect both the wholesale and retail sides of the industry, in relation to both securities and derivatives. Nor should MiFID II be seen as solely European, as its effect will be far reaching and influence all firms dependent on the European client base.

Recently legislation delaying the implementation of MiFID II to 3 January 2018 was published in the Official Journal of the EU. Despite the delay, firms need to continue to press ahead with their implementation work. There is still a lot to do to be ready in time for the new implementation date. In addition, the UK's referendum vote to leave the EU should not be taken as a sign for firms to stop their work as it is expected that MiFID II will be implemented before the UK concludes its exit negotiation. The FCA's statement on the EU referendum result stated: "Firms must continue to abide by their obligations under UK law, including those derived from EU law and continue with implementation plans for legislation that is still to come into effect."

**We are committed to helping firms keep on top of MiFID II**

Pegasus is our dedicated online resource housing all our MiFID II know-how and links to other resources clients will need for any MiFID II project.

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# Investor protection

Protecting the interests of customers is a cornerstone of European financial regulation, and in these pages, we set out our key materials on the core investor protection provisions of MiFID II.



Investor protection (conduct of business)



Impact of MiFID II on EU conduct of business regime



MiFID II Academy slides



40 minute briefing slides



Fireside Friday



Financial services breakfast



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- [Conduct issues for investment managers and advisers](#)
- [Inducements and related issues](#)
- [Best execution and related issues](#)
- [Conflicts of interest](#)
- [Product governance and intervention](#)
- [Telephone recording and record keeping, and client categorisation and the consequences](#)
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The logo consists of a stylized, upward-pointing chevron shape in a gold color, positioned above the first letter of the text.

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# Ninth Annual Markets Infrastructure Group Seminar-MIFIR and MiFID II, Brexit: What does it mean in the MIG space?

12 July, 2016



Properties	Period Range	Table	Study
88.32	87.95	88.33	87.97
10.7596	-0.0037	n.a.	+1.35
-0.17%	-0.16%	-0.15%	+1.55%
			+1.36
			+1.57%

SSLC CN	73.00		
KGL CN	2.06	75.14	
IAE CN	5.22	2.11	26.6
MN CN	10.45	5.22	902.3
MRS CN	2.85	11.50	201.92
MGL CN	9.00	2.85	524.3
OIL CN	.42	9.40	143.00
ORL CN	3.20	.50	491.6
PPN CN	11.95	2.40	9.21
SOR CN	1.00	11.95	100.5
SVC CN	7.91	1.19	599.6
TPS CN	2.54	8.00	50.18
UME CN	4.00	2.54	3.5

# Contents

- What is the current state of play?
- Possible options for the UK
- What does this mean in practice
- The third country recognition picture in the markets space
- Scenarios and options



What is the current state of play?

# What is the current state of play?

- 23 June 2016, Referendum: 'Should the United Kingdom remain a member of the European Union or leave the European Union?'
- Turnout was 72.2% and Leave won 51.9% of the vote across the UK. Remain won 48.1%
- London, Scotland and Northern Ireland as regions voted to remain but the referendum result is determined on a UK wide basis
- Referendum result is not legally binding and has no immediate legal consequences but the politics of it means it cannot be ignored
- David Cameron: 'The British people have voted to leave the European Union and their will must be respected'



# Key points to remember in the Brexit debate

## We are still in the EU and will be for some time:

- Whilst the UK is negotiating its exit it remains a full member of the EU and is subject to EU legislation
- For example the EU Market Abuse Regulation came into effect in the UK (and the rest of the EU) on 3 July 2016
- FCA announcement on 24 June 2016: “Firms must continue to abide by their obligations under UK law, including those derived from EU law and continue with implementation plans for legislation that is still to come into effect”
- The reference to legislation still to come into effect is interesting and has one eye to MiFID II and MiFIR that apply from 3 January 2018

