Deutsche Bank
Global Equities

Global Market Structure – Europe

Execution Excellence

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MiFID II: What is new for buy side? Extraterritoriality

Topic 7

What does "Extraterritoriality of MiFID II" mean?

- 'Extraterritoriality' refers to the application of any law or statute to foreign facts.
- It is important to note that MiFID II has limited extraterritorial 'application', but a far bigger 'implication'. This means that non-EEA investment firms may not be directly impacted by MiFID II, however, they will need to ensure that they are MiFID II compliant (to the extent required) when they access EEA markets. Likewise, EEA firms will need to assess the impact of MiFID II restrictions on their businesses outside the EEA.
- The authorities (ESMA, national competent authorities and legislators, European Commission etc) have not yet provided comprehensive definitive guidance on the extraterritorial application of MiFID II and this continues to puzzle the industry as we approach 3 January 2018. There is growing concern among market participants that there may not be enough time to be fully prepared for a smooth transition if the clarifications come in too late.
- This document is divided into two parts. In Part I we discuss how MiFID II will be implemented and in Part II we have highlighted other industry wide issues broadly covering the following topics - share trading obligation, tick sizes, payment for research, direct electronic access, best execution, transaction reporting and trade reporting.

Part I – MiFID II Implementation Approach

What is in scope for MiFID II?

- Article 1(1) of MiFID II on 'Scope' states that the directive applies to investment firms, market operators and data reporting services providers located in the EEA and branches of third country firms providing investment services or performing investment activities in the EEA[1].
- Therefore, all EEA branches of EEA and non-EEA firms are *prima facie* in scope. Non-EEA firms and their non-EEA branches are not covered *per se*- this statement is not unqualified and MiFID II may apply if such firms serve clients located within the EEA or wish to trade EEA markets.
- Currently, there is no definitive guidance for application of MiFID II to non-EEA branches of EEA firms.

[1] EEA countries not part of the EU have opted to apply MiFID II.

What is the status of non-EEA branches of EEA firms?

Whether or not non-EEA branches of EEA firms are obligated to comply with MiFID II, and if they are, to what extent, is unclear from the current regulatory text. Level 1 text of MiFID II and MiFIR is silent on the degree of supervision home regulators should exercise on non-EEA branches for their MiFID activities. Therefore, currently it is left open to the home legislatures and national competent authorities to determine the extent of supervision required through their respective transposing legislations (for MiFID II) and guidance (for MiFIR).[2]

Until any specific direction is provided by the authorities, EEA firms having non-EEA located branches will have to devise their own approach to implement MiFID II. Outlined below are, by way of example, three likely approaches to interpreting the territorial scope of MiFID II.

- A strict and conservative interpretation of the 'Scope' provision would mean that all non-EEA branches of EEA firms have to comply with the regulation *in toto*. A branch is not a separate legal entity, but only another place of business for the head office. Therefore adopting a strict interpretation would mean that all rules that apply to the head office should also apply to all branches equally no matter where they are located.

- An alternative approach to interpreting MiFID II is that as a general rule non-EEA branches are out of scope unless expressly covered. This interpretation is supported by Article 26, MiFIR on Transaction Reporting which specifically requires EEA entities to submit transaction reports to regulators for transactions concluded by all their branches regardless of their location. One could argue that this Article offers clear evidence of limited application of MiFID II to non-EEA branches. It essentially strengthens the view that only certain parts (where text clearly requires) of MiFID II apply to non-EEA branches. The rationale behind this proposition is that if the legislators assumed that all provisions should apply to all branches (both EEA and non-EEA), they wouldn't have felt the need to expressly include 'branches' for transaction reporting obligations.

- A purposive approach to interpretation involves analysing various provisions of the Level 1 text and trying to identify the objective they seek to achieve. Once the purpose/objective is identified, the scope of territorial application is defined accordingly. For example, transparency provisions are designed to enhance price formation and transparency in financial markets within the EEA. Therefore, one could argue that application of these provisions should be limited to transactions carried out on execution venues within the EEA. Extending the applicability of these provisions to non-EEA branches does not contribute to transparency within the EEA markets, because such branches would reflect pricing and liquidity within their respective local markets. Hence, one could argue that non-EEA branches should be excluded from transparency provisions, unless expressly included.

How will MiFID II rules be implemented?

