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 **NORTON ROSE FULBRIGHT**

# **MiFID II: extended briefing on different angles on investor protection**

Norton Rose Fulbright LLP  
5 April 2017



# Content:

1. **General topics**
2. **Buy-side topics**
3. **Sell-side topics**
4. **Retail topics**



# Programme

Room: Terrace suite		Room: 1&2	
<b>Registration and breakfast</b> 8:30 – 8:45			
<b>Introduction</b> 8:45 – 8:55			
<b>Session 1</b> 8:55 – 9:40	<b>General topics:</b> <ul style="list-style-type: none"> <li>• Conflicts</li> <li>• Records</li> <li>• Compliance tools</li> </ul>	<b>Session 1</b> 8:55 – 9:40	<b>Sell-side topics:</b> <ul style="list-style-type: none"> <li>• Appropriateness</li> <li>• Research</li> <li>• PFOF</li> </ul>
<b>5 minute break</b>			
<b>Session 2</b> 9:45 – 10:30	<b>Buy-side topics:</b> <ul style="list-style-type: none"> <li>• Scope: applicability and UK gold-plating</li> <li>• Hot topics</li> <li>• The non-EU dimension</li> <li>• How is the buy-side preparing</li> </ul>	<b>Session 2</b> 9:45 – 10:30	<b>General topics:</b> <ul style="list-style-type: none"> <li>• Conflicts</li> <li>• Records</li> <li>• Compliance tools</li> </ul>
<b>Coffee and tea</b> 10:30 – 10:45			
<b>Session 3</b> 10:45 – 11:30	<b>Institutional topics:</b> <ul style="list-style-type: none"> <li>• Dealing with ECPs and professional clients</li> <li>• Best execution</li> <li>• Manufacturing</li> </ul>	<b>Session 3</b> 10:45 – 11:30	<b>Retail topics:</b> <ul style="list-style-type: none"> <li>• Product governance</li> <li>• Advice and inducements</li> <li>• Structured products</li> </ul>

# Should you hear the fire alarm

- Please listen to instructions and exit the building via the front entrance.



# A new sector analysis icon on Pegasus

## Pegasus

Preparing for MiFID II



MiFID II and MiFIR (together 'MiFID II') will underpin the provision of investment services across and into Europe, both in terms of how trading is carried on and how firms organise and conduct themselves. They will affect both the wholesale and retail sides of the industry, in relation to both securities and derivatives. Nor should MiFID II be seen as solely European, as its effect will be far reaching and influence all firms dependent on the European client base.



The home page of our MiFID II online resource 'Pegasus' has a new sector analysis icon

Click on the new icon to be taken to a new sector analysis web page



# New sector analysis page on Pegasus

## Sector analysis

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MiFID II will dramatically change almost the entire market place as we know it today, with far-reaching impacts on everyone engaged in the dealing and the processing of financial instruments.



**Sell-side**



**Buy-side**



**Retail**



**Institutional**

**The new sector analysis web page has four icons: sell-side, buy-side, retail and institutional**

**Click on these to be taken to a sector specific web page**

# Sell-side web page

## Sector analysis - Sell-side

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### Slides

### Webinars

- [MiFID II Academy: Update on conduct issues, March 16, 2017 \(08:44 – sell side perspective analysis on appropriateness, inducements and best execution\)](#)

### Videos

Clicking on the sell-side icon will take you to a web page where we will add related NRF material

The relevant slides from today's seminar will be added here

8 mins and 44 seconds into this MiFID II Academy webinar there is a discussion on these MiFID II topics from a sell-side perspective

New videos will appear here shortly

# 1. General topics

**John Davison**

**Head of Projects – Regulatory Compliance Consulting**

**Norton Rose Fulbright LLP**



# **In this session we will cover:**

**Conflicts of interest – key considerations**

**Record keeping – areas of focus**

**What firms should think about practically in the context of these matters**

**Compliance tools and techniques – evaluating and strengthening**

# Conflicts of interest – key considerations

# Conflicts of interest - Summary

## Section III of the MiFID II Delegated Regulation:

**Determining relevant conflicts** – where the firm or person:

- Is likely to make a gain / avoid a loss at the client's expense
- Has an interest in the outcome of a service provided to a client / a transaction carried out for a client distinct from the client's interest
- Has a financial or other incentive to favour the interest of another client over that client
- Carries on the same business as the client
- Will receive from a person other than the client an inducement in relation to a service provided to the client (monetary or non-monetary)

**Conflicts of interest policies:**

- In writing, appropriate to the firm
- Must identify **specific** conflict risks
- Must specify procedures for independence:
  - prevent / control information exchange
  - separate supervision of relevant persons
  - remove link between remuneration of relevant persons on each side of conflict
  - limit ability to exercise inappropriate influence over investment-makers
  - prevent simultaneous involvement of relevant persons in other investment services, where there might be conflict
- Disclosure to clients is a measure of last resort and must make this clear
- Policies must be reviewed, at least annually

Firms must keep a record of activities that might give rise to conflicts entailing a risk of damage to clients and report to senior managers at least annually

# Conflicts of interest – 10 principle focus areas

On the surface, many will think that a historically robust conflicts framework should sustain. However, there is considerably more nuance:

1. Considerably more onus on firms to **prevent** conflicts
2. Reliance on **disclosure** as a risk mitigant no longer acceptable – disclosure is a last resort
3. Need to think about **all conflict risks**, not just ‘material’ risks
4. Onus on firms to take ‘**appropriate**’ rather than ‘reasonable’ steps – requiring positive determination from organisations
5. Expectation that firms focus systems and controls on the **identification** and **resolution** of conflicts
6. Larger firms with multiple parts need to consider their entire organisation’s conflicts and impacts
7. Significant focus on inducements
8. Internal staff remuneration is key
9. Focus on conflicts disclosures
10. Reports to management on conflicts annually

# Conflicts of interest – what this now means

The changes to conflicts will require some changes in compliance and risk management behaviours and some practical considerations:

***Policy:*** policies will need to be reviewed prior to implementation and must now focus on:

- How first line of defence staff can identify, escalate and mitigate potential conflicts
- The use of disclosure – when is it acceptable to use and how that gets approved
- Documenting conflicts in a conflicts register – how this is done and how it is maintained
- Responsibilities for each part of the conflicts process

***Conflicts clearance:*** with a greater focus on prevention of conflicts, it is even more important that there is an early detection and assessment capability, to demonstrably reduce reliance on disclosure. Specifically, clarity is required around:

- How to identify potential conflicts, however material
- How to ensure that these are properly dealt with prior to undertaking business

***Mind-set change and education:*** there may, for many organisations, need to be a change in how conflicts are considered. Specifically:

- Changing from a detection to a prevention approach
- Focussing on all potential conflicts, rather than specifically materials ones
- No longer accepting that “conflicts happen”, such that the number of conflicts that are not prevented at source are reduced

# Record keeping – areas of focus

# Records

***Maintaining proper records has always been fundamental in demonstrating effective system and control. However, data and record obligations increase under MiFID. Specifically:***

- Significant increase in data required for transaction reporting
- Need to be able to demonstrate best execution – records will be key to reflecting practical approach
- Will need to maintain proper records of monitoring of trade execution
- Need to produce conflicts reports for management will require good underlying conflicts data
- Requirement to monitor all communications, internal and external including:
  - communications with clients (voice or electronic);
  - communications with another person relating to transactions on own account or for client services; and
  - communications relating to a covered activity.

Whilst many of these requirements may be embedded in organisational practice, internal arrangements will come under greater scrutiny than before.

# Records – what the changes mean

## 1. Greater reliance on robust IT infrastructure and the need for compliance and risk functions to engage

- Voice recording and transaction reporting data will need robust underlying systems to sustain data that can be retrieved

## 2. Evidence in firms likely to be scrutinised more by authorities

- Monitoring will be key here in ensuring that proper evidence is maintained

## 3. Need to notify customers, new and existing, that calls may be recorded prior to doing business

- Controls will need to be embedded across all business lines to ensure that this is happening consistently

## 4. Requirement for “durable medium” – if business undertaken by other mediums than telephone

- Where minutes / other written records are required, discipline to document and maintain will be critical

## 5. Reasonable steps to prevent use of private equipment is required

- Whilst this may be embedded, this is an opportunity to consider policies and controls in this space

## 6. Need to maintain for at least 5 and potentially 7 years

- Robust record retention systems required and disposal arrangements to ensure compliance with MiFID II and privacy obligations

# Disclosure to clients – the importance of data

## Levels 1 and 2

### Costs and Charges

- Must provide information on **costs / charges** of **services, advice, product** and how to pay the costs and charges must disclose inducements
- Costs and charges must be **aggregated** so client understands the **overall cost** and **cumulative effect** on return (with **itemised breakdown** on request) and firms are to provide their clients with an **illustration of the cumulative effect** of costs on return when providing investments (both pre and post-sale)
- Delegated Regulation has not adopted ESMA's advice that firms should be allowed to provide clients with separate figures comprising the aggregated initial costs and charges, the aggregated ongoing costs and charges and the aggregated exit costs
- Must be provided "in good time" ex-ante and ex-poste annually
- Disclosure to all clients (including ECPs) but professional clients and ECPs can **agree to receive** more limited information but not for portfolio management OR where there is an embedded derivative OR (for ECPs) where a product will be on-sold
- Level 2 includes prescriptive examples

### Reports

- 
- Firms to provide clients with adequate reports in a **durable medium**
  - Trade confirmations to be sent to **professional clients** like they already are for retail clients
  - Portfolio management statements to be sent at least **every quarter** (unless a client has online access and has actually accessed their statement)
  - Reporting applies to ECPs unless they agree to receive reports in a different way / different content / timing

# Compliance tools and techniques – evaluating and strengthening

# Compliance tools

**Compliance functions need to consider their existing control and governance arrangements in light of MiFID II. Specifically, compliance functions need to consider:**

- Policies and procedures – their compliance with the legal requirements of MiFID as well as ensuring that they set proper, defined standards of behaviour
- Training – both in terms of educating on specific MiFID obligations as well as operationalising the more nuanced interpretations of the requirements
- Role of trade surveillance – in terms of how it is resourced to deal with the changes in MiFID II
- Thematic monitoring and assurance and the extent to which some targeted work is needed leading up to and post implementation on specific subject areas
- Management information – whether there is correct and sustainable underlying data to provide information to clients and to management

**Compliance functions should also give consideration to (to the extent these haven't been done):**

- Undertaking a formal risk and control assessment of the key areas of MiFID II, to evaluate exposure
- Ensuring that proper attention is given to areas requiring specific attention or where there may have been historic weaknesses
- Ensuring that the sustainability of IT and controls is being built into implementation, to accommodate business growth and changes in strategic focus

**Given the focus on prevention and 'appropriateness', Compliance functions will need to look at their frameworks and approaches to ensure that they are properly identifying and mitigating risk**

# What compliance functions should do

1. Ensure that all policies and procedures are being updated in a manner that accommodates the more risk and evidence focussed approach. This will ensure that there is proper definition and clarity around expectations

2. Provide relevant training, including targeted training to individuals in key roles. Ensure that training covers the more nuanced elements of MiFID II and enforces the standards embedded into policy

3. Review trade surveillance arrangements to ensure their sustainability

4. Review record keeping arrangements and proposals, to ensure the proper capture, retention and disposal of records

5. Ensure that proper focus is being placed on IT development, focussing on areas subject to significant change (e.g. transaction reporting and voice recording)

6. Ensure that proper focus is placed on investor protection, including disclosure requirements and product governance

7. Assess remuneration approaches to ensure that there are no material or obvious risks associated with the approach being undertaken



**Any questions?**

***If you have any further questions, please email us at [financial.services@nortonrosefulbright.com](mailto:financial.services@nortonrosefulbright.com)***