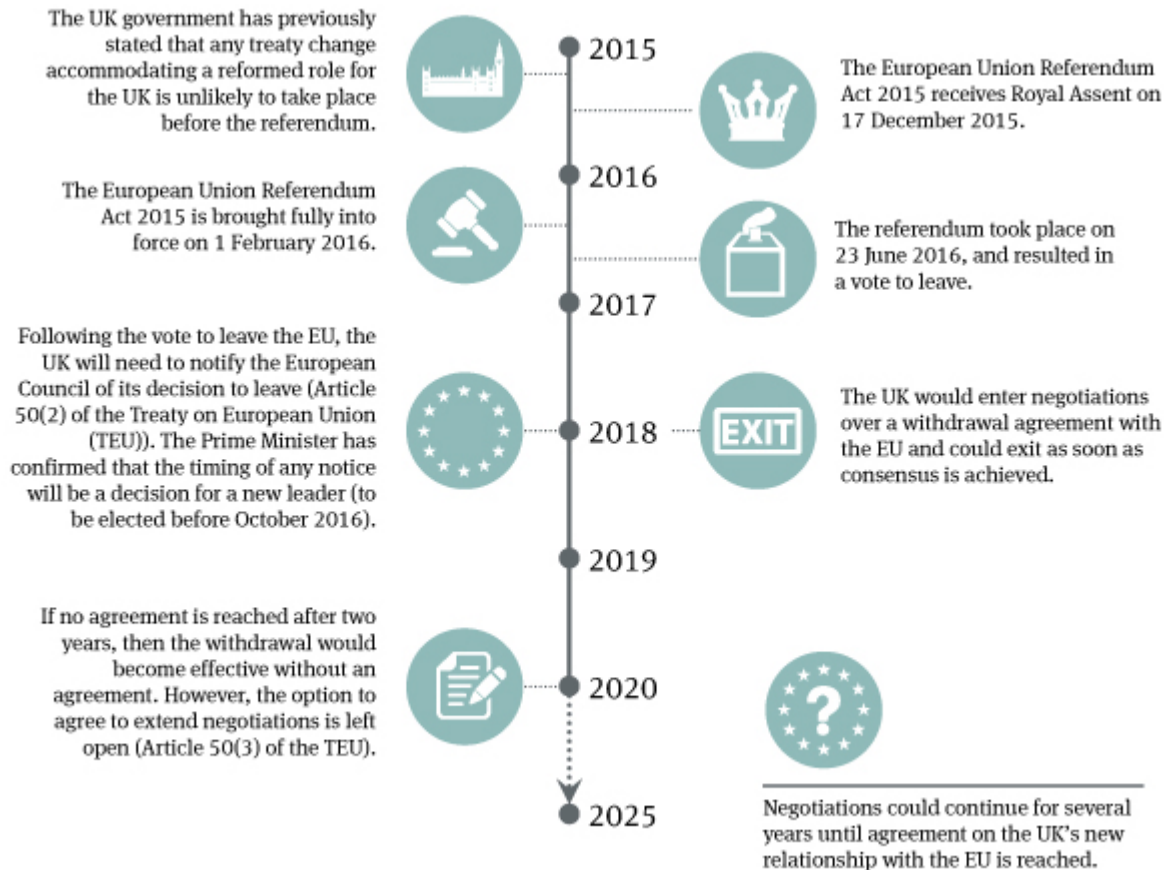
## Equivalence:

- Key concept in a number of EU Directives and Regulations including EMIR
- Importantly MiFIR contains equivalence provisions for third country investment firm access to the EU Single Market

## International commitments:

- Much of financial services EU legislation is derived from standards and principles produced by international standard setting bodies: the G20, the Basel Committee, the Financial Stability Board, the International Organization of Securities Commissions
- An important analysis may be where EU legislation diverges from international standards e.g. the remuneration provisions in CRD IV are outside Basel III

