

What do Indian Entities Need to Know about MiFID II?

The Markets in Financial Instruments Directive (“**MiFID II**”), which came into effect on 3 January 2018, is a European legislation, consisting of two parts, the MiFID II directive (2014/65/EU) and the MiFIR regulation (2014/600/EU) that has certain far reaching implications on the Asia Pacific Region including India.

The 2008 financial crisis highlighted the need for greater investor protection and robust regulatory framework and thus the first iteration, MiFID I, came into effect which subsequently expanded through MiFID II. The aim of this regulatory framework was to provide more transparency to investors (“**Objective**”) which in-turn laid the foundation for more robust global markets and cast additional compliance obligations on underwriting entities that came within the purview of MiFID II and were engaged in an international bond offering by an Indian entity (“**International Bond Offering**”).

This alert (**Alert**) discusses the top **five** common queries that are often raised in relation to Indian entities, which could fall within the impact of MiFID II and are engaged in International Bond Offerings either as an underwriter or as an issuer. We hope you find the issues raised in this Alert useful and reach out to the Dorsey team members in case of any questions.

MiFID II - Response to Top Five Questions

1. What is an In-scope Entity for purposes of MiFID II?

Even though MiFID II is a European regulation, in the context of an International Bond Offering, MiFID II still has potential implications for underwriting entities that interact with European Economic Area (“**EEA**”) or have branches or subsidiaries in the European Union (“**EU**”).

To be precise, MiFID II may be applicable to entities that:

- have authorized branches or subsidiaries in the EU;

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- trade or service EU clients/markets and deal with EU counterparties;
- distribute products in the EEA;
- arrange back-to-back trades via an EEA entity;
- distribute EEA manufactured products in India;
- trade on EEA venues/EEA underlying's on non-EEA venues; and/or
- provide execution and research to EEA managers.

Any of the above would come within the purview of MiFID II. Therefore underwriting entities that are generally engaged in an International Bond Offerings will all likely fall within the scope of MiFID II (**"In-scope Entities"**).

2. Who is a "distributor" or a "manufacturer"?

MiFID II sought to achieve its Objective by introducing a new classification based on the two broad types of responsibilities usually handled by underwriters mainly those who limit their responsibilities to (i) marketing, offering and placing of the relevant securities in the European Economic Area (**EEA**), and others (ii) that are involved in the actual underwriting and allocation process. The underwriters engaged in the former activity would be classified as "distributors" and the latter as "manufacturers". Therefore, where an underwriting entity that is a settlement bank, arranger, a joint global coordinator or a joint lead manager, it would be called a "manufacturer". In all other situations, an underwriter entity would be a "distributor" unless such an entity is playing a very inactive role on the transaction (for example where such underwriter has lent its name to the transaction for a certain fee mainly for inclusion of its name for league table purposes etc.) in which case such an entity would not even be a "distributor".

However, for an underwriter to be classified as a "distributor" or "manufacturer" under MiFID II, the entity must first be an In-scope Entity.

3. What are the obligations of an In-scope Entity underwriter that acts as a "distributor" and a "manufacturer" in the context of an International Bond Offering?

At the onboarding stage, In-scope Entities should appropriately classify clients and identify the suitability and appropriateness of the relevant product that such In-scope Entities are planning to trade with or introduce to such clients, based on the clients' knowledge, skill and experience. Therefore the focus at this stage is on the right research so that In-scope Entities are able to offer and recommend products and services as per the needs and characteristics of the target market.

In brief, the manufacturer's obligation is to determine the target market and to keep it current. The distributor's obligation is to feed information back to the manufacturer. If there is no manufacturer or if the distributor hasn't received any information from the manufacturer, the distributor must then determine the target market on its own.

Also, the manufacturers are under a duty to disclose the broad regulatory framework governing the International Bond Offering and the allocation policy by which the

securities are sought to be allotted to the prospective Indian issuer. However where the lead bank is a non-MiFID II entity then the responsibility would fall on the In-Scope Entities that are “distributors” to share such information with the prospective Indian issuer.

Needless to say, in compliance with the basic objective of MiFID II, In-scope Entities (both manufactures and distributors) would need to demonstrate that they have mechanisms and processes in place to ensure transparency and ensure best practices for their interactions with EU counterparties or at their authorized branches or subsidiaries in the EU and the EEA. It may also be worth mentioning here that MiFID II requires In-scope Entities to forecast transaction costs that the client would have to pay and to that extent make such disclosure to the client. This obligation to disclose costs would be applicable on all EU firms that are involved in any kind of non-EU entity trades and by that extent would be applicable to all In-scope Entities that may have to help EU entities with appropriate disclosure under MiFID II requirements.

