Key EU Legislative/Regulatory Updates

This *Kirkland Alert* sets out in summary form certain key legislative and regulatory developments in EU and UK legislation that are likely to have an impact on private equity and other fund managers and advisors in the United Kingdom. The developments discussed in this *Alert* are:

- Markets in Financial Instruments Directive II and the Markets in Financial Instruments Regulation (**"MiFID II"**);
- The Packaged Retail and Insurance-based Investment Products Regulation (**"PRIIPS"**);
- The Market Abuse Regulation (**"MAR"**);
- The European Market Infrastructure Regulation (**"EMIR"**);
- The Financial Crime Return; and
- Other developments, such as the Senior Managers Regime and Fourth and Fifth Money Laundering Directives.

Markets in Financial Instruments Directive II ("MiFID II")	
What is MiFID II and when will it come into effect?	• The Markets in Financial Instruments Directive (2004) or "MiFID" is the EU framework directive that governs the provision of investment services and activities in EU Member States. • MiFID is in the process of being repealed and recast by (i) a Directive on markets in financial instruments, and (ii) a Regulation on markets in financial instruments amending the European Markets Infrastructure Regulation (see below). • EU Member States are required to complete and publish transposing measures by 3 July 2017. • In the UK, the Financial Control Authority ("**FCA**") has undertaken three separate consultations on MiFID II, and is expected to publish a Policy Statement containing finalised rules transposing the MiFID II provisions into UK law in April/June 2017. • MiFID II, as implemented in each EU Member State, will apply from 3 January 2018.
Who does MiFID II impact?	• EU investments firms (including arranger/adviser firms) that have been authorised under and required to comply with MiFID to date should consider how MiFID II will impact their business and their ongoing compliance obligations. • In addition, the FCA is likely to extend the scope of certain MiFID II requirements to non-MiFID firms such as UK managers authorised under the Alternative Investment Fund Managers Directive.

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Markets in Financial Instruments Directive II ("MiFID II") (cont'd)	
What do private equity and other fund manager firms need to do?	• The legislative reforms under MiFID II that require comprehensive changes to compliance arrangements and systems and controls are primarily expected to impact (i) banks and other firms trading in financial instruments and related investments, (ii) market venues, and (iii) investment firms providing advisory/investment management services on a discretionary basis to individual clients. • The overall impact of MiFID II on UK private equity and other fund managers and advisors is therefore not expected to be extensive. For now, such firms should take note of certain key provisions under MiFID II, including provisions on independent advice, best execution, inducements, product governance, the classification of local authorities as professional clients and telephone taping requirements (see below for further detail on these provisions). • Firms should keep a watching brief on developments in the FCA's implementation of MiFID II, and in particular, review the final implementing rules in the FCA's Policy Statement (once published mid-2017) to determine the steps they need to take to ensure that their activities and services are MiFID II-compliant by 3 January 2018.
What are the key changes?	• MiFID II introduces various changes and enhancements to requirements that currently apply under MIFID, which might impact firms differently depending on their scope of permissions and investment activities. Firms should assess these changes on a case by case basis. This note summarises certain key changes below: • **Organisational requirements:** MiFID II sets out a number of organisational requirements that enhance existing requirements under MiFID, and in certain cases, impose new obligations on firms. Significantly, these requirements include: ➢ a new product governance regime, imposing requirements on firms that manufacture and distribute financial instruments (e.g., fund interests) to act in the clients' best interests during all the stages of the life-cycle of the relevant products and to implement product review and approval processes to assess the target market and risks for new products and monitor existing products on an ongoing basis to ensure they remain consistent with the needs of the target market; ➢ recording conversations and electronic communications relating to all financial instruments (e.g., a private share deal) rather than just those conversations relating to securities trading on regulated markets, as presently required, and retaining these records for 5 years. In addition, certain existing exemptions applicable to investment managers and corporate finance firms will be removed under MiFID II. The FCA is considering applying these obligations to UK firms such as alternative investment fund managers that are not authorised under or otherwise required to comply with the provisions of MiFID; and ➢ data security requirements, including implementing sound administrative and accounting procedures, internal control mechanisms, effective procedures for risk assessment, and effective control and safeguard arrangements for information processing systems. In particular, firms will be required to put in place sound data security mechanisms to guarantee the security and authentication of the means of transfer of information, minimise the risk of data corruption and unauthorised access and to prevent information leakage, maintaining the confidentiality of the data at all times. • **Investor protection and provision of investment services:** MiFID II introduces a number of new conduct of business requirements that are designed to strengthen investor protection in the EU. Significantly, these requirements include: ➢ a ban on independent advisers and discretionary investment managers receiving and retaining any inducements (fees, commissions or any monetary or non-monetary benefit);

