
TABLE OF CONTENTS

Introduction

1

Background

1

MiFID Objectives

2

The Timeline

2

The Framework

2

The Scope

3

The Key Areas of MiFID II

4

In Summary

12

MIFID II – EXPANDING REGULATORY REFORM IN EUROPE

INTRODUCTION

The objective of this paper is to provide BNYMellon Asset Servicing’s perspective on the impacts of changes to The Markets in Financial Instruments Directive (“MiFID” or the “Directive”) as proposed in a package of amendments (“MiFID II”) and a regulation (“MiFIR” or the “Regulation”) currently under consideration by the European Parliament and the European Council. This paper will provide an overview of MiFID II and MiFIR and summarise the extent of the impacts that are known today. With the release of final standards expected in the next six months, further updates on impacts to Asset Servicing products and services will be provided.

BACKGROUND

The Markets in Financial Instruments Directive became a core pillar in the European Union (“EU”) financial markets regulatory system when it was implemented on 1 November 2007. The Directive’s main objectives were to increase competition, improve investor protection and, combined with other Directives, help create a single market for financial services and activities in the EU. The key measures implemented through the directive were: best execution and order-handling practices, categorization of clients, investment research, conflicts of interest, outsourcing, transaction reporting, pre- and post-trade transparency and regulation of trade-related market infrastructure. The introduction of the Directive has resulted in lower trading costs per transaction, reduced bid-ask spreads and faster trading times as envisioned by the European Commission (the “EC”).

However, expected benefits from the new competitive landscape have not flowed equally to all market participants. In particular, and it is the opinion of the European Commission that these benefits have not always been passed onto the end investor. The trading environment has become more complex and fragmented and the financial crisis has exposed weaknesses in the regulation of instruments (other than shares) traded mostly between professional investors (e.g., derivatives).

After extensive review and consultation, MiFID II and MiFIR are being introduced to regulate various segments of the market and make them more transparent, with significant attention being paid to instruments traded Over-The-Counter (“OTC”). The EC also seeks to ensure investor protection given the complexity of some market instruments and markets.



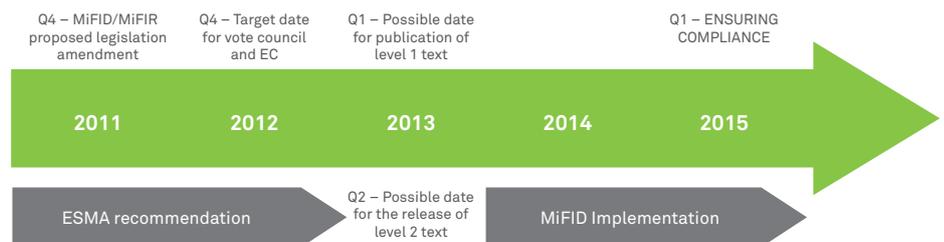
MIFID II/MIFIR OBJECTIVES

- to establish a safer, sounder, more transparent and responsible financial system
- to ensure a more integrated, efficient competitive EU financial market
- to deliver on the G20 commitment to tackle less regulated and more opaque parts of the financial system (mainly in instruments trading OTC)
- to contribute to establishing a single rulebook for EU financial markets
- to help further develop a level playing field of member states and market participants
- to improve supervision and enforcements
- to reduce costs to participants, improve conditions of access and enhance global competitiveness

THE TIMELINE

The diagram below sets out the proposed timings for MiFID II/MiFIR. This schedule may change as details are released. Some changes will be implemented as regulations (under MiFIR) that will take direct effect in EU member states without transposition by those states. Others changes will be implemented through a directive that will then need to be transposed into the national laws of each member state.

FIG.1: TIMELINE



THE FRAMEWORK

MiFID II/MiFIR is split into two pieces of legislation: a Directive and a Regulation. Directives allow member states some flexibility in transposing to local law, whereas Regulations are binding on and take direct effect in all member states.

