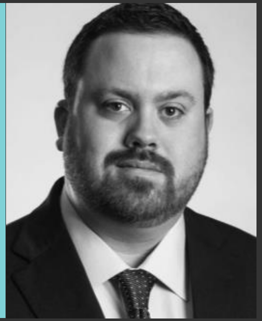
With you today

Marie Gervacio, Executive Director, Advisory, E&Y Advisory Services Limited

- Marie has over 17 years of advisory and assurance experience in the banking and asset management sectors, and dealing with insurance clients.
- She has experience in regulatory-driven change as part of a broader focus on helping financial institutions manage risk and respond to regulatory-driven change resulting from regulatory requirements with global reach.
- She currently leads the EY APAC MiFID II campaign, serves as the Hong Kong Financial Services Internal Audit Lead, and is a frequent speaker on risk and compliance themes, including MiFID II, risk culture, FATCA and CRS.



William Hallatt, Partner, Financial Services Regulatory, Herbert Smith Freehills

- William has over a decade of experience in advising on financial regulatory matters, covering both contentious and non-contentious issues.
- He has broad experience in advising clients in Hong Kong, Europe and the UK on areas including governance structures, systems, controls and conduct of business issues.
- He also advises on the extraterritorial impact of MiFID II, the UK and European market abuse regimes, and anti-money laundering and terrorist financing requirements.

Hannah Cassidy, Partner, Financial Services Regulatory, Herbert Smith Freehills

- Hannah advises international and regional financial institutions in the investment banking, retail banking, wealth management, asset management and insurance sectors.
- Working at every level from board to compliance and business teams, she advises on issues such as conduct risk, governance arrangements, individual accountability, mis-selling and complaints-handling.
- She was involved in drafting AIMA's submission response to the HK SFC in relation to its consultation on changes to the SFC's Fund Manager Code of Conduct and also advises on the extraterritorial impact of EU legislation, including MiFID II.

MiFID II presentation

1. Research unbundling overview
2. Key considerations
3. Costs and charges disclosures
4. Operational aspects
5. Next steps

HERBERT SMITH FREEHILLS

EY Building a better working world

MiFID II

Research unbundling overview

Overview

MiFID II will go into effect in January 2018

- No free research can be offered
- Use of Research Payment Account (RPA) or out of own Profit & Loss
- Systematic policy required for research spending
- Extraterritorial impact

Current landscape – considerable duplication, waterfront providers

Investment trends – changes are happening at a time of flux in the investment process

Research budgets – falling research and headcount budgets

Structural change – market push model is being replaced with the pull model

Regulatory requirements

Free research cannot be offered

- The investment firm shall not accept any monetary or non-monetary benefits (Para. 8 of *MiFID II Article 24)*
- Research that is tailored or bespoke cannot be a minor non-monetary benefit and can have material value *(ESMA Consultation Paper ESMA 2015/549)*

Use of RPA or out of own P&L

- Research can no longer be paid for with trading commissions
- Use of RPA which will be funded as a specific charge to the client or via a commission sharing arrangement (CSA)
- Payment out of P&L

Systematic policy required for research spending

- Obligation to provide a written policy on research funding setting out:
  1. The qualitative criteria against which the research is assessed
  2. The formulas used to allocate the research budget
  3. The process for reviewing the quality of research received

  (AMF public consultation)
- Repapering of commission arrangements

Impact on APAC firms

EU firm / branch of a EU firm

- Regardless of whether an EU firm (or the branch of an EU firm) has an EU or non-EU client, the EU firm is required to unbundle its research costs.
- A buy-side firm cannot avoid research unbundling obligations from delegating portfolio management responsibilities to a non-EU firm.
- Many EU firms are part of global groups, which affects how research is to be shared in the group.

Sell-side non-EU broker

- A non-EU sell-side firm in APAC dealing directly with EU clients might be asked to trade at an execution only rate and might have to separate order flow from EU clients.
- This applies regardless of whether orders are executed in a local (non-EU) instrument or an instrument with a dual EU listing.

Non-EU investment firm giving money to a MiFID II investment firm

- The non-EU investment firm will be notified of all charges, including costs associated with research.
- All investors regardless of locale will be required to agree on the research charges with the MiFID II investment firm (Delegated Directive, 7 April 2016, Article 13(b)(ii)).

Non-EU investment firm giving orders to an EU broker to execute

- The EU broker will not be able to create soft dollars for trading.

