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COMPLIANCE SPOTLIGHT

WHAT MIFID II MEANS TO YOU

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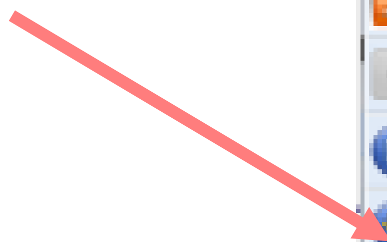

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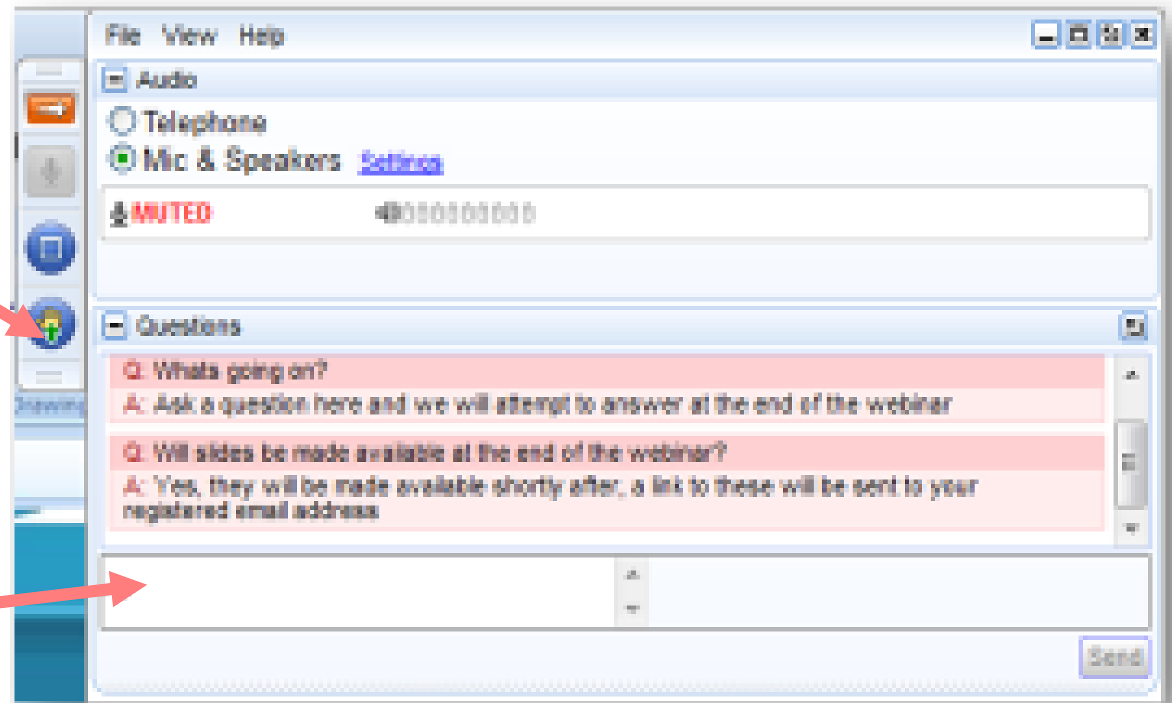

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Learning Objectives

- By attending this webinar you will be able to:

1. Describe the background of MiFID II.
2. Understand the key elements of MiFID II and how this is impacting firms.
3. Recognise what initial actions you need to be aware of to help prepare for the changes.

MiFID II

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Objectives

To give participants an all-round picture of the relevant regulatory changes that the Markets in Financial Instruments Directive II - MiFID II - implemented, and their effect.

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The background

- **1 November 2007** MiFID I (the original MiFID Directive) came into force on

- Intended to:
  - improve the competitiveness of EU financial markets
  - A single market for investment services and activities
  - high degree of harmonised protection for investors in various financial instruments

- **2008** financial crisis exposed weaknesses in MiFID I
  - trade transparency etc.
  - reviewed two years after implementation

- **20 October 2011**, the European Commission adopted a legislative proposal for the revision of the Markets in Financial Instruments Directive, known as the MiFID review.

- Revised and recast MiFID Directive implemented on 3rd January 2018.

