April 10, 2017

MiFID II: The Essential Guide

This document is a part of our series discussing MiFID II. Here, we have provided a general overview of MiFID II and presented a high level view of the contentious topics which are discussed in more detail in our topic specific documents. Links to these documents have been provided at appropriate places for easy navigation.
This document covers the following topics:

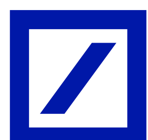
- Trading Obligation
  - Shares
  - Derivatives
- Systematic Internalisers
- Pre Trade Transparency
  - Trading Venues
  - Systematic Internalisers
- Trade Execution by Systematic Internalisers
  - Equities
  - Non Equities
- Post Trade Transparency or Trade Reporting
  - Trading Venues
  - Investment Firms
- Transaction Reporting
- Algorithmic and High Frequency Trading
- Direct Electronic Access
- Best Execution
- Research Unbundling

What is MiFID II?

The Markets in Financial Instruments Directive (MiFID) I was implemented in November 2007 with a view to establishing a single market for financial services within Europe and level the playing field for firms and venues. As required by the directive itself, the European Commission conducted a review of certain provisions in December 2010.

By then, the financial crisis of 2008 had exposed shortcomings in the financial services sector including inadequacies in the areas of transparency and investor protection. This led to the planned review becoming a substantive overhaul of the MiFID I regime when formal proposals for a recast directive were presented before the EU Parliament in 2011.

MiFID II was developed through the Lamfalussy Process (named after Alexandre Lamfalussy, chair of the EU advisory committee that devised the method) which is commonly used for developing financial service industry regulations in the European Union. The process consists of



the following 4 levels:
Level 1: Framework legislation (directive or regulation) is proposed by the EC (European Commission) to the Council of the European Union and the European Parliament. Following tri-party negotiations among the EC, the Council of European Union and the European Parliament, a compromised text is adopted. Whereas a framework directive is transposed by member states into national legislations, a framework regulation applies to all member states directly without the need for transposing.
Level 2: Level 2 measures are made up of more detailed implementing measures to supplement Level 1 framework legislation. These are prepared by the EC with assistance from European Securities and Markets Authority (ESMA) and put to a vote in the Council for adoption. When adopted, they become a part of the European legal system.
Level3: ESMA drafts and issues guidance on the meaning of Level 1 and Level 2 to facilitate convergence of regulatory practices across national regulators as well as participants.
Level 4: The EC checks that the member states' implementation of the directive is proper and complete; and takes action where implementation does not meet expectation.

MiFID II was eventually adopted and published in the Official European Journal on June 12, 2014.The Level 1 Text comprises of a directive - which will be transposed into national legislation by member states, and a regulation (MiFIR) - which will be applicable directly to all member states without the need for transposition.

Why is it important?

MiFID II is a suite of legislation which is set to redesign the trading landscape in the EU. Broadly speaking, it prescribes the manner in which investment firms will be able to provide financial services and products to investors as well as setting out rules and controls for operating trading venues.
For investment firms, this piece of legislation has far reaching consequence not only on their business models and operations but also on technology, systems, data and people.

What is the timetable?

The MiFID II package will go live on January 3, 2018. Below is a brief status update on the publication of the relevant legislative texts:
Level 1 Text: Finalised and published- MiFID II, MiFIR. National transpositions of the directive are expected during Q2 2017.
Level 2 Text (technical standards, delegated acts): Most of these have been adopted and finalised. The current status of the documents can be found here.
Level 3 Text: Guidelines and Q&A's by ESMA and national regulators are likely to be published in 2017.

What does the MiFID II package cover?

MiFID II and MiFIR together cover the following areas:
- Organisation and authorisation of investment firms;
- Rules for trading venues- Regulated Markets, MTF's and OTF's;
- Rules for Systematic Internalisers;
- Operating conditions for investment firms;
- Investor Protection;
- Market Transparency and Integrity;
- Trading Obligation;
- SME Growth Markets;
- Rights of investment firms;
- Access to CCPs, clearing and settlement facilities;
- Operating conditions for third country firms;
- Trading in Commodity Derivatives;
- Data Reporting Services;
- Powers and Functions of Competent Authorities, ESMA and EBA.