FIG.2: FRAMEWORK

The Markets in Financial Instruments Regulation (MiFIR) focuses on:	The Markets in Financial Instruments Directive (MiFID) focuses on:
<ul style="list-style-type: none"> – Disclosure of trade transparency data to the public and competent authorities – Removing barriers to non-discretionary access to clearing facilities; – Mandatory trading of derivatives on organised venues; – Specific supervisory action regarding financial instruments and positions in derivatives; and – Provision of services by a third country 	<ul style="list-style-type: none"> – Specific requirements regarding the provision of investment services; – Organisational conduct of business requirements for investment firms and trading venues; – The authorisation and ongoing obligations applicable to providers of data services; – Powers and sanctions available to competent authorities; and – Rules applicable to third country firms operating in the EU via a branch.

THE SCOPE

The scope outlines who is impacted, what activities and what instruments are considered by the Directive.

FIG.3: THE SCOPE

Organisations	Activities	Financial Instruments
<ul style="list-style-type: none"> – Investment firms – Credit institutions – Portfolio managers – Broker-dealers – Stock brokers – Corporate finance companies – Commodity firms – Market operators – Central counterparties – Data service providers 	<ul style="list-style-type: none"> – Reception and transmission of orders in relation to finance instruments – Execution of orders on behalf of the client – Dealing on own account – Portfolio management – Investment advice – Underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis – Placing of financial instruments without a firm commitment basis – Operation of Multilateral Trading Facilities* – Safekeeping and administration of financial instruments for the account of clients, including custodianship and related services such as cash /collateral mgmt.* 	<ul style="list-style-type: none"> – Transferable securities – Money market instruments – Undertakings for Collective Investment in Transferable Securities (UCITS) funds – Emission allowances* – Financial derivatives – Financial Contracts for Difference (CFDs) – Commodity derivatives which: Many be settled in cash or physically; are not for commercial purposes and have the characteristics of other derivatives; relate to climatic variables, freight rates, or inflation rates or other official economic statistics; and any other derivatives contracts not mentioned in section C of Annex 1

*an addition from MiFID I

FIG.4: THE KEY AREAS OF MIFID II

The Directive can be summarised into seven main areas outlined in the below table. Further details on each area can be found throughout the remainder of this document.

1. Market Structure	Introduces new market structures and expands the use of vehicles on those market structures
2. OTC Derivatives & Commodities	New to MiFID and in scope for MiFID II
3. Transparency	Expands the need for transparency and reporting beyond shares to depositary receipts, ETFs, derivatives, bonds, structured finance products and certificates
4. Investor Protection	Aims to enhance investor protection through upgraded selling rules and the use of pre-contractual documentation
5. Organisational Requirements	Stipulates the make up of boards and management committees, and their organisational responsibilities
6. Third Country Access	Sets out rules for those outside of the EU to do business within it
7. Position Limits	Lays out restrictions and position limits as well as details on sanctions

THE KEY AREAS OF MIFID II

1) MARKET STRUCTURES

The Level Playing Field

A central aim of MiFID II is to ensure that all organised trading is conducted on a regulated trading venue, i.e., through regulated markets, multilateral trading facilities (MTFs), systematic internalisers (SIs) and organised trading facilities (OTFs). Identical pre- and post-trade transparency requirements will apply to all venues and identical organisation and market surveillance will apply to all four venues.

Certain derivatives will have to be traded on a regulated trading venue and ESMA will develop technical standards to determine the class of derivatives subject to the trading obligation and the date from which the trading obligation takes effect. ESMA has set out rules regarding suspension of instruments from trading venues as well as co-operation and exchange of information among the venues.

Trading Venues - The New Requirements

Trading venues must:

- Publish annual data free to the public on execution quality (for example number of orders cancelled prior to execution, speed of execution, price);
- Make post-trade information available free of charge 15 minutes after the execution of a transaction;
- Offer pre- and post-trade data separately;
- Lay out transparent rules governing access to the facility; and
- Have specific risk controls directed at firms who engage in algorithmic or high frequency trading.

Trading venues on which commodity derivative contracts are traded must adopt appropriate or suitable alternative arrangements designed to support liquidity, prevent market abuse, and ensure the orderly pricing and settlement conditions.

Firms are required to make public, on an annual basis, for each class of financial instruments, the top five execution venues where they have executed client orders in the preceding year. Venues where the most liquid commodity derivatives are traded should publish an aggregated weekly breakdown of the positions held by different types of market participants, including the clients of those not trading on their own behalf (i.e., as agent).