Key Areas for Today

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Client Categorisation **Client Agreements** **New definition of regulated advice** **Independent Advice** **Appropriateness** **10% rule in portfolio management** **Product Governance** **Product Approval Requirements**	**Disclosure, KID and PRIIPs** **Inducements** **Bundled Services** **Costs and Charges** **Conflicts of Interest** **Remuneration Policies** **Client Assets – CASS** **Call Recording & Telephone Taping**

Client categorisation/client agreements

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- **MiFID II rules impose more administrative and record-keeping duties on firms;**
  - Requests to be opted up to a higher classification have to be made in writing
  - Must specify the circumstances in which the opt-up will apply.

- **MiFID II extends to professional clients COBS 8 requirement**
  - firms to enter into a written basic agreement with retail clients.
  - must set out the “essential rights and obligations” of both parties.
  - Exemption where the service is one-off investment advice without a periodic suitability assessment.

New definition of regulated advice – the RAO

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- **September 2016** consultation to amend the definition of regulated advice
  - Article 53 FSMA(Regulated Activities) Order 2001 (RAO),
  - In line with the EU definition set out in MiFID.

- **This meant that only advice which makes a personal recommendation would be regulated.**
  - Recognised potential risks
  - E.g. fraudsters might attempt to use guidance services to distribute products, without being subject to regulation.

- **Government has changed the definition of financial advice for regulated firms. Regulated firms are giving advice only where they provide a personal recommendation.**
  - However, the Government left the wider RAO definition of advice as "advising on investments" in place for unregulated firms.

Independent advice

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- **Requirements on firms to provide information on certain areas**
  - E.g. services, investment strategies, costs and charges;

- **Obligations on an investment firm:**

- Disclose whether or not the advice provided is on an independent basis
- State whether the investment firm will provide the client with a periodic assessment of the suitability of the financial instruments recommended to that client;
  - [NB it is not a requirement to do this, but if the firm does it, the COBS requirements in relation to periodic assessments must be met].

Independent advice

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- New requirements on investment firms that provide investment advice on an independent basis.

- **Obligation on investment firms to ensure that they assess a sufficient range of financial instruments available on the market,**
    - sufficiently diverse with regard to their type and issuers or
    - product providers to ensure that the client's investment objectives can be suitably met

- and must not be limited to financial instruments issued or provided by:

    - **the investment firm itself,**
    - **entities having close links with the investment firm;**
    - **other entities with which the investment firm has such close legal or economic relationships, such as contractual relationships, as to pose a risk of impairing the independent basis of the advice provided.**

Appropriateness

- Distinction between ‘complex’ products and other ‘non-complex’ products.

- The appropriateness test must be carried out when a firm executes, or receives and transmits, a client order in relation to a complex product.

- Narrowed scope of products deemed automatically non-complex,
- Appropriateness test needs to be carried out in relation to a wider range of products.

- Firms also need to record the results of a test, including:

  - when a warning has been given, but the client wishes to proceed with the transaction regardless, and

  - whether the firm decided to carry out the client’s request in spite of its warning

Appropriateness

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The MiFID 2 Directive is more restrictive than MiFID in the products that can be treated as non-complex for the purposes of the appropriateness exclusion in Article 25(4).

For example:

- Shares are restricted to shares in companies, and specifically exclude shares in non-UCITS collective investment schemes.
- Bonds and money market instruments may not be treated as non-complex if they embed a derivative or incorporate a structure which makes it difficult to understand the risks.
- Certain structured UCITS are excluded.

The 10% rule in portfolio management/ leveraged and contingent liability transactions

The legislation requires firms providing portfolio management services to inform clients by the end of the working day when the value of their portfolio declines by 10% or more during a reporting period, and thereafter in multiples of 10%, creating uncertainty about responsibilities across the distribution chain, particularly when DFMs are running model portfolios on platforms and do not know the identity of their end clients.

Additionally investment firms that hold a retail client account that includes positions in leveraged financial instruments or contingent liability transactions must inform the client, where the initial value of each instrument depreciates by 10% and thereafter at multiples of 10%. Reporting must be on an instrument-by-instrument basis, unless otherwise agreed with the client, and must take place no later than the end of the business day in which the threshold is exceeded or, in a case where the threshold is exceeded on a non-business day, the close of the next business day.

Product governance

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- The PROD handbook sets out product governance requirements for manufacturers and distributors and applies to firms within the categories listed at PROD 1.3.1R.60.
- A firm that complies with PROD does not have to apply the guidance set out in the 'Responsibilities of Providers and Distributors for the Fair Treatment of Customers (RPPD)'.
- This is because PROD is intended to achieve the same aims. However, the RPPD remains applicable for firms not within the scope of PROD.