<table>
<tr><th colspan="2">Markets in Financial Instruments Directive II (“MiFID II”) (cont’d)</th></tr>
<tr><td>What are the key changes? (cont’d)</td><td>
➢ new best execution obligations which enhance existing requirements in a number of ways, including requiring firms to publish annually the top five execution venues where client orders are executed together with information on the quality of execution obtained, adhering to a stricter over-arching standard of best execution and ensuring that their policies are clear, easily comprehensible and sufficiently detailed; and
➢ provisions empowering national regulators to ban or suspend trading for specific products or types of financial practice, in certain circumstances, including where they are satisfied on reasonable grounds that there is a significant investor protection concern.
• Third country firms: MiFID II introduces a harmonised passport regime for non-EU investment firms which wish to provide services to eligible counterparties and professional clients in the EU. In each case, the EU Commission would require a determination that the firm is subject to equivalent supervision in its home jurisdiction. In light of the decision to leave the EU taken in the UK referendum of 23 June 2016, firms currently authorised in the UK and passporting their services to other EU countries under MiFID are considering whether they would be able to rely on these provisions in a post-Brexit scenario to continue to access EU markets using a MiFID II third country passport.
• Classification of local authorities: Due to a number of mis-selling concerns in connection with the sale of complex products to local authorities, MiFID II no longer permits firms to treat such investors as eligible counterparties or per se professional clients. Local authorities are now deemed to be retail clients, and firms would need to go through an “opt-up” process in order to treat them as elective professional clients.
• Transaction reporting: transaction reporting provisions under MiFID currently require firms to report to their regulator only those transactions in financial instruments admitted to trading on a regulated market and any “over-the-counter” or OTC contracts that derive their value from such instrument. MiFID II broadens the scope of these requirements to apply to a broader range of asset classes, including financial instruments trading on multilateral trading facilities (“MTFs”) and organized trading facilities (“OTFs”). Additionally, firms will be required to retain their transaction reports for five years.
• High-frequency trading (“HFT”), algorithmic trading and OTFs:
➢ HFT firms will be required to have in place suitable systems and controls, and will be subject to a range of restrictions and controls, which include testing of algorithms, built-in circuit breakers and allowing venues to adjust fees for cancelled orders.
➢ Certain kinds of OTC derivatives will need to be mandatorily traded on certain prescribed venues, i.e., regulated markets, MTFs or OTFs.
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<tr><th colspan="3">Packaged Retail and Insurance-based Investment Products (“PRIIPs”)</th></tr>
<tr><td>What is the PRIIPs Regulation and when will it come in to effect?</td><td colspan="2">• The PRIIPs Regulation is a directly applicable European regulation on key information documents for packaged retail and insurance-based investment products (i.e., “PRIIPs”).
• The definition of a “PRIIP” is extremely broad – it can encompass all types of fund, including alternative investment funds. Therefore, this may potentially include carry/co-invest vehicles as well as main fund vehicles.
• The PRIIPs Regulation was due to come into force following the end of 2016, but has been delayed by one year. The delay gives manufacturers and distributers of PRIIPs until 1 January 2018 to implement the requirements.
• The PRIIPs Regulation will apply to manufacturers (managers) and distributors of a PRIIP, if the PRIIP is “made available” to retail investors in Europe.
• The definition of “retail investor” is derived from separate legislation (MiFID II).
• Large institutional investors will likely automatically qualify as professional investors (not retail) but this may not be the case with all local authority or individual investors (including high-net-worth individuals).</td></tr>
<tr><td>Who is caught by the PRIIPs Regulation?</td><td colspan="2">• The precise territorial scope is not confirmed, although it appears likely (and the FCA has indicated) that the PRIIPs Regulation will, in addition to applying to European managers, also apply to offshore/U.S. fund managers to the extent that they market a fund to a European retail investor.
• The impact on carry/co-invest vehicles is unclear – the private equity industry is arguing that these vehicles should not be regarded as PRIIPs since they are not set up to provide investment opportunities for retail investors and are not packaged products. This position has not been formally confirmed.</td></tr>
<tr><td>What does the Regulation require?</td><td colspan="2">• The legislation requires production of a Key Information Document (KID) for a fund, setting out the risks, costs and expected returns of the product in a standardised format, intended to help retail investors compare products.
• Production would likely be onerous on the fund manager given the granularity of information required.