# Possible timing for Brexit



# Brexit – Notification and process (1)

## Notification

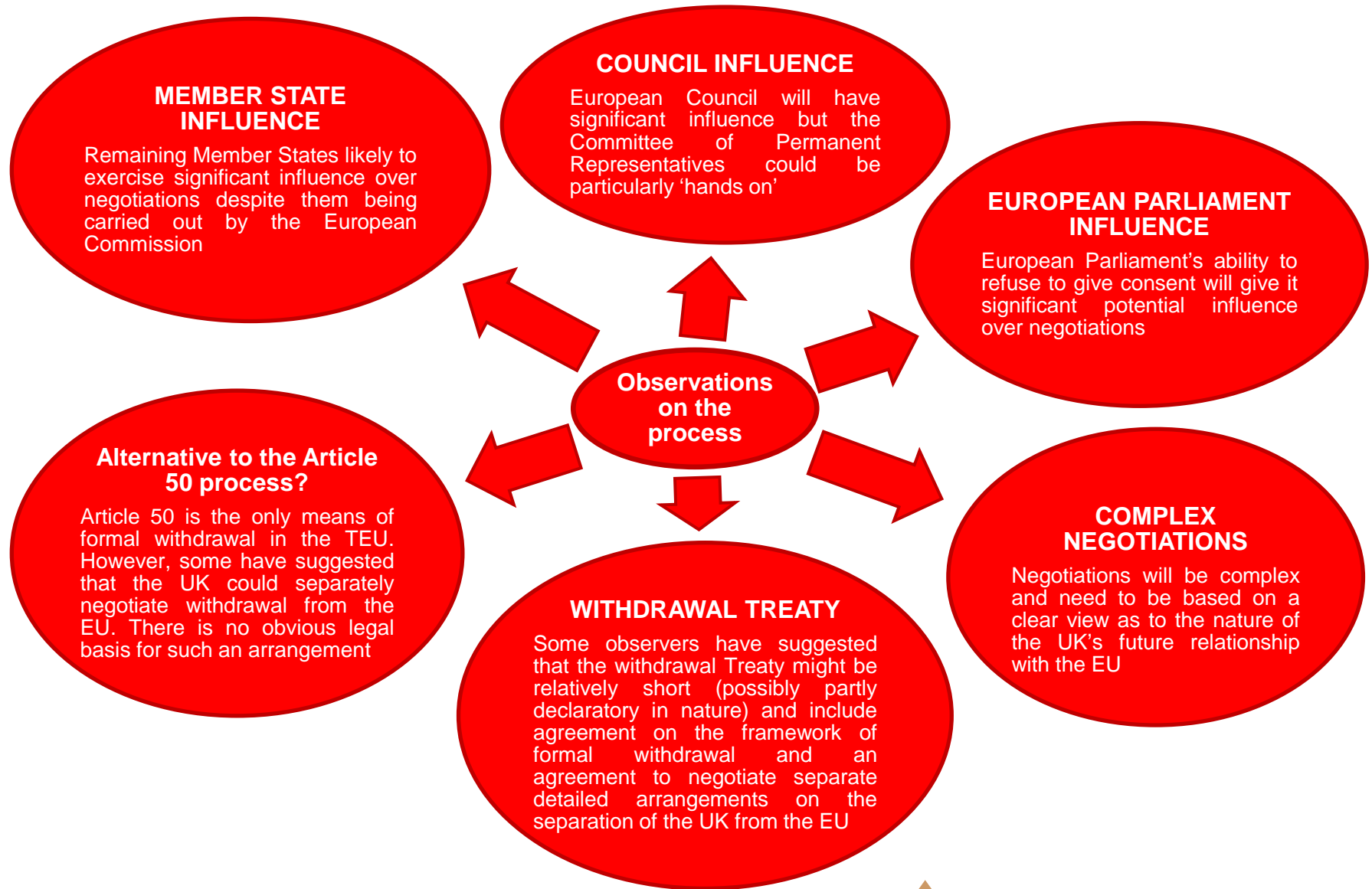
- Article 50 of The Treaty on European Union (TEU)
- Withdrawal decision is taken by the Member State 'in accordance with its own constitutional requirements'
- The withdrawing Member State must notify the European Council
- Article 50 is silent on the timing of the notification
- Article 50 has never been used before so there is an element of stepping into the unknown



## The Negotiation Process

- Parties to the negotiation are the EU and the withdrawing Member State
- The negotiations will be concluded by the Council (acting on a qualified majority basis) after obtaining the consent of the European Parliament
- The European Commission will carry out the negotiations on the EU side on the basis of the Council's agreed negotiation mandate
- The Treaties cease to apply to the withdrawing Member State from the date of the withdrawal agreement or, failing that, two years after formal notification was made
- The European Council (by a unanimous vote) can agree with the withdrawing Member State to extend the period of negotiation

# Brexit – Notification and process (2)





# Possible options for the UK

# Possible options for the UK – EEA

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- Referred to as the 'Norwegian option'
- Perhaps the easiest route to accommodate existing financial services business. For day-to-day purposes almost 'business as usual'
- Most financial services Directives and Regulations apply in the EEA and banks could continue to passport in and out of the UK (branches and cross border services)
- UK would not have voting rights on financial services legislation but will be bound by it and will have to continue to contribute to the EU budget



- Some financial services 'loose ends' as not all financial services activities are captured by EEA legislation e.g. AIFMD
- ESAs have no formal role in EEA which may result in increasing regulatory divergence: EEA Joint Committee solution adopted but backlog of legislation
- Subjection to the EFTA Court and Surveillance Authority may be politically sensitive
- UK would have to complete EFTA and EEA applications process – in practice having to secure the agreement of existing EEA members and EU Member States



- Freedom of movement for EEA staff into and out of London
- Free movement of persons will be politically sensitive

# Possible options for the UK – Bespoke agreements

## Bilateral – the ‘Swiss’ option

- Opportunity for UK to agree bespoke arrangements, flexed to suit policy goals and different activities and services
- Switzerland has had to accept free movement of persons and other areas of EU legislation but without any ability to vote on measures
- There may be a need to make a financial contribution to the EU budget
- The Swiss example has required the negotiation of a series of sector focused agreements which have required complex and time consuming negotiations
- Complete access to the EU markets may not be achieved. Switzerland has achieved limited concessions in relation to financial services. Swiss banks cannot passport into the EU
- There are indications that there is no EU appetite to use a bilateral, multi-tiered model more widely. Comments from EU institutions suggest that future arrangements will need to be more institutional in approach
- Equivalence assessment should be achievable given UK’s EU background

