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#4 MiFID Briefing Series

The MiFID II Review

FCA discussion paper on MiFID II conduct of business and organisational requirements

So far in our MiFID Briefing Series we have reported on European developments (the legislation and ESMA discussion and consultation papers). Now MiFID II has firmly hit our shores. This briefing looks at the first of two papers published by the UK authorities. The first is the FCA discussion paper 'Developing our approach to implementing MiFID II conduct of business and organisational requirements' published on 26 March 2015. The second paper published by HM Treasury 'Transposition of the Markets in Financial Instruments Directive II' on 27 March 2015 will be subject to another Ashurst briefing which will follow shortly.

The details of the FCA discussion paper are examined below. This is the first publication from the FCA dealing with some – and certainly not all – of the MiFID II proposals. Further papers will be published by the FCA on the other parts of the MiFID II proposals, such as markets and reporting requirements. Some key messages at a glance:

- potential introduction of taping requirements for corporate finance firms and discretionary managers;
- discussion of the meaning of relevant market in the context of independent advice; and
- further limits on the ability to pay inducement payments in perpetuity.

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STRUCTURED DEPOSITS

MiFID II has been extended to cover structured deposits and imposes investor protection provisions on firms selling or advising clients in relation to structured deposits(Article 1(4) MiFID II). Additionally, ESMA published a consultation paper in the same week as the FCA that (amongst other things) sets out the relationship between structured deposits and the appropriateness test pursuant to Article 25(4)(v) MiFID II. In the UK, structured deposits are currently regulated through BCOBS, not through COBS. The PRIIPS Regulation will also cover structured deposits.

The FCA has therefore set out three options to deal with these European developments. First, the FCA could copy the relevant MiFID II COBS requirements into the BCOBS handbook (although this would also mean that some of these provisions would apply to non MiFID investments in the scope of BCOBS). The second option is to apply MiFID II requirements to structured products through COBS, expressly dis-applying other parts of COBS to structured products. Finally, the third option is to incorporate structured deposits into COBS, with other requirements for structured deposits maintained in BCOBS. The inference that can be drawn from the FCA's proposals is that the FCA prefers the latter.

COMMISSIONS AND OTHER BENEFITS FOR DISCRETIONARY INVESTMENT MANAGERS ("DIMS")

The FCA highlights the new MiFID II rule which effectively bans investment managers from accepting third party commissions, fees and monetary and non-monetary benefits. We set out in our previous briefings the development of the European position on this issue, particularly in relation to ESMA's proposals for a new 'Research Payment Account' (see Ashurst MiFID Briefing 3 here).

The MiFID II rules do however permit firms to accept these payments if they are rebated back to the client as soon as possible however, the FCA is proposing similar rules to RDR which would also ban any rebate. The FCA argues that allowing rebating would create confusion and the possibility of regulatory arbitrage. The FCA expects that most DIMs will be applying existing RDR standards therefore continuing with this rule would make it easier for DIMs.

CLIENT CATEGORISATION – LOCAL PUBLIC AUTHORITIES AND MUNICIPALITIES

MiFID II categorises local authorities as retail clients who can request to 'opt-up' to elective professional status in certain circumstances. Member States are permitted to adopt specific alternative or additional criteria in the opting up process. In the UK, local authorities are currently permitted (under COBS 3.5.2A.R) to be treated as a per se professional client if they meet the existing MiFID test for large undertakings.

The FCA proposes three options: no change to existing opt up criteria for local authorities (for both MiFID and non-MiFID business) with additional guidance; introduction of new rules which would strengthen the quantitative element of the opt-up criteria for local authorities for MiFID business; or a complete change of current rules to strengthen the opt-up regime for local authorities so that the alternative quantitative opt-up criteria for local authorities to mirror the large undertakings test.

The FCA also proposes applying retail status of local authorities with possibility to opt-up for both MiFID and non-MiFID business.

