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 **NORTON ROSE FULBRIGHT**

MiFID II Academy – Impact on fund managers

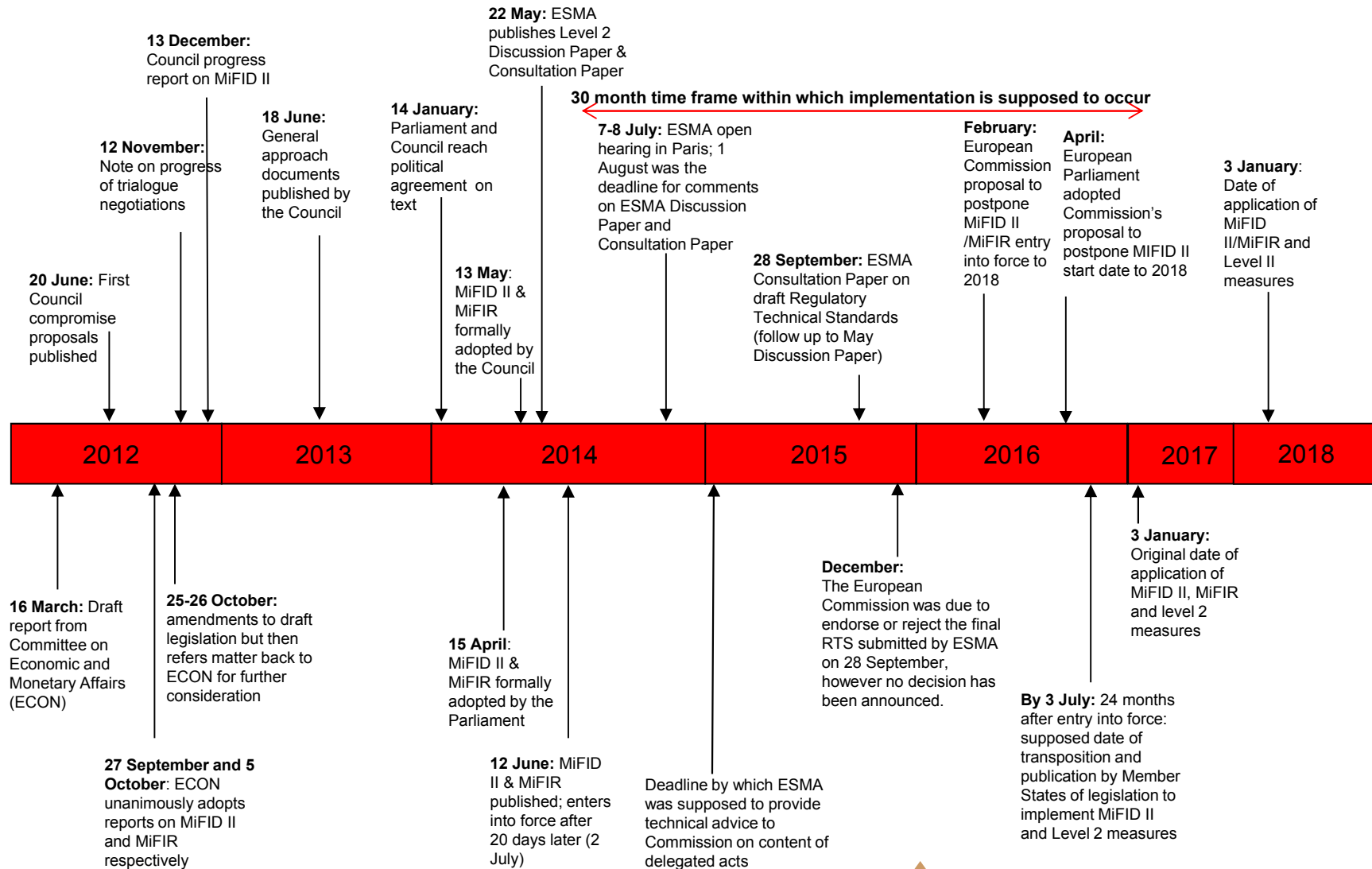
Floortje Nagelkerke
24 January 2017

NFC 60.66



Introduction

Timing: MiFID II and MiFIR



Dutch transposition

MiFID II implementation

- Article 93 MiFID II: Member States shall adopt and publish, by 3 July 2016, the laws, regulations and administrative provisions necessary to implement this Directive
- Consultation Ministry of Finance, July 2015
 - closed on 6 July 2015
 - Lot of the detail will be implemented into the Decree on Conduct of Business Supervision of Financial Undertakings (*Besluit Gedragstoezicht financiële ondernemingen Wft*)
 - All RTS/ITS will be regulations which will have direct effect into Dutch law
- Dutch Legislative proposal implementing MiFID II, October 2016 (<https://zoek.officielebekendmakingen.nl/dossier/34583/kst-34583-2?resultIndex=1&sorttype=1&sortorder=4>)
- How to keep informed:
 - AFM MiFID review page - <https://www.afm.nl/nl-nl/professionals/onderwerpen/mifid-ii>
 - <http://www.regulationtomorrow.com/the-netherlands/>
 - <http://www.nortonrosefulbright.com/knowledge/technical-resources/pegasus/norton-rose-fulbright-briefings-slides-and-webex-recordings/>
 - http://ec.europa.eu/finance/securities/isd/mifid2/index_en.htm
 - <http://www.esma.europa.eu/page/Markets-Financial-Instruments-Directive-MiFID-II>
 - <https://zoek.officielebekendmakingen.nl/dossier/34583>