Trading Obligation

For further details visit our documents on Topic 2 and Topic 6.

Shares

What is the Trading Obligation for Shares?

MiFID II is designed to move more OTC bilateral trading to regulated venues. To achieve this, Article 23 of MiFIR requires an investment firm to ensure the trades it undertakes in shares admitted to trading on a regulated market or traded on a trading venue, take place on a Regulated Market (RM), Multilateral Trading Facility (MTF), an equivalent third country trading venue or with an SI.

There are two primary exclusions under Article 23 of MiFIR - (i) trades that are "non systematic, ad-hoc, irregular and infrequent (the "De Minimis Exclusion");[1] or (ii) trades that are carried out between eligible and/ or professional counterparties and do not contribute to the price discovery process (the "Price Discovery Exclusion"). Level 2 text lists the types of trades that do not contribute to the price discovery process. Some examples are: (i) transactions executed by reference to the volume weighted average price or the time weighted average price; (ii) constituent transactions of a portfolio trade consisting of five or more different shares; (iii) securities financing transactions.

This rule has created ripples in the industry due to its extraterritorial reach. To put the problem in its starkest terms, EU investment firms could be restricted from trading dual listed securities (primarily listed in a 3rd country) on 3rd country venues where primary liquidity is observed. Instead, firms will be forced to trade such securities on EU venues which are not as liquid, unless the relevant 3rd country venues are deemed equivalent.

Derivatives

For further details on this topic, visit our document on Topic 6.

What is the Trading Obligation for derivatives?

Article 28 of MiFIR requires that certain standardised derivative contracts be traded through EU trading venues (RMs, MTFs and OTFs) or equivalent third country venues. The obligation only applies to those classes of derivatives that are: i) declared subject to the clearing obligation under EMIR, ii) sufficiently liquid and iii) are admitted to trading or traded on at least one EU trading venue.

At this stage, several aspects of the obligation are uncertain as ESMA is consulting the industry on a number of aspects of this obligation, including the approach to assess liquidity of various subsets of derivatives. ESMA has indicated that it may implement a staggered approach towards implementation; although large counterparties should be ready to comply from January 2018.

The industry expectation is that most benchmark G3 (EUR, GBP, USD) and credit index swaps will be covered. Currently, no equity derivatives are in scope.

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[1] Article 23(1), MiFIR.

Systematic Internalisers

For more details on this topic, visit our document on Topic 2.

What is a Systematic Internaliser (SI)?

An SI[2] is an investment firm which regularly deals on own account when executing client orders outside of a trading venue (i.e. RM, MTF or OTF) without operating a multilateral system. It is the capacity of an investment firm to execute orders in particular instruments and should not be confused with trade enabling software or a trading venue.

Alongside trading venues, SIs are also subject to pre and post trade transparency requirements. Taken together, trading venues and SIs are described as 'execution venues' in the legislation.

How can firms become SIs?

A firm will be an SI in an instrument if its OTC trading is "organised, frequent, systematic and substantial". For a relevant instrument, the legislation provides quantitative thresholds for assessing each of these criteria. 'Substantial' can be assessed by either using threshold criterion 1 or criterion 2 (non-cumulative test) and firms will be considered to be dealing on a 'substantial' basis if they meet any one threshold.

- Calculations under criterion 1 consider the number of OTC trades (of the firm) in that instrument over the previous 6 months as a percentage of total turnover in that financial instrument executed by the firm on a trading venue or OTC during the same period.
- Calculations under criterion 2 consider the number of OTC trades (of the firm) in that instrument over the previous 6 months as a percentage of total turnover in that instrument executed in the EU on a trading venue or OTC during the same period.

Calculations to establish whether a firm is an SI in each instrument will need to be performed at the beginning of each quarter by reference to the previous 6 months data. In its published Q&A's, ESMA stated that it intends to publish EU wide data for the first time to perform SI calculations by August 1, 2018 covering a period from 3 January 2018 to 30 June 2018. Investment firms will have to perform their first assessment and, where appropriate comply with the systematic internaliser obligations (including notifying their National Competent Authority) by September 1, 2018. Alternatively, investment firms may opt-in and register themselves as an SI in specific instruments from January 2018 regardless of their OTC volumes.