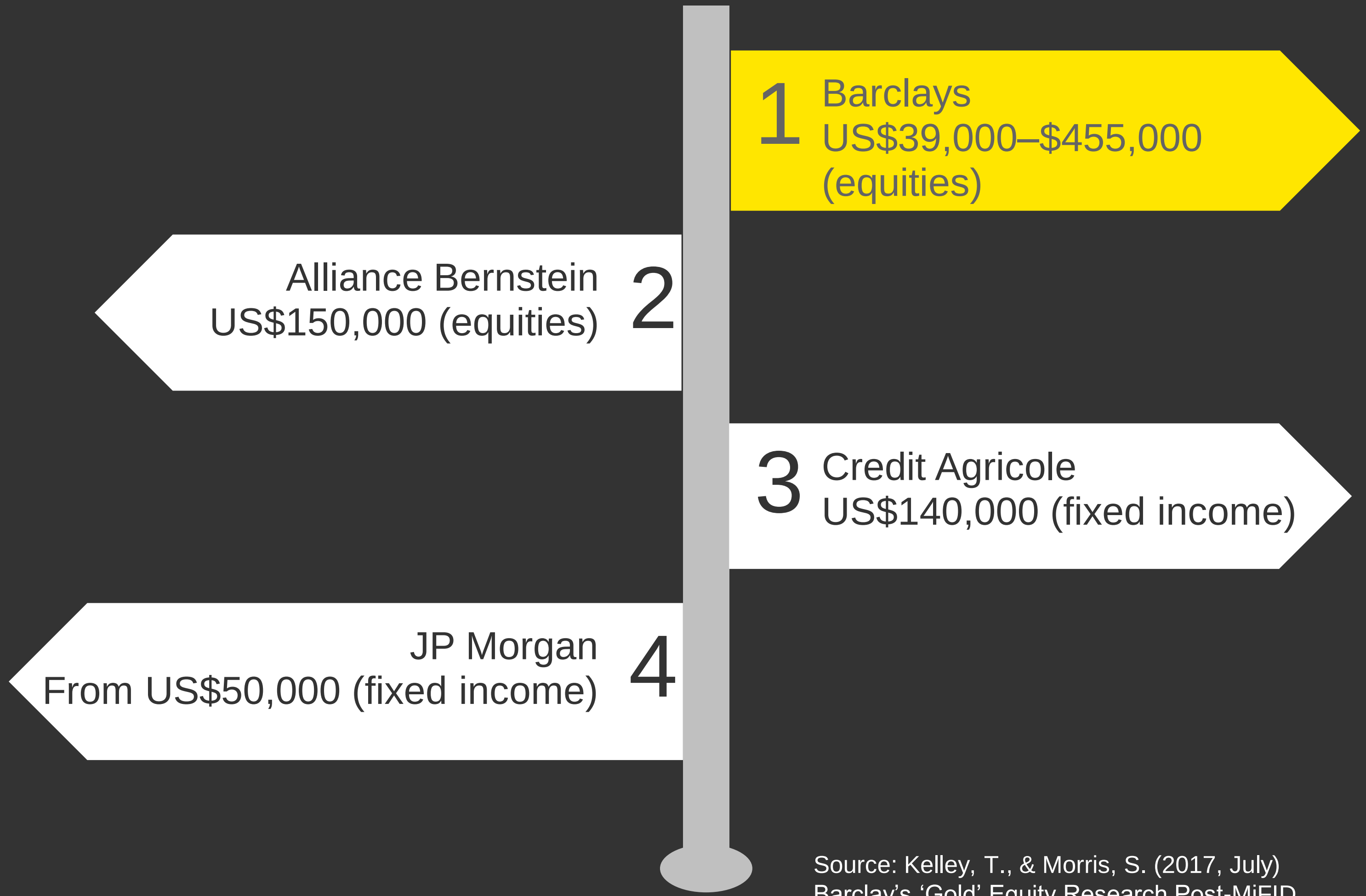
MiFID II

Key considerations

Sell side overview

For APAC, MiFID II compliance is being driven by commercial motivations

- European clients are requesting research unbundling per MiFID II to meet their own regulatory obligations.
- Traditionally “bundled” services will require a specific carve-out of research costs.
- Structural changes will drive new practices, underpinned by enhanced controls and transparency to avoid provision of inducements.
- There is a potential reduction in number of brokers being used by buy side.
- There is a potential for new mechanisms to monetize research.



Source: Kelley, T., & Morris, S. (2017, July) Barclay’s ‘Gold’ Equity Research Post-MiFID May Cost $455,000. *Bloomberg Markets*.