An Improved Regime for SME (Small & Medium Enterprises) Markets

To complement various recent EU initiatives and to assist SMEs in obtaining financing, MiFID II would create a new subcategory of markets known as SME growth markets.

“Small and medium-sized enterprise” for the purposes of the Directive means a company that has had an average market capitalisation of less than EUR 100 million on the basis of end-year quotes for the previous three calendar years;

An operator of such a market (which is usually operated as an MTF) could elect to apply to have the MTF also registered as an SME growth market if it meets certain conditions.

The registration of these markets should raise their visibility and profile and help lead to common pan-European regulatory standards for such markets that are tailored to take into account the needs of issuers and investors in these markets while maintaining existing high levels of investor protection.

2) OTC DERIVATIVES AND COMMODITIES

As part of significant efforts under way to improve the stability, transparency and oversight of OTC derivatives markets, the G20 has agreed that trading in standardised OTC derivatives should move to exchanges or electronic trading platforms where appropriate. An OTC contract cleared through an exchange or trading platform will follow a process similar to that followed by current exchange-traded derivatives (i.e., futures and options).

Consistent with the requirements already proposed by the Commission (through EMIR) to increase central clearing of OTC derivatives, the proposed provisions in this Regulation will require trading in suitably developed derivatives to occur only on eligible platforms, that is, regulated markets, MTFs or OTFs. This obligation will be imposed on both financial and non-financial counterparties exceeding the clearing threshold in EMIR. The Commission and ESMA have yet to prescribe the list of “eligible” derivatives, taking into consideration the liquidity of the specific instruments.

Trading in OTCs and the Authorities

The proposals would overcome the current fragmentation in the powers of regulators to monitor and supervise positions. In the interest of the orderly functioning of markets or market integrity, the authorities would be given explicit powers to:

- Apply limits on the number of contracts which any given market member or participant can enter into over a specified period of time, or alternative arrangements with equivalent effect;
- Demand information from any person regarding the positions held in the derivative instruments concerned as well as in emission allowances;
- Intervene at any stage during the life of a derivative contract and take action that a position be reduced; and
- Limit the ability of any person or class of persons from entering into a derivative contract in relation to a commodity.

Trading in OTCs and Reporting

Member States shall ensure that regulated markets, MTFs, and OTFs which admit to trading or trade commodity derivatives or emission allowances or derivatives thereof:

- Make public a weekly report with the aggregate positions held by the different categories of traders for the different financial instruments traded on their platforms;
- Provide the competent authority with a complete breakdown of the positions of any or all market members or participants, including any positions held on behalf of their clients, upon request; and
- The transparency requirements will be calibrated for different types of instruments, notably equity, bonds, and derivatives and apply above specific thresholds.

The Addition of Emission Allowances

Despite previous fraudulent activities, which eroded trust in the carbon market, the carbon market has experienced significant growth within the past 5 years with market size rising from Eur 6 billion to Eur 90 billion.

The lion's share of transactions are in the form of derivatives, many in the form of spot transactions, which are not currently subject to the same level of legislation.

Emission Allowances will be brought within the scope of MiFID II with the intention of enhancing the oversight of the carbon market. Specific pre- and post-trade transparency requirements will be developed, taking into account the specificities of emission allowances as instruments of trade and other unique features of the carbon market.

3) TRANSPARENCY AND REPORTING

MiFID's overarching goals of promoting transparency, competition and investor protection are heavily dependent on the quality and availability of market data upon which investors and investment firms rely in the conduct of investment activity. In order to achieve MiFID's goals, it is necessary to focus on format, cost and capacity for consolidation so that data is available and meaningful for those who would rely on it.

Pre- and post-trade transparency requirements are to be extended beyond shares, however, due to the different structure of markets in non-equity instruments compared with those in equities, the precise transparency regime is expected to be tailored to specific types of instruments respectively.

Post-trade requirements, to be specified in further detail in implementing legislation, are suggested for all bonds and structured finance products that are accompanied with a prospectus as well as all derivatives eligible for central clearing and those submitted to trade repositories, regardless of where the trades take place.

Pre-trade requirements, also to be further detailed in implementing legislation, are suggested for the same instruments both when traded on organised venues as well as when offered by investment firms in over-the-counter market.