## Free trade agreement – the ‘Canada’ option

- Single agreement approach with central authority
- Opportunity to negotiate and agree arrangements which would be suited to UK policy goals and which reflect the nature of different financial services activities and services
- Based on the experience of other such arrangements agree an FTA could be time consuming or though observers note that the UK and the EU should be able to leverage existing knowledge and practice to achieve a shorter timetable
- The assumption is that an FTA would need to provide significant beneficial access to the financial services internal market
- FTAs are sometimes considered to be associated more with goods than services. To the extent that services are captured by FTAs it is not typical for FTAs to reflect the level of detail associated with the provision of financial services

# Some of the other challenges on either EEA or bespoke models

- ESMA now has direct supervisory powers, e.g. in relation to repositories and the current EEA Treaty has not caught up with this

EEA

## Bespoke models

- Numerous other areas of law need to be considered
- For example, mutual recognition of recovery and resolution under BRRD, insolvency law and settlement finality
- Rome and Brussels conventions on choice of law and jurisdiction
- Important to keep all of this in context as there remain significant barriers to cross-border business within the single market as shown by the Giovannini report updates

# Possible options for the UK – WTO

Negotiations would be made within the WTO framework presumably with the aim of agreeing sufficiently 'deep' access to the Single Market

General Agreement on Trade in Services (GATS) could provide a framework for agreeing access to Single Market but is more high level in nature and scope is not as wide as Single Market provisions

Risk that GATS based arrangements would not offer sufficient access to EU as there are features such as the prudential 'carve out'

Potential for the use of non-tariff barriers that could effectively fetter the ability for firms to develop their businesses

Concerns regarding 'behind-the-border' barriers

What does this mean in practice?

# Application of existing EU law and judgments

## Directives

Directives must be implemented by each Member State. In the UK FS Directive requirements have been implemented by means of primary legislation (e.g. FSMA), secondary legislation (e.g. the Regulated Activities Order) and regulatory rules (principally the PRA Rulebook and FCA Handbook)

## 'Soft' law

Existing guidance and commentary from ESAs (e.g. EBA) likely to be persuasive from the interpretation of existing implemented EU law in the UK

## Regulations

Regulations are directly applicable and obtain their authority from the Treaty. If the UK ceases to be subject to the Treaty such authority will fall away. Possible Brexit transitional legislation to provide post-Brexit domestic authority

## CJEU judgments

Pre-Brexit court judgments have influenced many areas of English case law and English courts' assessment of EU instruments (i.e. Treaties, Regulations, Directives etc.). It is possible that the UK courts may start to move away from such decisions once the UK is no longer bound by EU law and/or such decisions may be superseded by post-Brexit legislation

# Issue 1: Where does a service or activity take place?

## – Markets business from outside the UK

Are investment services and/or activities taking place within the jurisdiction?

MiFID II / MiFIR: permits third country firms to provide services to clients (both retail and professional) within the EU at the client's "exclusive initiative"



UK Government minded not to exercise the discretion to apply the MiFID II branch regime in Article 39: concern that UK overseas persons exclusion would be substituted with narrower concept of own exclusive initiative for retail and elective professional clients

UK exclusion for "overseas persons" in Article 72 of the RAO, which includes exclusions for particular investment services and activities carried on in the context of a "legitimate approach" or carried on "with or through" an authorised or exempt UK person



## Issue 2: Impact on types of firms – EEA branches

### If no passporting and no bilateral deal:

- EEA branches would need to apply for authorisation unless UK grandfathering arrangements for existing EEA incoming banks are created
- EU law apportionment of regulatory duties (i.e. the Home/Host split) will go. PRA likely to take a view on equivalence. Eurozone countries working assumption that the PRA will regard ECB prudential regulation as equivalent
- Review of some non-Eurozone regulatory standards? Possible intervention on prudential grounds if concern with Home State regulation and recovery and resolution framework. In some cases possible requirement to subsidiarise ?
- Potential for PRA to re-impose UK liquidity rules? PRA approach to third country branches (self-sufficiency or waiver) possibly extended to EEA branches?
- Greater hands-on approach in relation to business models? EEA branches may be treated similarly to third country branches currently. Regulators will assess critical economic functions (CEF)

### Existing incoming EEA branch regulation

If an EEA based model were to be agreed it should in practice enable the retention of the bank and investment business passport – in practice almost business as usual



## Issue 2: Impact on types of firm – third country branch

**Existing third country branch**

Banking business: currently, such branches do not benefit from passporting rights and there should be no material impact on banking business