Product approval requirements

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Specific rules for firms that manufacture or distribute financial instruments (shares, bonds, derivatives and units in collective investment schemes).

These include the following:

- **An investment firm which <u>manufactures</u> financial instruments for sale to clients must maintain, operate and review a process for the approval of each financial instrument and significant adaptations of existing financial instruments before they are marketed or distributed to clients.**
  - The process must specify an identified target market of end clients and ensure that all relevant risks to that target market are assessed and the intended distribution strategy is consistent with the target market.

- **A firm must regularly review financial instruments it offers or markets,**
  - taking into account any event that could materially affect the potential risk to the identified target market, to assess whether the financial instrument remains consistent with the needs of that market and whether the intended distribution strategy remains appropriate. **Stress testing must occur.**

Product approval requirements

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An investment firm which manufactures financial instruments must also make available to any distributor all appropriate information on the financial instrument and the product approval process, including the identified target market of the financial instrument.

Where an investment firm **offers or recommends** financial instruments which it does not manufacture, it must have in place adequate arrangements to obtain the information on the financial instrument and the product approval process, including the identified target market of the financial instrument, and to understand the characteristics and identified target market of each financial instrument.

Firms that collaborate in manufacturing products are required to have a written agreement setting down their respective responsibilities.

Disclosure

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The FCA has published new and more detailed costs and charges disclosure requirements for firms doing MiFID business.

For non-MiFID firms, unless the firm is an Article 3 firm, the rules that apply in relation to costs and charges are unchanged.

It has also published new disclosure provisions relating to firms doing MiFID business that apply in relation to:

- cross-selling/bundled products or services,
- some more detailed post-sale reporting requirements, and
- a revised requirement to retain records for at least five years

Disclosure

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- **No standardised format setting out how firms should calculate and disclose point-of-sale or post-sale information**, including information on costs and charges

- **Firms need to develop their own approach to disclosure**
  - meet the needs of their clients
  - reflect their business propositions

- **The FCA has implemented rules to reflect the MiFID II requirements for the provision of reports to clients on the service provided**
  - including the costs and charges incurred
  - 10% depreciation reporting requirements applying to a client's managed portfolio, or to a client's position in leveraged financial instruments or contingent liability transactions.

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Disclosure – KIDs and PRIIPs

Advisers also need to be aware of the requirement to issue a Key Information Document (KID) in advance whenever they distribute Packaged Retail and Insurance-based Investment Products (PRIIPs) to retail clients. This requirement came into force in the same week as MiFID II.

Inducements

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Research-related inducements

The relevant rules apply to collective portfolio managers as well as to MiFID II investment firms.

The FCA has created two new COBS sections:

- COBS 2.3B sets out requirements that, if met, allow a firm to receive third party research without it constituting an inducement,
- COBS 2.3C sets out requirements on firms that supply both execution and research to provide discrete pricing for each of those services (and any other services) to ensure greater transparency to recipient firms, particularly those that may wish to use the option of paying for research from their own resources or through a RPA.

Inducements generally

The rebating of inducements is now banned in relation to retail clients and in respect of both independent and restricted advice. This applies in relation to MiFID, equivalent third country and Article 3 firm business – as well as advising on retail investment products (RIPs), in line with existing requirements under the RDR.

Bundled services

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Under Article 24(11) of the MiFID 2 Directive, **when an investment service is offered together with another service or product as part of a package, the investment firm must tell the client whether it is possible to buy the different components separately. and must provide for separate evidence of the costs and charges of each component.**

Where such a package is offered to a retail client, and the risks arising from the package are likely to be different from the risks associated with the components taken separately, the firm must provide an adequate description of the different components and the way in which their interaction modifies the risks.

Bundled services

MiFID II allows research not to be treated as an inducement provided that it is paid for **directly by the firm** or by **a separate research payment account (RPA)**, funded by specific research charges to the client.

Costs and charges

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The Directive requires firms to **provide clients with an aggregate figure of all costs and associated charges for their investment services**. The following must be provided;

- **Upfront cost aggregation** (which will require **pre-estimates**, which must be regularly reviewed to ensure they are realistic)
- **Annual cost aggregation** (i.e., reflecting all costs actually incurred)

For both of these, the firm needs to aggregate all costs and associated charges imposed by the firm (for manufacturing and managing the financial instrument(s)), and by any other firm to which the client has been directed. The total must be expressed as an annual monetary sum and also as a percentage of the client's investments.