On the basis of a purposive interpretation, MiFID II obligations can be organised into two primary categories, either 'organisational' or 'conduct of business' obligations. These terms are not specifically defined in MiFID II but several provisions of the text refer to them. Pre and post trade transparency rules and trading obligations (Article 23, MiFIR for shares and Article 28, MiFIR for

[2] While CESR stated, pursuant to MiFID 1's implementation, that 'non EU branches of MiFID firms are out of scope of MiFID', CESR did qualify this guidance by stating this was the position except where the level 1 or 2 text expressly required otherwise, or where implementation by the entire entity was necessary to ensure compliance with the obligations' underlying objectives. ESMA has not as yet issued any similar guidance with respect to MiFID 2 obligations, but it should be noted that ESMA's website still includes the CESR guidance, and presumably, therefore, continues to support it.

derivatives) don't follow this dichotomy and form a separate category of rules called the 'market' rules. The implementation of transparency rules is discussed separately.

Broadly speaking, 'conduct of business' obligations are those requirements that an investment firm must observe when providing investment services to clients. This category includes rules regarding disclosure of costs and charges, inducements, client reporting, best execution etc. On the other hand, 'organisational' requirements are prescriptive regulatory standards that govern an investment firm's internal processes, structures and functions with respect to MiFID regulated activities. These include rules regarding identification and management of conflicts of interest, complaints handling, record keeping, transaction reporting etc.

Generally, organisational rules are applicable at an entity level. Therefore, all branches whether located within EEA or non-EEA are in scope in respect of their MiFID regulated activities irrespective of whether the branch undertakes MiFID regulated activities for EEA or non EEA clients. Firms must follow these principles in implementing 'organisational' rules. Conduct of business rules are aimed at improving the standards of protection offered to investors when doing business with EEA investment firms. Therefore, these rules are generally applicable to MiFID regulated activity undertaken by a MiFID investment firm where the Service location[3] is within the EEA for all clients and where the Service location is non-EEA, for EEA clients only. Therefore, firms must apply conduct of business rules to all MiFID regulated activity in accordance with these principles.

How will pre and post trade transparency rules be implemented?

Transparency provisions cannot strictly be bucketed as organisational or conduct of business rules as they are aimed at enhancing the functioning of financial markets within the EEA. Therefore, transparency rules are classified as 'market' rules. Even within this category, the application of pre and post trade transparency rules would differ because these apply to different categories of investment firms.

The pre trade transparency rules we are considering here are applicable to investment firms which act as Systematic Internalisers (SI) and post trade transparency (for investment firms this is referred to as trade reporting) rules apply to all MiFID II investment firms that trade in instruments traded on EU trading venues (TOTV instruments), outside the rules of a trading venue (SI or OTC basis).

Pre Trade Transparency

Pre trade transparency rules will be applicable to Deutsche Bank when it acts as an SI in specific TOTV instruments. Where DB acts as an SI in shares TOTV, DB will publish 2 way firm quotes in sizes upto standard market size during normal trading hours via its authorised APA (Approved Publication Arrangement). As an SI for equity derivatives TOTV, where DB is prompted for a quote and it agrees to provide the quote; DB will make the quote public if the instrument is liquid and quote size is below SSTI (size specific to instrument, as defined by ESMA). These quotes will also be published via DB's authorised APA.

All published quotes will be provided from DB's EEA locations.

Post Trade Transparency

MiFID firms that trade in TOTV instruments outside the rules of a trading venue will need to publish trade reports for such transactions in real time, subject to applicable deferrals. For shares, trade reports have to be published within 1 min of executing the transaction and for equity derivatives trade reports have to be published within 15 mins of execution. Each

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[3] Service Location is defined as the location of the authorised person servicing the client- this is typically the location of a salesperson, trader or a sales trader, as applicable.

transaction is required to be reported only once by the 'seller' firm in the transaction unless only the 'buyer' firm is an SI, where the SI will publish.

Where DB trades in TOTV instruments on Third country trading venues, it may be required to publish certain trades via its APA in the EEA. If trades are concluded on a Third country trading venue which ESMA has put on a list of venues with a comparable or similar post trade transparency regime, then DB will not re-report these trades in the EEA. However, if ESMA considers the third country trading venue to not have a similar/comparable post trade transparency regime, then DB is required to report such trades via its APA.

ESMA's guidance on trade reporting obligations for investment firms states that OTC transactions concluded by EEA firms with non-EEA firms have to be reported by MiFID II investment firms via their APAs. This guidance is likely to cause over-reporting of certain transactions. For example, all OTC trades in equity securities in the US are reported via FINRA's Trade Reporting Facility (TRF), which is not a trading venue. Current ESMA guidance indicates that OTC trades in TOTV shares concluded by EEA firms in the US will have to be re-reported by them via their authorised APAs. This would lead to double reporting of such transactions and potentially sending confusing information to markets.