How extraterritorial is MiFID II
Scenario analysis

Illustrative for discussion

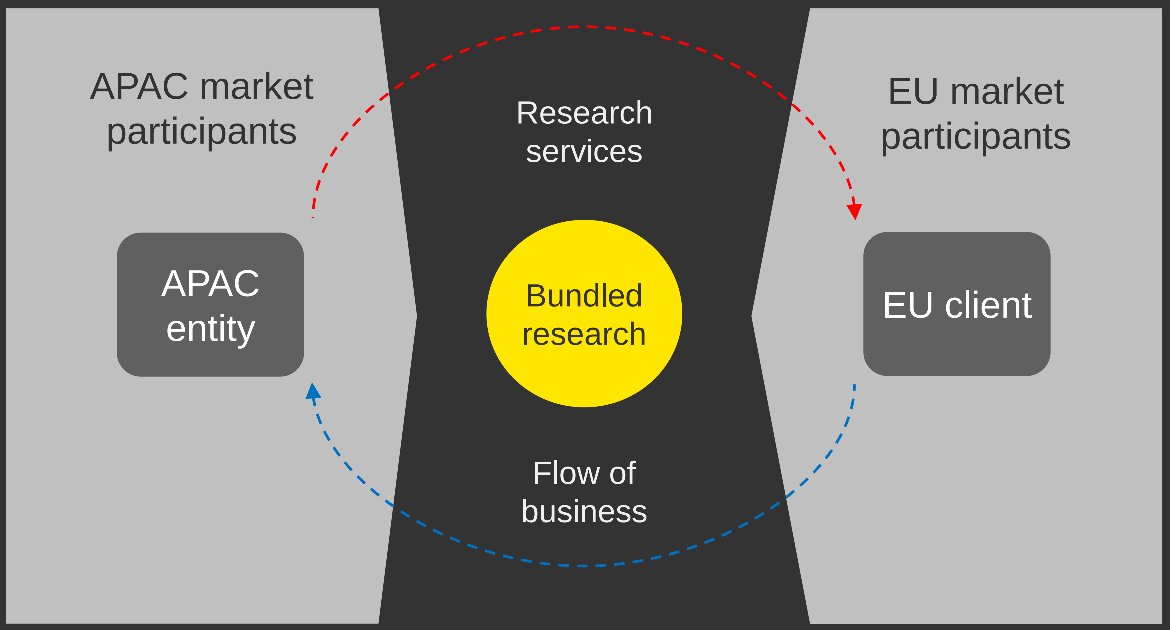
MiFID II impact

- Although the APAC entity is not under MiFID II obligations, and thus can provide bundled research service, EU clients would not be able to receive research they have not explicitly paid for. Therefore the APAC entity may need to be able to charge separately for research.
- MiFID II requirements are driving changes in expectations from buy-side research consumers and new practices, including demand for higher-quality research, FICC research potentially being provided for free on publicly available platforms and the emergence of boutique or spin-off research players.

Indicates research

Indicates transaction

APAC entity provides research bundled with trading services to EU clients.



MiFID II requirements

- MiFID II states that EU firms should not offer or receive prohibited inducements and thus EU firms need to start charging for their research publications.

MiFID II impact

- EU clients may need to pay separately for research -a change to the current trend of bundled dealing commission.

Industry concern: Research usually operates under a global business model, while MiFID II is applicable at an entity level. Therefore research providers might have to develop a framework to categorize which research reports are generated by non-EU entities vs. EU entities and which needs to comply with MiFID II

Please note this analysis does not represent a legal opinion and is not definitive. Extraterritorial impact depends on specific firm models and further regulatory guidance which may change the impacts described.

Buy side – current models

"Bundled" research

Commission Sharing Arrangements (CSAs)

Manager pays

Buy side – paying for research under MiFID II

1. Research payment account (RPA)

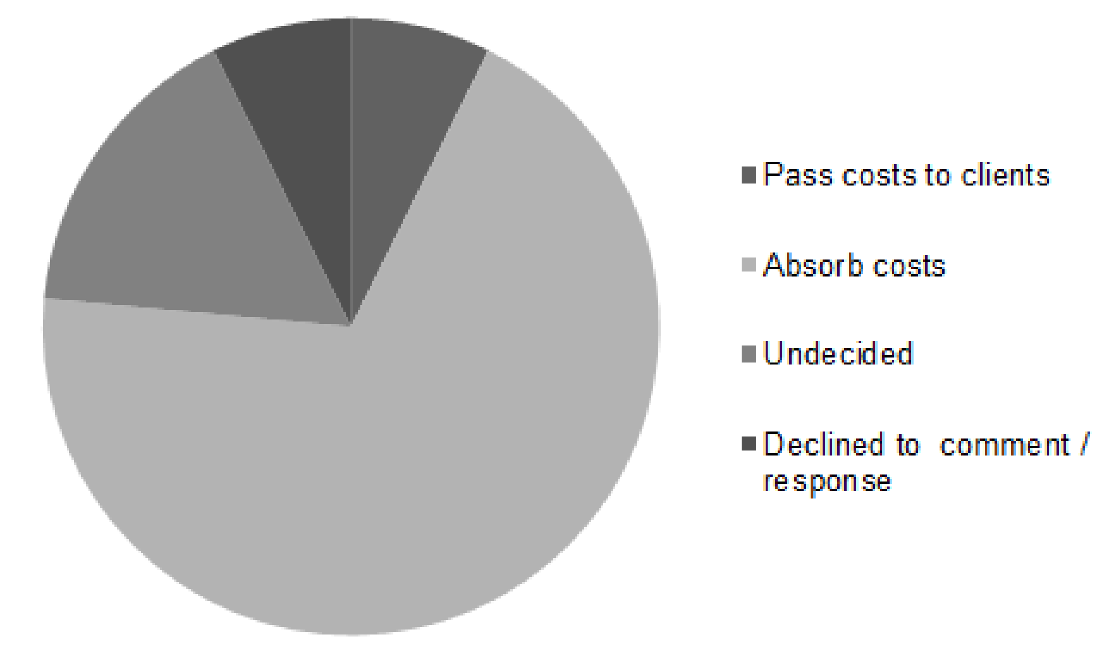
- Two possible models:
    - Funded by direct payments from clients
    - Funded by execution