Costs and charges

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Illustration of the impact of charges

Both the upfront and annual cost totals must be accompanied by an illustration of their cumulative impact on the client's investment return.

In the absence of further guidance from the FCA or ESMA, the challenge for MiFID II project managers has so far been to **design a pragmatic solution that demonstrates reasonable endeavours to meet the spirit of the requirements.**

Conflicts of interest – strengthening of requirements/inducements

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Article 23 of the MiFID II Directive addresses conflicts of interest. **The main change from MiFID 1 is that investment firms must take all appropriate steps to identify and prevent conflicts of interest in relation to receipt of inducements from third parties or by the firm's own remuneration and other incentive structures.**

SYSC 10 requires firms to have in place **"appropriate" rather than "reasonable" steps to identify and manage conflicts – this will increase the burden on firms in this area.**

MiFID II bans independent advisers and portfolio managers from receiving any (non-minor) monetary or non-monetary benefits from third parties when dealing with retail and professional clients.

Remuneration policies

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- Investment firms need to **review their remuneration policies**
  - if they do not yet have one, will need to adopt one
  - for staff involved in the provision of services for clients
  - to ensure they meet the Directive's requirements and are
  - aimed at encouraging responsible business conduct
  - fair treatment of clients and
  - avoiding conflicts of interest in those individuals' relationships with the client.

CASS

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General liens/security interests/rights of set-off

- MiFID II follows the UK approach in prohibiting the use of general liens and similar arrangements over client assets. Firms need to demonstrate that all arrangements have been reviewed. Where general liens are in place, firms need to consider whether it is possible to demonstrate a legal requirement for the lien. Obtaining legal assurance in third country jurisdictions can be expensive and time-consuming.

CASS oversight – the CF 10a function

- Most firms should have already considered the responsibility for CASS operational oversight. However, the new rules go further in clarifying the FCA's expectations of a CF10a.
- A CF10a must have sufficient skill and authority, and firms must allocate this responsibility to a single director or senior manager (or more than one under a job-share arrangement). **Guidance is explicit that the FCA 'would normally expect a firm not to allocate any additional responsibilities…' to the allocated person unless appropriate to do so at 'a small and non-complex firm'. Policy documents and role descriptions may need to be updated to reflect the new rules.**

CASS

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CASS oversight – the CF 10a function

The changes impact all CASS investment firms (small, medium and large), as the regulator pushes for a "single director or a senior manager of sufficient skill and authority" not to have any other responsibilities in addition to their CASS oversight responsibilities, unless the firm is satisfied on reasonable grounds that:

- The individual will still be able to discharge the CASS oversight responsibilities effectively; and
- The firm's full compliance with CASS will not be compromised

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Call recording

The FCA amended its original proposal to require advisers to tape telephone calls under MiFID II by saying they can also make a written note of the conversation. In its policy statement published PS 17/05, the FCA said: *"Based on the responses received and following extensive industry engagement, we have concluded that additional flexibility for all Article 3 retail financial advisers is appropriate.*

This is because the business model of many of these firms is such that a full taping obligation may not always be proportionate. As such, the FCA proposes that these firms, irrespective of size, can comply with the 'at least analogous' requirement by either taping all relevant conversations or taking a written note of all relevant conversations. The decision to tape or take a note should be taken at the level of the firm rather than in relation to individual relevant conversations or the relevant conversations of different advisers. This flexibility will not be available to MiFID investment firms who can be characterised as RFAs [retail financial advisers]"

Telephone taping

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- Harmonised requirement on firms to record telephone conversations and electronic communications relating to (or intended to relate to):
  - transactions concluded when dealing on own account
  - providing client order services that relate to the reception, transmission and execution of orders.

- Replaced the FCA's 2009 domestic taping regime.

- The current partial exemption for discretionary managers has been removed.

Telephone taping

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Article 3 financial adviser firms that opt to make a written note of a conversation must include the key points. The information to be recorded includes at least;

(i) Date and time of the meeting,
(ii) Location of the meeting,
(iii) Identity of the attendees,
(iv) Initiator of the meetings, and
(v) Relevant information about the client order including the price, volume, type of order and when it will be transmitted or executed.

The FCA would expect an analogous note taken of a relevant telephone conversation to include at least these details.

What is necessary is to be able to demonstrate the possible options that were suggested to the client, and what the client's reaction was.

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