

4 December 2015

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InfoNet



# *MiFID II/R Seminar*

## Investor Protection

Sponsored by



08.30 - 09.00      Registration

09.00 – 09.30      Presentation

*Jonathan Herbst, Partner, Norton Rose Fulbright*

*Hannah Meakin, Partner, Norton Rose Fulbright*

*Imogen Garner, Partner, Norton Rose Fulbright*

09.30 – 10.00      Presentation

*David Dudeney, Technical Specialist, Trading Compliance*

10.00 - 10.30      Q&A

*Jonathan Herbst, Partner, Norton Rose Fulbright*  
*Hannah Meakin, Partner, Norton Rose Fulbright*  
*Imogen Garner, Partner, Norton Rose Fulbright*

Financial institutions  
Energy  
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# **FIA Europe: Breakfast Briefing**

## **Retail and wholesale conduct – investor protection under MiFID II / MiFIR**

Jonathan Herbst, Hannah Meakin and Imogen Garner, Partners

Norton Rose Fulbright LLP

4 December 2015

# MiFID II: The big conduct themes

## MiFID I was not serious enough

- Belief that the letter of MiFID I was not fully implemented in areas such as best execution and conflicts so that a new, much thicker layer of regulation is needed
- Level playing field is the other side of this

## Suspicion of the industry

- Regulation as a solution to the ills of the principal / agent problem, asymmetric information and too many regulatory loopholes

## Retailisation

- Belief that there are limits in the ability of non-retail clients to appreciate the risk of their investments and a recognition that at the end of the chain often stands a retail customer

# Why it matters to the ETD market?

## Communication

What extra communications will you have to make at what points in the relationship?

How will those communications need to change?

## Information/ analytics

Where will you get the information you need?

What will you need to do with it?

How will you do that?

## Systems and controls

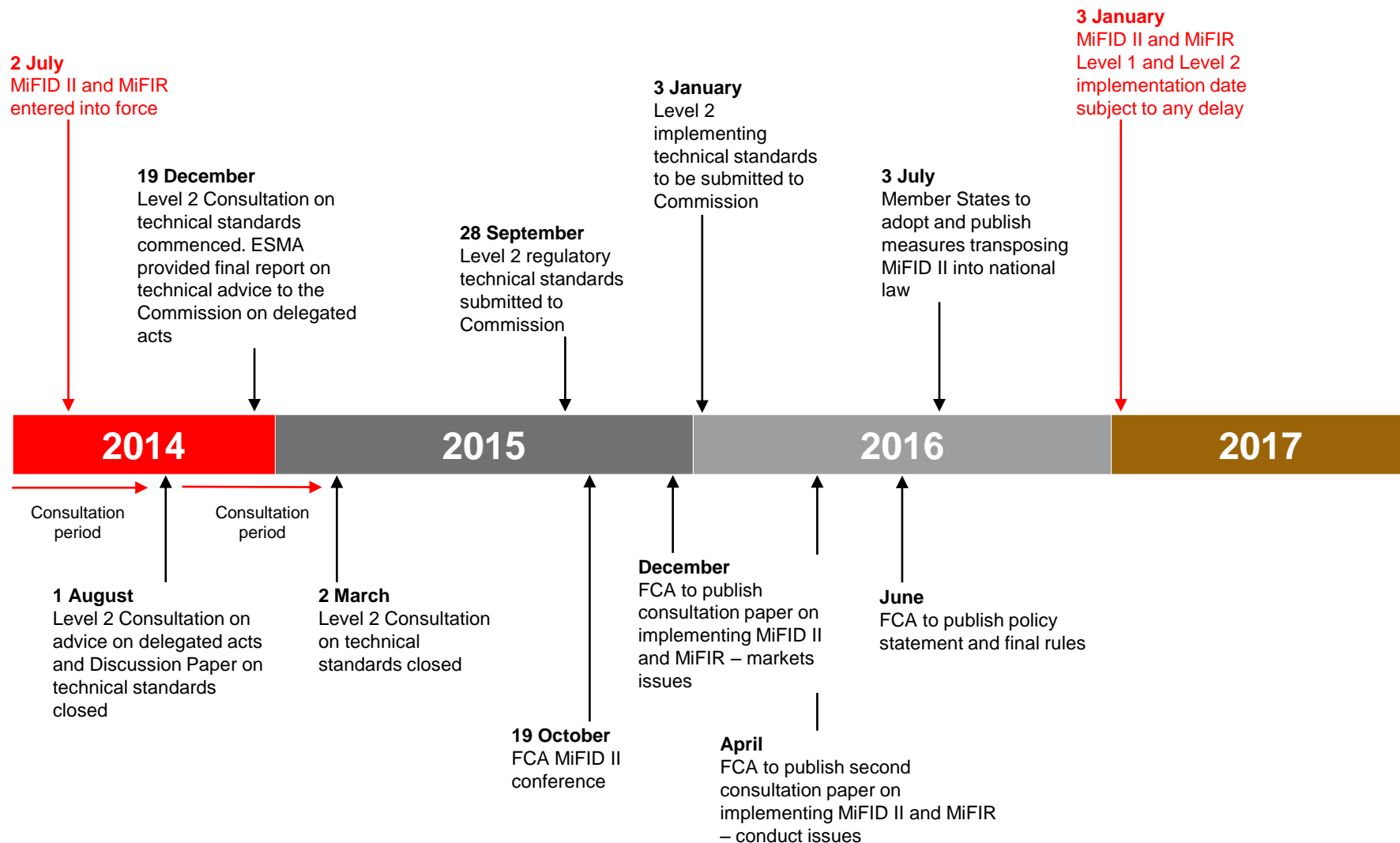
Which obligations will impact on your systems and controls?