## **2. Buy-side topics**

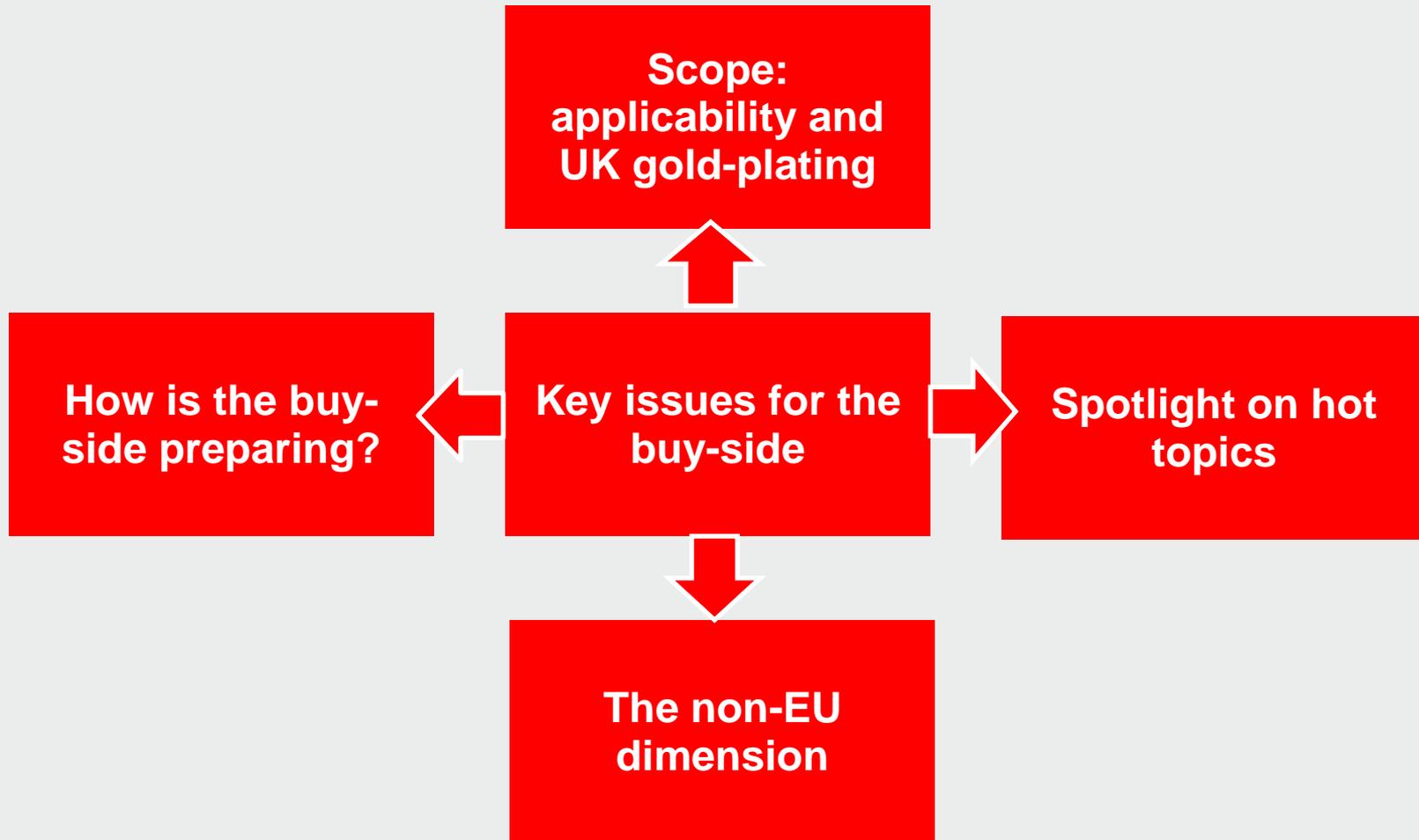
**Imogen Garner**

**Partner**

**Norton Rose Fulbright LLP**



# In this session we will cover:



# Scope: applicability and UK gold-plating

# Which EU asset managers will need to comply?



- EU legislation distinguishes between investment firms, that provide individual portfolio management services, and collective portfolio management firms (i.e. AIFMs and UCITS managers)

- Investment firms providing individual portfolio management firms are within the scope of MiFID II. AIFMs and UCITS managers are excluded, and their activities are governed by separate legislation

- The exception to this is where an AIFM or UCITS manager additionally provides 'top-up' investment services (such as the provision of investment advice or the management of segregated mandates) separately from the management of their collective funds

- AIFMs and UCITS managers (**CPMI firms**) will be subject to certain MiFID II requirements in relation to this top-up MiFID-scope business

- Note that an EU manager appointed by an AIFM, a UCITS management company or a self-managed UCITS or AIF will be an investment firm – and, as such, in scope for MiFID II

- **BUT: gold-plating by national competent authorities will change this basic position!**

# The basic position for CPMI firms

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

## However:

Article 6(3) of the UCITS Directive permits UCITS managers to provide:

- portfolio management
- investment advice, and
- safekeeping (in relation to CIU units)

Articles 12, 13 and 19 of current MiFID are applied to these services

The corresponding provisions in MiFID II are Articles 15, 16, 24 and 25

Article 6(4) of the AIFM Directive permits AIFMs to provide:

- portfolio management
- investment advice
  - RTO, and
- safekeeping (in relation to CIU units)

Articles 12, 13 and 19 of current MiFID are applied to these services

The corresponding provisions in MiFID II are Articles 15, 16, 24 and 25

# Provisions applicable to CPMI firms: the sources

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

# Potential UK gold-plating: key buy-side topics

In the UK, the FCA is currently proposing to extend three MiFID II conduct standards to collective portfolio management firms that do not carry out MiFID business, i.e. UCITS managers and AIFMs:

- inducements and research
- best execution
- recording of telephones and electronic communications.

This gold-plating complicates the application of MiFID for CPMI firms. The FCA has acknowledged this by stating that, rather than complying with different sets of rules for MiFID and collective portfolio management business, CPMI firms may wish to consider applying the higher of the two standards across its entire business:

*“A significant number of firms conduct MiFID and non-MiFID designated investment business. Our proposal not to apply MiFID II conduct standards to all designated investment business means that different sets of rules would apply to different aspects of a firm’s business. We recognise that firms may find it more practical to take a single approach to compliance for closely connected lines of business notwithstanding the differing regulatory standards. Therefore, if we decide, post-consultation, to adopt our proposal, firms should be able, as far as is feasible, to choose to apply a single set of standards based on the higher standards. We will consider further whether we need to make specific proposals to support this.” CP16/29*

# Spotlight on hot topics

# Setting the issues in context: the regulatory landscape for the buy-side

Asset management is high on the regulatory agenda and scrutiny of asset managers continues to increase

International reform agenda moving from banks to asset managers: little evidence of asset managers being a source of systemic risk but regulators appear to have their eye on liquidity risk management

Likely direction of travel in the UK following Brexit?

UK regulator has a long history of focussing on conflicts in the asset management space: see for example FSA November 2012 paper 'Conflicts of interest between asset managers and their customers: Identifying and mitigating the risks'

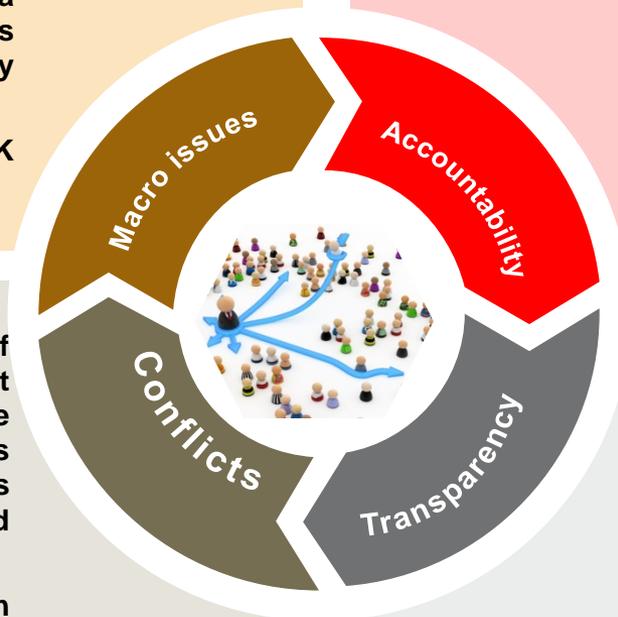
FCA 2016/17 Business Plan highlighted the risk of conflicts of interest arising from vertically integrated investment management models

Individual accountability agenda: UK senior managers regime to be extended to all financial services firms

Trend towards fines against individuals continuing

Significant focus on transparency vis-à-vis investors, costs and charges

Conduct and value for money agenda: UK FCA expected to issue final report on Asset Management Market Study later this year



# Conflict of interest

## Levels 1 and 2

### Policies and procedures

- Review conflicts policies – at least annually
- If having to disclose frequently, *presumption* that conflicts policy is deficient
- Procedures are required to address both how conflicts are *managed* and *prevented*
- Any risk of damage to the interests of one or more clients' needs to be considered (regardless of its materiality)

### Disclosure

- Limitations on use of disclosure – disclosure is to be used as a *'last resort'*
- Prescribed content of disclosure – *tailored* and *new warning* to be included in disclosures

### Managing techniques

- The same independence and operational separation requirements which apply to investment research now also apply to *'recommendations'* (i.e. 'non-independent research')
- Requirement for physical separation of analysts producing investment research
- If physical separation is disproportionate, need alternative information barriers (potentially extremely broad)
- Senior managers are to receive frequent reports (at least annually) on conflicts recorded in the conflicts log
- **Guideline 9:** Firms that distribute tied or bundled packages to ensure suitable remuneration models and sales incentives encouraging responsible business conduct, fair treatment of clients and avoidance of conflicts of interest for staff selling packages are in place and are monitored by senior management - **3 illustrations** provided
- Detail on managing when underwriting and placing

### Additional material (Level 3):

- ESMA's Final Report: Guidelines on cross-selling practices – Guideline 9
- ESMA Q&A on MiFID II: Section 6

# Conflicts of Interest

## UK implementation

The FCA is proposing to **amend** SYSC 10 and **align** it with MiFID II

Proposals include applying as rules requirements to take steps to identify and to prevent or manage conflicts – and extending to all firms the new detailed disclosure obligations under MiFID II

Currently, the conflict of interest requirements in SYSC 10.1 apply as rules to **all common platform firms and management companies**

For other firms, only SYSC 10.1.3 (identifying conflicts), SYSC 10.1.7 (managing conflicts) and SYSC 10.1.8 (disclosure of conflicts) apply as rules – with the remainder applying as guidance

Obligations to assess and at least annually review the conflicts policy, and requirements for senior MI, would be **extended to Article 3 firms** as guidance

Chapter 5 of CP16/29 discusses **implementation** of the MiFID II requirements related to conflicts of interest

Provisions contained in the delegated regulation do not need to be transposed for investment firms – however, as the FCA has decided to apply these provisions to other firms they will also be transposed into the Handbook

**UK  
implementation**

# Inducements

## *Levels 1 and 2: Independent advisors and portfolio managers*

- Cannot accept and keep any third party payments other than acceptable minor non-monetary benefits
- Must be reasonable and proportionate and of a scale that is unlikely to influence firm's behaviour to detriment of client's interests
- Must disclose before providing service

- Return to clients fees, commissions and monetary benefits ASAP after receipt
- Policy to ensure that amounts are allocated and transferred
- Inform clients through periodic statements

### **Acceptable minor non-monetary benefits:**

- (a) Information or documentation relating to products or services which is generic in nature or personalised
- (b) Issuer commissioned/paid third party new issuance material provided relationship disclosed and made available at the same time to other investment firms or general public
- (c) Participation in conferences, seminars and other training events
- (d) Hospitality of a reasonable de minimis value
- (e) Other minor non-monetary benefits which a Member State deems capable of enhancing the quality of service and are of a scale and nature that are unlikely to impair compliance with duty to act in client's best interest

# Inducements – research payment account

Provision of research is not an inducement if paid for through:

**Own resources**

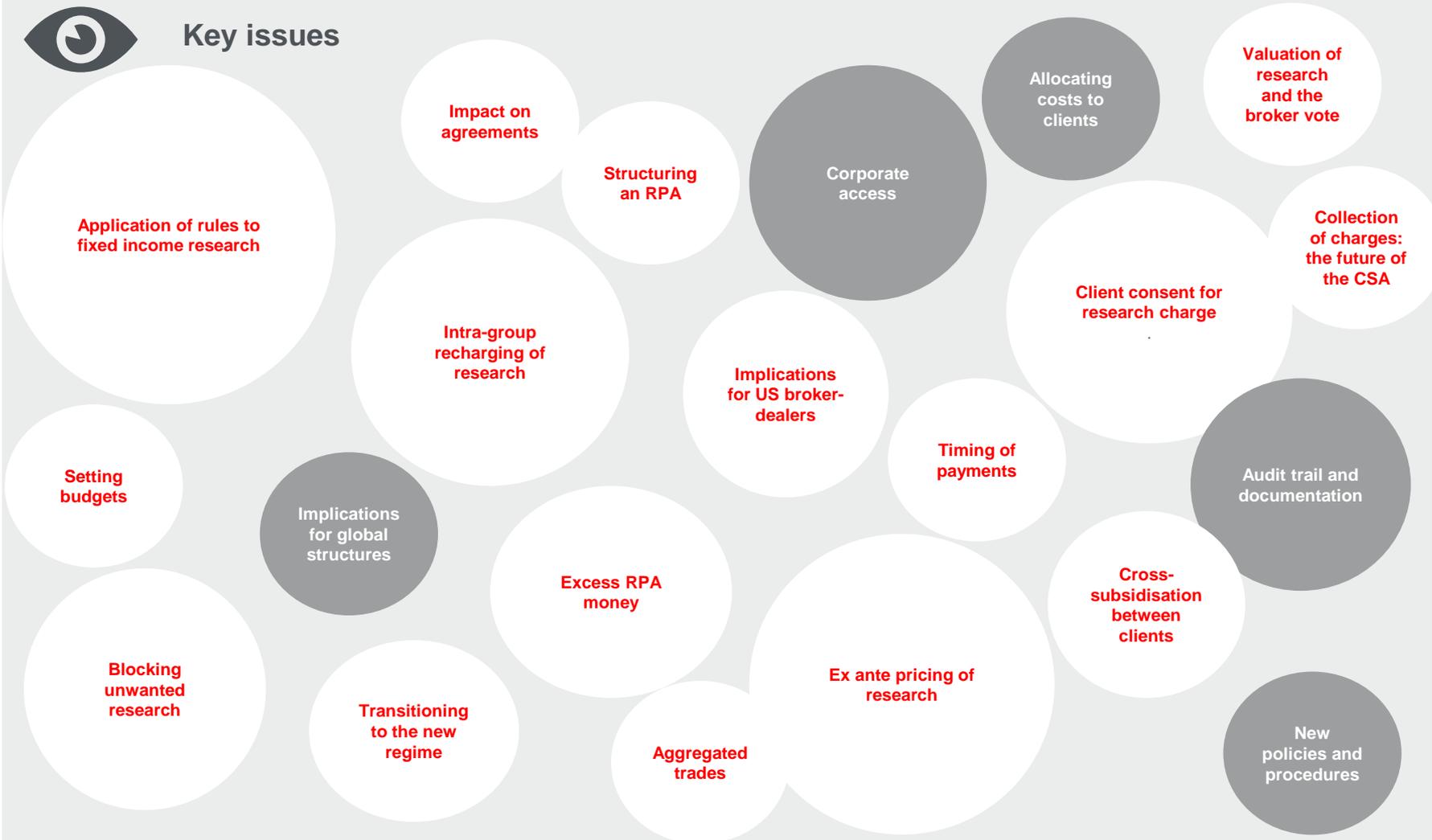
**OR**

**Research payment account, provided:**

- The account is funded by a specific research charge to client
- The research charge is based only on the firm's budget and is not linked to volume/value of transactions executed for clients
- Firm sets and regularly assesses a research budget, based on reasonable assessment of need for research
- Firm is responsible for research payment account
- Firm regularly assesses quality of research against robust quality criteria and ability to contribute to better investment decisions
- Before providing service, firm tells clients of budgeted amount and estimate research charge for the client
- Firm agrees research charge and frequency with which deducted in IMA/ToB
- Firm provide annual information on total costs incurred by client for research
- If required by client or competent authority, firm provides further information
- Where research charge collected alongside transaction commissions, research charge is separately identifiable
- Firm tells clients about any increase in the research charge in advance
- Any surplus at end of period is rebated or offset against research budget for following period – firm needs a process for this
- Allocation of budget is subject to appropriate controls and senior management oversight
- There is a clear audit trail of payments made for research and how determined by reference to quality criteria
- Firm has a written 'research policy', which goes to clients
- Firm cannot use the research payment account to fund internal research

# Inducements – unbundled research

UK implementation: some key hot topics



# Suitability

## Suitability assessment

- Where products are packaged or bundled, the overall package must be suitable
- Responsibility for carrying out assessment lies with firms
- If switching, benefits must outweigh costs
- Maintain adequate and up-to-date information in an ongoing relationship
- Firms need to ensure the information they obtain from clients reliable
- Firms need to satisfy themselves that they have obtained sufficient information from a client to determine that the recommendation will not only meet the investment objectives of the client but also their risk tolerance
- Need to consider whether alternative financial instruments are more suitable
- Suitability assessments apply to simplified advice models (e.g. through automated systems) but not where a firm executes orders or transmits orders to another firm to execute where there has been pre-agreed signals
- Firms should not recommend instruments where they are not suitable, regardless of whether this is derived from a firm having limited access to instruments or not
- Firms providing periodic suitability assessments must provide these at least annually, with the frequency of the assessment being increased depending on the risk profile of the client and the types of financial instruments recommended
- Firms need to satisfy themselves that they have obtained sufficient information from a client to determine that the recommendation will meet the investments objectives and risk tolerance of the client

## Suitability reports

- New requirement that firms must provide retail clients with a suitability report specifying how the advice meets the client's preferences, objectives and other characteristics
- Contents of reports not prescribed
- Must be personalised
- Identify if periodic review needed (i.e. in an ongoing service) – policies and procedures needed on this item

## Policies and procedures

- Policies and procedures needed so firms understand the products being recommended taking into account whether other equivalent products could be better
- The policies and procedures must include their understanding of investment services (not just products) offered to clients and also consider whether an equivalent investment service could be better

# Suitability: Level 3

## ESMA Q&A on MiFID II: Section 2

### **Q1 and Q5: Does the suitability report only have to be provided if the investment advice leads to a transaction?**

- No
- A report must be provided to a retail client when that client has been provided with advice regardless of whether a transaction occurs or not
- This includes where the advice is not to buy or sell an investment
- Although MiFID II refers to *'before the transaction is made'* this is when the report has to be made, but does not mean that the advice has to be followed by a transaction

### **Q3: Can reports be made available through a website?**

- Yes
- However, provided the website is a durable medium which means:
  - Where it is included in the secured area of the firm's website
  - The website is specifically dedicated to that client
  - The client receives a notification (via email or another means of communication) of the availability of the document
  - The choice of this medium is consistent with MiFID II requirements (i.e. website conditions)

### **Q6: What is the obligation when a client wishes to proceed to invest in an unsuitable instrument?**

- These are called 'insistent clients'
- Must clearly inform the client of the fact that the course of action that he/she wishes to undertake is not suitable for him/her

AND

- a clear explanation of the potential risks he would incur by doing so
- Firms need to have procedures to ensure they know when an investment was originated at client or firm's initiative

### **Q2: Should the report include the date when the advice was given?**

- Yes
- The date and time of the day when the advice was given should be included
- Also the date and time when the report is given
- ESMA recommends a 'time stamp' on reports

# Appropriateness and non-advised sales

## What is new?

- List of non-complex products **narrowed**
- The following are included as automatically deemed to be complex:
  - **AIFs**
  - **Units in a structured UCITS**
  - **Shares embedding a derivative**
  - Debt/money market instruments
  - Structured deposits
  - any products with a structure that makes it **difficult for clients to understand risks of return** or the **cost of exiting the product**
- Instruments which are **not 'expressly specified'** in the non-complex list can go through the additional assessment criteria

- **Change to test for non-complex products:**
  - (1) clause / condition / trigger that **fundamentally alters the nature** or **risk** of the investment or **pay out profile**
  - (2) explicit or implicit **exit charges** with the effect of making the investment illiquid
- Products not falling within the above test **are considered to be complex**
- New **record keeping requirements** in relation to the assessment of appropriateness (where appropriate, not appropriate, insufficient information, etc.)
- Appropriateness always required where **credit** is provided
- Appropriateness required on an **overall bundled package**

ESMA's Final Report: Guidelines on complex debt instruments and structured deposits  
(ESMA/2015/1783)

# Suitability and appropriateness

## *UK implementation: the headlines*

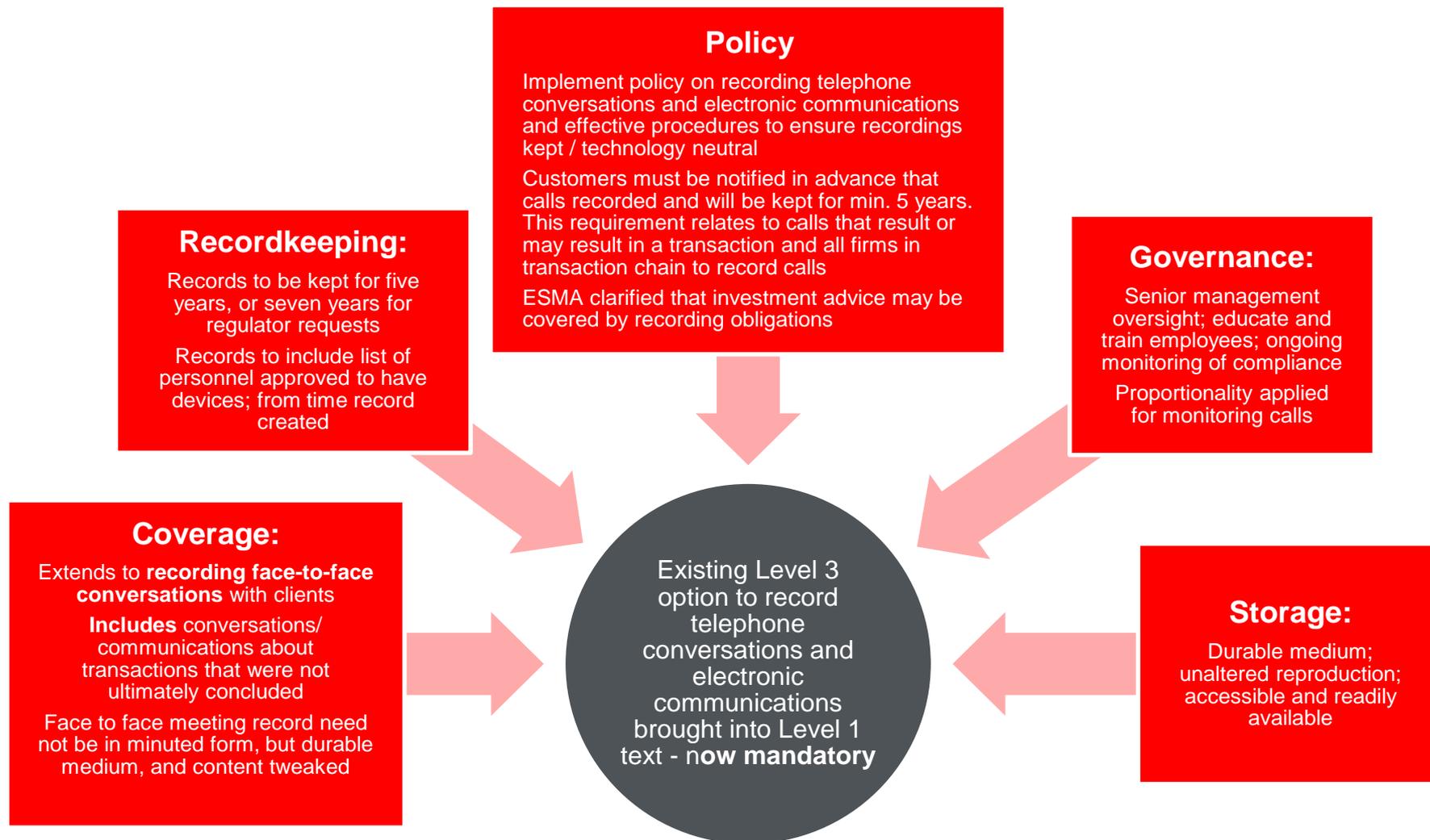
### Suitability

- Current suitability rules to stay in place for firms advising on, or managing portfolios in relation to, non-MiFID products for retail clients
- The MiFID suitability standards are more explicit than the current rules, but do not fundamentally alter their scope or nature – as such, we don't expect differing standards to apply for MiFID vs non-MiFID business

### Appropriateness

- Much industry debate about the classification of investments such as shares in non-UCITS retail schemes (NURSs) and investment trusts
- FCA has since confirmed that it considers NURS and investment trusts to be neither automatically complex nor automatically non-complex. These (and presumably similar investments, such as VCTs) must be assessed against the criteria in the MiFID Delegated Regulation. Firms are urged to apply a cautious approach, in cases of doubt

# Recording of communications



# Recording of communications: Level 3

**Q1: Which communications re: handling of orders and transactions need to be recorded?**

- Expectation that firms will record all internal telephone calls or electronic communications regarding the handling of orders and transactions
- No expectation that persons carrying on back-office functions will be captured by the requirements
- Records of any internal face-to-face conversations that relate to the receipt/transmission of orders, execution of orders and dealing on own account are caught by the general record-keeping requirements.