• There are complex calculation methodologies which will require significant data capture/input and the KID must be translated into an official language of each EU Member State where the PRIIP will be distributed to retail investors.
• There is an ongoing obligation to review and if necessary revise the KID in the event of significant change, and at least annually.</td></tr>
<tr><td rowspan="3">Am I in scope?</td><td>Territorial Scope</td><td>Does the PRIIPs Regulation Apply?</td></tr>
<tr><td>Manager is outside the UK</td><td>• Yes – if the manager will market to EEA retail investors
• No – if the manager will only market to EEA investors that are not retail investors
• No – if the manager will not market to any EEA investors (and the fund/product is not otherwise made available to EEA retail investors)</td></tr>
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<tr><th colspan="2">Market Abuse Regulation (“MAR”)</th></tr>
<tr><td>What is MAR and when did it come into force?</td><td>
MAR came into force with direct effect across the EU on 3 July 2016, and comprises two legislative instruments:
a Regulation repealing and replacing the existing Market Abuse Directive and its implementing legislation (which forms the basis of the UK’s pre-existing civil market abuse regime); and
a Directive on criminal sanctions for market abuse, which the UK and Denmark have opted not to implement into national law.</td></tr>
<tr><td>What are the key changes?</td><td>MAR seeks to establish a new, common regulatory framework on market abuse as well as measures to prevent market abuse and ensure the integrity of EU financial markets and enhance investor protection and confidence in those markets. MAR introduced several key changes to the pre-existing regime under the Market Abuse Directive, including:
An extension of the markets within scope (such as MTFs and OTFs), as well as additional financial instruments (such as emission allowances and related products);
An expanded definition of inside information and the introduction of a new market abuse offence, i.e., attempted market manipulation;
The introduction of a “market soundings” safe harbour in respect of the market abuse offence of unlawful disclosure of information, which is subject to various procedural requirements; and
Enhanced requirements for the detection and prevention of market abuse.</td></tr>
<tr><td>What do private equity and other fund manager firms need to do?</td><td>
New markets: It is fairly common for portfolio companies of private equity funds to have raised debt through the issue of listed bonds on MTFs such as the Irish Global Exchange Market or the Luxembourg Euro MTF. These companies and their bonds now fall within the formal scope of the EU market abuse regime. As a first step to determining the extent to which MAR impacts them and their portfolio companies, firms should look to their existing portfolio groups to ascertain whether one or more entities within such groups have bonds or other securities listed on MTFs. Following such assessment, firms should assess the extent to which existing compliance arrangements for the management of inside information are to be extended – and adapted for the new regime – to cover these markets.
Market soundings: Firms should consider whether there is any likelihood of personnel either making or receiving soundings, and should accordingly put in place arrangements (which can include drafting sounding policies, establishing recorded lines to make and receive soundings, reviewing record keeping arrangements and training staff on the new requirements and policies) to ensure that any soundings are carried out in compliance with the requirements under MAR.
Issuer obligations: In light of the extended scope of MAR to cover issuers of bonds listed on MTFs, many private equity firms are looking to assist those of their portfolio companies that now fall within the scope of MAR to understand and implement arrangements to comply with their obligations as issuers under MAR. These include the following:
putting in place arrangements to disclose inside information as soon as possible to the public, and delay such disclosure only if: (i) immediate disclosure would prejudice the legitimate interests of the issuer; (ii) the delay is not likely to mislead the public; and (iii) the issuer is able to ensure confidentiality, and arrange to notify the relevant competent authority (after the information is disclosed to the public) that the disclosure was delayed, and provide a written explanation of how the above conditions were met;
implementing an insider dealing policy tracking various requirements under MAR, including obligations on “persons discharging managerial responsibilities” and various record keeping obligations;</td></tr>
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Market Abuse Regulation ("MAR") (cont'd)	
What do private equity and other fund manager firms need to do? (cont'd)	➢ maintaining an "insider list" of persons with access to inside information including procedures for dealing with inside information at board-level; and ➢ arrangements to provide reports publicly (by way of a regulated information service or "RNS" distributed throughout Europe and a publicly accessible investor relations website). • The implementation of MAR is also a good opportunity for firms to review their existing practices for the internal management and flow of inside information, and train their staff on the new requirements under MAR.