4. What are the obligations of an In-scope Entity that acts as an issuer or a research provider in the context of an International Bond Offering?

All Indian entities including prospective issuers, that wish to trade with EU licenses traders must get a legal entity identifier number often referred to as the LEI number. LEI number is a 20 digit character, alpha-numeric unique identification number that identifies legal entities or structures and MiFID II mandates that clients be identified by way of their LEI numbers.

A point to note here is that MiFID II also impacts In-scope Entities providing research facilities to EU clients. This is so because while in the past research services were provided as a free add on-incentive and costs of such research was often bundled together with other services to be provided by an entity to its new clientele, MiFID II mandates that EU firms receiving such service unbundle research cost from the execution cost. Thus, there is a possibility that In-scope Entities providing research facilities to EU clients may be affected under various fee or commission sharing agreements or research-sharing work-scope.

Further, at the post-trading stage, relevant Indian entities acting as issuers may be required to provide detailed sales information to the “manufacturer” to help the “manufacturer” meet the manufacturer’s own obligation under MiFID II. For example, for dual listed securities, EU counterparties may request post-trade and transaction reporting from the relevant Indian entity and to that extent Indian entities would need to identify the dual-listed instruments it trades in to determine MiFID II’s impact on trading activity of such instruments.

It is therefore important for Indian In-scope Entities acting as prospective issuers to identify all EU counterparties involved in the transaction, at the pre-execution stage itself and understand the information and obligation that such Indian entities would have to comply with in order to facilitate compliance of various obligations by their different EU counterparties’ under MiFID II.

Similarly, as MiFID II requires that financial instruments be traded on an EEA venue or an equivalent third country venue, Indian In-scope Entities who wish to list or facilitate listing on two or more exchanges need to make sure that the additional local markets (other than the EEA exchange) to which listing is sought must be equivalent to that of the EEA venue.

Thus in the above background, Indian In-scope Entities acting as issuers, may have to put in place new systems and controls to monitor and manage their compliances under MiFID II as well as implement strict measures to monitor exchange of data with any EU or EEA entity or EU or EEA regulator.

Further, though record-keeping is not expressly mentioned for non-EU entities, given that certain Indian In-scope Entities acting as prospective issuers, may be a member of an EU exchange, the obligation of record keeping may extend to such Indian entities to the extent that the EU venue would need relevant information from all such Indian entities listed on its exchange for purposes of complying with the Exchange's own obligations under MiFID II.

5. What post-closing steps must In-scope Entities acting as underwriting undertake for showing compliance towards MiFID II?

Below are some of the steps that an underwriter may take as proof of compliance towards MiFID II.

- Maintain records of the instruction content and timing received from clients.
- Maintain allocation records that would provide a complete audit trail between the movements registered in clients' accounts and the instructions received.
- Maintain records of discussions and instructions or preferences provided by the issuer client, other members of the syndicate, on the allocation process, including any allocation requests received from investment clients.
- Maintain records of final allocation and justifications of such allocation made to each investment client.

Conclusion

While it is evident that MiFID II does not expressly set out its extra-territorial reach like that of the Market Abuse Regulation and clearly states that it is only applicable to EU investment firms, one cannot ignore the extra-territorial effect of MiFID II.

Even though the primary obligation of compliance under MiFID II is on EU/EEA entities, as most trades today involve non-EU entities (like that of Indian corporates and underwriters), the net of MiFID II compliance is cast much wider and such non-EU entities therefore also become bound by MiFID II regulations by virtue of being the sub-entities that facilitate the ultimate compliance of the EU entities with their MiFID II obligations.

Further, as it is not always clear from a reading of MiFID II regulations as to what are the specific compliances that In-scope Entities would need to comply with, given that such

compliance requirements vary from situation to situation. Therefore it is imperative that In-scope Entities understand and receive the right advice on their compliance obligation under MiFID II so that they continue to transact with EU entities with ease.

At Dorsey, our India desk co-chaired by David Cameron and Kenneth Kwok and supported by Senior Associate Debolina Saha is well-versed with the peculiar challenges that In-scope Entities routinely face. Coupled with our London in-house team, which is also able to assist with queries in relation to MiFID II, Dorsey is uniquely placed to answer any queries that Indian entities may have on MiFID II and MiFID II's extra-territorial effects.

Please contact our team below with any questions or for further assistance.

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