Impact on fund managers: Scope

- Collective investment undertakings and their managers are **exempted** from MiFID II (*art. 2(1)(i) MiFID II and recital 34*)

However:

- UCITS manager is allowed to provide:
 - portfolio management** and **investment advice** (and safekeeping)
 - MiFID II articles 15, 16, 24 & 25 apply
- AIF manager is allowed to provide:
 - reception and transmission of orders, portfolio management** and **investment advice** (and safekeeping)
 - MiFID II articles 15, 16, 24 & 25 apply
- Managers authorised in the EU and 3rd country managers may be indirectly impacted by MiFID II requirements where they distribute their products in Europe and where they receive services from or provide services to investment firms in the EU

Impact on fund managers: Source

Source of legislation:

Subject	MiFID II	RTS
Minimum own capital	Article 15	
Organisational requirements	Article 16	<ul style="list-style-type: none">- Delegated Directive C(2016) 2031- Delegated Regulation C(2016) 2398
General principles and information to clients	Article 24	<ul style="list-style-type: none">- Delegated Directive C(2016) 2031- Delegated Regulation C(2016) 2398
Suitability and appropriateness	Article 25	<ul style="list-style-type: none">- Delegated Regulation C(2016) 2398
Reporting to clients	Article 25	<ul style="list-style-type: none">- Delegated Regulation C(2016) 2398

Organisational requirements

Organisational requirements

Rules in relation to the following topics:

- Ensure compliance with MiFID and appropriate rules on personal transactions, including complaints handling
- Conflicts of interest
- Product governance rules?
- Business continuity
- Outsourcing
- Sound AO/IC, procedures for risk assessment, and control and safeguard arrangements for information processing systems
- Information security
- Recordkeeping, including telephone conversations and electronic communications
- Safeguarding of client's assets, including rules on financial collateral arrangements

Complaints handling

Complaints handling (I)

Fund managers to have an effective and transparent **complaints handling policy** for (potential) clients: **all** clients, not only retail clients

Complaint is statement of dissatisfaction addressed to the manager by a (potential) client relating to the provision of investment services

Complaints management policy:

- a) clear, accurate and up-to-date information about the complaints-handling process
 - b) endorsed by management body.
- Fund managers must **keep a record** of complaints received and measures taken
 - Fund managers will **publish** their complaints-handling process including:
 - a) information about the complaints management policy;
 - b) the contact details of the complaints management function
 - Fund managers must **provide this information to clients** or *potential* clients
 - a) on request; or
 - b) when acknowledging a complaint

Complaints handling (II)

- No charges are allowed for submission of complaints
- When **handling** a client or potential client's **complaint**, managers shall:
 1. communicate clearly, in plain language that is easy to understand;
 2. provide a response to the complaint without any unnecessary delay;
 3. explain the firm's position; and
 4. set out the client or potential client's options for referring the complaint to consumer Alternative Dispute Resolution (**ADR**) or court if the complaint has not been resolved to their satisfaction.
- Provide information on complaints and complaints handling to the relevant NCA (and ADR entity): on a **regular** basis
- Compliance function: analyse complaints and complaints handling data
- Adhere to out-of-court settlement bodies: in the Netherlands **KiFID**

Impact



Product governance

Product governance

MiFID II introduces a completely **new EU-wide product governance regime** which applies to both sides of the product development and sales process, namely to (if different):

- Introduction of a **product approval process**, including appropriate policies and procedures to ensure that the product or service complies with all applicable rules including those relating to disclosure, suitability / appropriateness, inducements and proper management of conflicts of interest (including remuneration)
- **Product manufacturers**: manager that creates, develops, issues and/or designs investment products, including managers advising corporate issuers on the launch of new securities
- **Product distributors**: managers that offer and/or recommend investment products and services
- **In principle not applicable to UCITS/AIF manager, however**, will distributors require UCITS/AIF managers to comply with the rules on for instance setting the target market as a service to them?
Note: SMSG comments to consultation ESMA
- Requirement to **identify the target market** for a product or service

Product governance

- Requirement for products to only be manufactured where they **meet the needs** of this target market.
- Requirements for **all risks** related to the target market to be assessed.
- Ensure the intended **distribution strategy** is consistent with the identified target market.
- Requirement for firms to **understand the features** of the product or service being sold.
- Requirement for the manufacturers of products to ensure the product or service **reaches the target market**.
- **Periodically review** the product, the target market and the distribution channel to ensure they all remain appropriate.
- **Requirements on distributors / sales intermediaries** to understand the product approval process, the target market and the features of the product or service.
- Ensuring that the management body or a corresponding governing body has **effective control** over the aspects mentioned above.