Quantitative thresholds for equities and certain non-equities are given below:

For Equities[3]:

Criterion	Description	Equities
Frequent and Systematic Basis (Liquid Instruments)	- Number of OTC transactions carried out by it on own account during the last 6 months when executing client orders as a percentage of the total number of transactions in the relevant instrument executed in the Union on any trading venue or OTC during the same period - Minimum trading frequency of OTC transactions during the last 6 months carried out by it on own account when executing client orders in the relevant financial instrument	>= 0.4% and at least daily
Frequent and Systematic Basis (Illiquid Instruments)	Minimum trading frequency during the past 6 months for transactions on own account when executing client orders (on average)	At least daily

[2] Article 4(1)(20), MiFID II.
[3] Delegated Regulation dt. 25th April, 2016.

Substantial Basis: Threshold Criterion 1	Number of OTC trades by investment firm in a financial instrument on own account when executing client orders during the past 6 months as a percentage total volume in the same financial instrument executed by the investment firm on own account or on behalf of clients and executed on a trading venue or OTC	>= 15%
Substantial Basis: Threshold Criterion 2	Number of OTC trades by investment firm in a financial instrument on own account when executing client orders during the past 6 months as a percentage of total volume in the same financial instrument in the European Union, on a trading venue or OTC (in nominal amount)	>= 0.4%

For Non-Equities[4]:

Criterion	Description	Bonds	Derivatives
Frequent and Systematic Basis (Liquid Instruments)	- Number of OTC transactions executed during the past 6 months by the investment firm on own account when executing client orders as a percentage of total number of transactions in the same financial instrument in the EU on any trading venue or OTC - Minimum trading frequency during the past 6 months for transactions on own account when executing client orders (on average)	2.5 % and at least once a week	2.5 % in the relevant class and at least once a week
Frequent and Systematic Basis (Illiquid Instruments)	Minimum trading frequency during the past 6 months for transactions on own account when executing client orders (on average)	At least once a week	At least once a week
Substantial Basis: Threshold Criterion 1	Number of OTC trades by investment firm in a financial instrument on own account when executing client orders during the past 6 months as a percentage total volume in the same financial instrument executed by the investment firm on own account or on behalf of clients and executed on a trading venue or OTC (in nominal amount)	25%	25% of the relevant class
Substantial Basis: Threshold Criterion 2	Number of OTC trades by investment firm in a financial instrument on own account when executing client orders during the past 6 months as a percentage of total volume in the same financial instrument in the European Union, on a trading venue or OTC (in nominal amount)	1%	1%

[4] *Id.*

Pre Trade Transparency

Trading venues and Systematic Internalisers

What is new?

Under the existing MiFID I regime, pre trade transparency requirements only apply to equities admitted to trading on regulated markets (RM). MiFID II expands the coverage of pre trade transparency rules to include other equity like instruments and non-equity instruments, traded not only on regulated markets, and MTFs, but also on OTFs (for non-equity instruments only).

What are the obligations?

For equity and equity like and non-equity instruments[5], operators of trading venues will be required to make public current bid and offer prices and the depth of trading interests at those prices which are advertised through their systems for equities and equity-like instruments and for non-equity instruments. The requirement also applies to actionable indications of interest. National competent authorities will continue to be able to waive pre-trade transparency obligations subject to certain criteria.

For liquid equity and equity like instruments[6], SIs will be required to make public firm quotes continuously during normal trading hours for transactions up to standard market size. For illiquid instruments, SIs will only have to disclose quotes to their clients upon request.

SIs will also be able to decide the size(s) at which they will quote. The minimum quote size for equities and equity-like instruments will be at least 10% of the standard market size of the relevant instrument.

For liquid non-equity instruments[7]**,** for sizes under the Size Specific to Instrument (SSTI), SI quotes are to be made public prior to execution. Quotes in illiquid instruments or in sizes that fall above the SSTI, if made public would expose liquidity providers to undue risk- therefore, such quotes are exempted from this requirement.

Can pre trade transparency requirements be waived?