2. Own funds

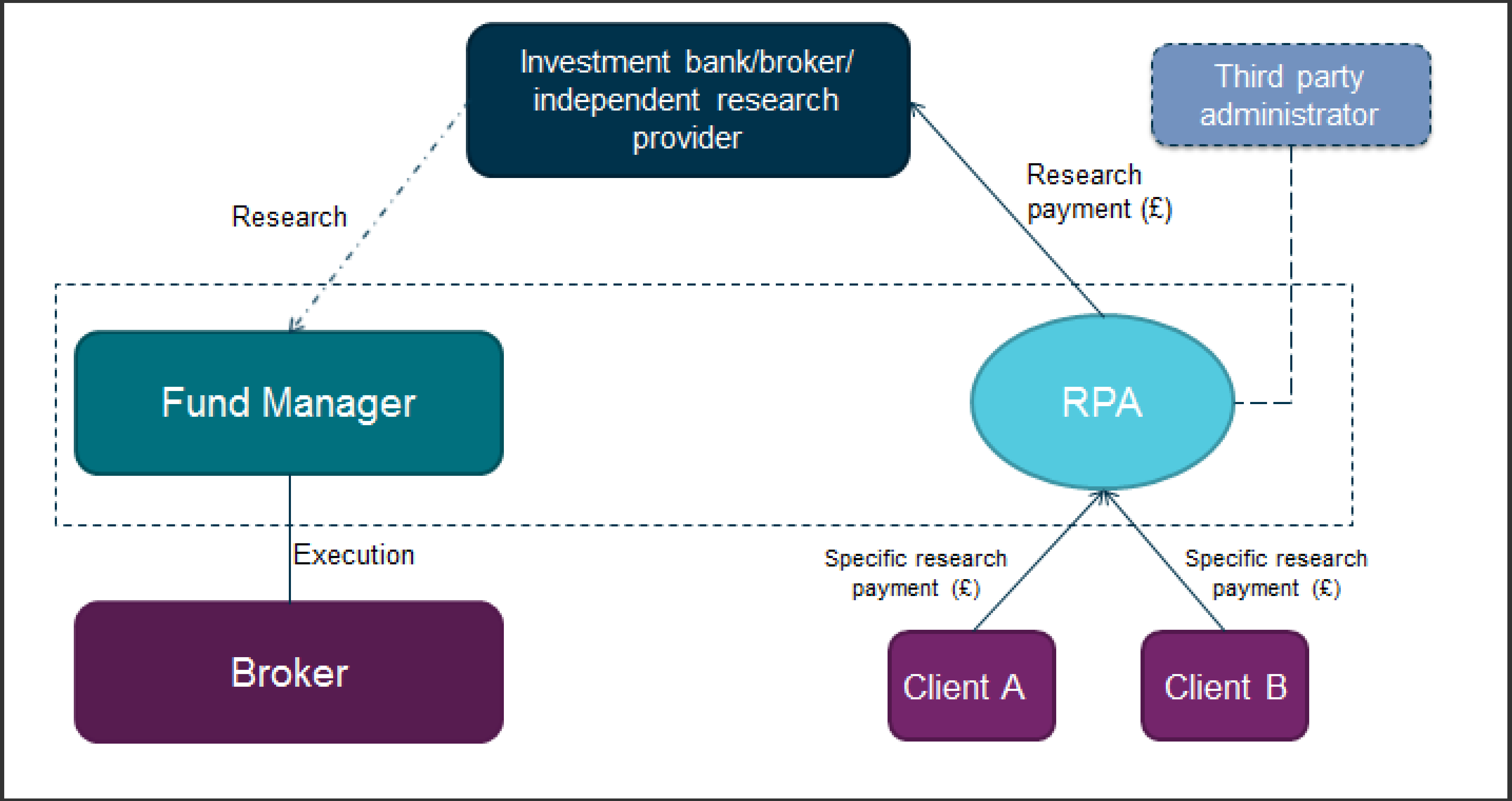
- Fund manager pays for research out of its own resources