**Q2: Can firms charge their clients to access recordings?**

- This is at the discretion of the firm
- There is no prohibition
- However, overall responsibility to comply with national laws on whether it is permissible to charge clients to access recordings

**Q3: How does proportionality work with monitoring records?**

- Means appropriate to the nature, size and complexity of a firm's business
- Consider likelihood of misconduct re: market manipulation or not acting in clients' best interests
- Non-exhaustive list of criteria to take into account: (i) volume and frequency of dealing on own account; (ii) volume, frequency and characteristics of client orders; (iii) characteristics of clients; (iv) financial instruments and services offered; and (v) market conditions
- The results of monitoring should also inform the frequency and scope
- Monitoring should be conducted regulatory and ad hoc and taking into account emerging risks

**Q4: What are the expectations by competent authorities on the retention of records for 7 years?**

- If a competent authority has not made a request to a firm to put aside recordings within 5 years (beginning of the retention period), a firm does not have to keep those recordings for longer than five years
- If a competent authority does request them, they should be retained until the competent authority needs them or they indicate that the recordings are no longer of interest
- If a firm is unclear, it should contact the competent authority for confirmation

# Recording of communications: Level 3

**Q5 and Q11: What types of communications are covered?**

- Includes (amongst others) video conferencing, fax, email, Bloomberg mail, SMS, business to business devices, chat, instant messaging and mobile device applications
- Conversations / communications with a client / person acting on behalf of a client
- Relates to an agreement by the firm to carry out one of the covered activities whether as principal or agent, or to reach an agreement to carry out one of the covered activities, even if does not conclude an agreement (including prices, solicitations, bids, offers, indications of interest and requests for quotes)
- Such as transmitting an order to a broker or placing an order with an entity for execution, conversations or communications relating to the handling of the order (including solicitations and acceptance of transactions)

**Q6: Can the monitoring function be done by compliance or does it need to be a separate department?**

- No separate department is required by MiFID II
- However, monitoring is an essential piece of the overall compliance and monitoring system a firm has to implement through governance arrangements

**Q7: Is the recording obligation a critical or important function for outsourcing rules?**

- Taping will be considered to be a critical or important operational function

**Q8: Does the recording need to be from start to end?**

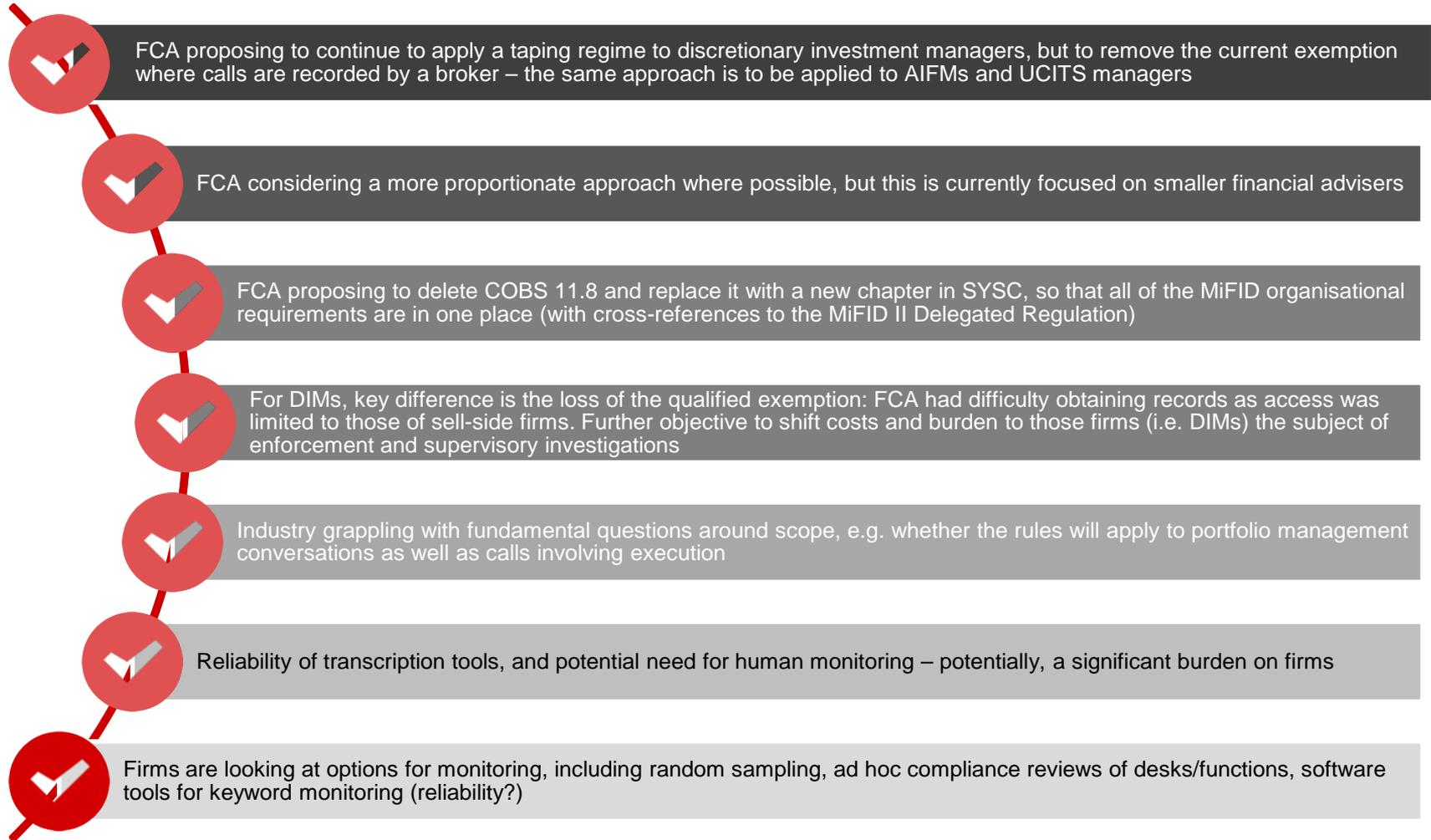
- Yes – firms need to record the entirety of telephone conversations and electronic communications
- This is because it is impossible to appreciate upfront whether the conversation will lead to the conclusion of a transaction

**Q9: Does giving clients access to the recording include a firm's internal communications?**

- Yes. The obligation extends to internal conversations and communications between employees and contractors of the firm which relate to the provision of the order

# Recording of communications

## *UK implementation: the headlines*



# What else are buy-side firms thinking about?

## Some other hot topics for the buy-side include:

- **Client categorisation of local authorities:** Per-se professionals where meet large undertaking tests, but otherwise retail unless opted-up. Proposed opt-up criteria consist of the qualitative test plus a re-calibrated quantitative test (required size of FI portfolio increased to £15,000,000)
- **Enhanced focus on inducements more generally, including gifts and hospitality**
- **Product governance:** PROD rules to be applied as guidance to AIFMs and UCITS managers; questions around scope and applicability to segregated portfolio managers and adviser-arrangers
- **ESMA Distribution Guidelines:** Industry concerns around practical workability in an open architecture context
- **Best execution:** Potential for application of MiFID II standards to UCITS managers and AIFMs
- **Disclosure of costs and charges:** Significant technical challenges for firms include:
  - development of systems to facilitate disclosure
  - interaction with other EU requirements (such as PRIIPs and the UCITS KIID)
  - disclosure of forward-looking costs at the point of sale
  - ease of obtaining information from others in the value chain

# The non-EU dimension

# How does MiFID impact the buy-side in a global context?

**EU investment manager or subsidiaries of global groups**

**Non-EU firms managing assets for EU clients on a cross-border basis**

**Non-EU firms acting as manufacturers or distributors of financial products in scope for product governance**

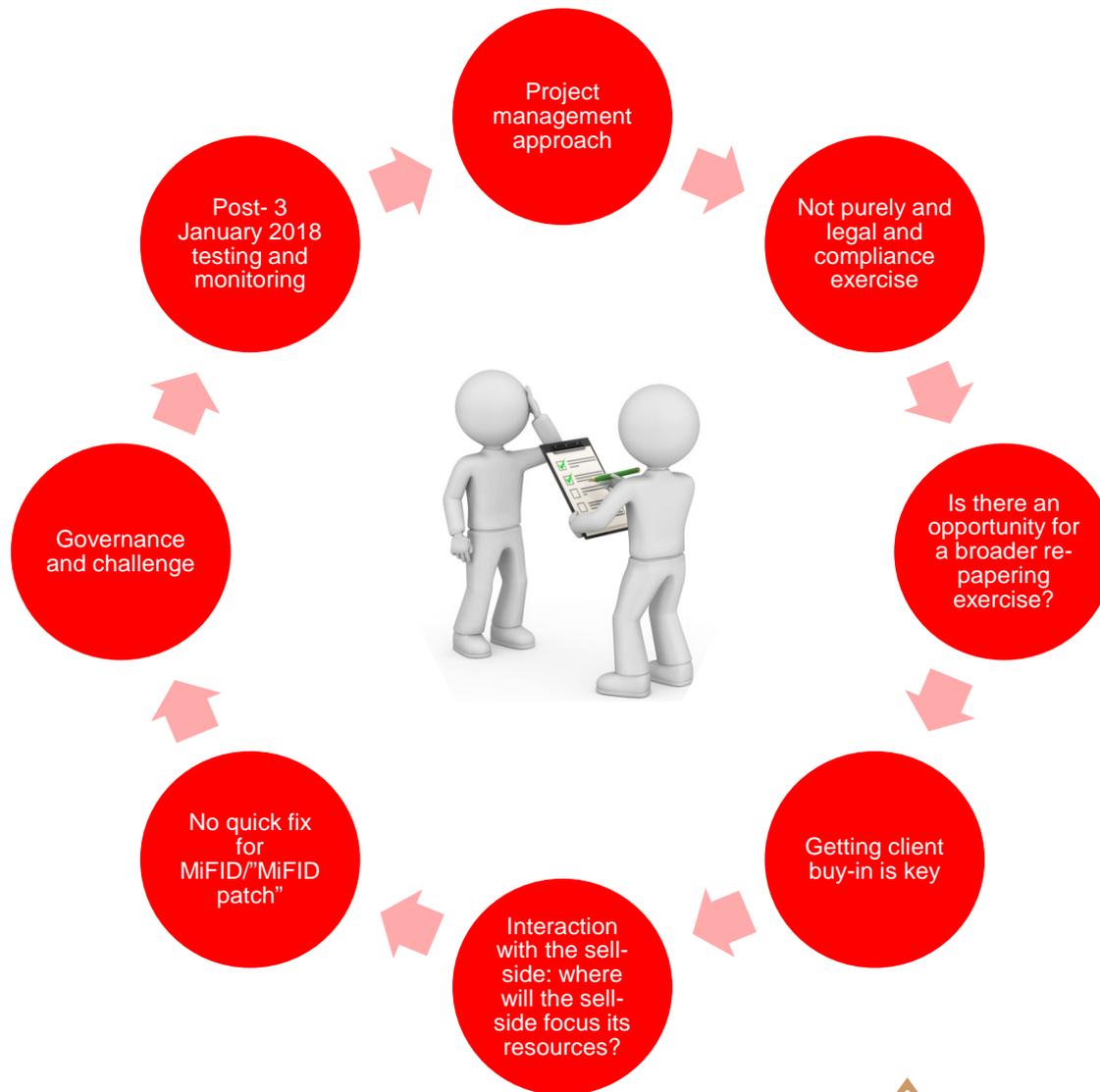
**Non-EU firms trading on EU markets**

**Non-EU firms receiving services from EU firms subject to MiFID II requirements**

**Non-EU firms providing sub-advisory or execution services to EU fund or portfolio managers**

# How is the buy-side preparing?

# How is the buy-side preparing for 3 January 2018?



# Our technical resource: Pegasus

Publications

Events

Learning and development

Online services

**Technical resources**

The Eurozone

Banking reform - Our guide to Banking reform

Capital Markets Union

AIFMD insight - Our guide to the AIFMD

Reinsurance - Our guide to reform affecting the insurance industry

Phoenix - Our guide to UK regulatory reform

The UK Corporate Governance Portal - access to the latest corporate governance developments

Blockchain, distributed ledgers, smart contracts and cryptocurrencies

OTC Oracle - Our guide to OTC derivatives regulatory reform

Legal privilege

UCITS insight

**Pegasus - Preparing for MiFID II**

Our products and experience

Legislation tracker

Legislation and

## Pegasus

Preparing for MiFID II



MiFID II and MiFIR (together 'MiFID II') will underpin the provision of investment services across and into Europe, both in terms of how trading is carried on and how firms organise and conduct themselves. They will affect both the wholesale and retail sides of the industry, in relation to both securities and derivatives. Nor should MiFID II be seen as solely European, as its effect will be far reaching and influence all firms dependent on the European client base.

Recently legislation delaying the implementation of MiFID II to 3 January 2018 was published in the Official Journal of the EU. Despite the delay, firms need to continue to press ahead with their implementation work. There is still a lot to do to be ready in time for the new implementation date. In addition, the UK's referendum vote to leave the EU should not be taken as a sign for firms to stop their work as it is expected that MiFID II will be implemented before the UK concludes its exit negotiation. The FCA's statement on the EU referendum result stated: "Firms must continue to abide by their obligations under UK law, including those derived from EU law and continue with implementation plans for legislation that is still to come into effect."

To say that MiFID II / MiFIR will change the way European markets operate in the future is without doubt hugely underplaying the likely impact of this legislation and staying on top of developments will be crucial for firms. Our blog, [Regulation tomorrow](#), tracks global regulatory developments. In particular the EU pages track materials published by the European authorities, as well as various member states' regulators, including those relating to MiFID II / MiFIR. Subscription to the blog is free and updates can be received on a daily or weekly basis.

**We are committed to helping firms keep on top of MiFID II**

Pegasus is our dedicated online resource housing all our MiFID II know-how and links to other resources clients will need for any MiFID II project.

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**Register to receive email updates**



**Any questions?**

***If you have any further questions, please email us at  
financial.services@nortonrosefulbright.com***

# 3. Sell-side topics

**Hannah Meakin**

**Partner**

**Norton Rose Fulbright LLP**



# In this session we will cover:

**Appropriateness**

**Research**

**PFOF**

# Themes for the sell-side

Need to understand your category before you can determine what conduct rules apply and how to comply with them

How do the markets obligations impact the investor protection rules? – e.g. trading obligation and best execution

Who is your client?

- Can you have more than one?
- Can you have none?

Concepts

- What does execution mean? Does it always mean the same thing?