No suggestion that UK will change its approach to third country branches: if anything there may be more ability for the UK to negotiate mutual recognition deals with third countries

For example, there has been exclusive Union competence in the areas covered by the *acquis* and this would fall away

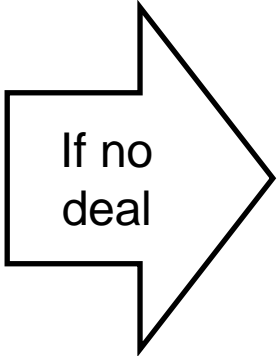


Limited impact of Articles 39 and 42 MiFID II

## Issue 2: Impact on types of firm – subsidiary: Investment business

Existing UK  
subsidiary

If an  
EEA/bilateral  
model were to  
be agreed it  
should in  
practice  
enable the  
retention of  
the investment  
business  
passport



If no  
deal

- Article 46 of MiFIR creates regime for third country institutional cross border business: Does not apply to opted up clients or retail clients
- Commission equivalence decision
- Firms must be subject to authorisation, sufficient capital requirements, organisational requirements and conduct of business, market integrity and transparency
- ESMA cooperation arrangements
- Application by firm to join ESMA register
- Setting politics aside, this seems well suited to the UK on the assumption that it will have implemented MiFID/CRD and applies CRR and MiFIR
- Also note that in any event there is an express reverse solicitation carve out from any Article 46 requirement
- This could all be wrapped up in a mutual acceptance by the UK of EU cross border business

## Issue 3: Recognition as the fallback option?

The big question is the extent to which UK markets are treated as equivalent

- Plenty of room under MiFIR to achieve this
- Article 23: Equities on third country market
  - Cross reference to complex/non-complex equities trading text under MiFID
  - Relevant to trading by EU investment firms
- Article 28: Derivatives on third country market
  - Reciprocity required
  - Authorisation requirement, transparency requirements
  - Relevant to trading by financial counterparties and non-financial counterparties plus

Post trade

- EMIR Article 25 third country CCP recognition
- Relevant to allowing EU counterparties to clear using UK CCPs

# The third country recognition picture in the markets space

# Third country rules - Equivalence (Article 46 and 47 MiFIR)

## Cross border business:

- A third country firm may provide investment services or activities to eligible counterparties and per se professional clients without establishing a branch BUT must be registered with ESMA
- European Commission must adopt an equivalence decision concerning home state regime of firm before registration can occur
- A third country firm must be subject to authorisation, sufficient capital requirements, organisational requirements and conduct of business, market integrity and transparency
- A third country firm must submit to the jurisdiction of a court or tribunal of the Member State relating to services and activities provided in that Member State
- Co-operation arrangements between ESMA and third country regulator
- RTS will be developed specifying the information that third country firms must supply to ESMA (currently set out in draft RTS 5)
- Note odd linkage of Article 28 for equivalent markets and Article 46 for third country firms: what about position of markets?

## Exclusive initiative of client:

- Reverse solicitation carve out applies to both MiFID II and MiFIR
- But note – wider exclusion under the RAO - Article 72, which includes exclusions for particular investment services and activities carried on in the context of a “legitimate approach” or carried on “with or through” an authorised or exempt UK person

# Third country rules – Transition (Article 54 MiFIR)

## Transitional provisions

- Where there is no Commission equivalence decision in respect of a third country, Member States may allow third country firms to continue to provide investment services to eligible counterparties and per se professional clients, if permitted by (and in accordance with) the relevant national regime
- MiFIR provides that firms will be able to continue to provide services and activities in accordance with national regimes until three years after the adoption of an equivalence decision in respect of the relevant third country
- This is permissive and does not stop the new registration regime being used during the three year transitional period

# Commission equivalence determinations

- **Required for:**

- Third country firms to use the ESMA Register for business with per se professional clients and ECPs only (automatic passport)
- Authorised branches of third country firms to use the passport (applies to per se professional clients and ECPs only)
- Third country trading venues to be used to meet the on platform trading obligation
- Third country CCPs to clear for EU trading venues or clearing members

- **Conditions:**

- Reciprocity:** Determinations of equivalence all require that the third country has an equivalent system for recognising foreign firms/tradingvenues/CCPs
- Cooperation Agreements:** Required with third country regulators (except for access for third country trading)



# The open access debate

MiFIR has an open access regime between EU CCPs and trading venues

A third country venue may request access to an EU CCP if the European Commission has adopted an equivalence decision in relation to that third country

A third country CCP may request access to an EU trading venue if that CCP has been recognised under Article 25 EMIR