3. Internally produced research

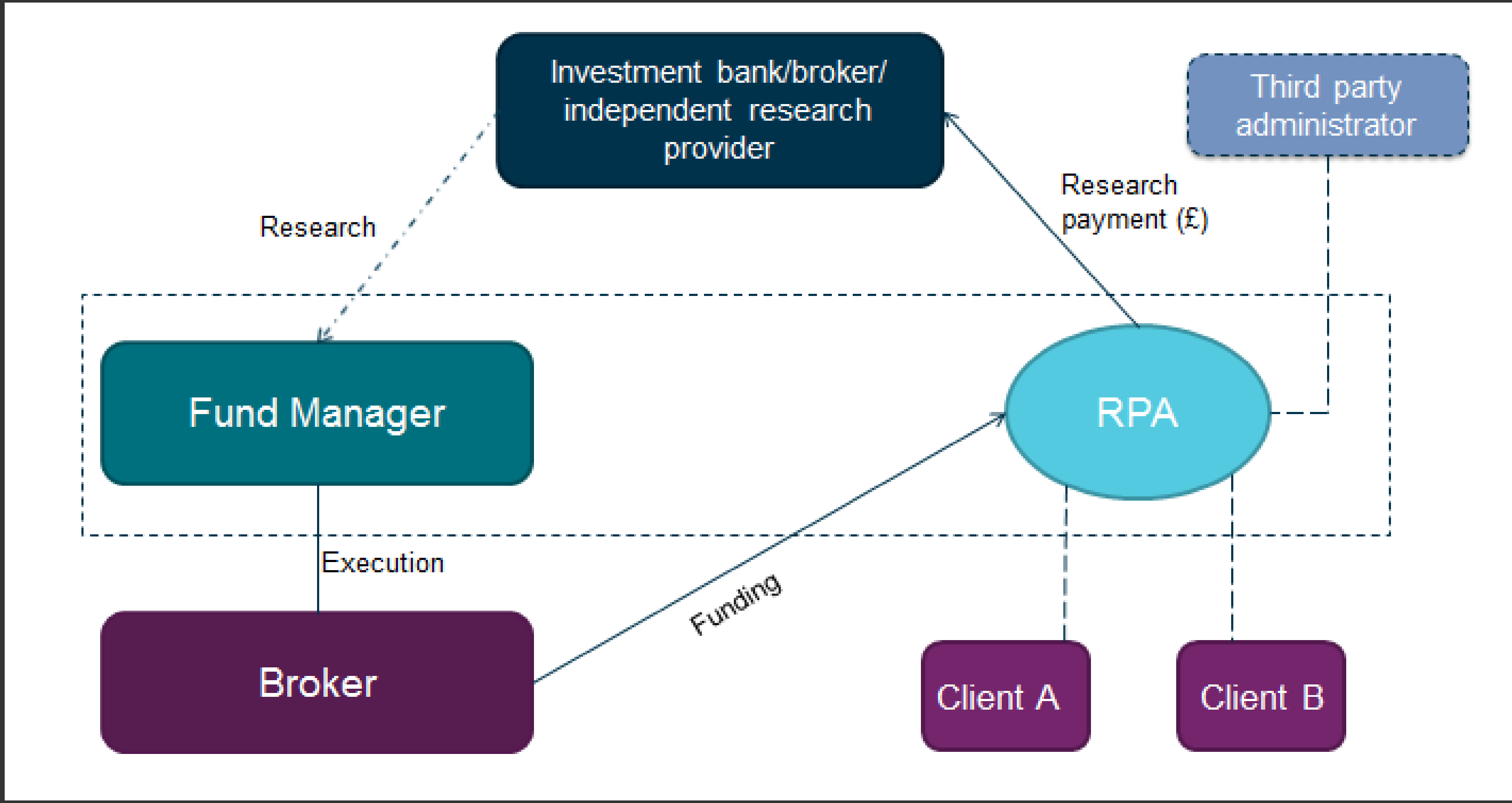
- MiFID II restrictions only apply to payments to third parties



RPA: overview – model A (client payment)