## Product life cycle

Do you design or sell a product? What will you need to consider as a result – at what stages of the life cycle?

When and how can the regulators intervene?

# Timing: MiFID II / MiFIR



# EU implementation

## Delegated Acts

- The Commission will prepare the delegated acts on the basis of ESMA's technical advice – although it may elect to depart from it
- Required for:
  - Definitions and exemptions (HFT, DEA, Algorithmic trading)
  - Research
  - Investor protection
  - Reasonable Commercial Basis
  - MiFID 2 Annex 1 Section C
- Expected publication November or December 2015
- As soon as it adopts a delegated act the Commission will notify the EP and Council
- EP and Council will consider the delegated acts adopted by the Commission and have the power to object, provided they do so within 3 months (which can be extended by a further 3 months)
- Once a delegated act is adopted it is published as a Commission Delegated Regulation in the OJ

## Technical standards

- ESMA submitted the draft RTS to the Commission for adoption on 28 September 2015
- ESMA must submit draft ITS to the Commission for adoption by 3 January 2016
- Required for:
  - RTS: most detailed MiFID II and MiFIR requirements
  - ITS: disclosure and reporting requirements
- Within three months of receiving the RTS the Commission must determine adoption:
  - If the Commission adopts the RTS without amendment the EP and Council may object within one month (extended by another month)
  - If the Commission adopts the RTS with amendment the EP and Council may object within three months (which can be extended by another three months)
- On receiving the ITS the Commission has three months to determine adoption (can be extended by one month)
- Once adopted the RTS and ITS are published in the OJ as an implementing Regulation or implementing Decision



# UK 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
- FCA states that the biggest practical challenges will be around issues such as transaction reporting, commodities position reporting and the provision of information to ESMA for various purposes
- But a significant part of its work will be about communication so that firms can get to grips with the new legislation and deal with the various notifications, authorisations and variations of permissions
- How to keep informed: our technical resource *Pegasus* and our blog *Regulation tomorrow*