Equivalence assessment: This includes reciprocity of open access

# Scenarios and options

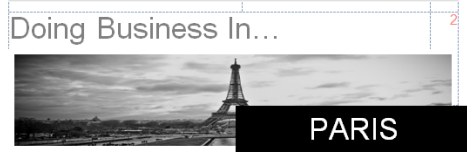
# Assessing the scenarios and options: our guide



<b>How do I get authorised?</b>	There must be an intention to establish a permanent presence in Ireland with mid-management in Ireland. There are a number of ways this can be satisfied but the Central Bank of Ireland (CBI) will expect, as a minimum, that senior management and key risk functions are located in Ireland such that day-to-day control rests in Ireland. A prescribed application form must be submitted for authorisation which varies depending on the particular type of financial services firm together with accompanying documentation (e.g. business plan, financials, etc.).
<b>How long does it take?</b>	The process is lengthy, usually taking in excess of 12 months for a credit institution, shorter for other types of financial services firms (e.g. 6-12 months for a MiFID investment firm (including preparation time)).
<b>How much does it cost?</b>	No filing fee is payable to the CBI. The process can be costly with professional advisors' fees to prepare the application. Costs vary depending on the type of licence applied for and the level of external support required.
<b>Do my senior managers need to be approved?</b>	Yes. Regulatory approval is required before an individual can be appointed to a Pre-Approval Controlled Function (PACF) director, CEO, CFO, CRO, etc. MiFID approval is also required for applicants to the management board of significant credit institutions and all credit institutions applying for authorisation.
<b>Who will my regulator(s) be and what are they like?</b>	CBI for both prudential and conduct matters, with some MiFID supervision for all credit institutions and less MiFID supervision for significant credit institutions. Recently, the CBI has become a more robust regulator and applies a risk-based approach to regulation applying most of the resources and a more intensive approach to the riskier firms it regulates, coupled with a credible threat of enforcement action for breaches of law/regulation.
<b>What will my regulatory capital requirements be?</b>	Credit institutions and in-scope investment firms are required to calculate their capital requirements in accordance with the criteria outlined in the CRD/CRR/IV. Less onerous prudential requirements apply for other types of regulated entity.
<b>What ongoing regulatory obligations will I have?</b>	There are ongoing regulatory requirements.
<b>Is the tax regime favourable?</b>	Yes. 12.5% for trading income. 20% for other income.
<b>What is the VAT level?</b>	Standard rate of 23% with lower rates for certain goods and services.
<b>What about employment laws?</b>	Labour laws and practices are restrictive.
<b>Where can I find more information?</b>	CBI Website - <a href="http://www.centralbank.ie">www.centralbank.ie</a>
<b>Pros</b>	<ul style="list-style-type: none"> <li>• Flight time to London City: 1h</li> <li>• Average rent EUR1,500</li> <li>• Strong, English-speaking population</li> </ul>
<b>Cons</b>	<ul style="list-style-type: none"> <li>• The regulator is a price-sensitive and slow to respond to a business.</li> </ul>

<b>How do I get authorised?</b>	There must be an intention to establish a permanent presence in Luxembourg with mid-management in Luxembourg. There are a number of ways this can be satisfied. An application form must be submitted for authorisation, at the relevant particular type of financial services firm together with accompanying documentation (e.g. business plan).
<b>How long does it take?</b>	2 months (which is prescribed by statute).
<b>How much does it cost?</b>	EUR2,500 (application fee) plus service provider costs (accountants, lawyers, consultants).
<b>Do my senior managers need to be approved?</b>	Yes. Approval from the CSSF is required for persons exercising key functions in credit institutions in Luxembourg (and other financial institutions).
<b>Who will my regulator(s) be and what are they like?</b>	Commission de Surveillance du Secteur Financier (CSSF) for both prudential and conduct matters. The CSSF used to be a light touch regulator but has not been as of late.
<b>What will my regulatory capital requirements be?</b>	Firms are required to calculate their capital requirements in accordance with the criteria outlined in the Capital Requirements Regulations.
<b>What ongoing regulatory obligations will I have?</b>	Required to give annual reports on internal and external Audit and Financial statements as well as ad hoc reporting requirements if certain statutory level of EUR2,000.
<b>Is the tax regime favourable?</b>	Yes. 25.22% for trading income. 20% for other income.
<b>What is the VAT level?</b>	18.17% with reduced rates for certain goods and services.
<b>What about employment laws?</b>	Labour laws and practices are restrictive.
<b>Where can I find more information?</b>	CSSF Website - <a href="http://www.cssf.lu/en">www.cssf.lu/en</a>
<b>Pros</b>	<ul style="list-style-type: none"> <li>• Flight time to London City: 1h 30m</li> <li>• Average rent EUR1,500</li> <li>• Strong, English-speaking population</li> </ul>
<b>Cons</b>	<ul style="list-style-type: none"> <li>• The regulator is a price-sensitive and slow to respond to a business.</li> </ul>