To tackle transparency and reporting requirements, MiFID has split the articles relating to this into two sections:

- Trade reporting to the Competent Authorities / ESMA
- Transparency reporting – pre / post trade reporting to the public and the Competent Authorities

FIG.5: TRANSPARENCY AND REPORTING

Investment firms will be required to report to Competent Authorities all trades in all instruments admitted to trading on a regulated market, OTCs included

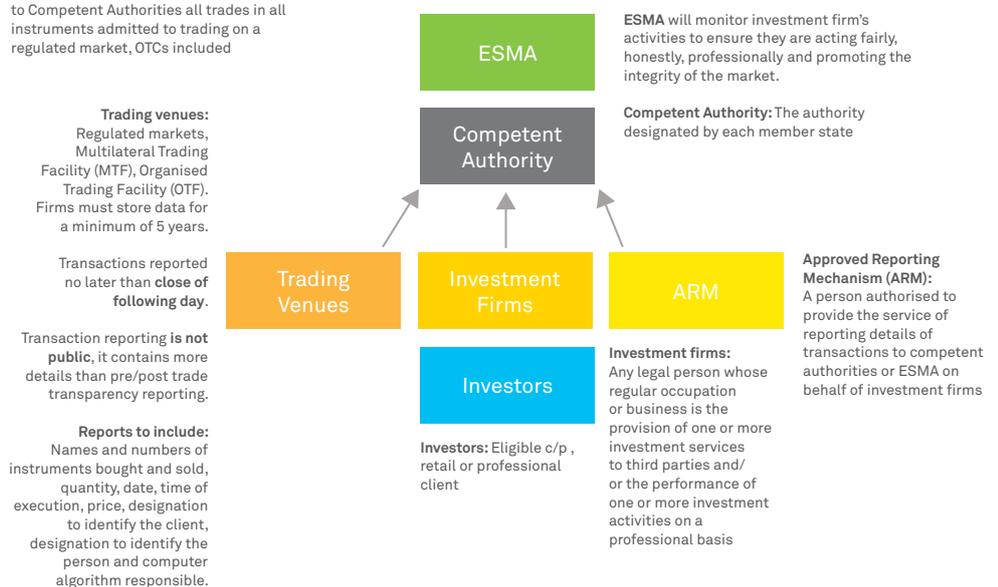
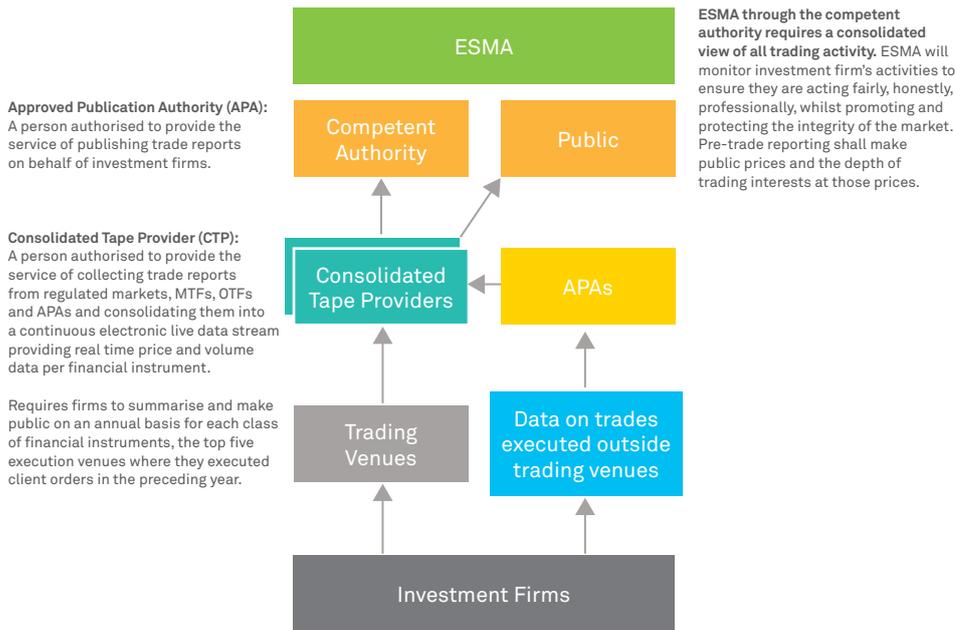


FIG.6: PRE/POST TRADE POTENTIAL FLOW



The issue of “dark pools”

In all markets, buyers need to know what prices sellers are quoting and vice versa, however, wholesale transactions are frequently carried out using non-public prices. “Dark pools”, or platforms where trading interests interact without full pre-trade disclosure to other users or the public, are a common feature of financial markets and provide an example of such “non-public” pricing mechanisms.