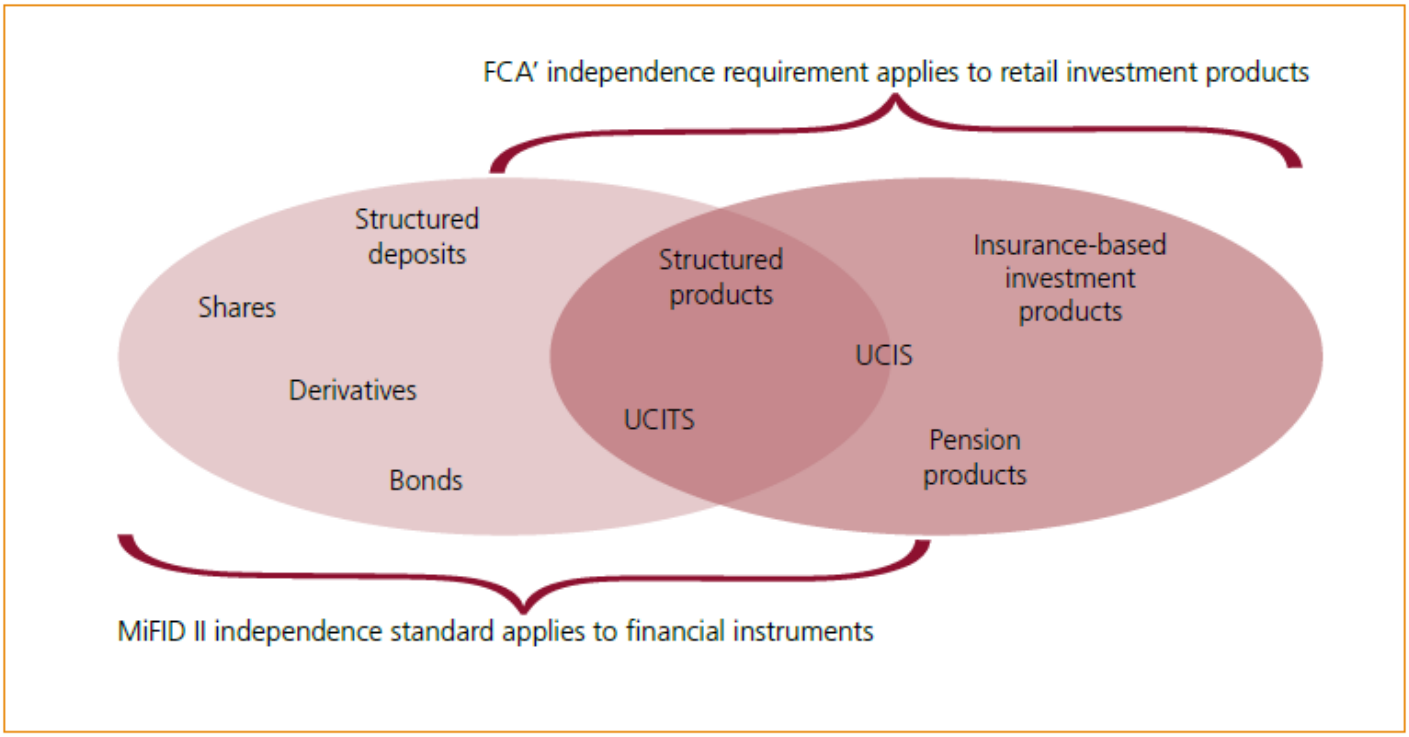
ADVISER INDEPENDENCE

MiFID II introduces a European standard for independent advice which ensures that firms providing independent advice do not limit the products they offer (either to those of the advisory firm or firms with close links to it). Existing standards on independence exist in the UK introduced as part of RDR, which allows firms in the UK to hold themselves out as providing independent advice in a particular relevant market and provide a 'comprehensive and fair' analysis of products in that market. The FCA is seeking views on whether market participants believe that the MiFID II requirements to consider a 'sufficient range of products' would allow financial advisers to redefine the breadth of products they need to consider before making a personal recommendation.

UK rules apply to all retail investment products ("RIPs") which include MiFID and non MiFID products. However MiFID II requires an independence standard for products currently outside the UK definition of RIPs (such as bonds, shares and derivatives) and the FCA does not believe it is proportionate to include such out of scope products within this definition. The FCA is considering whether there should be a separate standard introduced for these products or if it should replicate its existing approach to RIPs for a relevant

market which could encompass these products. One further alternative is to allow firms to consider a sensible 'basket' of products that it should consider if it wants to hold itself out as independent. The FCA believes it should retain its existing requirements on independence in relation to insurance based investments and pensions. Finally, in relation to structured deposits, the FCA believes these should be brought within the definition of a RIP given their substitutability with other MiFID II investment products.

A handy diagram in the FCA paper shows the current regimes that are under discussion.



REMUNERATION REQUIREMENTS FOR SALES STAFF/ADVISERS TO NON MIFID FIRMS

MiFID II introduces rules on incentives and remuneration for sales staff and advisers to avoid inappropriate selling of products. These rules have been enhanced by ESMA technical advice. The FCA has existing rules that have a similar effect either through its Principles for Business or remuneration codes in SYSC. The FCA is considering whether there should be 'cross cutting obligations for non-MiFID II firms […] regardless of the type of business they conduct'. Such extension of the MiFID II requirements could have a significant effect on other firms, such as consumer credit firms. The alternative for the FCA is to wait until future EU provisions have been confirmed to allow it to 'gap-fill' once there is greater certainty.