ESMA Consultation document on Guidelines on MiFID II product governance requirements

Product governance

- When a manager acts both as manufacturer and distribution of investments products, it should be required to comply with all relevant obligations for both manufacturers and distributors – same legal entity? only one single product governance process is needed.
- **Introduction of specific oversight, control and governance obligations** on managers that manufacturer financial instruments and on managers that distribute such products.
- **Final distributor in a distribution chain** has the obligation to comply with the distributor requirements, but the intermediate distributors will also have certain obligations:
 1. ensure the relevant product information is passed down the chain;
 2. enable the manufacturer to obtain information on product sales through the chain; and
 3. apply the product governance obligations for manufacturers to the service they provide.
- Obligations apply in an **appropriate and proportionate manner**, taking into account the nature of the investment product, the investment service and the target market for the product.
- That one criterion to consider in developing a product is the **threat it may represent to the orderly functioning or the stability** of financial markets.
- Some additional potential steps that may be appropriate for manufacturers to take when an event affecting the potential risk / return expectations of a product occurs (i.e. terminating distributor relationships, or liaising with the distributor to modify the distribution process, and informing the relevant national competent authority).
- **Oversight by compliance** over the product development / governance process.

Product governance

Manufacturers

- procedures and arrangements to manage conflicts of interest in design, creation and development process (including remuneration); analysis each time a financial instrument is manufactured
- governance processes for effective oversight and control over design, creation, issuance and development process, including expertise staff and compliance involvement
- assessment of target market of each financial instrument – characteristics, needs, objectives of type(s) of end client(s)
- assessment of risks posed by products and the circumstances that may cause these to occur, including scenario analysis
- impact of charging structure on target market considered
- provision of adequate information to distributors so they can understand and sell properly
- regular review of the products:
 - ensure the product remains consistent with the needs of the target market
 - ensure the distribution strategy remains appropriate
 - consider any event that could materially affect the risk to the target market
- positive obligation to check that products function as intended (rather than waiting for detriment to occur), namely:
 - Managers to review all investment products prior to any re-launch or re-issue
 - Managers to review investment products when aware of an event which could materially affect the potential risk to investors
 - Managers to review investment products at regular intervals

Distributors

- determine target market of the financial instrument for its clients
- product governance processes to ensure that products and services the firms intend to offer are compatible with characteristics, objectives and needs of the identified target market, and take into account other applicable MiFID conduct of business and organisational requirements
- periodic review of product governance arrangements (robust, and fit for purpose)
- provision of sales information to manufacturers, to assist manufacturers in meeting their post-sale product governance responsibilities
- involvement of compliance function in development and periodic review of product governance arrangements to detect any risk of failure by distributors
- endorsement of the management (or similar) body of the range of products / services offered and respective target markets
- provision of information to senior management in compliance function's periodic reports to management body
- with third-country manufacturers, ensure the level of product information obtained is of a reliable and adequate standard to ensure that products will be distributed in accordance with the characteristics, objectives and needs of the target market

Recordkeeping

Recordkeeping



Level 1

No substantive changes

- Level 1 confirms existing MiFID I requirements
- Level 1 text is slightly **altered** from that contained in MiFID I to make it clear that:
 - the records should also allow NCAs to fulfil their **supervisory tasks under other EU measures**
 - the records should also be able to be used to assist with **market integrity**
- Member States can **gold plate**

Level 2 (Consultation)

Moderate extension

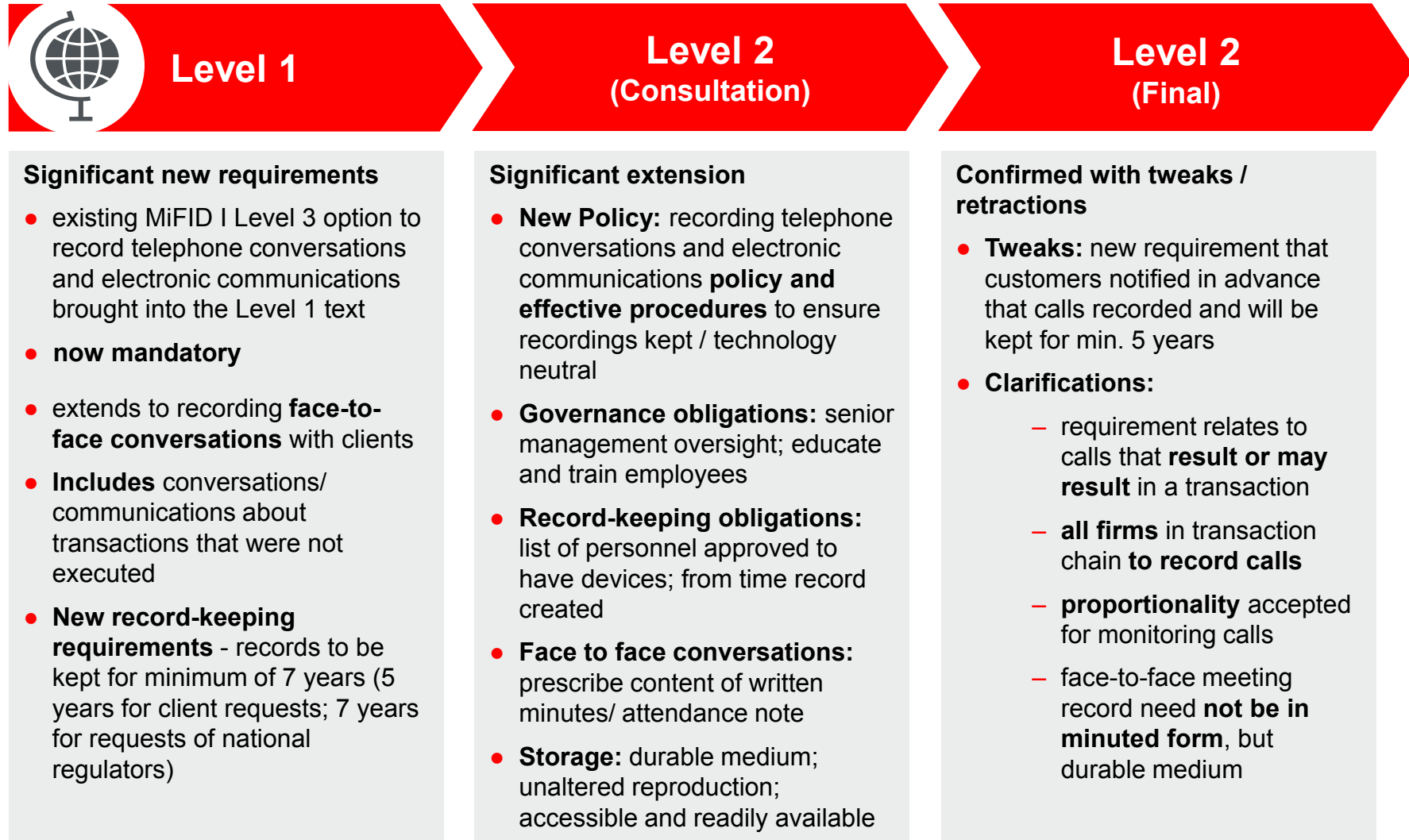
- For **harmonisation**, ESMA proposed that it should specify the records that need to be kept
- ESMA proposed:
 - a **non-exhaustive list** of the minimum records that firms should be required to keep
 - their **content**
 - the **length of time** for which they should be kept
- proposes that all records required to be maintained under **MiFID II, MiFIR, MAD and MAR** must be kept **in writing**