<b>How do I get authorised?</b>	There must be an intention to establish a permanent presence in Germany with mid-management in Germany. There are a number of ways this can be satisfied. An application form must be submitted for authorisation, at the relevant particular type of financial services firm together with accompanying documentation (e.g. business plan).
<b>How long does it take?</b>	Generally, applicants applying for a full banking licence wait 12 months for authorisation, however there is no standard time or stability period. Things depend on the individual circumstances.
<b>How much does it cost?</b>	Average EUR100,000 for filing the application plus service provider costs (e.g. accountants, lawyers, consultants).
<b>Do my senior managers need to be approved?</b>	No. However, BaFin may demand the dismissal of a Managing Director or Member of the Administrative or Supervisory Board if they are not deemed to be fit and proper.
<b>Who will my regulator(s) be and what are they like?</b>	BaFin for prudential matters and BaFin for conduct matters. BaFin is a robust regulator but should be taken seriously. CRR is significant cost institution.
<b>What will my regulatory capital requirements be?</b>	Firms are required to calculate their capital requirements in accordance with the criteria outlined in the CRD/CRR/IV. Additional criteria may be required.
<b>What ongoing regulatory obligations will I have?</b>	There are ongoing regulatory reporting requirements, as well as ad hoc reporting requirements (often events occur as well as the regular year end of a regulatory year). Certain banking institutions must be members of the German deposit protection scheme which involves transferring funds.
<b>Is the tax regime favourable?</b>	Approximately 30%, the exact rate depending on the municipality.
<b>What is the VAT level?</b>	Standard rate of 19% with lower rates for certain goods and services.
<b>What about employment laws?</b>	Labour laws and practices are restrictive.
<b>Where can I find more information?</b>	BaFin Website - <a href="http://www.bafin.de">www.bafin.de</a>
<b>Pros</b>	<ul style="list-style-type: none"> <li>• Flight time to London City: 1h 15m</li> <li>• Average rent EUR1,500</li> <li>• Strong, English-speaking population</li> </ul>
<b>Cons</b>	<ul style="list-style-type: none"> <li>• The regulator is a price-sensitive and slow to respond to a business.</li> </ul>



<b>How do I get authorised?</b>	There must be an intention to establish a permanent presence in France with mid-management in France. There are a number of ways this can be satisfied. An application form must be submitted for authorisation - to the ACPR for credit institutions and to the AMF for other types of financial services firms together with accompanying documentation (e.g. business plan).
<b>How long does it take?</b>	The process is lengthy, usually taking in excess of 12 months for a credit institution, shorter for other types of financial services firms. The AMF has 3 months to make its determination.
<b>How much does it cost?</b>	The process is costly as local advisors are needed and documentation must be translated into French but the application itself is free. Approximate costs are EUR100,000.
<b>Do my senior managers need to be approved?</b>	Yes. The approval of the ACPR/AMF is required for the appointment or removal of the most senior individuals who participate in the management of a financial holding company.
<b>Who will my regulator(s) be and what are they like?</b>	The ACPR for prudential matters and the AMF for conduct matters. Both regulators take a long time to address matters and their internal processes are cumbersome. Both regulators are robust and should be taken seriously.
<b>What will my regulatory capital requirements be?</b>	Firms are required to calculate their capital requirements in accordance with the criteria outlined in the Capital Requirements Regulations. However, there are certain exemptions which can have more favourable treatment.
<b>What ongoing regulatory obligations will I have?</b>	Banks and broker-dealers are required to complete annual filings in regards to audit and financial statements. Asset Managers must annual reports relating to compliance, management and financial statements. (There are also annual regulatory levies to be paid)
<b>Is the tax regime favourable?</b>	Not particularly. 30% corporate tax rate.
<b>What is the VAT level?</b>	Standard rate is 20% with a reduced rate of 10, 5.5 and 2.1% for certain goods and services.
<b>What about employment laws?</b>	Restrictive labour laws and practices.
<b>Where can I find more information?</b>	ACPR - <a href="http://www.acpr.banque-france.fr/en/accueil.html">http://www.acpr.banque-france.fr/en/accueil.html</a> AMF - <a href="http://www.amf-france.org/en_us/">http://www.amf-france.org/en_us/</a>
<b>Pros</b>	<ul style="list-style-type: none"> <li>• Flight time to London City: 1h 10m but there is also the Eurostar</li> <li>• Average rent EUR1,400</li> <li>• Home to five of the top 20 European banks by assets</li> </ul>
<b>Cons</b>	<ul style="list-style-type: none"> <li>• Due to the labour laws in France, it is a difficult jurisdiction to hire personnel.</li> <li>• The regulator has recently taken quite robust views contrary to those expressed in the remainder of Europe (for example in high frequency trading, retail CDO, controversial attitude to business).</li> <li>• High-profile terrorist threat.</li> </ul>