Trade Reporting Obligations under MiFID II

Type of Transaction	Transacting Party	Counterparty	Who reports?
OTC Trades in TOTV Instruments	MiFID Investment Firm (SI or non SI)	Non-MiFID Investment Firm	MiFID Investment Firm Reports
	MiFID Investment Firm (non SI)	MiFID Investment Firm (non SI)	Seller firm reports
	MiFID Investment Firm (SI)	MiFID Investment Firm (SI)	Seller SI reports
	MiFID Investment Firm (SI)	MiFID Investment Firm (non SI)	SI reports
	Non-MiFID Investment Firm	Non-MiFID Investment Firm	No MiFID trade report

Part II – Extraterritorial implications of MiFID II

What are the potential (unintended) consequences of extraterritoriality of MiFID II?

Some examples of extraterritorial effects of MiFID II are discussed below:

- Mandatory Share Trading Obligation: Share Trading Obligation (STO) created in Article 23, MiFIR mandates that trading in shares tradable on a trading venue may only take place on EEA execution venues (regulated markets, Multilateral Trading Facilities (MTFs) and Systematic Internalisers) or equivalent third country trading venues. For the purposes of this obligation, the definition of 'shares' includes all shares tradable on EEA markets, including secondary listings.

  EU exchanges enable trading in a large number of shares primarily listed outside the EEA. For such shares, the trading obligation would *prima facie* preclude EEA firms from trading such shares on primary or most liquid non EEA venues and force such transactions onto EU execution venues unless third country jurisdiction is deemed equivalent. Hitherto, discussions around equivalence of third country jurisdictions have predominantly been about access to third country trading venues only, given that permitted trading in third countries may only take place on trading venues. Therefore, the ability of EU firms to access OTC markets in equivalent jurisdictions is still unclear.

This obligation if brought into force in its current form is likely to weaken the global competitiveness of EEA Asset Management firms. No equivalence decisions for third country jurisdictions have been made yet and firms are left with little certainty about the impact of the trading obligation on their business. Over the long term, an inability of the firms to access primary pools of liquidity may hurt the flow of capital into the EU. Although it is expected that equivalence decisions will be made in favour of most developed markets e.g. in the US and Japan, having even a small number of exchanges not having equivalence status may have a big impact on the quality of execution offered to clients.

The impact of this will be reduced by the granting of equivalence to third country venues and by the recent legal analysis published by AFME which supports the view that the term 'undertakes' relates to the role of the final entity in the chain of execution. DBAG (an EEA incorporated entity) uses separate legal entities to access the major third country markets; therefore, if AFME's view is adopted we believe DB's service to its clients will not be disrupted. The AFME paper can be found here.

- Tick Size Regime: Under MiFID II, tick sizes for equities will be harmonised across the EU and will be developed in a manner which not only takes into account the price of the instrument, but also reflects its liquidity profile (See Appendix). In its Q&A, ESMA clarified that for non-EU equities, the applicable liquidity band will be determined taking into account the average daily number of transactions (ADNT) on the most liquid venue for that instrument within the Union and any trading activity conducted outside the Union should not be considered for these purposes.

  In the case of dual/cross listed stocks, for which main or primary liquidity is observed outside the Union, liquidity band will be determined on the basis of liquidity observed in the Union only. Non EEA jurisdictions follow different approaches to tick sizes and therefore there will be differences between the tick size for that instrument on the EEA venues and the 3rd country primary venue.

  Globally, jurisdictions use different approaches to determine tick sizes for instruments traded on their venues. Swiss regulators have stated that they will align their regime with MiFID II, but will consider liquidity on Swiss venues to arrive at the appropriate liquidity bands; whereas Swiss liquidity will not be considered for determining tick sizes in the EEA. While Swiss venues will use the same tick size table (as in the Appendix), their results will be different from the rest of EEA on account of different input data. Separately, the US follows an approach completely different from that in the EU or Switzerland.

- Direct Electronic Access (DEA) for non- EU proprietary trading firms: Under MiFID I, proprietary trading firms were exempt from all MiFID obligations. MiFID II reduces the scope of this exemption under Article 2(1)(d) by bringing into scope proprietary firms which use DEA to access an EEA trading venue.

  The text, however, divulges no further information or any other details about the approach to implement this inclusion. Taking a strict interpretation of the text would mean that all proprietary non-EU firms who wish to use DEA to trade EEA markets will need to be authorised under MiFID II as MiFID investment firms and also be subject to complete scrutiny by the relevant national competent authorities. For such a material change, an explicit impact assessment would need to have been undertaken; therefore a proportionate interpretation anticipated by the industry is that such firms may not have to be authorised as MiFID II firms provided that they are regulated by their local national competent authority.