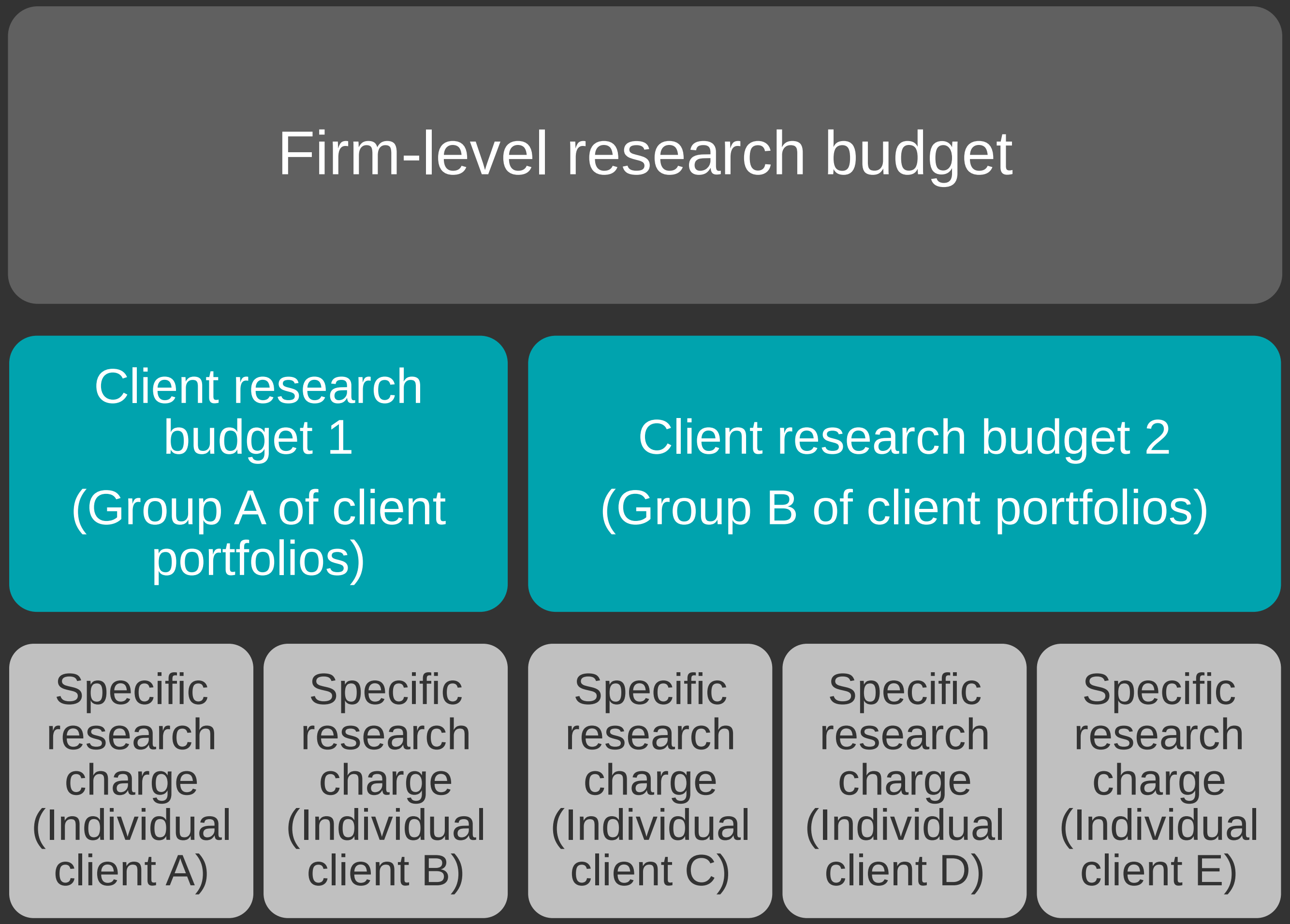


RPA: overview – model B (client payment)



RPA key issue 1
Setting the research budget

- An **estimate of forecast research costs**
- Must be based on a reasonable **assessment of the need for third-party research**
- Research budgets must be:
  - clearly **documented** (setting and managing the budget)
  - regularly **reviewed**
  - sufficiently **granular** (for pre-apportioning among client groups)
  - **disclosed** to the client
  - subject to **controls and senior management** oversight
- Will be the basis for **determining the specific research charge** for each client
- Budget can be **set for a group** of similar client portfolios (as shown in the second level of the diagram)



HERBERT SMITH FREEHILLS

RPA key issue 2
Setting clients' specific research charges

Key requirements

- Must be **agreed** by the client
- Can only be **based on the research budget** – that is, the charge **cannot** be linked to the **volume** and **value** of transactions executed.

Group client accounts

- Where setting a budget for several portfolios, a firm must still set a charge for individual clients. This could be done on a **pro rata** basis among all client accounts benefitting from the research based on the value of each client's portfolio, but the methodology is not prescribed (provided it is "fair").

Distributing research internally

- When making research accessible to internal staff, firms must have systems and policies in place to **allocate costs fairly to clients** and explain their approach to allocation in the written policy.

Current issues and uncertainties (1 of 2)

1. Definition of "research"

- There is uncertainty around what constitutes "research".
- "**Minor" non-monetary benefits** are **excluded**: non-substantive material unlikely to influence the firm's behavior, e.g., short-term market commentary, summaries of corporate issuers' statement and (potentially) issuer-sponsored third-party coverage.

2. Quality of research

- Firms must have **"robust quality criteria."**
- Quality criteria must be linked to **estimating research budgets** and **assessing research purchased** by research providers.
- ESMA: Firms should have a **methodology** to establish what they expect to pay for research, e.g.,. set measureable criteria as to how it will value the type, level and quality of service.
- Internal rate cards or thresholds for individual providers may be useful.

3. Pricing

- An agreement is required to set out **indicative costs**, with the ability to flex what is ultimately paid (based on pre-determined quality criteria).
- How will research received during **telephone conversations** be costed and documented?
- **Pay as you consume** models: metrics on what research is read and actually used.

Current issues and uncertainties (2 of 2)

4. Client money and surpluses

- When the funds are deducted from a client, the funds belong to the asset manager (i.e.,**not** client money).
- ESMA: Firms should use “best efforts” to **align** the **timing of the charges paid by the client** and the **payments made to research providers.**
- If there is a **surplus** in the RPA, firm should **rebate** those funds to the client or use them to **offset** the charges for the following period.

5. Unsolicited research

- Firms should **not accept free research.**
- Firms should have mechanisms in place to **block the receipt of unsolicited research** (e.g., explicit instructions to brokers, IT systems, compliance oversight of what material has been received, and a mechanism for analysts to flag unwanted research).