# Investor protection requirements

	Introducing brokers	Executing brokers	Clearing brokers	Systematic internalisers	OTF operators	MTF operators	Proprietary traders (assuming no clients)	Comments
<b>Conflicts of interest</b>	Y	Y	Y	Y	Y and special duty in Art 18	Y and special duty in Art 18	X	All types of clients
<b>Product governance</b>	Y	Y	Y	Y	Y	Y	Y	Manufacturers and distributors
<b>Inducements</b>	Y	Y	Y	Y	Y	N	N	Not ECPs
<b>Appropriateness</b>	Y	Y	Y	Y	Y	N	N	Ex only, in practice, just retail clients
<b>Best execution</b>	Y	Y	Y if executing orders	Y	Y	Only Art 27(3) applies	N	Not ECPs
<b>Order handling</b>	Y	Y	Y if executing orders	Y	Y if executing orders	N	N	Prompt rule doesn't apply to ECPs

# Appropriateness

# Appropriateness: overview



# When is appropriateness not necessary?

## Non-complex products

- Execution or reception and transmission only but not granting credit or loans
- Service is provided at client's initiative
- Firm has clearly told client it need not assess appropriateness and client does not benefit from that protection
- Firm complies with conflicts duties

## Professional clients

- Firm can assume they have necessary knowledge and experience
- Products and transactions for which the client is professional client

# What is a complex financial instrument?

## List of non-complex products **narrowed**

### **The following are automatically deemed to be complex:**

- Shares that embed a derivative
- Shares in non-UCITS collective investment undertaking (i.e. AIFs)
- Units in a structured UCITS
- Shares embedding a derivative
- Debt/money market instruments that embed a derivative or incorporate a structure that makes it difficult for client to understand risk
- Structured deposits which make it difficult for client to understand risk or return or exit costs

### **Third country markets may be deemed equivalent where:**

- they are subject to authorisation and effective supervision on ongoing basis;
- they have clear and transparent rules on admission of securities to trading;
- security issuers are subject to periodic/ongoing information requirements; and
- market transparency/integrity, i.e. ensured by prevention of market abuse

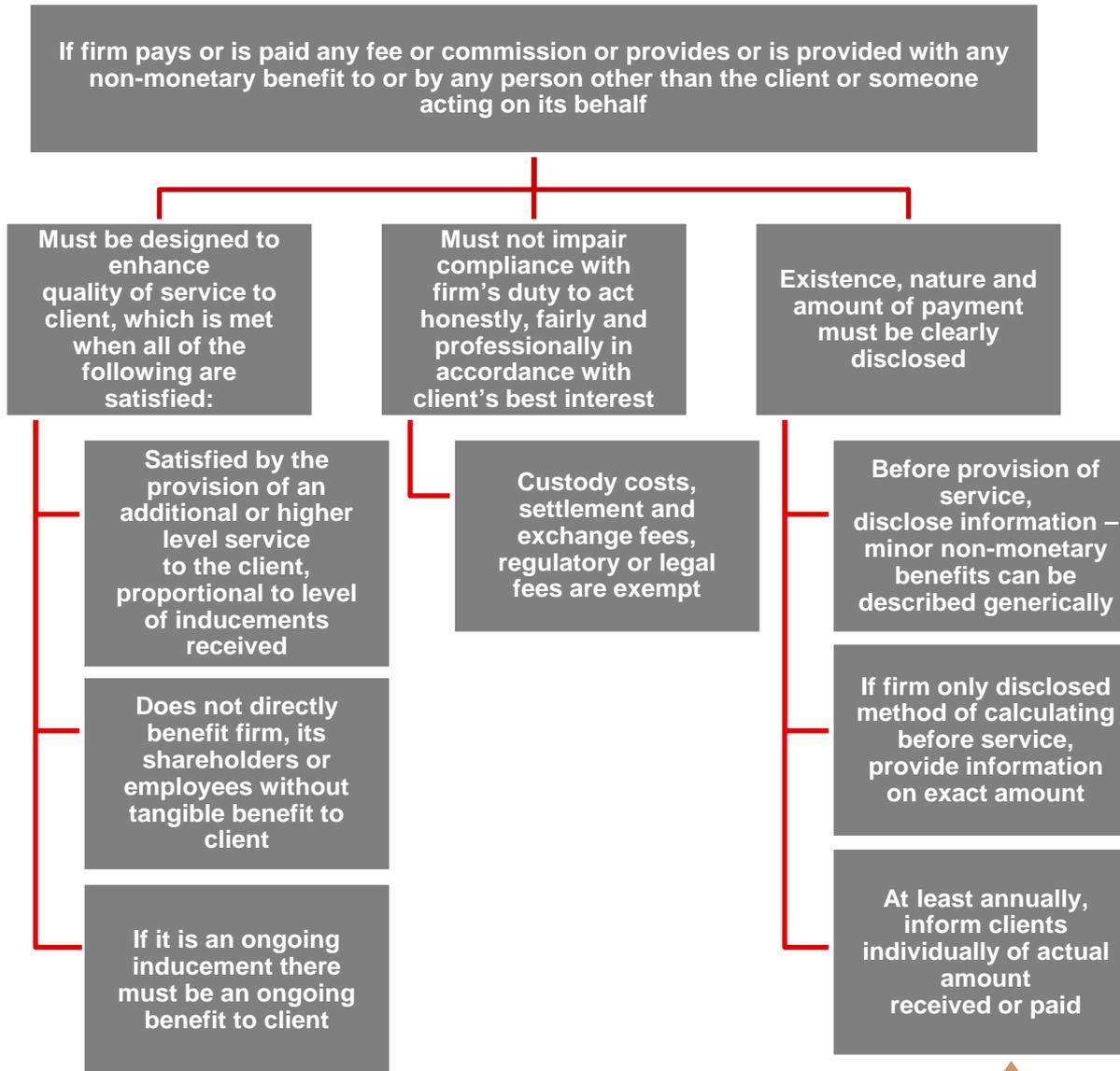
### **An instrument should also be considered as complex if it satisfies any of the following:**

- Derivatives and transferable securities with right to buy or sell securities or cash settlement by reference to an underlying
- Infrequent opportunities to realise at publicly available market or independently validated prices
- It involves actual or potential liability exceeding cost of acquiring
- Clause / condition / trigger that fundamentally alters the nature or risk of the investment or pay out profile
- Explicit or implicit exit charges with the effect of making the investment illiquid
- Inadequate publicly available information on characteristics or unlikely to be readily understood by average retail client needing an informed decision

**ESMA's Final Report: Guidelines on complex debt instruments and structured deposits  
(ESMA/2015/1783)**

# Inducements

# Inducements



- Why is this relevant?
- Considerable detail at level 2
  - Qualitative v quantitative evidence of enhancement of quality
  - How will firms demonstrate it?

# Inducements – independent advisors and fund managers

- Cannot accept and keep any third party payments other than acceptable minor non-monetary benefits
- Must be reasonable and proportionate and of a scale that is unlikely to influence firm's behaviour to detriment of client's interests
- Must disclose before providing service

- Return to clients fees, commissions and monetary benefits ASAP after receipt
- Policy to ensure that amounts are allocated and transferred
- Inform clients through periodic statements

## Acceptable minor non-monetary benefits:

- (a) Information or documentation relating to products or services which is generic in nature or personalised
- (b) Issuer commissioned/paid third party new issuance material provided relationship disclosed and made available at the same time to other investment firms or general public
- (c) Participation in conferences, seminars and other training events
- (d) Hospitality of a reasonable de minimis value
- (e) Other minor non-monetary benefits which a Member State deems capable of enhancing the quality of service and are of a scale and nature that are unlikely to impair compliance with duty to act in client's best interest

## Why is this relevant?

- Full price unbundling mandated
- No reference to execution-related services
- Where does this leave current permissible services?
- How will the FCA exercise its power?

# Inducements – research payment account

*Provision of research is not an inducement if firm pays through:*

**Own resources**

**OR**

## **Research payment account provided:**

- The account is funded by a specific research charge to client
- Set and regularly assess a research budget
- Firm is responsible for research payment account
- Firm regularly assesses quality of research against robust quality criteria set out in a policy
- Firm assesses its ability to contribute to better investment decisions
- Before providing service, tell clients of budgeted amount and charge and agree research charge and frequency in terms and conditions
- Provide annual information on total costs incurred by client for research
- If required by client or competent authority, provide further information
- All operational arrangements must identify research charge separately
- Tell clients about any increase in advance
- Any surplus at end of period must be rebated or offset against research budget for following period
- Allocation of budget is subject to appropriate controls and senior management oversight
- Cannot use to fund internal research
- Firm providing execution services must identify separate charges that only identify execution costs

## **Why is this relevant?**

- Where does it leave the CSA model?
- How do you make a research payment account work?
- Client money account implications
- Shutting off nil value service agreement

# What does this mean for your research?

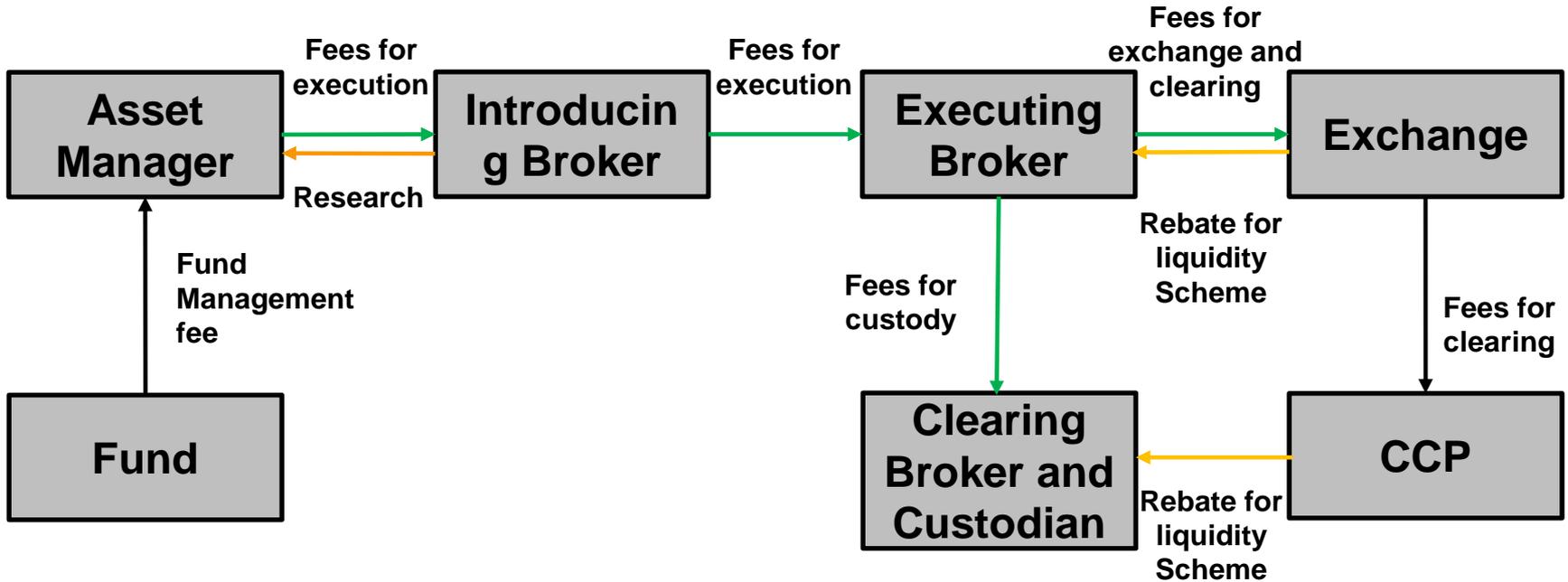
## Acceptable minor non-monetary benefit

- Limited types of research:
  - Short market updates with limited commentary or opinion
  - Communications between a trading desk and a trader in another firm seeking market information to immediately execute an order (e.g. on available liquidity or recently traded prices)
  - Material summarising public news stories (e.g. public quarterly results reports or other market announcements)
- Buy-side can receive
- Free goods argument is difficult and firms also providing execution can't provide research for free
- Recipient firms need to assess it – they may block or divert it via Compliance
- Sell-side could help with this but ESMA Q&A makes clear it is recipient's responsibility and not to rely on labels

## Investment research

- Buy-side will have to pay – themselves or through RPA
- Buy-side will have to assess quality of research and contribution to better investment decisions
- How to value research – who should value it?
- Must identify separate charges for execution only – any other benefit or service must be charged separately and not be influenced by payment for execution
- Providers should have systems and controls to stop providing unsolicited research where this is not wanted

# Worked example



## Key

- Banned
- Permitted
- Inducements to which tests apply
- To be discussed

# Investment recommendations

## Investment research

- Information recommending or suggesting an investment strategy, explicitly or implicitly, concerning one or several financial instruments or issuers, including any opinion as to the present or future value or price of such instruments, intended for distribution channels or for the public:
  - Labelled or described as investment research or in similar terms or otherwise presented as an objective or independent explanation of the matters contained in the recommendations; and
  - If it were made by an investment firm to a client, it would not constitute investment advice

## MAR requirements: apply to first part of definition only, but a range of producers

- Take reasonable care to ensure information is objectively presented and interests/conflicts of interest are disclosed – detailed obligations in RTS 2016/958
- Similar information must be provided about third parties who disseminate recommendations, including an indication of any substantive alterations
- ESMA Q&A on MAR contains guidance on what constitutes a recommendation – most conclude that this must be done on a case by case basis and one answer suggests that information not relating to a financial instrument or issuer could be within scope if it allows a reasonable investor to deduce an implicit recommendation

