



SCORPEO

CORPORATE ACTIONS AND MIFID II

26th June 2017

CORPORATE ACTIONS AND MIFID II

BACKGROUND

Transaction reporting requirements were amended under Directive 2014/65/EU¹ (MiFID II) and Regulation (EU) No 600/2014² (MiFIR), which were approved by the European Parliament on 15 April 2014 and by the European Council on 13 May 2014. The two texts were published in the Official Journal on 12 June 2014 and entered into force twenty days following, on 2 July 2014. Many of the obligations under MiFID II and MiFIR were further specified in the Commission Delegated Directive³ and two Commission Delegated Regulations^{4,5}, as well as regulatory and implementing technical standards developed by the European Securities and Markets Authority (ESMA).

MiFID II and MiFIR, together with the Commission delegated acts as well as regulatory and implementing technical standards will be applicable from 3 January 2018.

INTRODUCTION & EXECUTIVE SUMMARY

The wording of the 10 October 2016 Guidelines and Final report for MiFID II transaction reporting state that Corporate Events where 'some discretion by the investor' can take place are reportable, 'since there is an investment decision taken at the point in time of the creation, expiration or redemption.'

The draft standards and guidance are not complete in terms of discussion on all possible financial instruments and the specific reporting requirements necessary. Consequently there is room for debate as to which precise instruments 'on exercise' will require reporting under MiFID. While individual country regulators may choose to implement the regulations differently, our view is that most institutions may naturally end up 'over-reporting' rather than try to instigate reporting by each individual jurisdiction.

This legislation for the first time introduces a reporting requirement to the respective local regulator as to the election choices made by each individual investor. This raises the issue not only of compliance but also of potential monitoring of choices and outcomes.

As no further published guidance is expected prior to implementation in January this short paper seeks to discuss the apparent 'gaps' within the regulations and look at these areas we believe will be of concern to investors.

*SCORPEO will be seeking explicit confirmation on these points as highlighted throughout the piece from the relevant regulatory bodies. We invite our clients to discuss with us any similar issues they may have so we may act as a consolidator and subsequent distributor of answers to all clients facing these common issues. This is made more urgent given that ESMA may take **four to six months** to answer policy questions that raise new points of interpretation.*

The table below summarizes our current understanding and the potential issues SCORPEO are seeking to clarify. The specific issues and areas of uncertainty are then individually considered:

CORPORATE EVENT	REPORTABLE	UNCERTAINTY
Dividends with Voluntary Elections	Yes	Stock default election Purchase of Dividend
Rights Issues	No	Open offers / Entitlement offers Oversubscription Applications
Stock Tenders	Yes	Debt like-instruments
Drip Dividends	No	Instigation of Drip

CORPORATE ACTIONS AND MIFID II

DIVIDENDS WITH VOLUNTARY ELECTIONS

The exclusions from RTS 22 under Article 2(5)(h) are described in 5.6.2.6 of ESMA/2016/1452 as being financial instruments “such as an option, a covered warrant, a convertible or exchangeable bond, an allotment right or a subscription right”, with Example 11 outlining the exercise of a financial instrument with a choice between receiving cash or the underlying financial instrument to the original held position [emphasis added]:

“5.6.2.6 EXCLUSIONS UNDER ARTICLE 2(5)(H)

Exercising a financial instrument such as an option, a covered warrant, a convertible or exchangeable bond, an allotment right or a subscription right by the owner of the financial instrument does not trigger transaction reporting obligations for the Investment Firm exercising the option or the Investment Firm being exercised against²³. Where the exercise results in the delivery of another financial instrument this is also not reportable by either the Investment Firm exercising the option or by the Investment Firm being exercised/assigned against.

EXAMPLE 11

Investment Firm X exercises a financial instrument, there is no transaction reporting obligation in relation to the exercise of the financial instrument.

Where Investment Firm X exercises a financial instrument and receives the underlying financial instruments instead of cash, the resultant acquisition of the underlying financial instrument is not reportable either.

Where the Investment Firm X exercises a financial instrument and has to choose whether to receive cash or the underlying financial instruments, it is not reportable.”

This Example would therefore seem to apply to a Dividend with Voluntary Election as the ‘financial instrument’ in question, where the Shareholder exercises their choice to receive either cash or shares as the ‘underlying instrument’. However, our understanding is that a ‘financial instrument’ in this instance is an instrument which on purchase has an electable choice embedded within it, such as an option with cash/stock exercise options or a convertible bond. The transaction reporting for the initial purchase of that instrument does not then require a subsequent report on exercise.