MiFID II proposes to continue to allow dark pools to continue but only as long as they do not cause competitive distortions and reduce the overall efficiency of the price discovery process for the security concerned.

Limited cases where transparency can be waived, and for how long, will need to be precisely defined. Such waivers are necessary, for instance, to protect investors selling large quantities of shares to avoid moving the market down.

As transparency rules are extended to other instruments, the Regulation also envisions the possibility of specific waivers, taking into account the nature of trading and of the participants in the different asset classes. The specific conditions under which waivers may operate would, as for shares today, be defined in implementing measures once the regulation is approved.

Finally, the introduction of the new organised trading facility (OTF) category will vastly improve pre-trade transparency in the case of trading activity currently taking place in the dark, by subjecting these platforms to the same transparency conditions as other venues.

Price regulation in the area of market data

Market participants need data on trading activity, including prices and volumes in order to make decisions about how and when to invest. The data should be available on an equal and easily accessible basis.

At present various incentives exist for data providers and vendors to sell their data at rates or in a way which do not correspond to the “reasonable commercial basis” or to the straightforward “consolidation of data with similar data from other sources” which MiFID envisioned.

A series of steps are thus proposed to deliver on these objectives. Failing that, it is proposed that the Commission could define more precisely what constitutes a “reasonable commercial basis”.

4) INVESTOR PROTECTION

Investor Protection is one of the key aims of MiFID II and the enhancement of the investor protection framework strengthens the framework for the provision of investment advice and portfolio management.

It tackles inducements, i.e., the possibility for investment firms to accept incentives from third parties, and clarifies the conditions / arrangements for investors to transact freely. It re-enforces a framework on cross-selling and the requirements concerning funds / instruments belonging to clients. It classifies safekeeping (i.e. custody) – inappropriately – as a “core” investment service (this is inappropriate due to the fact that MiFID does not regulate post-trade activity, which instead is regulated under other more appropriate legislation) and is intended to improve the information delivered to clients in respect of services provided and orders executed.

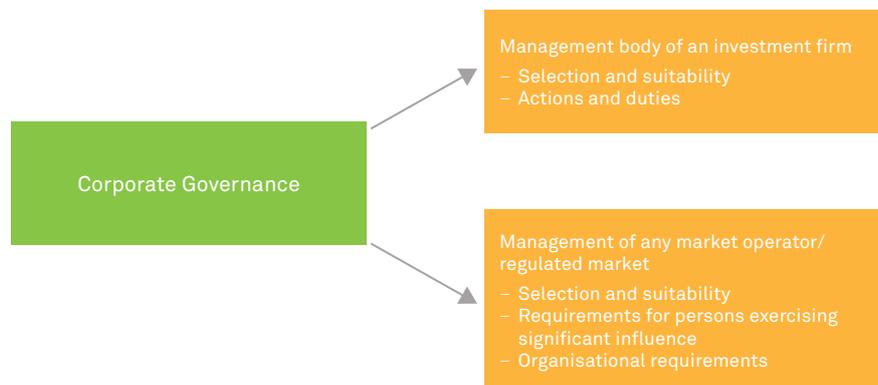
Firms must act honestly, fairly and professionally in accordance with the best interest of the clients. Marketing materials must be fair, clear and not misleading. Information will be provided to clients on:

- Investment advice - Specifically whether the advice is on an independent basis or based on broad or on a more restricted analysis of the market;
- Whether the client will be provided with ongoing assessment;
- Appropriate risks associated with the investment strategy;
- Execution venues; and
- Cost and associated charges.

Member states must require that investment firms take all reasonable steps to obtain, when executing orders, the best possible result for their clients taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order.