6. Intra-group research

- Rules apply equally to research from other group entities (i.e. firms will need to use RPA funds, pay for research directly or refuse to accept research from other intra-group entities).
- Firms must pay particular attention to their obligations to **assess the quality of research,** and maintain appropriate **controls and oversight** when making **intra-group payments.**

MiFID II

Costs and charges (C&C) disclosures

Challenges in formulating C&C disclosures

- Operational difficulties with data capture
- Difficult to develop systems that facilitate disclosure to ensure consistency with disclosure requirements
- Difficulties in obtaining information from other firms in the distribution or execution chain (which may not be subject to MiFID II)

Key C&C provisions

- All costs and associated charges related to investment or ancillary services and financial instruments must be disclosed.
- Clients must be provided with an aggregated overview of all costs and charges of the investment, including the possibility to request an itemized breakdown.
- The information provided to the client should allow the client to understand the cumulative effect of C&Cs on the return of the investment.
- Clients must be informed about the method of payment, including when payments are provided by third parties.
- Clients should be provided with the above information at point of sale (ex-ante) as well as, where applicable, post-sale (ex-post) on an annual basis.
- The information must be provided to all categories of clients, but professional clients and eligible counterparties may opt out of some requirements.

C&C disclosures

Aggregation of C&Cs

- Aggregated C&Cs totaled and expressed both as a cash amount and percentage
- May provide separate figures comprising aggregated initial C&Cs, ongoing C&Cs and exit C&Cs
- Information provided should allow the client to understand overall cost as well as cumulative effect of C&Cs on the return of the investment

Annual C&C

- Should reflect actual investment amount at the time the disclosure is produced

Upfront C&C

- Use incurred costs as a proxy for the expected costs and charges or reasonable estimations
- Review ex-ante assumptions on the basis of post-sale experience and make adjustments where necessary

MiFID II

Operational aspects

Operational aspects – sell side
Commission unbundling – illustrative workflow

Sales → Pre-trade → Execution → Post-trade → Clearing → Settlement → Reporting

Sales: Client trades cash equities with APAC equities or prime desk

How to ensure that broad auxiliary services offered by non-cash equity / prime business units do not serve as inducements to trade?

Pre-trade: Client wants to unbundle

- Will the outreach letter used to determine if the client wants to unbundle also go to cash equities clients and prime clients?
- Will the client outreach letter go to clients with EEA sub-funds? Will the client outreach go to third-country clients wishing to comply purely for commercial reasons?
- How will MiFID II preferences be recorded by the relevant systems?

Post-trade: Jurisdiction where trade is initiated has licensing restriction

- For instance, where there is a local difference in one or two APAC locations:
  - Determine definitive list of affected jurisdictions
  - Work with business and IT to develop a commercial solution

Settlement: Trade settled in EMEA

- Trades settled outside of EMEA have been deemed out of scope, but should they be?
- Scenarios to consider:
  - A global hedge fund with operations in the EEA wants to unbundle research for all jurisdictions, including APAC stocks settling in APAC
  - A HK-based hedge fund settles trades in APAC, but wishes to comply with MiFID II unbundling requirements to appease a large EEA-based investor.

Operational aspects – sell side
Research production and distribution – illustrative workflow

Push/pull:	Pull distribution	Push distribution
Channel:	Client proactively accesses research via several platforms (e.g.,, Thomson Reuters)	Front office (research analysts, research sales and sales traders) distribute research to clients via: 1. Email 2. Bloomberg mail 3. Bloomberg chat
Consideration:	How do we ensure clients access only what they pay for, (i.e., avoid providing inducements)?	How do we ensure front-office staff do not inadvertently provide inducements (e.g., unsolicited research)?

Operational impact – buy side
Policy requirements

Offering and inducements

Sub-category	Potential operational impact	Impact
Independent vs. non-independent Article 24 (4), 24 (7), 24 (8)	Establish/amend policies regarding investment advisory and portfolio management, client information, investment universe and third-party distribution of funds. For APAC-based asset managers with UK operations, in the context of a potential hard Brexit, the use of third-party distributors into Europe should be examined closely.	
Inducement transparency Article 24 (4), 24 (5), 24 (7), 24 (9), 25(6)	Establish/amend policies regarding inducements, including the unbundling of research fees from execution and retention of client information. Non-EEA domiciled entities will be impacted by market pressure only, i.e.,, by EEA clients and counterparties requesting certain measures be implemented in line with their domestic expectations. Any umbrella investment agreements between entities must also be carefully considered. For example, the research obtained by a HK entity under a Commission Sharing Arrangement may violate a UK entity's regulatory compliance. Solutions to this should be addressed in a gap analysis with the outcome captured in the policy.	
Collaborations with intermediaries Article 24(7), 24(8), 24(4), 26	Establish/amend policies regarding the cooperation with intermediaries.	

Potential impact Low Medium High

Operational impact – buy side
Process requirements

Offering and inducements

Sub-category	Potential operational impact	Impact
Independent vs. non-independent Article 24 (4), 24 (7), 24 (8)	Amend processes regarding investment advisory and portfolio management, eligible investment research, inducements, and pricing (first and second line of defense). Entities will require a perspective on those clients to whom they provide advice or to whom they may potentially provide advice in the future.	
Inducement transparency Article 24 (4), 24 (5), 24 (7), 24 (9), 25(6)	Amend investment advisory process in terms of inducements, pricing and transparency (first and second line of defense). This covers processes around research payments, including evaluating research providers, calculation and funding of research costs (i.e.,, out-of-pocket vs. RPA solutions), and cost attribution for investor disclosure. Research sharing between entities may pose regulatory risks to the UK entity if not unbundled.	
Collaborations with intermediaries Article 24(7), 24(8), 24(4), 26	Amend processes to ensure cooperation with intermediaries in terms of inducements, pricing, client opening and servicing (first and second lines of defense).	