## MiFID II requirements: apply to investment firms and credit institutions

- **If it doesn't satisfy the MiFID II conditions:**
  - It should be treated and distributed as a marketing communication
  - It must make clear that it has not been prepared in accordance with legal requirements designed to promote the independence of investment research and that it is not subject to any prohibition on dealing ahead
- **Whether or not it satisfies the MiFID II conditions:**
  - It must comply with conflicts procedures and measures in relation to analysts involved in producing research and others whose responsibilities or business interests may conflict
- **If it does satisfy the MiFID II conditions:**
  - It is investment research and firms must have additional arrangements in place – e.g. to prevent dealing ahead of publication, personal transactions contrary to research, physical separation where appropriate and dealings with issuer and others with an interest in the subject matter

# Can you still trade at a spread?

**OTFs: Operator is not permitted to execute orders in the OTF against its own proprietary capital or that of an affiliate unless:**

- It is acting in a matched principal capacity as defined in MiFID II and has the client's consent; or
- In relation to sovereign debt for which there is no liquid market

**Matches principal means no market risk and no profit or loss, other than a previously disclosed commission, fee or charge**

**Firms must provide information on all costs and charges (widely defined) save that you can agree to a limited application for:**

- ECPs unless the financial instrument embeds a derivative and the counterparty intends to offer it to clients
- Professional clients unless the firm is providing portfolio management or investment advice or the financial instrument embeds a derivative

**Firms must be able to show that payments to and from third parties comply with inducements rules**

**Asymmetric price slippage is not permitted - unfair and not in line with best execution**

# What changes might we make to the agreements?

## Brokerage agreements

- Scope – e.g. changes in financial instruments
- Information including costs and charges
- Inducements and conflicts disclosures
- Transaction reporting
- Post trade transparency
- Brexit proofing?
- Ancillary documentation:
  - Best execution and conflicts policies
  - Opt up process

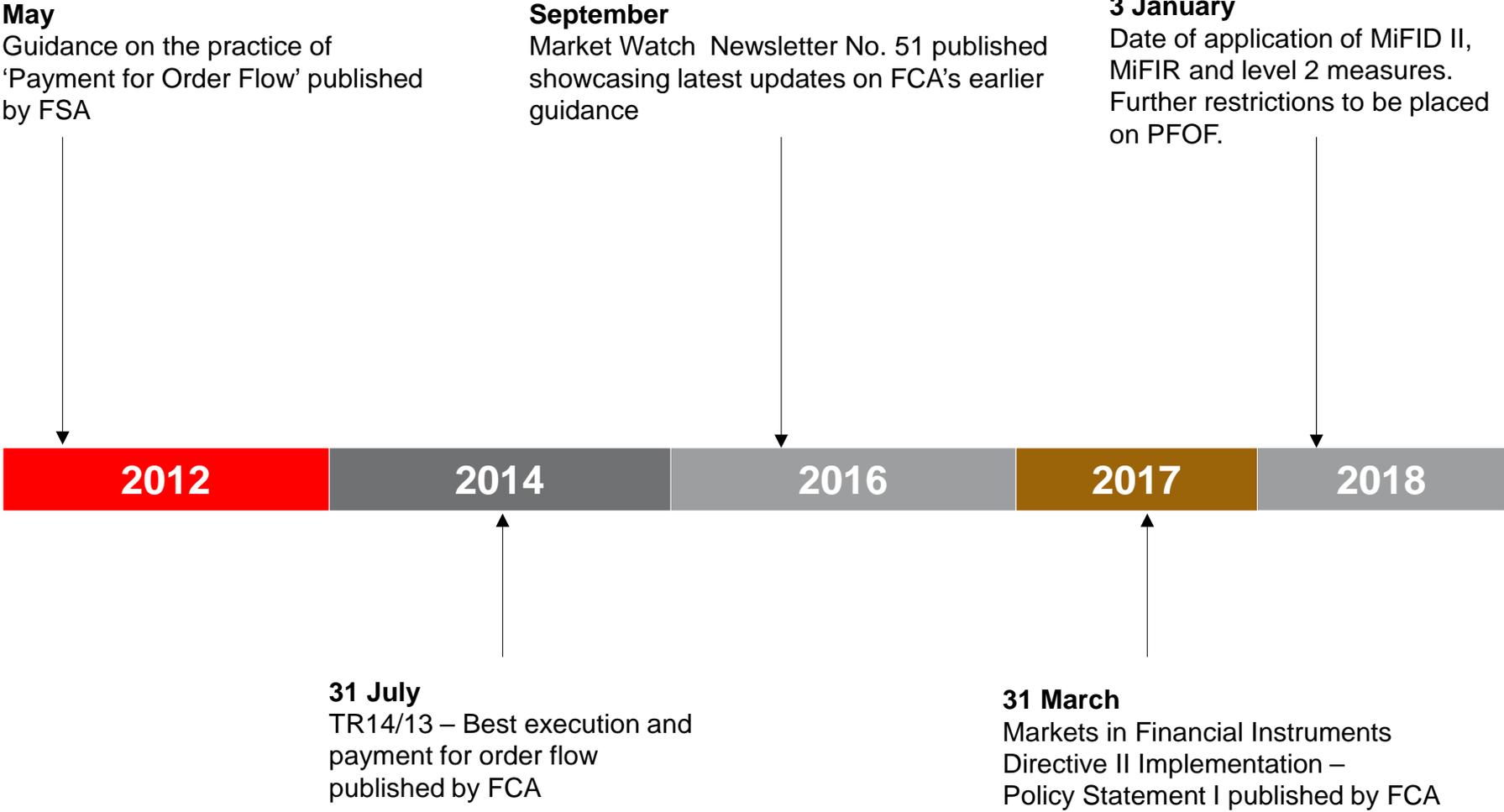
## MTF/OTF Rules

- Pre-trade transparency waivers and volume cap
- Access to and use of market data
- Personal data consents
- Offering transaction reporting?
- Position limits
- Suspension of products from trading
- Changes to reflect clearing and straight through processing (**STP**)
- Ancillary documentation
  - Market making agreements
  - Algo policies and procedures

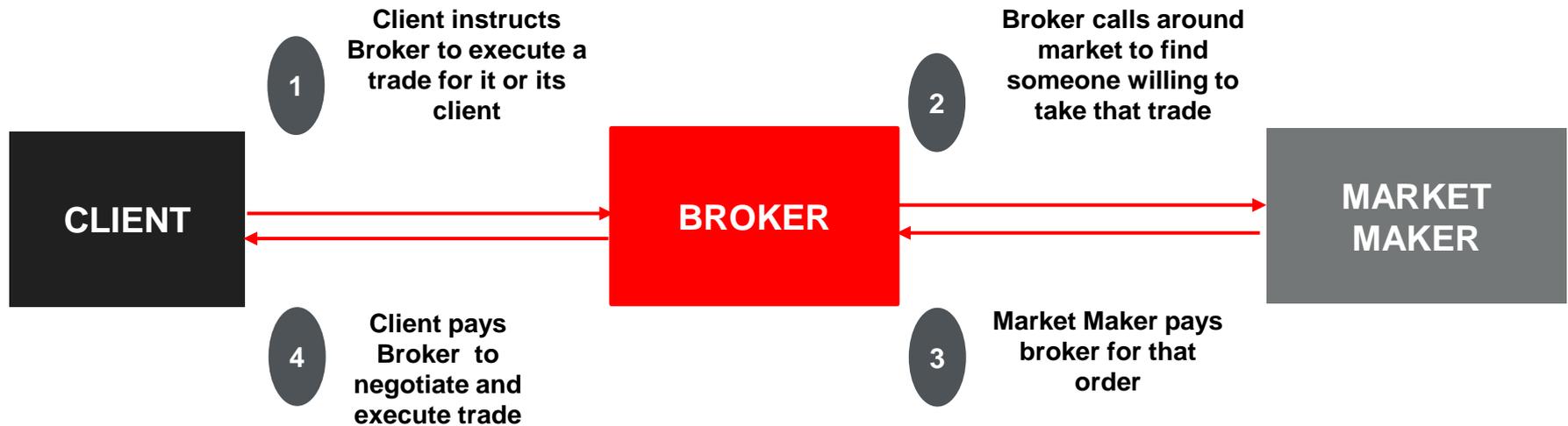
COBS 8A - Firms must have a client agreement.

# Payment for order flow (PFOF)

# Timeline: FCA publications on PFOF



# Basic PFOF Model



**Issue:** Can this be done in accordance with MiFID II obligations?

# Problems with PFOF – Inducements

## MiFID I / FCA concerns:

- Broker needs to demonstrate:
  - quality enhancement
  - broker's duties
  - disclosure (could be summary)
- FCA concerned that broker cannot comply with these conditions - how can broker justify that payment from market maker is designed to enhance the client's quality of service?

## What is MiFID II impact?

- Quality enhancement tests clearer under MiFID II:
  - proportionately better service
  - tangible benefit to client
  - services are not biased / distorted
- Disclosure requirements stricter under MiFID II - no summary
- PFOF payments are incompatible with rule on inducements
- Whilst inducements rules do not apply to firms dealing with ECPs, firms must still comply with conflicts of interest obligations under SYSC 10

# Problems with PFOF – Best execution

When executing an order for a client that legitimately relies on the firm to act on its behalf, a firm must take all reasonable steps to obtain the best possible results taking into account the execution factors

To engage in PFOF trades, firms must:

- Demonstrate that they compared available prices from different market makers, including those that did not pay for order flow and document that accordingly
- Monitor and review the effectiveness of their best execution arrangements on an ongoing basis

FCA was concerned that receipt of payment from a market maker may encourage broker to choose the market maker without considering best outcome for client

MiFID II requires firms to take all sufficient steps to not receive any inducement for routing client orders to a particular trading or execution venue which would infringe the requirements on conflicts or inducements. This will make it more difficult for PFOF to survive under MiFID II

Best execution does not apply to dealings with ECPs

# Problems with PFOF – Conflicts

## MiFID I/FCA concerns:

- Applies to all client types
- Firm must take all **reasonable** steps to identify and prevent conflicts of interest between itself and its clients, including operating effective organisational arrangements
- If the arrangements are insufficient to ensure with reasonable confidence that risks of damage to the interests of a client will be prevented, firm must clearly disclose the general nature and/or sources of conflict to the client before undertaking business for the client
- Disclosure should only be used as a last resort
- FCA says it has yet to see an example of an effective conflicts management arrangement for charging PFOF in ECP initiated trades

## How does MiFID II impact this?

- Higher bar for firms—must take all **appropriate** steps
- Disclosure of PFOF should be a last resort. A firm's reliance on disclosure may suggest that a firm has inadequate conflicts management arrangements
- FCA has expressly questioned whether it is possible to manage a direct, self-created conflict such as PFOF other than by ceasing the practice
- NB: Conflicts rules apply to ECPs as well as other clients so only dealing with ECPs does not solve this

# A couple of other points

# Best execution

## Question

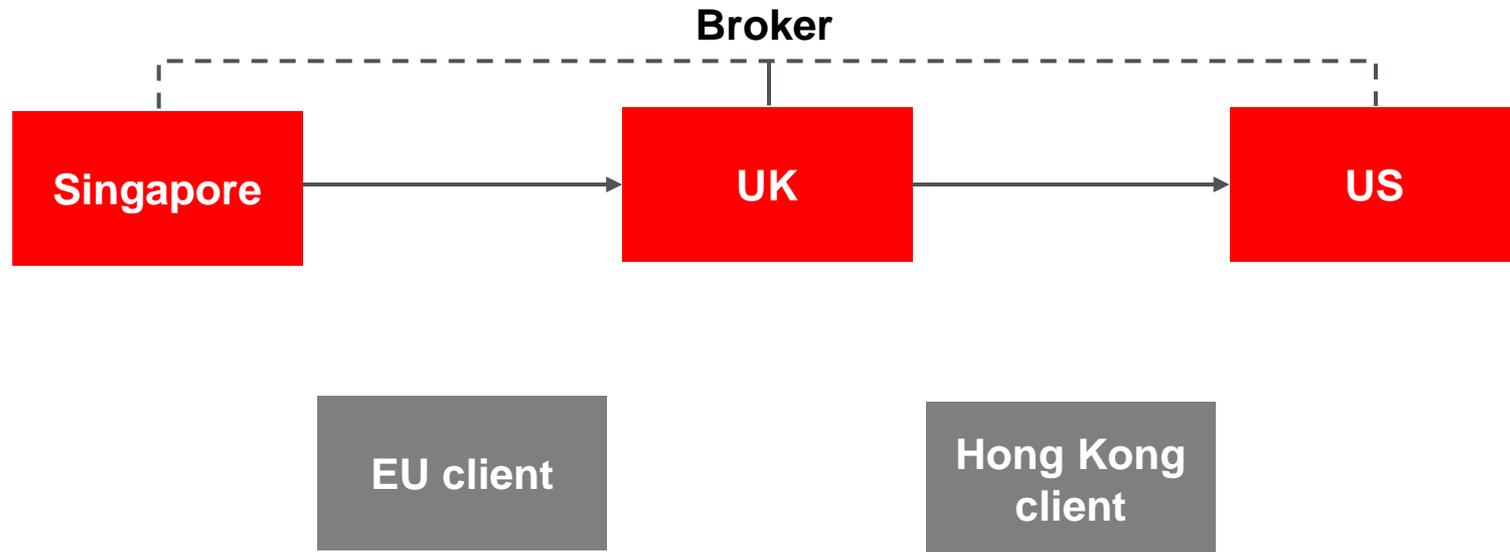
*How does the best execution duty relate to other obligations under MiFID II, particularly for OTFs and SIs?*

## Obligations

- *Best execution*
- *Trading obligation for shares*
- *Trading obligation for derivatives*
- *SIs making firm quotes*

- MTFs do not have to provide best execution; OTFs and SIs do
- OTFs have to exercise discretion but they cannot connect with an SI or another OTF in such a way that enables orders to interact. How limiting is this?
- An SI's quotes must reflect prevailing market conditions, and they can only price improve where the better price falls within a public range close to market conditions
- Best execution must be subject to the trading obligations, where these apply
- Where a firm is acting as agent for a client which is subject to best execution, the trading obligations should be observed

# Follow the sun models



- When do MiFID II conduct rules apply?
  - EU client
  - non-EU client
  - separate legal entities and branches
- Who is a client of which entity/branch?
- What does the client think is happening?