Our understanding is that if a shareholder is long stock and receives a Dividend with Voluntary Election on ex. date, they will be required to transaction report on election of stock. (The purchase of additional equity on election date with settlement on corporate action delivery date.)

However, when considering Dividends with Voluntary Elections where shareholders have the choice to receive either a Cash dividend or a Stock alternative, within Europe these events take different forms depending on the local legal and clearing/settlement requirements. E.g.

Spain – Here the dividend is listed and trades on exchange. E.g. Santander dividend from October 2016, ISIN ES0613900904. Stock is the default if no choice is made.

UK – Here there is no ISIN applied to the dividend. E.g. Royal Dutch Shell dividend from May 2017. (The UK is currently in a consultation period to move to apply an ISIN to these events.)

Despite these differences in listing/trading, the underlying event pattern is the same throughout, where shareholders have the right to elect to receive either cash or shares.

These examples however also highlight the areas where the regulations are simply unclear in that they do not consider the nuances of the real processes:

- In Spain, where the default election is stock, is an investor required to make a report when electing for cash?
 - How would that be done?
- If a Dividend with Voluntary Election is purchased in the market or OTC, and that purchase is transaction reported, is the subsequent election choice then also reportable?
 - If on purchase it then considered a ‘financial instrument’ as per any other option, would the subsequent reporting of the exercise then be incorrect and ‘double counting?’

CORPORATE ACTIONS AND MIFID II

RIGHTS ISSUES

Subscription rights are explicitly mentioned in 5.2.6.2 above, and therefore the exercise of such right, or any cash proceeds received from not exercising would be exempt from reporting under 2(5)(h).

However, there are some rights which do not have a tradeable instrument such as an open offers or entitlement options which for example in the UK are distributed in Crest to shareholders and have limited transferability only for settlement of a bona-fide market claim. (i.e. buys/sells over ex. date of the corporate event.)

SCORPEO are looking to confirm if all rights issues irrespective of trading on exchange or transferability will not be required to transaction report on exercise.

In some Rights issues, as well as the right to participate pro-rata in the corporate event, holders of rights have an additional option to participate to purchase additional shares at the rights strike price if other shareholders let their rights lapse for zero value. So called 'excess applications' or 'oversubscription applications'. Our view is that this additional choice to participate would not be covered under the 2(5)(h) exemption as the investor has made an additional investment decision outside of the initial exemption, but again we are seeking clarity on this.

STOCK TENDERS

In Tender offers, there is an exemption granted in the Guidelines 5.6.2.10 which discusses Exclusions under 2(5)(n), as per example 15:

"A company makes a tender offer to purchase back its bonds from investors at a premium. The conditions for the offer had already been published in an information disclosure or prospectus. The company engages Investment Firm X to act as manager. There are no transaction reporting obligations for Investment Firm X or the investors since the conditions have been published in advance and the investors only had the choice to accept or decline the tender offer."

2(5)(n) however specifies only debt: "(n) an exchange and tender offer on a bond or other form of securitised debt where the terms and conditions of the offer are pre-determined and published in advance and the investment decision amounts to a choice by the investor to enter into the transaction with no ability to unilaterally vary its terms."

This specific exemption from transaction reporting applies as stated, 'since the conditions have been published in advance and the investors only had the choice to accept or decline the tender offer.' This exemption relies upon the fact that the investor has no ability to unilaterally vary its terms.

While the exemption is for tenders for Debt instruments only, we note that Tender offers under published conditions with no ability to be varied by the investor are common also in Equities. We will therefore be seeking clarification why the over-arching principle of the exemption should not equally apply to Equities – else it seems in our opinion to make an artificial and arbitrary distinction between different instruments only on the basis of their classification in the capital structure. For example, if the tender offer were to be extended to a hybrid instrument such as a deep in the money (near equity like) perpetual convertible bond it would be exempt from transaction reporting; whereas a tender offer for an equity listed preferred dividend stock would require reporting. However the underlying economics as well as the investor choices to participate or not are near identical.

We would also like clarification on 'Dutch Auctions' where investors participation alters the price paid within the range of prices offered by the company. Is this viewed as allowing investors to 'unilaterally vary' the terms on offer?