5) ORGANISATIONAL REQUIREMENTS

FIG.7: ORGANISATIONAL REQUIREMENTS



Investment Firm - Selection and Suitability

Selection criteria and appropriateness with respect to the management body:

- Investment firms are required to have a policy promoting gender, age, educational, professional and geographical diversity on the management body.
- Investment firms are required to notify the competent authorities of all members of its management body and of any changes to its membership.
- The competent authorities will refuse authorisation if it is not satisfied that the persons who effectively direct the business of the investment firm are appropriate.
- Management of investment firms is required to be undertaken by at least two people meeting the requirements.

- Member states may authorise investment firms that are natural persons or to investment firms that are legal persons managed by a single natural person. Member states nevertheless require that alternative arrangements be in place to ensure the sound and prudent management of such investment firms and the adequate consideration of the interests of clients and the integrity of the market.
- The natural persons concerned must be of sufficiently good repute, possess sufficient knowledge, skills and experience and commit sufficient time to perform their duties.

Investment Firm – Actions and Duties of the Management Body

To ensure members commit sufficient time to perform their duties, they are not allowed to combine at the same time more than one of the following combinations of positions:

- One executive directorship with two non-executive directorships; or
- Four non-executive directorships.

Executive or non-executive directorships held within the same group are considered one single directorship.

The management body of an investment firm is required to ensure that the firm is managed in a sound and prudent way and in a manner that promotes the integrity of the market and the interest of its clients. To this end, the management body is required to:

- Define, approve and oversee the strategic objectives of the firm;
- Define, approve and oversee the organisation of the firm
- Define, approve and oversee a policy as to services, activities, products and operations offered or provided by the firm, in accordance with the risk tolerance of the firm and the characteristics and needs of the clients to whom they will be offered or provided; and
- To provide effective oversight of senior management.

The management body shall monitor and periodically assess the effectiveness of the investment firm's organisation and the adequacy of the policies relating to the provision of services to clients and take appropriate steps to address any deficiencies.

Market Operators and Regulated Markets

Members of the management body of any market operator face the same requirements as MiFID lays down for the management body of an investment firm.

Organisational requirements

- The regulated market is required to identify clearly and manage the potential adverse consequences of any conflict of interest between the interest of the regulated market, its owners or its operator and the sound functioning of the regulated market.
- The regulated market is also required to be adequately equipped to manage risks to which it is exposed, to implement systems to identify all significant risks to its operation, and put into place effective measures to mitigate those risks.
- They must also have sound management of the technical operations of the system; and have transparent and non-discretionary rules and procedures that provide for fair and orderly trading.
- They must establish objective criteria for the efficient execution of orders and have effective arrangements to facilitate the efficient and timely finalisation of the transactions executed under its systems.
- Finally they must have sufficient financial resources to facilitate its orderly functioning at the time of authorisation and in the future.

6) THIRD COUNTRY REGIME

A 'Third country financial institution' is an entity, the head office of which is established in a third country, that is authorised or licensed under the law of that third country to carry out specified investment activities in the EU. The directive creates a harmonised framework for granting access to EU markets for firms and market operators based in third countries to ensure a level playing field for all financial services actors in the EU territory:

- Uniform treatment of third country firms accessing the Union, ensuring that an equivalent assessment has been carried out by the Commission in relation to the regulatory and supervisory framework of third countries;
- Comparable level of protections to investors in the EU receiving services by third country firms;
- Trading obligations will apply to third country entities; and
- Third country trading venues will be assessed in terms of their compliance to EU rules.

Third Country and Establishment of a Branch

The provision of services to retail and professional clients requires the establishment of a branch in the EU that is appropriately regulated under MiFID to provide the relevant investment services. Sufficient initial capital should be at free disposal of the branch. This poses particular challenges for EU investment firms such as asset managers, brokers and global custodians requiring access to non-EU brokers, counter-parties and sub-custodians to access non-EU markets where the EU firms are acting for retail or professional clients.

Services provided to eligible counterparties would not require the establishment of a branch; third country firms could provide them subject to ESMA registration. They would be supervised in their country and agreement between the supervisors in third countries and national competent authorities and ESMA would be necessary.

7) POSITION LIMITS & EFFECTIVE SANCTIONS

Regulated markets, operators of MTFs and OTFs which admit trading or trade commodity derivatives must apply limits on the number of contracts which any given market participant or member can enter into over a specified period of time, or provide for an alternative arrangement such as position management with automatic review thresholds, with a view to:

- Support liquidity;
- Prevent market abuse; and
- Support orderly pricing and settlement conditions.