European Market Infrastructure Regulation ("EMIR")		
What is EMIR and who does it apply to?	• EMIR is broadly the EU equivalent of Title VII of the Dodd-Frank Act in the United States and similarly addresses counterparty credit risk and transparency in the OTC derivatives markets. OTC derivatives include forwards, swaps and futures with a broad range of underlying assets. • EMIR imposes obligations on counterparties to OTC derivatives including reporting and risk mitigation requirements which are already in effect. Obligations for certain combinations of counterparty to clear OTC derivatives trades through a clearing house and exchange collateral on non-cleared trades will come into effect over the next 4 years. • Precisely how (and when) these obligations apply will depend on how a counterparty to an OTC derivative is categorized under EMIR.	
Am I in scope?	***Territorial Scope***	***Does EMIR Apply?***
	Manager is inside the UK	• If you are a UK on-shore manager then any fund managed by you established anywhere in the world will be a "financial counterparty" or "FC" for the purposes of EMIR. • On-shore managers should already be reporting OTC derivatives trades for their funds and putting risk mitigation techniques into their ISDA Agreements as well as preparing for the **clearing** and **collateral exchange** obligations. Please see below. • If the managing entity itself is trading, it will not be an FC unless it is also authorised as an investment firm. Otherwise it will be a "non-financial counterparty" or "NFC" and should confirm if it is above or below certain thresholds of derivatives. NFCs above the thresholds are known as "NFC+" and are subject to more onerous obligations.
	Manager is outside the UK	• If you are a manager which would require authorisation as an investment firm or similar entity if you were established in the EU, then you are a hypothetical third country FC and certain obligations will apply to you when you trade with European entities. • Any fund established anywhere in the world, managed by an off-shore manager outside of Europe will be a hypothetical third country NFC and it should be confirmed if the fund would be NFC+ or NFC-. • The risk mitigation, clearing and collateral obligations all apply to hypothetical FCs and NFC+ entities when trading with European entities.