Level 2 (Final)

Confirmed and extended

- Extended and enhanced record keeping requirements for **client orders, decisions to deal, transactions and order processing**
- Even if no transaction results
- Record-keeping requirements apply **regardless of technology** used to keep the record
- Despite market push-back, the list of records is **non-exhaustive**
- Only applies **from 3 Jan 2018**
- Level 3 ESMA **guidelines** expected

Recording telephone conversations and electronic communications



Impact



General principles and information to clients

General principles and information to clients

Rules in relation to the following topics:

- Act honestly, fairly and professionally
- Understanding all aspects financial instruments
- Information fair, clear and not misleading. Marketing clearly identifiable.
- Appropriate information in good time
 - Specific on investment advice
 - Specific on financial instruments and investment strategies
 - Specific on cost and charges
- Best execution
- Client categorisation
- Client agreement
- Inducements
- Remuneration staff
- Cross selling

Best execution

Best execution - applicability

- The obligation applies to **executing orders in any type of financial instrument**, including OTC derivatives
- It applies when a firm **executes orders, provides portfolio management and when receiving and transmitting orders**. **Not applicable** if client gives specific instruction: if so, managers to provide a warning to retail client
- This is true for both retail and professional clients. Best execution continues not to be owed to eligible counterparties

Execution policy – factors

- Explain what constitutes 'all sufficient steps' taking into account client classification, services to be provided, execution factors, execution venues and specific instruction. Explain how the execution factors of price costs, speed, likelihood of execution and any other relevant factors are considered as part of 'all sufficient steps'
- Execution factors to be considered: price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order.
New obligation: for retail clients, best execution in terms of total consideration:
 - price of the financial instrument
 - costs relating to execution
 - all expenses incurred by the client which are directly relating to the execution of the order (including execution venue fees, clearing and settlement fees);
 - any other fees paid to third parties involved in the execution of the order
- Include criteria for determining the relative importance of best execution factors:
 - characteristics of the client (retail or professional)
 - characteristics of the client order
 - characteristics of financial instruments that are the subject of that order
 - characteristics of the execution venues to which that order can be directed

Execution policy - summary

- Firms need to provide provide retail clients with a summary of the policy
- Summary to be tailored for retail clients
- Summary should focus on price
- Summary to include link to most recent execution quality data published.
- Inform clients of material changes: limited to an obligation to inform clients with whom the firm has an 'on-going relationship'. Material change is significant event of internal or external nature that could impact the best execution factors (cost, price, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order)

Best execution – after execution

- Following the execution of an order, a fund manager must inform its client **where that order was executed**
- Summarise and make public on an annual basis, for each class of financial instruments, the **top five execution venues** in terms of trading volumes where they executed client orders in the preceding year and information on the quality of execution obtained
- In complying with its existing obligation to monitor the effectiveness of its order execution arrangements and to, where appropriate, correct any deficiencies, a fund manager will also be required to take into account the information it is required to publish relating to the quality of **execution** of transactions and the summary of its **top five execution venues** for each class of financial instruments
- Upon request, managers will not only be required to **demonstrate to the regulator** that they have executed their orders in accordance with their execution policy but also their general compliance with the best execution obligation

Client classification

Client classification



Level 1

Moderate changes

- **No change** to categorisation of retail, professional and eligible counterparty clients
- Change to **municipalities and local public authorities**:
 - **no longer** able to be *per se* eligible counterparties or professional clients
 - default categorisation is **retail client**
 - can opt up to elective professional client status in certain circumstances
- No change to criteria to become elective eligible counterparties
- Member States able to **gold plate**

Level 2 (Consultation)