**Any questions?**

***If you have any further questions, please email us at  
financial.services@nortonrosefulbright.com***

## **4. Retail topics**

**Charlotte Henry**

**Senior Associate**

**Norton Rose Fulbright LLP**



# In this session we will cover:



**Key issues with product governance including disclosure of costs and charges**



**Interplay between advice and inducements including disclosure**



**Structured products and packaged products and linkages between MiFID II with PRIIPs**



**Recording communications**

# Product governance and intervention

# Product Governance / Distribution / Intervention

## UK Implementation



### • **PROD** includes:

- ✓ Existing statement of policy on FCA's use of FSMA temporary product intervention rule-making power
- ✓ MiFID II provisions as rules or guidance (see earlier slide)
- ✓ Additional information copied from RPPD to 'explain certain concepts'
- ✓ In due course, a new chapter will be included to implement the Insurance Distribution Directive which will contain additional product governance obligations for insurance products

### • **PROD** does not include:

- ✗ Will not include rules in relation to product intervention as these will be scattered throughout the FCA Handbook where relevant (i.e. similar to COBS 14.2 which restricts the sale of Cocos to retail clients)
- ✗ Will not yet cover other market sectors – so RPPD will remain for those other market sectors
- ✗ Blanket requirements for in-scope firms - the requirements are to be applied "*in a way that is appropriate and proportionate*" (PROD 3.1.2R) which takes into account the nature of the financial instrument/structured deposit/investment service and the target market

New rules in PROD will require existing distribution agreements to be reviewed/amended

New rules in PROD will require new distribution / co-manufacturing agreements to be entered into (i.e. in-scope firms manufacturing with out-of-scope firms)

# Product Governance / Distribution / Intervention

## UK Implementation – Scope and Territoriality

### Verbatim copy out but wider applicability

- Applied as **rules** for UK firms undertaking MiFID business (including appointed representatives)
- Applied as **rules** for UK firms manufacturing structured deposits (this will include banks)
- Applied as **rules** for EEA firms undertaking MiFID business from an establishment in the UK (but not where the EEA firm is undertaking business on a cross-border basis only into the UK)
- Applied as **rules** for UK firms undertaking MiFID business into other EEA states (whether on a cross-border basis or from an establishment in that member state) but not where the business is provided from an establishment in that member state to clients in that member state (as then the rules of the host member state apply)
- Applied as **rules** for Article 3 MiFID exempt firms
- Applied **by contract** to in-scope firms dealing with out-of-scope firms (i.e. in-scope distributor dealing with out-of-scope manufacturer)

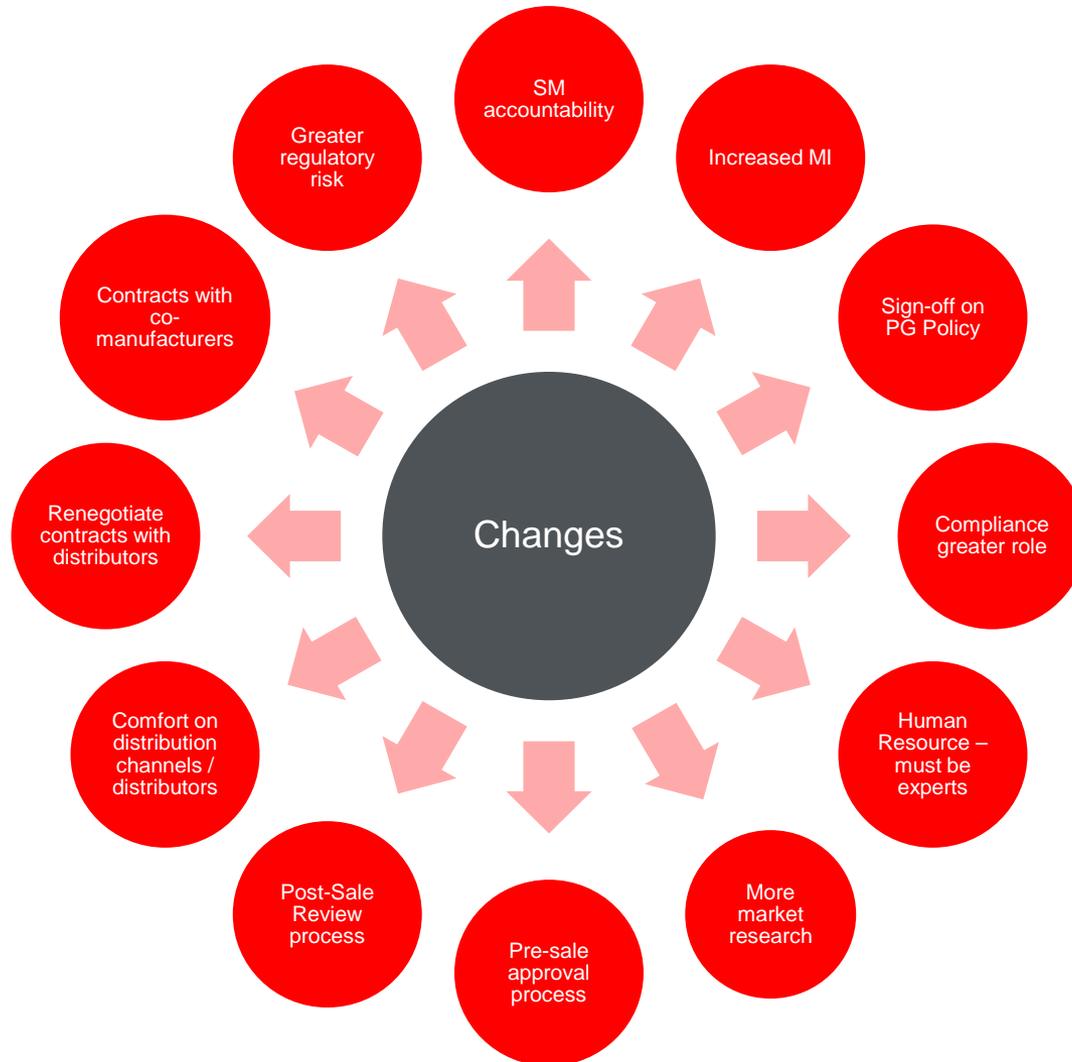
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*an evolution of existing standards rather than requiring significant change*

”

- Applied as **guidance** for other non-MiFID firms that manufacture or distribute MiFID financial instruments (UCITS, AIFMs) or structured deposits (but note the application of PROD as rules for banks manufacturing structured deposits)
- Applied as **rules** for UK branches of third country firms and to third country firms (even if no UK branch) where there is a UK client unless they are relying on the Overseas Person Exclusion or are otherwise not ‘doing business’ in the UK

# Impact



# Transitional arrangements

## Back book of products

- Draft guidelines: products manufactured / distributed before 3 January 2018 are out of scope
- Relaunch / reissue back in scope
- Products manufactured before 3 January 2018 but distributed after, in scope (treat product as if manufactured by an out-of-scope entity)
- PLUS: tie to annual review process

## Exceptions

- Reviewing existing distribution arrangements
- Existing products that are not closed off for investment

“

MiFID II product governance obligations are to be observed from the date of application of MiFID II

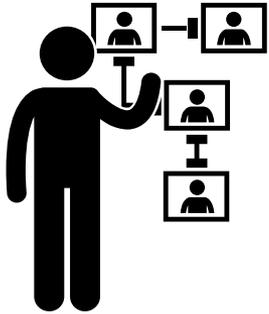
*ESMA Level 3 (draft)*

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# Challenges

# Challenges



## Definition of manufacturer

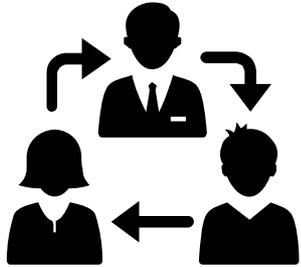
- 'creation, development, issuance and / or design'
- Co-manufacturers
- Link with PRIIPs: In scope for one regime, in scope for the other?



## Relationship with distributors

- Providing an 'adequate standard' of information to distributors
- Products sold to ECPs who on-sell
- Obtaining the right information to conduct robust product reviews
- Assessing the distribution network

# Challenges



## Out of scope entities

- Non-EEA manufacturers
- Non-EEA co-manufacturers
- Non-EEA distributors



## Financial instruments

- Distinguishing financial instruments from each other
- High volume financial instruments
- Feasibility of target market assessment (especially in portfolio management)
- Application to online distribution channels
- Logistical challenges with specific tailored information

# Territorial scope

- *Products sold from inside the EEA to outside the EEA*

Location of manufacturer	Location of counterparty	Location of counterparty's client	Subject to product governance arrangements?
EEA	EEA	EEA	<ul style="list-style-type: none"> <li>✓ If counterparty and client are retail or professional</li> <li>✗ If counterparty and client are ECP (unless client on-sells)</li> </ul>
EEA	EEA	Non-EEA	<ul style="list-style-type: none"> <li>✗ Unless client on-sells back into the EEA</li> <li>✓ If counterparty is retail or professional</li> </ul>
EEA	Non-EEA	EEA	<ul style="list-style-type: none"> <li>✓ If client is retail or professional</li> <li>✗ If client is ECP (unless they on-sell)</li> </ul>
EEA	Non-EEA	Non-EEA	<ul style="list-style-type: none"> <li>✗ Unless client on-sells back into the EEA</li> </ul>

# Challenges



## Conflicts of interest

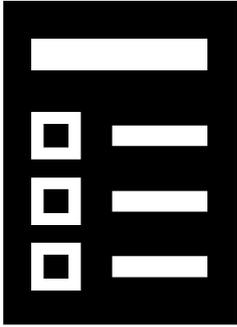
- Procedures and measures to ensure conflicts are managed
- Timing for analysing conflicts



## Proportionate implementation

- Assessing proportionality
- Evidence

# Challenges



## Product Approval Process

- Effective oversight
- Effective control
- Necessary experience of human resource in design process
- Scenario analysis – timeframe
- Scenario analysis – relevant scenarios
- Record-keeping and audit trail
- Triggers for re-approval



## Target Market

- Potential target market
- Theoretical knowledge
- ‘Sufficiently granular level’
- Link with PRIIPs



# Costs and charges

# Disclosure to clients

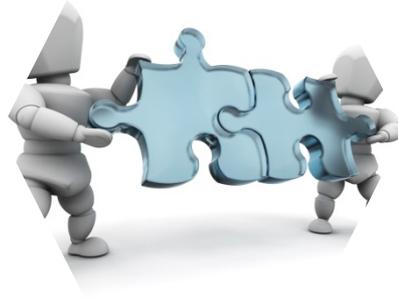
Subject to Brexit...



- Provide information on **costs / charges of services, advice, product** and how to pay
- **Aggregated** so a client understands the **overall cost** and **cumulative effect** on return (with an **itemised breakdown** on request)
- **Illustration to be provided of the cumulative effect** of costs on return when providing investments (both pre and post-sale)
- Provide “in good time” ex-ante and ex-poste annually
- Disclosure to all clients but professional clients and ECPs can **agree to receive** more limited information but not for portfolio management OR where there is an embedded derivative OR (for ECPs) where a product will be on-sold
- Level 2 includes prescriptive examples
- New COBS 2.2A and COBS 6.1-A
- Significant differences between current UK requirements and MiFID II, current requirements maintained for non-MiFID business
- PRIIPS is one of the EU measures that the UK dislikes

# Product Governance

Must disclose information on all costs, and associated charges, relating to both investment and ancillary services, and the financial instruments



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## Manufacturers

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Pass on information on costs

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What about where costs are built into the price?

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Pass over the KID instead (even though not designed for the distributor)?

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Inconsistent views in market – i.e. margin, underwriting costs

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Input into the illustrations?

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## Distributors

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Reliance on information provided by manufacturers (contractual protection)

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Any due diligence to be conducted?

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What if no costs are wrong / not fully disclosed? (i.e. agreed discounts)  
Overriding obligation of 'fair, clear and not misleading'

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Regulatory liability to customer for disclosing manufacturers' costs if they are incorrect?