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<tr><th colspan="3">European Market Infrastructure Regulation (“EMIR”) (cont’d)</th></tr>
<tr><td rowspan="2">What are the obligations under EMIR that fund managers should be thinking about next?</td><td>Exchange of collateral</td><td>

EMIR requires the timely exchange of collateral, in the form of initial and variation margin, between FCs trading with FCs/NFC+ where the trades are not cleared through a clearing house.
Initial margin covers future exposures due to a counterparty’s default and is paid both ways between the parties.
The initial margin rules are more extensive and onerous but will not apply where one of the counterparties has an aggregate month end average notional amount of non-cleared derivatives which is below 8 billion EUR. Investment funds may be treated separately from the rest of their group for the purposes of calculating this threshold if they are bankruptcy remote and not guaranteed by their fund manager or other funds.
Variation margin covers exposures created by price movements, is calculated on a daily basis and must be provided to the receiving party within the same business day.
Eligible forms of collateral are provided for in EMIR and haircuts must be applied to certain forms of collateral such as debt securities. Cash is not subject to any haircuts.
Counterparties must put in place policies and procedures relating to the use of collateral.

Applies to?
FCs trading with FCs/NFC+, e.g., UK managed funds trading with a UK bank. Entities outside of Europe that would be FCs/NFC+ if they were established in Europe will also be caught by this obligation when trading with European banks.
When?

The initial margin rules are being phased in over the next four years.
Variation margin will go live for FCs and NFC+ counterparties with more than 3 trillion EUR of uncleared derivatives in February 2017.
For other FCs and NFC+ counterparties, the variation margin obligation goes live on 1 March 2017.

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<tr><td>Clearing</td><td>

Trades in certain OTC derivatives are subject to a requirement to be cleared through a clearing house or “central clearing counterparty” when entered into by any FCs with other FCs or with NFC+ (including non-European hypothetical FCs and NFC+).
Currently, certain interest rate swaps and credit default swaps will be subject to the clearing obligation.
Accessing the services of a central clearing counterparty will be an additional expense.

Applies to?
FCs trading with FCs/NFC+, e.g., UK managed funds trading with a UK bank.
When?

The starting date of the clearing obligation depends on the class of derivatives, e.g., interest rate swaps or credit rated derivatives.
FCs and NFC+ with more than 8 billion EUR of non-cleared derivatives were to start clearing certain interest rate swaps on 21 December 2016. Funds may be treated separately for the purposes of

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European Market Infrastructure Regulation ("EMIR") (cont'd)		
What are the obligations under EMIR that fund managers should be thinking about next? (cont'd)	Clearing (cont'd)	calculating this threshold. • The European Securities and Markets Authority is delaying the start of the first clearing obligation for FCs and NFC- below the 8 billion EUR threshold by two years.
What do private equity and other fund manager firms need to do?	• Firms should already have confirmed the EMIR status of any entity or fund in their business which trades in OTC derivatives, including for hedging purposes. • While EMIR is largely in force, firms should monitor implementation timelines as regards collateral exchange and the clearing obligation. • Firms should confirm if any of their trades could be in scope for clearing and collateral exchange. • Firms should begin putting in place policies and procedures for dealing with variation margin and consider if these processes can be managed in-house or if a service provider for managing collateral would be necessary.	