Moderate extension

- **No changes proposed** to treatment of municipalities and local public authorities from Level 1
- **New changes proposed** for who can qualify as an elective eligible counterparty
 - ESMA proposing to **delete one of the limbs** of the test for who can be an elective eligible counterparty
 - the limb that allows **small undertakings** who are professional clients to opt-up
 - therefore, **only large undertakings** who are professional clients can opt-up

Level 2 (Final)

Confirmed with extensions

- Confirmation that who can qualify as an elective eligible counterparty is **essentially large undertakings**
- **New requirement** recommended by ESMA for elective ECPs:
 - **specific procedure** for the opting up process
 - includes **warning** to ECPs that they are losing protection
 - ECP to provide **written confirmation** that they are requesting ECP status either **generally** or for **specific service**
 - acknowledgment that ECPs are **aware of consequences**

Impact



Client agreement

EU developments



Level 1

No changes to MiFID I

A binding written agreement is also required

- when providing DEA
- where acting as a general clearing member

Level 2 (Consultation)

- Applies to retail and **professional** clients (with investment advice only when periodic assessment is provided)
- No written agreement is necessary with retail client: investment advice does **not** provide **periodic assessment**
- Essential rights and obligations are:
 - Nature and extent of investment advice service
 - Main features of custody services, incl role in corporate actions and SFT
 - If portfolio management is provided: type of financial instrument and types of transactions that are allowed and which are prohibited

Level 2 (Final)

Retained with minor tweaks

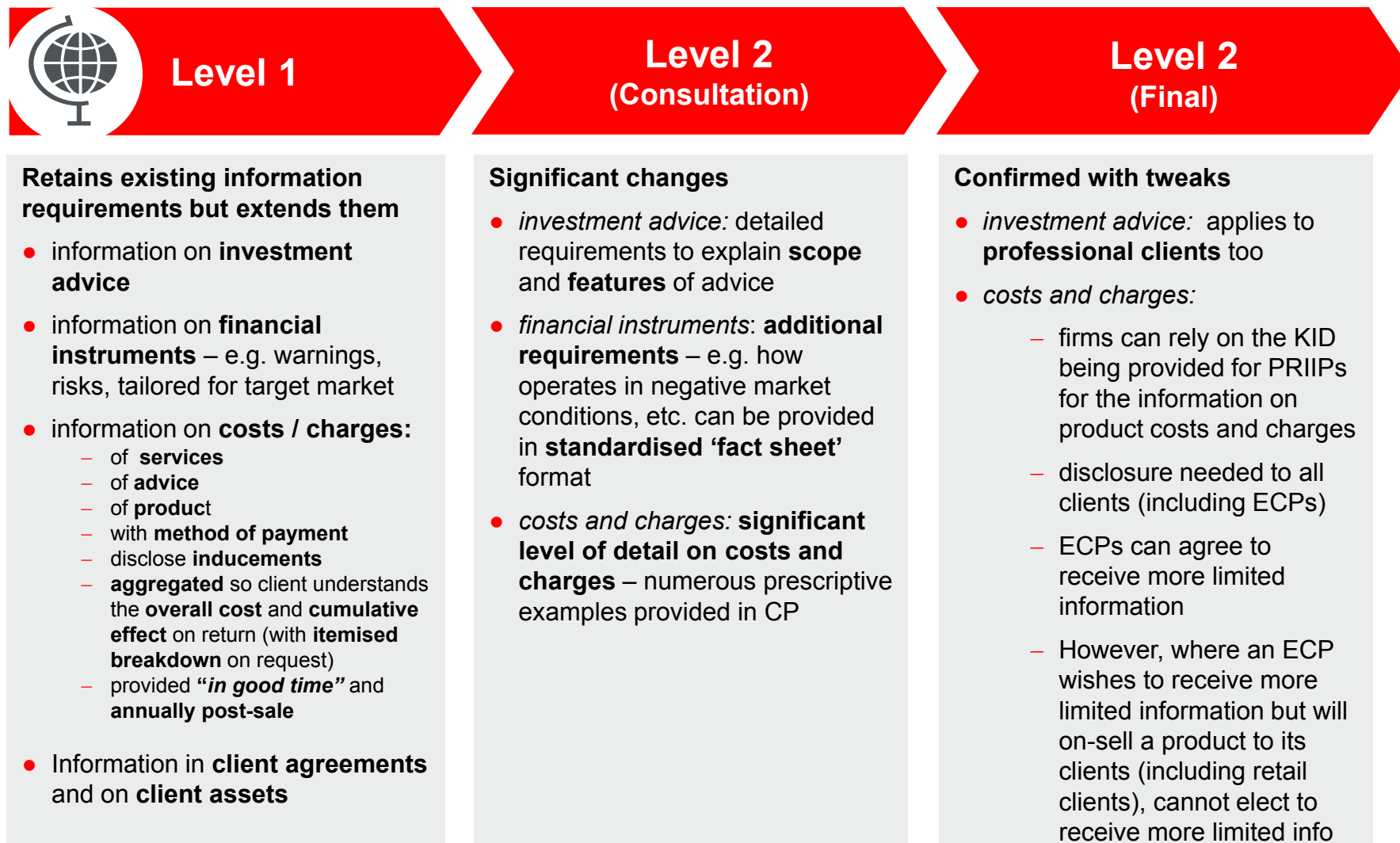
- Applies to retail and **professional** clients, intention to establish a **continuing** business relationship
- No written agreement is necessary with retail client: investment advice does **not** have **continuing** relationship
- Essential rights and obligations as consulted upon are **confirmed**.