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# Advice and inducements

# Existing UK regime

## MiFID II has a ban on retaining payments but...

...in the UK, regardless of whether a payment might meet the permitted inducement rules (COBS 2.3A):

- ✘ Cannot be paid to/received by advisors in connection with personal recommendation to retail clients (COBS 6.1A)
- ✘ Cannot be paid to/received by advisors re: referral to discretionary managers (COBS 6.1A.4AC)
- ✘ Cannot be paid by product providers (to advisors / platforms) (COBS 6.1B)
- ✘ Cannot be paid to/by platforms (some exceptions) (COBS 6.1E)
- ✘ Dealing Commission Rules (COBS 11.6)

“

We will be considering whether we need to make new notifications under MiFID II. It is possible that this may be necessary if, for example, we end up going ahead with our proposals on inducements

*FCA Article 4 notifications*

”



# Independent and restricted advisory businesses

## Retail

- Cannot receive at all (COBS 6.1A)
  - Payments for 'Genuine non-RDR services' used to be excluded from the ban (i.e. payments that were not in connection with the personal recommendation, provided they still met inducements test)
  - Now only 'reasonable minor non-monetary benefits' can be received in connection with any advisory business
  - Go to COBS 2.3A.15R for list of non-monetary benefits (for investment business)
- OR
- Go to COBS 6.1A.5AR for list of non-monetary benefits for other business



## Professional

### Independent advice

- Cannot receive and retain fees, commission or monetary benefits (COBS 2.3A.12R)
- Cannot accept non-monetary benefits other than 'acceptable minor non-monetary benefits'
- Go to COBS 2.3A.15R for list of acceptable non-monetary benefits

### Restricted advice

- Not expressly addressed
- Still stay within COBS 2.3A as is MiFID business. So any monetary or non-monetary benefit would need to comply with COBS 2.3A.15R

# Portfolio management businesses

## Retail

- Cannot receive at all (COBS 2.3A.11R)
- 'Acceptable minor non-monetary benefits' excluded
- Go to COBS 2.3A.15R for list of non-monetary benefits



## Professional

- Cannot receive and retain fees, commission or monetary benefits (COBS 2.3A.12R)
- Cannot accept non-monetary benefits other than 'acceptable minor non-monetary benefits'
- Go to COBS 2.3A.15R for list of acceptable non-monetary benefits

# Permitted non-monetary benefits

Question of fact whether the inducements conditions are satisfied (COBS 2.3.14G).

- **Non-monetary benefits in connection with independent/restricted advisory businesses to retail clients that relate to business that is not investment business)**

## COBS 6.1A.5AR

Category 1: Information or documentation relating to a RIP or service that is generic in nature or personalised to reflect the circumstances of an individual client

Category 2: Investment research

Category 3: Participation in conferences, seminars and other training events on the benefits and features of a specific RIP or service

Category 4: Hospitality of a reasonable de-minimis value, such as food and drink during a business meeting or a conference, seminar or other training events in Category 3

- **All others**

## COBS 2.3A.15R

Category 1: Information or documentation relating to a financial instrument or investment service that is generic in nature or personalised to reflect the circumstances of an individual client

Category 2: Investment research

Category 3: Participation in conferences, seminars and other training events on the benefits and features of a specific financial instrument or investment service

Category 4: Hospitality of a reasonable de-minimum value, such as food and drink during a business meeting or a conference, seminar or other training events in Category 3

# Training – FCA Finalised Guidance (2014)



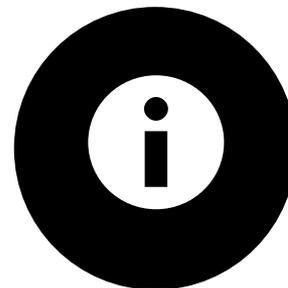
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## Permitted

Training available to all advisory firms on the features and benefits of providers' products or services

Training available to all advisory firms on subject areas relating to advisers' CPD

Reimbursement of reasonable costs incurred by advisory firms in organising training events. Providers can share the cost of training where more than one provider gives training provided it is UK based and the costs are for the actual training given



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## Not permitted

Paying advisory firms to attend training

Paying for training where there is no enhancement of the service to clients

Incentivising advisory firms to attend training through other means

Contributing disproportionately to the costs of organising a training workshop for a particular advisory firm

Paying for UK advisers to receive training outside the UK

# Conferences and Seminars: FCA Finalised Guidance (2014)



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## Permitted

Payments **to independent advisory firms** which are proportionate contributions designed to recover the costs associated with the providers' active participation (e.g. presenting on features / benefits of products / services or legislative / technical matters)

Payments **to independent advisory firms** calculated by reference to (i) the overall costs to the advisory firm in organising the event; (ii) the presentation time of the provider; and (iii) the number of advisers in attendance



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## Not permitted

Payments to participate in annual conferences without active participation (e.g. presentation stand)

Payments calculated by reference to cost of face-to-face meetings with each individual adviser

Payments for conferences / seminars outside the UK

Payments by sole providers or restricted advice product panels

Payments that are more than what advisory firms pay (advisory firms should pay 'significantly more')

Payments to reimburse all costs involved in running seminars and conferences

# Hospitality and Gifts: FCA Finalised Guidance 2014

- ✘ Expensive hospitality events including events overseas
- ✘ Events over a period of several days
- ✘ Events including the spouses / partners of advisers
- ✘ Sponsorship of events which cover a significant proportion of the costs of arranging the event
- ✘ Payments of ‘an unreasonable value’ (e.g. payments which do not satisfy all of the following:
  - Event is in the UK and not based on criteria that incentivises poor behaviour (e.g. volume of business generated) and is for business purpose (e.g. product training)
  - Food / drink payments are proportionate
  - Providing accommodation is necessary (e.g. event over 2 days, remote location)
  - Costs calculated on a ‘per head’ basis, assessed against previously agreed monetary limits set by an appropriate committee certified by a ‘second line’ function (e.g. compliance)
  - Prizes / gifts not extravagant / linked to business purpose (e.g. knowledge of provider’s products / services)
  - Hospitality / gift log maintained, cumulative payments assessed against monetary limits, logs regularly reviewed and independently audited by compliance periodically

“

*Providers are still taking advisers to comedy shows, pop concerts and golf tournaments*

”



# FCA's expectations

- ✓ If firms are in any doubt whether payments comply with COS 2.3, they should assume they do not and not make them or accept them
- ✓ Payments should not result in advisory firms recovering more than their 'reasonable' costs
- ✓ Both providers and advisers have an obligation to ensure payments and benefits do not create conflicts or amount to inducements – i.e. providers should feel free to conduct an audit of costs incurred by an advisory firm before making any payment
- ✓ The greater the amount of payments a provider makes, the more likely a breach of the rules will occur
- ✓ The guidance applies to payments to unregulated entities in the same group as the advisory firm



# Inducement disclosures

# Disclosure

**Acknowledge that the firm is receiving a monetary/non-monetary benefit**

**Describe the nature of the benefit (generic terms are acceptable)**



**Detail needs to be sufficient so that clients can decide whether to go ahead with the investment or seek more detailed information**

**Give a likely indication of the value of the benefit. This is to allow clients to be aware of the possible level of inducements**

# Structured products

# Issues

- FCA expectation that structured products cannot be sold to retail clients without advice
- Nuance between having a structured product versus a structured deposit
- Overlapping MiFID II and PRIIPs requirements regarding costs disclosure and performance scenarios
- Strict classification of structured products into 'complex' criticised
- Concern over the wide discretion that European supervisory authorities have been given to exercise intervention powers
- Distinction between manufacturers and distributors not clearly addressed

“  
Structured products market blasts MiFID II complexity test  
”





# MiFID II and PRIIPS

# Interaction between PRIIPs and MiFID II

## PRIIPs

- Very prescriptive disclosure
- Standardised and restrictive KID template

### Product disclosure

- Not as prescriptive as PRIIPs
- Left to firms to decide best format
- Overriding obligation that information is 'fair, clear and not misleading'

- Focusses on completeness and sufficiency of product cost disclosures

### Cost disclosure

- Focus on aggregation and disaggregation of price of instrument and service
- Rec. 78 of MiFID II – firms can rely on information contained in the PRIIPs KID for product costs
- NB: MiFID II also requires the provision of transaction cost information

- PRIIPs KID requires a "comprehension alert" for products that might be difficult to understand

### Product complexity

- MiFID II requires advice to be provided prior to sale for complex products

- Pre-contractual disclosure
- Kept up to date

### Timing of product information to investors

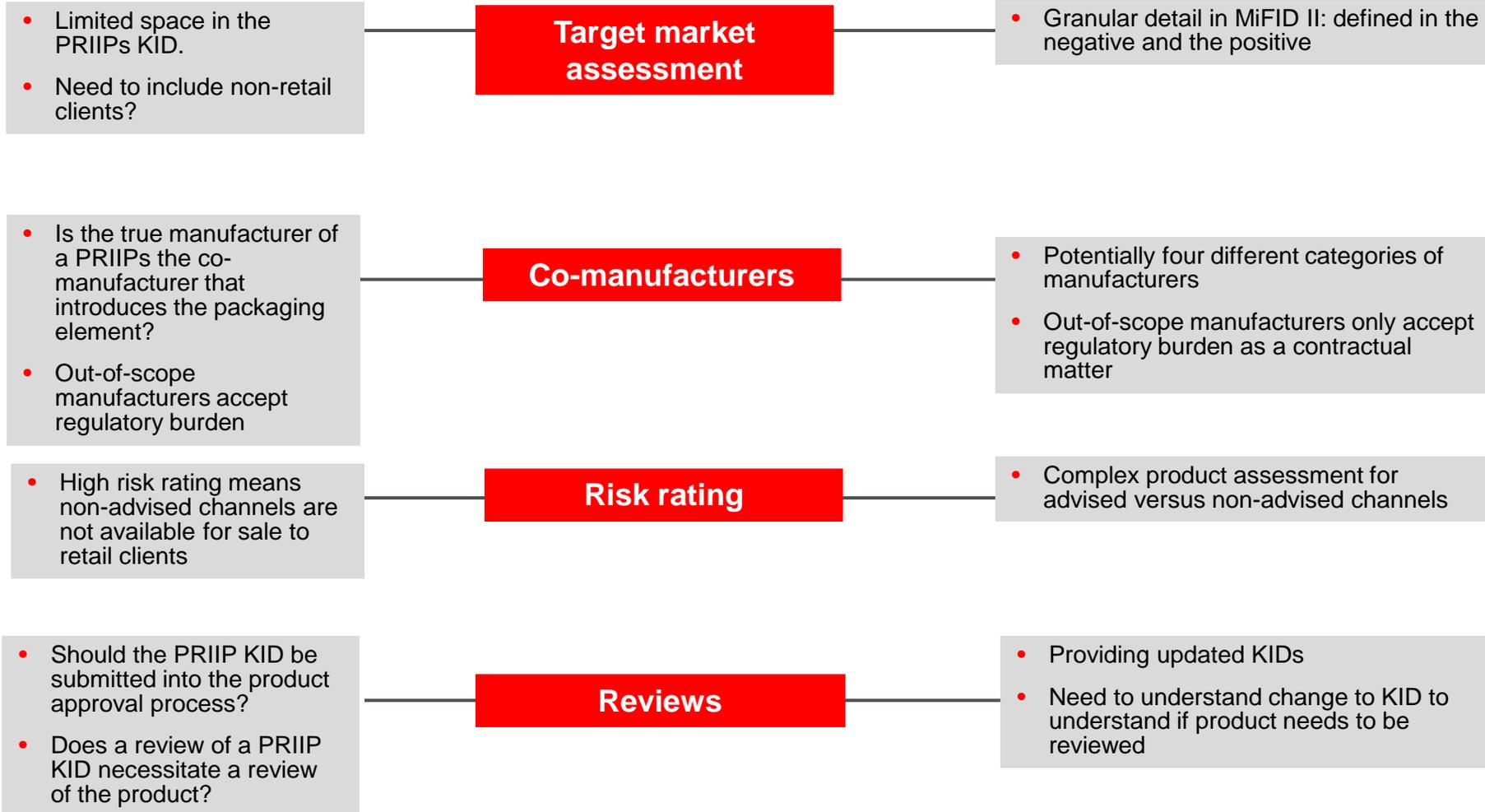
- Pre-contractual and generic
- Post-sale and specific
- Ongoing

## MiFID II

# Interaction between PRIIPs and MiFID II

## PRIIPs

## MiFID II



# Recording communications

# Latest from FCA: PS 17/5

## Article 3 retail financial advisers

- Flexibility in order to comply with 'at least analogous' requirements
- Either tape all relevant conversations OR take a written note of all relevant conversations
- Decision to be applied at the level of the firm as a whole (not in relation to individual conversations, or different advisers)



## MiFID firms that are retail financial advisers

- No flexibility
- Must comply with requirements
- FCA still finalising details firms must include in the note
- Expected to be published in June

FCA has earmarked this topic as likely to be in its post-implementation thematic review



**Any questions?**

***If you have any further questions, please email us at  
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# Get in touch with us



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The logo consists of a stylized, upward-pointing chevron shape in a gold color, positioned above the first letter of the text.

**NORTON ROSE FULBRIGHT**