Existing exemptions from pre trade transparency requirements for equities have been retained and extended to equity-like instruments[8] under MiFID II. National competent authorities are empowered to allow 4 kinds of pre trade transparency waivers to trading venues:

- Large in Scale (LIS) orders can avail a waiver from pre-trade transparency requirements under MiFID II. This is designed to protect large orders from adverse market impact, price movements and market distortion;
- Reference Price Waiver (RPW) facilitates dark trading as long as the execution price is the midpoint of the spread as found on the reference market of the security. Where the midpoint price is not available, the opening or closing price of the relevant trading session should be taken as the Reference Price;
- Negotiated Trade Waiver (NTW) exempts systems that formalise negotiated transactions provided that the trades are within the current volume weighted spread on the order book or market maker quotes;
- Order Management Facility waiver (OMW) enables iceberg orders held in facilities operated by regulated markets or MTFs, where only a portion of the order is visible.

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[5] Articles 3 and 8, MiFIR.
[6] Article 14, MiFIR.
[7] Article 18, MiFIR.
[8] Article 4, MiFIR.

For non- equity instruments, under Article 9 of MiFIR, National Competent Authority's (NCAs) may waive the pre-trade transparency obligations for non-equity instruments to:[9]

- Orders that are large in scale compared to normal market size;
- Orders held in an order management facility of a trading venue pending disclosure (iceberg orders);
- Actionable indications of interest in request-for-quote or voice trading systems that are above a size specific to the financial instrument which would expose liquidity providers to undue risk;
- Derivatives which are not required to be traded on RMs, MTFs or OTFs for which there is not a liquid market, as per Article 9 of MiFIR

Is there a restriction on the volume of trading carried out under the waivers?

For equities, in order to limit the volume of trading taking place under the waivers, RPW and NTW will be subject to volume caps[10]. This is referred to as the "Volume Cap Mechanism" in Article 5, MiFIR. In particular the volume of trading in any share or equity-like instrument that can be carried out under the NTW and RPW will be capped at:

- 4% of European trading per trading venue; and
- 8% of European trading across all venues.

ESMA has clarified that large in scale transactions are not to be considered in calculating volume caps. Further, volume caps will not be applicable for negotiated transactions- i) in illiquid instruments executed within close range of a reference price and ii) transactions which are subject to conditions other than the current market price of that financial instrument.

Once the limits have been reached under these waivers, trades can be executed with an SI.

No comparable rule for non-equities is provided.

[9] Article 9, MiFIR.
[10] Article 5, MiFIR.

Trade Execution- Systematic Internalisers

Equities

SI's quoting obligations: For liquid instruments, SIs are required to publish two way firm quotes on a regular and continuous basis during normal trading hours (defined by the firms). For illiquid instruments, SIs have to disclose quotes to their clients upon request. SIs may choose the size(s) at which they wish to quote provided the minimum quote size is at least 10% of Standard Market Size, and the maximum quote size is the Standard Market Size.[11]

Access to SI quotes: On the basis of their commercial policy, SIs may decide which clients have access to their quotes. The "commercial policy" must be based on objective, non-discriminatory and clearly established standards, implying that clients/ customers falling within the same category (based on published objective criteria) should be extended similar terms and conditions.[12]

Withdrawal of Quotes: SIs are allowed to withdraw quotes under "exceptional market conditions". Exceptional market conditions are defined in Level 2 text and include situations where the relevant market halts trading or suspends market making obligations in an instrument.[13]

Pricing restrictions for SI: Prices published by SIs should reflect the "prevailing market conditions". Prices will be deemed to be reflecting "prevailing market conditions" if they are close in price at the time of publication to quotes of equivalent size for an instrument on its relevant market.[14]

Quotes may be updated by SIs at any time provided that it is consistent with the firm's intention to trade with its clients. Price improvement where prices better than those quoted are quoted to clients is permissible in "justified cases" as long as the price quote falls in a close range to prevailing market conditions or within the firm's spread.[15]

Dissemination of firm quotes: SIs are required to specify their preferred mode(s) of publication on their website. Quotes may be disseminated to the public through a firm's proprietary systems, a trading venue or through an Approved Publication Arrangement (APA) - a data reporting service provider which facilitates the consolidation and publication of such data. A firm may use one or more means to publish firm quotes. Publication has to comply with the following conditions[16]:

- Where a firm uses the facilities of a trading venue or an APA, it is required to disclose its identity in the quote.
- All quotes have to be published in a machine readable format.
- Quotes need to be published in human-readable format where the firm uses its proprietary systems.