Impact

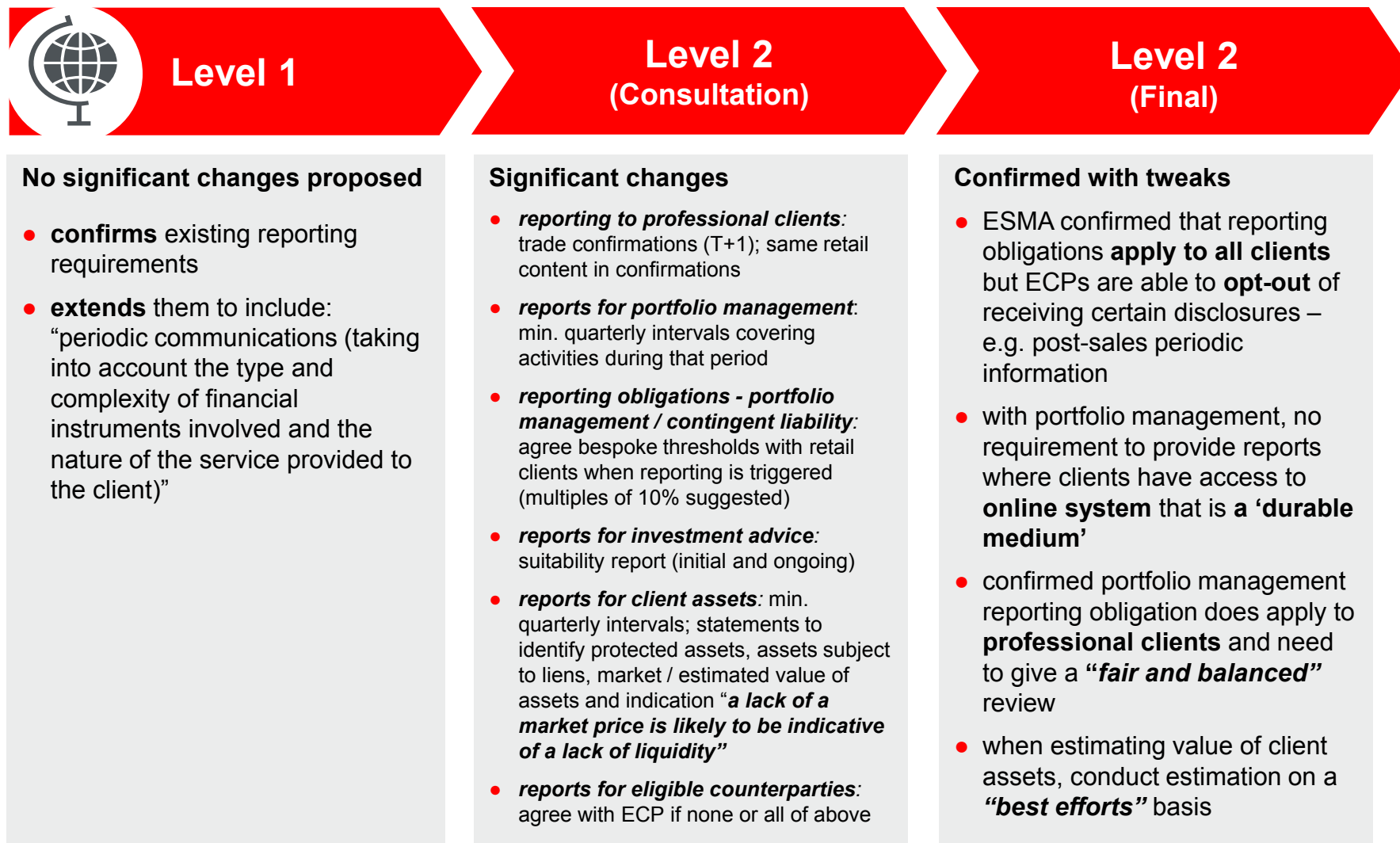


Information to clients

Information to clients



Reporting to clients



Information to clients – PRIIPs, KIID & UCITS KID

- PRIIPs Regulation and UCITS/AIFM Directive set out product information requirements.
- PRIIPs Regulation sets out **Key Information Documents (KID)** for packaged retail and insurance-based investment products.
 - AIF managers must comply with the PRIIPs Regulation from 31 December 2017
- UCITS Directive sets out **Key Investor Information Document (KIID)**.
 - **UCITS** managers **are exempted** from complying with the PRIIPs regulation until 31 December 2019
- PRIIPs KID regime will exist in parallel to disclosure requirements set out in MiFID II, big potential problems

Investment advice



Level 1

- **No change** to definition of 'investment advice'
- New concept of '**independent**' investment advice
- **Factors** to be satisfied to be independent:
 - assess a **sufficiently wide** range of products on the market
 - assess a **sufficiently diverse** range of products (by type, issuer, product provider)
 - not only consider products offered by **associated firms** / firms with **close legal / economic relationships**
 - not **receive and keep** third party payments

Level 2 (Consultation)

- Amending definition of investment advice by **deleting** an exclusion - where advice given "**through distribution channels**"
- **Criteria** for independent advice:
 - define and implement a **selection process**
 - **additional restrictions** where focus is limited e.g. marketing restrictions; client confirmation on limited focus; firms demonstrate limited focus appropriate for client
- **Additional criteria** for firms providing both independent and non-independent advice – e.g. not describe whole business as 'independent', etc.