DRIP DIVIDENDS

Exemption from transaction reporting under Article 2(5)(l) is granted to Drip dividends as the shareholder instead of receiving dividends as cash, elects in advance without choice to have their dividends reinvested in the underlying equity. While this is specifically non-reportable, Scorpeo will be seeking clarification as to whether the initial choice is reportable, as the receipt of dividends in the underlying equity or cash is effectively granted by choice as the investor is able to instigate/cancel the drip program at their discretion. Put differently, how is this 'without choice' as a shareholder is making a decision to retain the drip program and therefore buy shares rather than receive cash.

CORPORATE ACTIONS AND MIFID II

SOURCE DOCUMENTS:

https://www.esma.europa.eu/sites/default/files/library/2016-1451_final_report_on_guidelines_mifid_ii_transaction_reporting.pdf

Final Report – 10 October. **ESMA/2016/1451**

https://www.esma.europa.eu/sites/default/files/library/2016-1452_guidelines_mifid_ii_transaction_reporting.pdf

Guidelines, Transaction Reporting, order record keeping and clock synchronisation under MiFID II - 10 October 2016. **ESMA/2016/1452**

https://www.esma.europa.eu/sites/default/files/library/2015/11/2015-esma-1464_annex_i_-_draft_rts_and_its_on_mifid_ii_and_mifir.pdf Regulatory technical and implementing standards – Annex 1. **ESMA/2015/1464** (RTS 22 from pg. 422 onwards. Pg, 427,428 has exemptions Under Article 2, 5.)

REFERENCES

¹ Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU.

² Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012.

<http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R0600&from=EN>

Article 26 – Obligation to report transactions

³ Commission Delegated Directive of 7.4.2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to safeguarding of financial instruments and funds belonging to clients, product governance obligations and the rules applicable to the provision or reception of fees, commissions or any monetary or non-monetary benefits. The Commission Delegated Directive was published on 7 April 2016 and no objection has been expressed by the European Parliament or the Council on the MiFID II Delegate Directive and Delegated Regulation within the period set in Article 89 of MiFID II.

⁴ Commission Delegated Regulation of 25.4.2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive. The Commission Delegated Regulation was published on 25 April 2016 and no objection has been expressed by the European Parliament or the Council on the MiFID II Delegate Directive and Delegated Regulation within the period set in Article 89 of MiFID II.

⁵ Commission Delegated Regulation of 18.5.2016 supplementing Regulation (EU) No 600/2014 of the European Parliament and of the Council with regard to definitions, transparency, portfolio compression and supervisory measures on product intervention and positions. The Commission Delegated Regulation was published on 18 May 2016 and no objection has been expressed by the European Parliament or the Council on the MiFID II Delegate Directive and Delegated Regulation within the period set in Article 50 of MiFIR.

DISCLAIMER

This presentation has been sent to you by SCORPEO Analytics™ Limited. SCORPEO Analytics™ Limited (FCA Firm Ref Number 749284) is authorised and regulated by the Financial Conduct Authority (FCA). This presentation, including its contents and attachments, if any, are confidential. Unless specified as investment research, any reference made to financial instruments is a marketing communication which has not been prepared in accordance with the legal requirements designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of investment research. If you are not the named recipient, you may not review, copy, disseminate, distribute or forward this e-mail message or disclose its contents to anybody else. If you have received this e-mail in error, please notify the sender and immediately delete it. Copyright and any other intellectual property rights in its contents are the sole property of SCORPEO Holdings Ltd. and its affiliates. E-mail transmission cannot be guaranteed to be secure or error-free.

The sender therefore does not accept liability for any errors or omissions in the contents of this message which arise as a result of e-mail transmission. If verification is required please request a hard-copy version. Although we routinely screen for viruses, addressees should check this e-mail and any attachments for viruses. We make no representation or warranty as to the absence of viruses in this e-mail or any attachments. Please note that to ensure regulatory compliance and for the protection of our customers and business, we may monitor and read e-mails sent to and from our server(s). The registered office SCORPEO Analytics™ Limited is Third Floor, 34 Threadneedle St, City of London, EC2R 8AY. The FCA register appears at <http://www.fca.org.uk/register/>. The FCA regulates the financial services industry in the United Kingdom and is located at 25 The North Colonnade, Canary Wharf, London, E14 5HS.