Limits are to be transparent and non-discriminatory, specifying the scope, exemptions and clear quantitative thresholds.

Position Limits - Position Reporting by Categories of Traders

Regulated markets, MTFs and OTFs which admit to trading / trade commodity derivatives or emission allowances must::

- Make public a weekly report with the aggregate positions held by the different categories of traders for the different financial instruments traded on their platforms; and
- Provide the competent authority with a complete breakdown of the positions of any or all market participants, including any positions held on behalf of their clients.

Member states will require members and participants of regulated markets, MTFs and OTFs to report to respective trading venues the details of their positions in real time, including positions held on behalf of their clients.

Effective Sanctions – Effective Application of Sanctions

Administrative sanctions and measures will apply to those natural or legal persons, to investment firms and to market operators' management bodies responsible for a breach. Administrative sanctions and measures that can be applied include the following:

- A public statement indicating the natural or legal person and the nature of the breach;
- An order requiring the natural or legal person to cease the conduct and to desist from repetition of that conduct;
- Withdrawal of the authorisation of an investment firm in accordance with Article 8 (Withdrawal of Authorisations);
- A temporary ban against any member of the investment firm's management body or any other natural person, who is held responsible, to exercise functions in investment firms;
- In the case of a legal person, administrative pecuniary sanctions of up to 10% of the total annual turnover of the legal person in the preceding business year; where the legal person is a subsidiary of a parent undertaking, the relevant total annual turnover shall be the total annual turnover resulting from the consolidated account of the ultimate parent undertaking in the preceding business year;
- In the case of a natural person, administrative pecuniary sanctions of up to €5,000,000, or equivalent in the national currency of that member state on the date of entry into force of this Directive;
- Administrative pecuniary sanctions of up to twice the amount of the benefit derived from the violation where that benefit is determined; and
- Criminal sanctions are not covered by this proposal.

FIG.8 : THE OVERLAP WITH OTHER REGULATIONS

UCITS – UCITS is the basis for an integrated market facilitating the cross-border offer of collective investment funds. Are subject to MiFID II.

AIFMD –The depositary services business will be subject to new liabilities and will have additional oversight duties. Aligns the management and safekeeping of alternative investment fund assets to the rules governing UCITS funds. In scope for MiFID II.

PRIPs –The PRIPs Directive will seek to harmonise the consumer protection standards around retail investment products, including UCITS funds. Potential impact Key Investor Information In scope for MiFID II.

EMIR - All standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties. MiFID II introduces this concept.

SLD – The Commission's work on the legal aspects of holding and disposition of assets and safekeeping and administration. Custodians are currently in scope for MiFID II.

ICSD – Investor Compensation Scheme Directive – all investment services and activities covered under MiFID II should be subject to ICSD.

RDR - exists in the UK. Firms will be required to set their own charging structure based on the level of services they offer; Disclose all client charges upfront, either by way of a fee tariff or price list; and deliver an ongoing service for any series of regular fees the client is paying, unless the product is a regular payment product.



IN SUMMARY

The impact of MIFID II and MiFIR is far reaching. The following table summarises key areas to be considered by clients and Asset Servicing providers. With the release of final standards expected in the next six months, further updates on impacts to Asset Servicing products and services will be provided.

FIG.9: THE IMPACT TO BNY MELLON ASSET SERVICING CLIENTS

Market Structure	Non-discretionary access to venues	Trading of derivatives on regulated markets	SME markets introduced	Rules for Systematic Internalisers	
OTC Derivatives & Commodities	Must comply with MiFID II	ESMA have certain powers of intervention	Specific capital / reporting requirements		
Transparency	Pre / Post trade transparency reporting to the market / authorities		Trade reporting to the authorities		
Investor Protection	Fee unbundling	Best Execution	Key Information Documents (KID)	Client money / asset rules	Client classification
Organisational Requirements	Enhanced governance		Enhanced risk controls for high frequency / algorithmic trading		
Third Country Access	Require a branch to service retail clients		Require ESMA registration for c/p trading		
Position Limits	Instill position limits	Reporting requirements	Outlines sanctions rules		
<div style="border: 1px solid black; padding: 2px; width: fit-content;">Potential to outsource this function</div>					

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