Level 2 (Final)

Confirmed with minor tweaks

- **Selection process** to include:
 - **diversified selection** of instruments considered
 - **not limited** to instruments provided by firm or associated entities
 - **proportionate number** and **variety** of instruments
 - **adequately representative** of those available in the market
 - criteria for comparing instruments to include **all relevant aspects**
 - neither selection nor recommendations should be **biased**

Level 3 guidelines expected

Information to clients: costs and charges

- Information on costs / charges:
 - Point of sale: services and financial instrument
 - method of payment (incl. disclose inducements)
 - aggregated so client understands the overall cost and cumulative effect on return (with itemised breakdown on request): upfront, ongoing, exit
 - Post sale disclosure: ongoing relationship
 - Timing: provided “in good time” and annually post-sale
- Professional investors may agree limited information, except in case of investment advice or portfolio management, or financial instruments concerned embed a derivative
- If ECP wishes to receive more limited information but will on-sell a product to its clients (including retail clients), cannot elect to receive more limited information

Suitability & appropriateness

Suitability and appropriateness

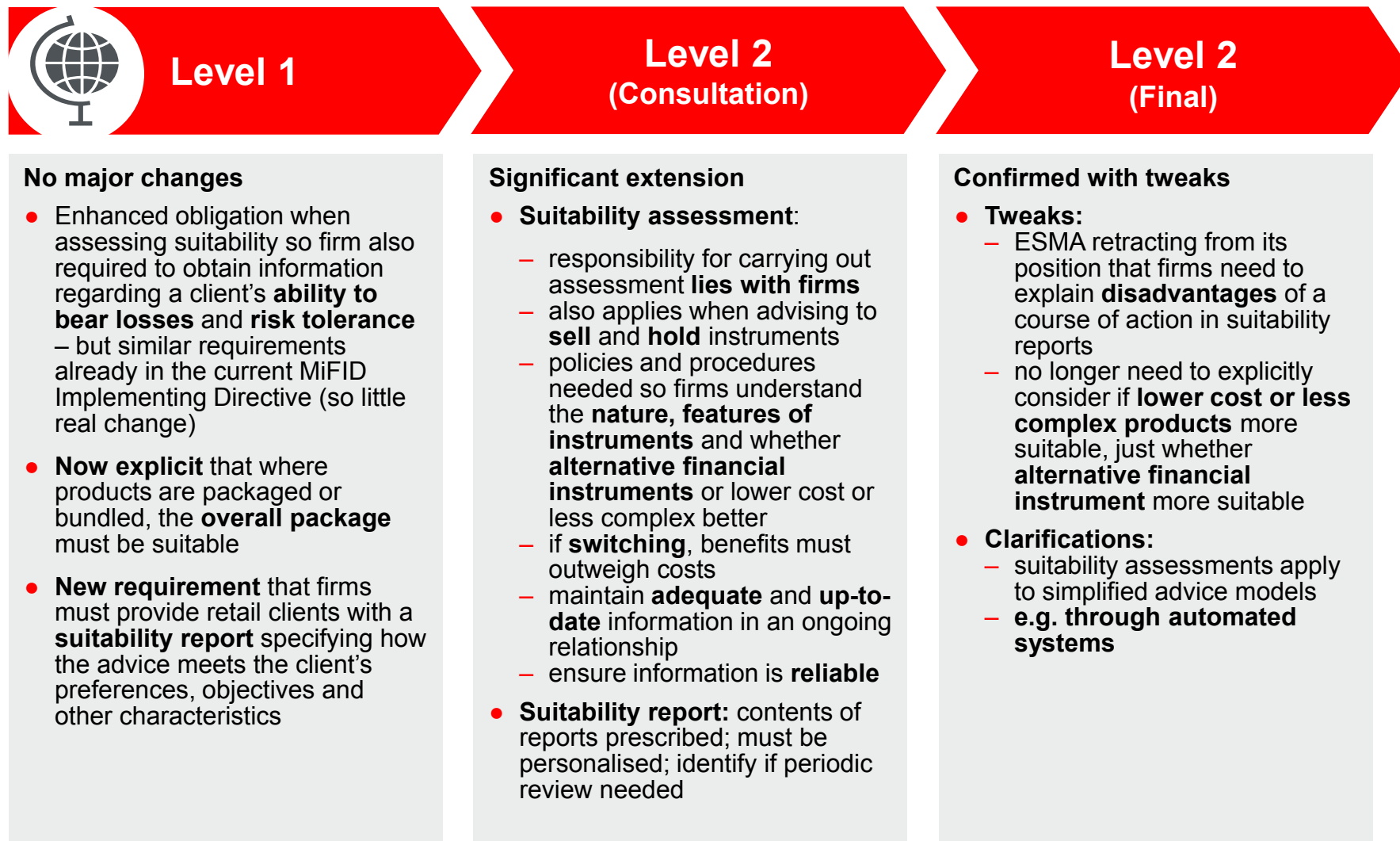


- Managers must obtain the following information from a client or a potential client before providing the above services:
 - its knowledge and experience of the investment field in which the investment advice or portfolio management is to be offered;
 - its financial situation including his ability to bear losses; and
 - its investment objectives including the risk tolerance
- Obligation to take reasonable steps to ensure that investment advice and decisions to trade (incl. to buy or to hold) are suitable
- Obligation also applicable to a package of services or bundled products and structured deposits