Potential impact: Low, Medium, High

Operational impact – buy side
System requirements

Offering and inducements

Sub-category	Potential operational impact	Impact
Independent vs. non-independent Article 24 (4), 24 (7), 24 (8)	If the firm decides to provide financial advice to its EEA clients directly, they will need to implement or amend tools to capture the investment life cycle in accordance with the provision of financial advisory services.	
Inducement transparency Article 24 (4), 24 (5), 24 (7), 24 (9), 25(6)	Implement/amend tools to ensure correct inducement and commission calculation (aggregated and broken down) as well as client transparency around inducement costs.	
Collaborations with intermediaries Article 24(7), 24(8), 24(4), 26	The implementation of tools and interfaces for intermediaries in order to ensure the intermediaries' MiFID II compliance	

Operational aspects – sell side
Sell side customer challenges

- Customer challenge
  - How to service clients in a tiered manner?
  - How to manage entitlements more effectively in research distribution?
  - How to maximize research readership on existing research distribution platforms?
  - How to monetize research using emerging cash-based research collections?

- What they want help with
  - Mechanisms to control and manage research services offered to asset managers
  - New research distribution capabilities and ability to engage with clients
  - New mechanisms to monetize research
  - Ability to reach and market to non-direct clients

Operational aspects – sell side

Summary of operational and implementation considerations

1

Research pricing – pricing research separately from trading or execution fees

- "All-you-can-eat" options and fixed fees for research reports.
- Basis for offering research: geographical, sector, analyst or a combination of all.
- Charging for Fixed Income and macroeconomic research - Indirect investment strategy value means difficulty quantifying.

2

Research distribution – avoiding the provision of inducements when distributing research

- Can platforms and aggregators support broker pricing or distribution strategy? If clients access reports not paid for, this may be an inducement.
- Front-office research analysts, research sales and sales traders will change the way they "push" research to their clients; Bloomberg chats and e-mail will require more "policing".

3

Unbundling and RPA administration – brokers deciding whether to operate their own RPA

- Can clients deposit their funds directly into the RPA?
- Commission Sharing Arrangements – how will research allocation work (which systems and processes will be needed to ensure clients stay within their RPA budgets)?
- RPA administration charges? Providing RPA administration for free would likely be an inducement.

MiFID II

Next steps

Next steps
Sell side

1. **Confirm client expectations and needs on unbundled research**

2. **Perform/complete commission workflow analysis, including detailed mapping of the transaction, production and distribution processes**

3. **Begin governance, policies and procedures build, particularly around designing controls to prevent the offering of inducements, and explore solutions that enable ongoing monitoring and Management Information**

Next steps
Buy side

- Conduct impact assessment of research unbundling requirements.
- Perform a self-assessment of research consumption and needs.
- Prepare research charge collection agreements with relevant key providers.
- Talk to clients about their expectations regarding research and C&Cs.
- Explore systems/methods/record-keeping protocols to best capture data required for C&C disclosures.

Upcoming

Oct	Nov	Dec	**2018**	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	**2019**

Implementation

- Assess current policies & processes and design new policies and processes
- Document systems requirements and work closely with technology throughout build-lifecycle
- Legal agreement repapering
- Perform enhanced distributor due diligence
- Adapt client reporting

Validation

- Support technical quality assurance, assuring validation of requirements' completeness and correctness based on legal and compliance analyses
- Legal assumption validation and monitoring support is critical to successful delivery of regulatory-driven projects as it secures both the analysis realized and the project timeline

Assurance

- **Second line (management assurance):** assurance of ongoing monitoring of the design and operation of controls in the first line, as well advising and facilitating risk management activities
- **Third line (independent assurance):** independent assurance over managing of risks, internal audit plays the leading role

Governance

- Assistance with set up and monitoring of ongoing business line governance

3 Jan 2018

MiFID II deadline

Q&A

EY | Assurance | Tax | Transactions | Advisory

About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

EYG no. 05663-174GBL

ey.com

About Herbert Smith Freehills

Herbert Smith Freehills is one of the world’s leading professional services businesses, bringing together the best people across our 26 offices, to meet all your legal services needs globally. We can help you realise opportunities while managing risk.
Established in 1982, our Hong Kong office is the hub of Herbert Smith Freehills' Asia operations, and our largest office in the region. We advise regional and international clients on regulatory matters, dispute resolution, corporate and capital markets, energy, telecommunications, media and technology, projects and infrastructure, and banking and finance. In addition to our Hong Kong-qualified partnership, our multicultural team is drawn from a range of jurisdictions and backgrounds, including England and Wales, the US, Mainland China, Australia and Southeast Asia.

https://www.herbertsmithfreehills.com/