<b>How do I get authorised?</b>	There must be an intention to establish a permanent presence in the Netherlands with mid-management in the Netherlands. There are a number of ways this can be satisfied. An application form must be submitted for authorisation together with accompanying documentation (e.g. business plan). The application form is submitted to the Dutch Central Bank (DNB) for bank or insurer's licence and to the Netherlands Authority for Financial Markets (AFM) for an investment firm licence.
<b>How long does it take?</b>	Both the AFM and DNB application processes take a maximum of 13 weeks, which is prescribed by statute. However, if they request additional information, this term is suspended until the additional information is provided.
<b>How much does it cost?</b>	Banking licence - €1,500. EUFI (application fee) plus some additional costs for integrity and suitability screenings. Investment firm licence - €500. DNB (application fee) plus some additional costs for integrity and suitability screenings. These costs are in addition to service provider costs (accountants, lawyers, consultants).
<b>Do my senior managers need to be approved?</b>	Yes. Daily policymakers and supervisory directors need to be listed for suitability by DNB or the AFM. (Co-)policymakers and supervisory directors also need to undergo an integrity screening performed by DNB of the AFM. For certain financial institutions (e.g. bank and insurer) the scope is extended to secondary senior officers.
<b>Who will my regulator(s) be and what are they like?</b>	DNB for prudential matters and the AFM for conduct of business matters. Due to the financial crisis, DNB and the AFM approach has been stricter, as a result of which cooperation periods are generally longer. The AFM is a strict regulator to assess. It is generally sensible but can become unnecessarily aggressive on particular issues.
<b>What will my regulatory capital requirements be?</b>	Firms are required to calculate their capital requirements in accordance with the criteria outlined in the CRD/CRR/IV.
<b>What ongoing regulatory obligations will I have?</b>	Meeting threshold conditions - in particular ensuring the suitability and integrity of daily (co-)policymakers; ensuring ethical operations management, maintaining controlled and sound business operations; maintaining minimum own funds, solvency and liquidity ratios; meeting ongoing and ad hoc regulatory reporting requirements (e.g. submitting annual accounts).
<b>Is the tax regime favourable?</b>	In line with most EU jurisdictions - 25% corporate tax rate. No financial transaction tax and double taxation can generally be avoided. Favourable regime for holding and financing companies.
<b>What is the VAT level?</b>	Standard rate is 21% with reduced rates for certain goods and services.
<b>What about employment laws?</b>	Flexible working practices with standard employment rules in force but are similar to the UK. Having local speaking workers will be important.
<b>Where can I find more information?</b>	AFM - <a href="http://www.afm.nl/en">http://www.afm.nl/en</a> Dutch Central Bank - <a href="http://www.dnb.nl/en/home/">http://www.dnb.nl/en/home/</a>
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<b>Cons</b>	<ul style="list-style-type: none"> <li>• The market in the Netherlands is somewhat sticky and traditional, so 'who you know' is important. In this regard it is very different to doing business in the UK.</li> <li>• It is not yet clear which way the politics will play out.</li> </ul>



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Location

Global >

Home

About

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## Financial services: *Regulation tomorrow*

Tracks financial services regulatory developments and provides insight and commentary



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New prescribed rate of interest in effect in South Africa

South Africa: Protection of Investment Act 2015 assented to



### Revision of The Singapore Code on Take-overs and Mergers

Proposed Amendments to the Securities & Futures (Reporting of Derivatives Contracts) Regulations

Hong Kong: SFC concludes on expanding scope of short position reporting

Hong Kong: Introducing mandatory clearing and

### About

Our blog, Financial services: Regulation tomorrow offers a convenient resource for those keeping track of the evolving and increasingly complex global financial services regulatory environment. It reports on financial services regulatory developments and provides insights and commentary across Africa, Asia, Australia, Canada, Europe and the United States. We cover a broad range of financial services regulatory topics including banking and capital adequacy regulation, clearing and settlement, anti-money laundering, insurance, regulation and compliance retail and wholesale conduct and securities regulation.

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# Conclusion

# Drawing the strands together

There are a number of different possibilities: The EEA or the WTO options are the two extremes

It is prudent to consider the scenarios and options based on the “worst case”

Even in the no deal case, there are a number of nuances based on CRD and MiFIR which make the picture more subtle

The main thing is to do some calm analysis: Recognition is an example of this

# Questions



# Get in touch with us

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