Execution restrictions on SI: SIs are required to execute client orders at the quoted prices up to the size being quoted. Orders which exceed the quoted size but are less than the standard market size must also be filled at the quoted price; though SIs have no obligation to trade in sizes above the quoted size.[17]

[11] Article 14(3), MiFIR.
[12] Article 17, MiFIR.
[13] Article 15, MiFIR.
[14] *Id.*
[15] Article 15(2).
[16] Article 17(3)(a).
[17] Article 15(4).

Non- Equities

SI's quoting obligations: Where SIs are prompted by a client for a quote and they agree to provide it, they are required to make firm quotes public in liquid instruments for sizes under SSTI (Size Specific To Instrument). For illiquid instruments, they are not required to make the quote public and may disclose the quote to the client if they so agree.

SIs may also apply for pre trade transparency waivers provided to venues.[18] As a general rule, SIs are not subject to any pre trade transparency requirements where they deal in sizes above SSTI.[19]

Quoting and pricing restrictions: SIs are allowed to update their quotes at any time and withdraw their quotes under exceptional circumstances. Quoted prices should reflect prevailing market conditions when compared to prices at which transactions are concluded on a trading venue. In justified cases, they may even execute at a better price provided that the price falls within a public range close to market conditions.[20]

Access to quotes: Notwithstanding the obligation to make firm quotes public, SIs may choose which clients have access to their quotes. Access to quotes should be based on objective, non-discriminatory standards and commercial policy.[21]

Trade Execution: Where they publish their quotes to clients, SIs are required to honour the published price with all such clients to whom the quote is made available where the quoted size is at or below SSTI.

[18] Article 18(1), MiFIR.
[19] Article 18(6), MiFIR.
[20] Article 18(9), MiFIR.
[21] Article 18(5), MiFIR

Post Trade Transparency- Trade Reporting

For more details on this topic, visit our document on Topic 1.

Trading Venues

What is new?

The post trade transparency regime has been extended to include equity like and non- equity instruments and instruments traded on MTFs, OTFs and SIs. The rules on post trade transparency obligations of trading venues are contained in Article 6 (for equities) and Article 10 (for non-equities), MiFIR.

What are post trade obligations for trading venues?

For both, equity like and non-equity instruments, operators of trading venues are required to publish the price, volume and time of transactions concluded on their platforms as close to real time as is technically possible. This trade data will need to be made available to the public separately and on a reasonable commercial basis, and must ensure non-discriminatory access.[22]

NCAs will continue to be permitted to authorise the deferred publication of post-trade information based on the size or type of the transaction, although such arrangements must be clearly disclosed to market participants and to the public. Deferrals on other grounds may be sought where necessary. See our document on Topic 6 for more details.

Investment Firms

What is new?

MiFID II retains the, “as close to real time as is technically possible” reporting requirement (with some differences between equity and non-equity instruments), although the manner of complying with the requirement will change substantially. While investment firms will need to continue publishing real time trade reports, they now need to collect more data than before and employ a data reporting service provider for its dissemination.

The obligation to publish in real time is suspended where a deferral is granted by a national competent authority. See our document on Topic 6 for more details.

What are trade reports?

For all transactions (concluded either on own account or on behalf of clients in equity or non-equity instruments), investment firms (including systematic internalisers) have to publish the price, volume and the time at which they were concluded. This data has to be made public, as close to real time as is technically possible, in an effort to improve transparency and price discovery in the market.[23]

Each individual transaction concluded outside the rules of a trading venue has to be reported through an Approved Publication Arrangement (APA) once. Transactions concluded on a trading venue have to be reported by the operator of the venue.

Which party is required to report the transaction?

Under the current rules, parties to a transaction may mutually decide which of them will take on the obligation for trade reporting. Typically, buy side firms prefer their brokers to assume responsibility for post trade reporting. MiFID II reallocates this responsibility based on the firms’ status and capacity.[24]

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[22] Articles 6 and 10, MiFIR.
[23] Articles 20 and 21, MiFIR.
[24] Article 20(3)(c) and Article 12, RTS 1.