- Research Unbundling: MiFID II investment firms will be prevented from receiving prohibited 'inducements' from third parties with the scope of 'inducements' covering Research content as well. This means that they will not be allowed to receive this content from Research providers operating in third countries where it is acceptable to supply this content without separately charging for it.

An alternative to procure third party Research is to buy it for a “hard dollar” payment, but even this creates a peculiar problem for US broker- dealers. It is potentially illegal for US broker-dealers to accept hard dollar payments from US domiciled clients for supplying Research without being registered as Investment Advisors under the Investment Advisers Act of 1940. The standard of obligation for Investment Advisors under the respective legislation is higher (compared to broker-dealers) as they owe a fiduciary duty to their clients and are not allowed to engage in principal trading without their client’s express permission. Whether US broker-dealers will be caught by this provision when dealing with EEA based clients is pending clarification. Press reports suggest that that the SEC is going to clarify that payments received by US broker-dealers under MiFID II are allowed. However, we are awaiting formal clarification from the SEC.

In view of these regulations, brokers in non-EEA jurisdictions will have to work out their payment/pricing structures and other legal documentation for Research provided to EEA firms.

- Best Execution and Transaction Reporting: Many non-EEA firms are realising that they may also have some commercial pressure to follow MiFID II obligations to ensure compliance for their EEA based customers. For example: Consider a scenario where an EEA Asset Manager servicing an EEA client, routes an order to a non-EEA broker for execution. Per MiFID II, the EEA Asset Manager will owe its clients best execution and additionally will also have to produce periodic reports to evidence its adherence to best execution obligations. To be able to provide and demonstrate best execution to its clients, the EEA Asset Manager would need to be able to evidence that they have taken all sufficient steps to achieve best execution from the non-EEA broker as well. Therefore, the EEA asset manager may require the non-EEA broker to have an order execution policy, submit relevant reports and take ‘all sufficient steps’ to ensure best execution’.

  Similarly, the EEA Asset Manager may require the non-EEA broker to supply electronic details of the relevant trades in a format compatible with supplying complete and accurate Transaction Reports to its regulator.

Other documents in this series may be accessed here:

- Topic 1, Update 1 MiFID II – Trade and Transaction Reporting
- Topic 2, Update 1 MiFID II – Systematic Internalisers, Trading Obligation and MPT
- 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, Update 1 MiFID II – Impact on Non-Equities
- An Overview of MiFID II
- Directory of Documents

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Appendix

Annex to RTS 11: Tick Size Table

	Liquidity bands					
Price ranges	**0 ≤ Average daily number of transactions < 10**	**10 ≤ Average daily number of transactions < 80**	**80 ≤ Average daily number of transactions < 600**	**600 ≤ Average daily number of transactions < 2000**	**2000 ≤ Average daily number of transactions < 9000**	**9000 ≤ Average daily number of transactions**
0 ≤ price < 0.1	0.0005	0.0002	0.0001	0.0001	0.0001	0.0001
0.1 ≤ price < 0.2	0.001	0.0005	0.0002	0.0001	0.0001	0.0001
0.2 ≤ price < 0.5	0.002	0.001	0.0005	0.0002	0.0001	0.0001
0.5 ≤ price < 1	0.005	0.002	0.001	0.0005	0.0002	0.0001
1 ≤ price < 2	0.01	0.005	0.002	0.001	0.0005	0.0002
2 ≤ price < 5	0.02	0.01	0.005	0.002	0.001	0.0005
5 ≤ price < 10	0.05	0.02	0.01	0.005	0.002	0.001
10 ≤ price < 20	0.1	0.05	0.02	0.01	0.005	0.002
20 ≤ price < 50	0.2	0.1	0.05	0.02	0.01	0.005
50 ≤ price < 100	0.5	0.2	0.1	0.05	0.02	0.01
100 ≤ price < 200	1	0.5	0.2	0.1	0.05	0.02
200 ≤ price < 500	2	1	0.5	0.2	0.1	0.05
500 ≤ price < 1000	5	2	1	0.5	0.2	0.1
1000 ≤ price < 2000	10	5	2	1	0.5	0.2
2000 ≤ price < 5000	20	10	5	2	1	0.5
5000 ≤ price < 10000	50	20	10	5	2	1
10000 ≤ price < 20000	100	50	20	10	5	2
20000 ≤ price < 50000	200	100	50	20	10	5
50000 ≤ price	500	200	100	50	20	10

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