TAPING REQUIREMENTS

MiFID II requires Member States to impose certain authorisation, supervision and conduct of business/organisational requirements that are 'analogous' to those under MiFID II to firms exempt from MiFID II ("Article 3 firms"). The FCA clarifies that 'analogous' does not mean 'identical to' (and it has checked this with the European Commission). With this in mind, the FCA has said that in relation to taping requirements of certain transactions – a new organisational requirement under MiFID II – it would welcome views on whether to extend these requirements to Article 3 firms. Taping requirements which are primarily a method to gather evidence of market abuse are clearly less relevant for retail financial advisers, a sector in which market abuse is rare but not unheard of according to the FCA. However the FCA considers that taping requirements could be beneficial in corporate finance businesses. This would mean that such firms may need to implement measures to deal with recording on a durable medium, recordkeeping of certain face to face conversations and recording of certain internal calls,

amongst others which may signify a significant change for some firms.

Under existing rules, DIMs were granted two exemptions from the FCA's taping rules relating to either communication with other firms that are subject to taping rules and where such communications are a small proportion of relevant conversations and infrequent. If Article 3 firms were subject to requirements there would be an inconsistency with the requirements on DIMs and the FCA therefore proposes removal of these exemptions. DIMs will no longer be able to rely on these exemptions.

COSTS AND CHARGES

MiFID II introduces requirements for firms to disclose all costs and charges associated with the investment service and financial instrument at the point of sale and annually. The implementation of this rule is difficult for the FCA due to other developments such as the PRIIPs Regulation and UCITS Directive. The FCA is calling on firms to highlight what the challenges will be to ensure consistency across all these regimes in their implementation.

INDUCEMENTS

MiFID II strengthens existing standards on third party inducements that firms can receive. The FCA discussion paper does not examine the issue of research as an inducement for portfolio managers which was already covered in a previous feedback statement in February 2015 (and which we summarised in our Ashurst briefing here). The MiFID II regime is stricter in some aspects than existing domestic FCA rules (e.g. the ban on DIMs accepting and retaining fees, commissions or other non-monetary benefits discussed at section 3 above).

Current FCA rules on adviser charging and inducements apply to all adviser firms (both restricted advice and independent advice). The FCA believes that it should carry across the more restrictive inducements regime to firms providing restricted advice. MiFID II applies the same ban to DIMs who are only subject to the general inducements rule in the UK. This change will have a significant impact on these firms. Similarly the MiFID II ban applies to professional clients as well as retail, whereas the current RDR ban only applies to retail.

Firms who carry out arranging, rather than advising, will remain subject to the general inducements provisions. However MiFID II enhances the provisions by making the existing MiFID implementing measure requirements (the 'quality enhancement test', not impairing the firm's duty to act in the client's best interest, and disclosure requirements) a level 1 requirement in the actual directive. If ESMA's technical advice is adopted there are a number of circumstances where the inducement will be deemed not to have met the quality enhancement test including where the inducement is not justified by the provision of an additional or higher level of service, the inducement directly benefits the firm, its shareholders or employees without benefit to the client, and/or where an ongoing inducement is not justified by the provision of an ongoing benefit to the relevant client. This will be a key point for introducing brokers or where such a firm makes payment to such firms where there is no ongoing service being provided.

APPROPRIATENESS TEST FOR COMPLEX AND NON-COMPLEX PRODUCTS

MiFID II introduces a distinction between complex and non-complex products for sales made through a personal recommendation or portfolio management service. Whether a product is deemed 'complex' will determine if the firm must conduct an appropriateness test to understand the knowledge and experience of the client. Existing UK requirements on appropriateness are contained in COBS10. The MiFID II provisions restrict what can be classed as 'non-complex' and affect in particular debt securities, structured UCITS, non-UCITS CIS (commonly a NURS) and structured deposits if the underlying product structure make it difficult to understand the risk of return or cost of exiting, for example.

The FCA highlights that this will be a significant change for firms, particularly in relation to NURSs, but that it expects the appropriateness assessment to be more rigorous where a firm is offering complex financial instruments to inexperienced customers. It is likely that these rules will mean that firms cannot make direct offer financial promotions and may also impact online distribution models. The FCA is urging firms to consider what needs to be done within their businesses to adapt to this change.

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