The obligation to report is on the investment firm that sells the financial instrument when the transaction between two investment firms relates to instruments traded on a trading venue, but is executed outside the rules of a trading venue. However, if one of the parties to the transaction is an SI in that instrument, then the obligation to report is on the SI, regardless of whether the SI is the buyer or the seller.

Relevant extract of Article 12, RTS 1 is given below:

"4. Where a transaction between two investment firms is concluded outside the rules of a trading venue, either on own account or on behalf of clients, only the investment firm that sells the financial instrument concerned shall make the transaction public through an APA.

5. By way of derogation from paragraph 4, where only one of the investment firms party to the transaction is a systematic internaliser in the given financial instrument and it is acting as the buying firm, only that firm shall make the transaction public through an APA, informing the seller of the action taken."

Post Trade Reporting- Transaction Reporting

For more details on this topic, visit our document on Topic 1.

Investment Firms

What are transaction reports?

Investment firms are required to submit transaction reports to their regulators to assist them in detecting any misconduct in the market. These will be more detailed compared to the trade reports with approximately 65 fields to be populated, including details about the identity of the investment firm, the capacity in which it entered into the transaction, details on the investment decision makers and any algorithms involved in the transaction. Non-natural persons need to be identified using a executing LEI, and for natural persons, a passport number /national ID number etc will be required.[25]

How are firms expected to comply with this requirement?

All investment firms which conclude transactions in: financial instruments traded on a trading venue or for which a request for admission to trading has been made; financial instruments where the underlying financial instrument is traded on a trading venue; and financial instruments where the underlying instrument is an index or a basket composed of financial instruments traded on a trading venue. Even if such transactions are not traded on an EU trading venue, an investment firm will still be required to submit transaction reports to national regulators as quickly as possible, but no later than the close of the following working day.

Firms may provide these reports themselves or fulfil their reporting obligations by sending data to i) an Approved Reporting Mechanism (ARM) acting on the firms' behalf, or ii) the trading venue through whose system the transactions were completed. While the primary obligation to make complete, timely and accurate reports to the competent authority is on the investment firm, the ARM/trading venue will be responsible to submit the report once the investment firm has sent this data to ARMs or trading venues.

[25] Article 26, MiFIR.

Algorithmic and High Frequency Trading

For more details on this topic, visit our document on Topic 4.

What is Algorithmic Trading?

Algorithmic Trading is defined in Article 4(1)(39)[26] of MiFID II as trading in financial instruments where a computer algorithm automatically determines individual parameters of orders such as whether to initiate the order, the timing, price, or quantity of the order or how to manage the order after its submission, with limited or no human intervention. Systems that are only used for the purposes of routing orders to one or more trading venues (Automated Order Routers.[27]) are outside the definition of algorithmic trading.

What is Algo Flagging?

Going forward, Investment firms will have to provide information about the use of algorithms in their transactions in both Trade and Transaction Reports. Firms will need to include “ALGO” flags to signify the involvement of an algorithm in a transaction and also algorithm identifiers to specify the function of the algorithm- whether investment decision making or execution.

More information on Trade and Transaction Reports may be found in our document on Topic 1.

What are the obligations on firms pursuing algorithmic trading?

Investment firms engaging in algorithmic trading will need to implement a number of measures to ensure that they do not expose the markets to undue risk. Therefore, firms have to ensure that their systems are resilient and have been appropriately tested before being used for trading. As an ongoing measure, they will have to monitor algorithmic trading activity in real time and continuously operate post trade controls. As well as maintaining an elaborate governance structure for algorithmic trading, firms need to ensure that they have adequate well trained staff (including a compliance function) competent to handle systems trading algorithms. For efficient and effective monitoring by regulators, firms bear the obligation to maintain especially detailed records of algorithmic activity.[28]

What is High Frequency Trading (HFT)?

HFT is defined as a subset of algorithmic trading in Article 4(1)(40) of MiFID II and is characterised by the presence of all of the following:

- Infrastructure intended to minimise network and other types of latencies, including at least one of the following facilities for algorithmic order entry: co-location, proximity hosting or high speed direct electronic access (DEA);
- System determination of order initiation, generation, routing or execution without human intervention for individual orders or trades; and
- High message intraday rates which constitute orders , quotes or cancellations: a) an average of at least 2 messages per second per instrument per trading venue or b) an average of at least 4 messages per second for all instruments on a trading venue.