FCA Handbook – Financial Crime Return ("FCR")	
What is it and when does it take effect?	• The FCA has introduced an annual financial crime return to replace ad hoc data collection. The FCA will use the information contained in the FCRs to better identify financial crime risks and trends, as well as possible emerging issues. The data will also be used to enable the FCA to provide better quality and more consistent comparable data, to risk-rate firms accurately and better target specialist resources on firms that pose the highest financial crime risk. • The data will be collected through the FCA's electronic reporting system, GABRIEL. • The provisions in the FCA Handbook relating to FCR came into force on 31 December 2016.
Who does it apply to?	• The regulation affects firms subject to the Money Laundering Regulations ("MLRs"), including banks, building societies, designated investment firms, investment firms, mortgage lenders, electronic money institutions, consumer credit firms, life insurers, retail investment intermediaries and mortgage intermediaries. • There are carve-outs for certain types of firm, such as investment firms with revenue of less than £5 million. • General insurers, general insurance intermediaries and credit unions are not required to submit returns, at least initially, although general insurance firms are expected to fall within the scope of the rules at a later date.
What do I need to do?	• A firm must submit the FCR to the FCA annually in respect of its financial year ending on its latest accounting reference date. A firm is only required to submit data that relates to parts of its business subject to the MLRs. • A firm will need to list its customers and the jurisdictions in which it operates (i.e., where the firm has a physical presence or actively markets its services), confirming those considered to be high risk, within the last two years. • The FCA has indicated that 'customer' should be interpreted to mean a 'customer' or 'client' as defined in the FCA Handbook, which gives rise to the possibility that an investor may be deemed to be a client for these purposes. • To acknowledge the short timelines for submission, the FCA will allow firms to complete their first FCR on a best endeavours basis within a remittance period of 60 business days from the date of the firms' financial year end. This means that a firm with a 31 December year end would be required to submit the FCR in late March 2017.

Other Developments	
Senior Managers Regime	• In March 2016, a new senior managers regime applicable to UK banks, building societies, credit unions, PRA-designated investment firms and branches of foreign banks operating in the UK came into force. The regime was meant to reform the extant approved persons regime, and strengthen the individual accountability of senior managers in the banking sector. • The new regime includes: ➢ a requirement on all individuals performing a senior management function to be approved by the UK regulator; ➢ a certification regime applicable to all employees who could pose a risk of significant harm to the firm or any of its customers. Such individuals are not required to be be pre-approved by a UK regulator, but instead must be certified as fit and proper for their roles on a continuing basis by the firm; and ➢ a set of conduct rules that are high-level requirements applying to persons within the scope of both the senior management regime as well as the certification regime, that replaced the requirements under the FCA's Statements of Principle and Code of Practice for Approved Persons Sourcebook (APER). • The FCA intends to extend this new regime to other non-bank firms, including private equity and other fund advisor/arrangers and managers. The FCA is expected to consult with firms and industry bodies on an appropriate senior managers regime for non-bank firms in the course of 2017, and implement final rules applicable to such firms in 2018.
Fourth Money Laundering Directive	• The Fourth Money Laundering Directive ("MLD IV") is a European legislative initiative which aims to protect the financial system by means of the "prevention, detection and investigation of money laundering and terrorist financing". It follows previous Money Laundering Directives which have been implemented throughout Europe. • On-shore UK or European advisors will be in scope of MLD IV, as they are under the Third Money Laundering Directive which requires firms to carry out due diligence on persons with whom they enter into business relationships. • MLD IV introduces certain changes to the European anti-money laundering regime, which will need to be implemented by the EU member states, including: ➢ there will no longer be any automatic entitlement to use simplified due diligence for certain persons and any decision to proceed on that basis must be justified in line with a risk-based approach; ➢ the scope of the concept of "politically exposed persons", who must be subject to enhanced and more detailed diligence, is being widened to include persons in prominent domestic public positions (and their family members and close associates) as well as those in other jurisdictions; and ➢ the obligation on firms to report suspicious transactions is extended to attempted transactions. • MLD IV will be followed by the Fifth Money Laundering Directive ("MLD V") which, among other things, clarifies the provisions of MLD IV by providing for prescribed enhanced due diligence procedures and requires the EU member states to establish a central mechanism for identifying the holders and controllers of bank accounts. • In terms of timing, EU member states currently have until 26 June 2017 to implement MLD IV into their domestic law. The MLD V legislation proposed moving the implementation of MLD IV forward with MLD V itself to be implemented by 26 June 2017. However, a large number of member states expressed concerns about this timeline and the European Council and Parliament will now begin considering the MLD V legislation in early 2017 and the MLD IV implementation date has not thus far been amended.

If you have any questions about the matters addressed in this *Kirkland Alert*, please contact the following Kirkland authors or your regular Kirkland contact.

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