- Managers must obtain information regarding clients' experience and knowledge in order to enable it to determine if the products and services envisaged are appropriate:
 - the types of financial service, transaction and regulated financial instruments the client is familiar with;
 - the nature, volume and frequency of the client's transactions in regulated financial instruments; and
 - the level of education, profession or former profession of the client
- Obligation also applicable to a package of services or bundled products and structured deposits
- Managers may assume that the appropriateness test is satisfied if dealing with professional clients, and not applicable to ECPs

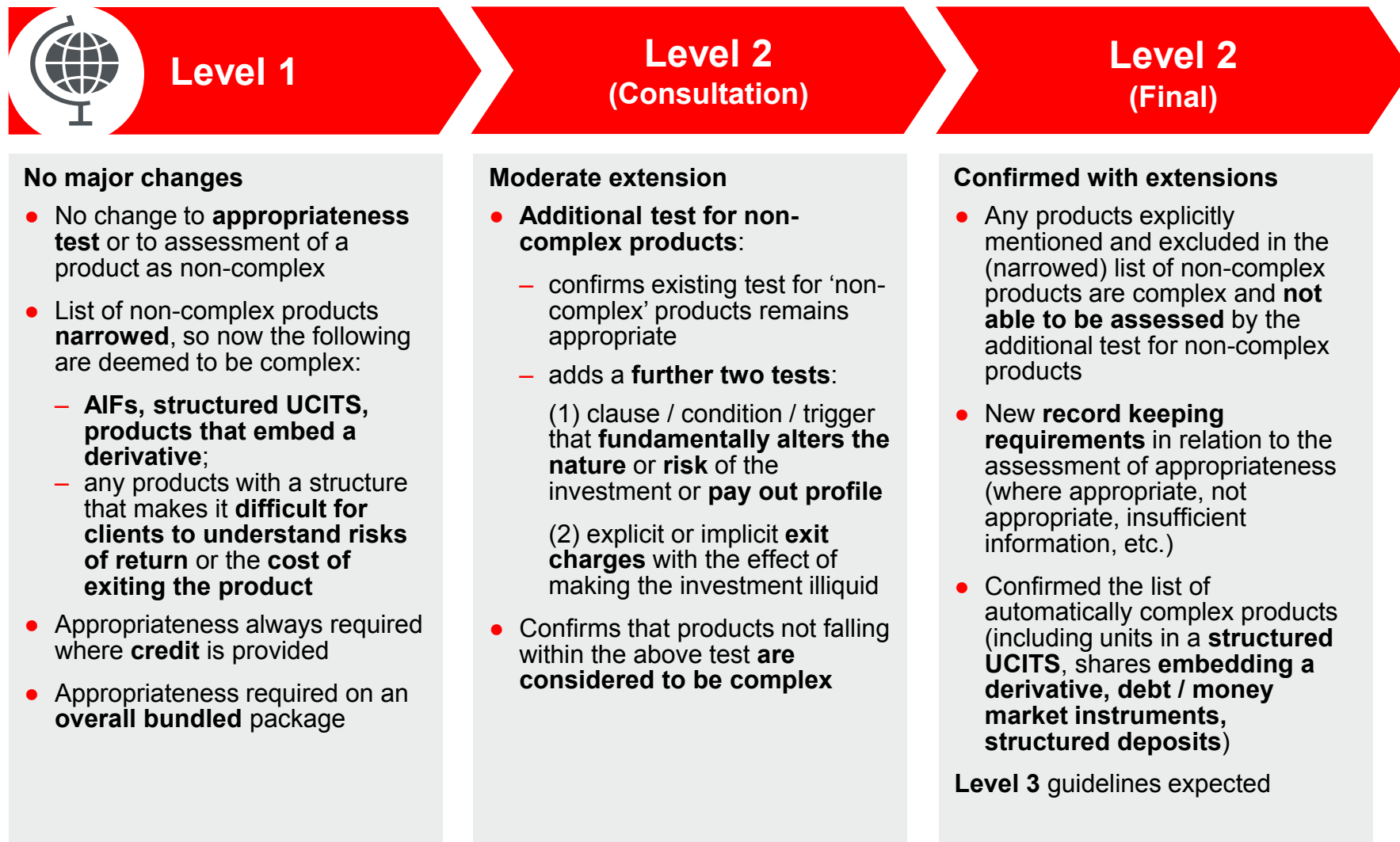
Suitability



Requirements suitability assessment

- Maintain adequate and up-to-date information in an on-going relationship
- Ensure information is reliable
 - Ensure clients awareness of importance accurate and up-to-date information.
 - Undertaking valid and reliable assessments client's knowledge, experience and risk tolerance.
 - Tools are appropriately designed for use and fit-for-purpose.
 - Questions should be understandable, capture accurate reflection of client's views and needs and information is necessary.
 - Ensure consistency of information.
- Managers can rely on information provided by its clients unless they are aware that it is manifestly out of date, inaccurate or incomplete
- If a manager does not obtain the necessary information to assess suitability, it must not make a personal recommendation or take a decision to trade

Appropriateness and ex-only sales





Questions

The logo for Norton Rose Fulbright, featuring a gold chevron icon above the text "NORTON ROSE FULBRIGHT" in red.

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