What are the order record keeping obligations for HFT firms?

HFT firms are required to maintain records for their submitted orders, including cancellations,

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[26] Article 4(1)(39) MiFID II: Algorithmic Trading means trading in financial instruments where a computer algorithm automatically determines individual parameters of orders such as whether to initiate the order, the timing, price or quantity of the order or how to manage the order after its submission, with limited or no human intervention, and does not include any system that is only used for the purpose of routing orders to one or more trading venues or for the processing of orders involving no determination of any trading parameters or for the confirmation of orders or the post-trade processing of executed transactions.

[27] Relevant Extract from Level 2 text: Recital 22, of *Delegated Directive “Algorithmic trading should encompass smart order routers (SORs) where such devices use algorithms for optimisation of order execution processes that determine parameters of the order other than the venue or venues where the order should be submitted. Algorithmic trading should not encompass automated order routers (AOR) where, although using algorithms, such devices only determine the trading venue or venues where the order should be submitted without changing any other parameter of the order.”*

[28] Article 17(1), MiFID II.

executed orders and quotes on trading venues in accordance with Article 17(2), MiFID II and Article 28, RTS 6. *Inter alia*, the details about the function of their algorithms (investment decision or execution) have to be recorded immediately after order submission. These records are to be maintained for 5 years from the date of submission of the order.

Direct Electronic Access

For more details on this topic, visit our document on Topic 4.

What is Direct Electronic Access (DEA)?

DEA[29], as defined in Level 1 is an arrangement whereby a client (DEA client) is allowed to enter orders into a market's trade matching system for execution using the market member's (DEA provider) trading code. There are 2 types of DEA: Direct Market Access (DMA) - whereby the DEA client utilises the DEA provider's infrastructure; and Sponsored Access (SA) - whereby the DEA user does not use the DEA provider's infrastructure.

Level 2 offers a refined definition of DEA[30] which states that a person shall not be said to have DEA unless they have *'discretion regarding the exact fraction of a second of order entry and the lifetime of the order within that timeframe'.* By not clarifying the meaning of "exact fraction of a second", Level 2 leaves the meaning of DEA open to varying interpretation by regulators, trading venues and DEA providers which may have unintended consequences.

What are the obligations on DEA providers?

DEA providers are responsible for the trading of their DEA clients. Therefore firms intending to provide DEA will be subject to comprehensive measures including extensive due diligence on client systems and controls. Firms will need to implement pre-set trading and credit thresholds and also conduct a proper assessment and review the suitability of clients using the service not only in terms of their capabilities, controls and financial resources but also making a subjective assessment[31] of their credibility, intentions and trustworthiness. When assessing the suitability of clients, DEA providers should satisfy themselves that the controls put in place by their clients are commensurate with the nature, scale and complexity of the expected trading activity.[32] Generally speaking, DEA providers need to update the regulators about the details of their clients using the DEA facility and also report any infringements by them.

What is not considered DEA?

Certain arrangements have been specifically excluded from being considered DEA. These include (i) arrangements where client orders are intermediated through members of trading venues, (ii) online brokerage arrangements where clients have direct access to venues and (iii) arrangements where client orders are submitted to venues through mechanisms for optimisation of order execution process.

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[29] Article 4(1)(41).
[30] Delegated Regulation dated 25th April, 2016 available here
[31] RTS 6, Recital 13.
[32] Article 17(5), MiFID II.

Best Execution

For more details on this topic, visit our document on Topic 3.

What is new for Best Execution (best ex)?

Under MiFID I, firms or venues were not required to publish execution data to demonstrate compliance with best ex requirements. Albeit firms were required to demonstrate compliance in accordance with their best execution policy. In contrast, MiFID II makes best execution obligations more proactive for trading venues and firms by asking them to publish execution data periodically.

Going forward, firms will be required to "evidence" their compliance with best ex obligations by publishing execution data.[33]Populating report templates provided in Level 2 will require a meticulous effort from firms. Investment firms will have to implement more robust controls, governance and review provisions to ensure that execution policies and arrangements are consistently achieving best execution.

What do Investment Managers have to publish?

Based on their trading volumes, Investment Managers have to publish their top 5 execution venues annually. This means that potentially, data has to be captured not only for trading venues but also for systematic internalisers, market makers and other liquidity providers- located both within and outside the EU. Investment Managers utilising the services of SIs to execute transactions should include such SI-brokers in their top 5 execution venues reports.

In order to make the data more comparable, Investment Managers will be required to calibrate this data for each asset class. Specific details about the format and content of these reports are provided in RTS 28.

What do trading venues and systematic internalisers have to publish?

Execution venues (i.e. Regulated Markets, MTFs. OTFs, Market Makers, or other liquidity providers and SIs) are required to publish data relating to execution quality (at least annually) without charge, for individual financial instruments, including details about price, speed and likelihood of execution.

Execution venues are required to publish separate reports for each financial instrument per market segment in order to ensure the relevance of captured data. Information about costs, including execution fees, market access fees, and fees for using terminals etc also has to be disclosed.

Specific details about the format and content of these reports are provided in RTS 27.

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[33] Article 27, MiFID II.

Research Unbundling

For more details on this topic, visit our document on Topic 5.

What is new here?

Presently, buy side firms that use a 'bundled' approach, pay just one rate of commission to their brokers and receive Research as an ancillary benefit. This means Investment Managers (and by extension client funds) pay more for the same Research if they just trade more. Regulators see this as a problem and are seeking more transparency into the use of investor funds towards expenses such as Research by disallowing the bundled approach and asking brokers to attach a price to each of the services (including Research) they provide to Investment Managers.

MiFID II will require that the Research received by Investment Managers is paid for separately from execution, if it is not to be considered as an inducement. MiFID II requires Investment Managers to pay for 3rd parties for Research from either their own resources or from a separate client funded Research Payment Account (RPA).[34]

Firms that provide execution need to identify a separate charge for their services such that the charge reflects only the cost of execution services. Every other benefit that is ancillary to execution must have a separately identifiable charge. Firms that provide execution and other services need to ensure that the supply and charges for such other services are not dependent on the level of payment for execution. Minor non-monetary benefits are outside the scope of this rule.

What is the definition of Research?

The scope of the term Research for the purposes of unbundling could be interpreted broadly and is likely to capture all material coming out of the Research Department. It could also capture some of the more substantive material emanating from banks' Sales & Trading departments. Firms need to bear in mind that the mere labeling or organisational structure of the firm will not take any material in or out scope and the test is on the substantive content of the material and services. Research includes both material and services- e.g. written products, calls, meeting, models etc.

What do the rules say?

MiFID II requires Investment Managers to agree the following terms with their clients at the beginning of the year – a Research budget, a Research charge and the frequency with which that charge will be applied to client resources throughout the year. Unless the Investment Manager intends to pay for 3rd party research out of its own resources, client funds shall fund the RPA for payment to 3rd party Research providers. Investment Managers will also be responsible for the operation of the RPA and have to ensure that they treat all their clients fairly by applying a charge which only reflects the Research benefit derived by them.

Investment Managers also have to implement measures to assess the quality of research received and discuss appropriate pricing with their providers. ESMA has provided guidance for firms dealing with unsolicited Research provided to them for free. As per this guidance, firms will need to make an assessment of the content provided to them and if they decide that the material provided is substantial and meets the definition of 'Research', they then either need to pay for it or stop accepting it. In any case, MiFID II firms may not retain any Research received for free without making a quality assessment.

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[34] Article 24(7) and (8), MiFID II.

Deutsche Bank
Global Equities

Global Market Structure- EMEA

Stephen McGoldrick
stephen.mcgoldrick@db.com
+44(20)754-75552

Gargi Purandare
gargi.purandare@db.com
+44(20)754-70168

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- Topic 2 MiFID II – Systematic Internalisers and Matched Principal Trading
- Topic 3 MiFID II – Best Execution
- Topic 4, Update 1 MiFID II – Direct Electronic Access and Algorithmic Trading
- Topic 5 MiFID II – Research Unbundling
- Topic 6 MiFID II – Impact on Non-Equities
- Directory of Documents

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