## HM Treasury

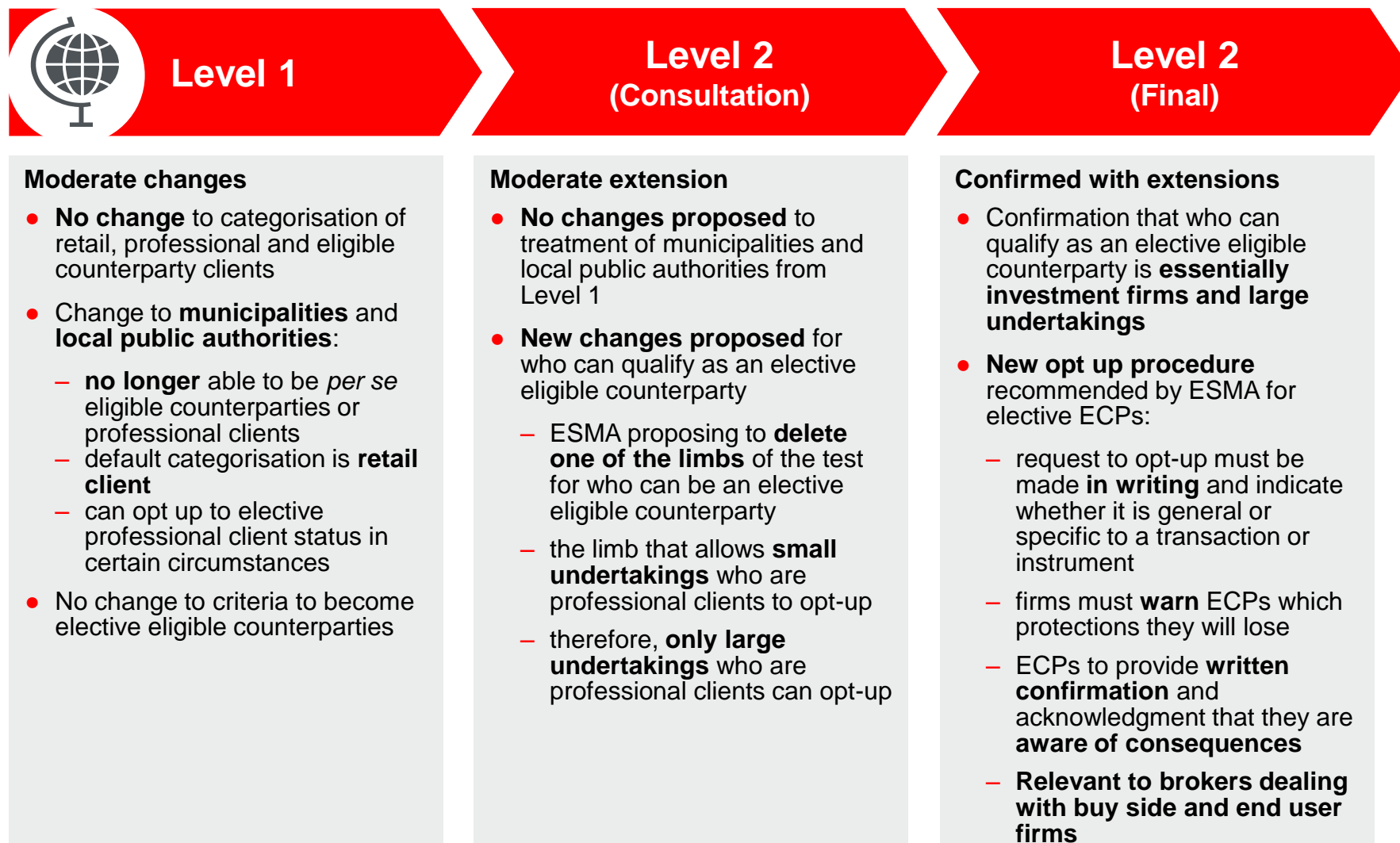
- March 2015: Published consultation paper on transposition of MiFID II
- Consultation closed 18 June 2015. Government expects that the draft legislation will be made in 2016

## FCA

- December 2015: Publication of the first consultation paper on implementing MiFID II – markets issues
- April 2016: Expected publication of second consultation paper on implementing MiFID II – conduct issues
- Q1 2016: New draft authorisation application forms to become available
- April 2016: FCA intends to start accepting draft authorisation applications
- June 2016: FCA feedback and policy statement confirming final changes to its Handbook
- July 2016: FCA authorisation applications can be submitted

# Communication

# Client categorisation



# Client categorisation



**Moderate impact** for those firms dealing with elective ECPs and municipalities/local public authorities

Firms dealing with local public authorities and municipalities will need to **reassess their categorisation** and downgrade them if they are categorised as ECPs

**New procedures** for opting up professional / retail clients to ECP status

Firms dealing with **small undertakings** that have been opted up to elective ECP may need to **recategorise them as professional clients**

## ISSUE

DP: FCA considering three options for opting-up local authorities to professional client status and is minded to implement a different system just for local authorities.

FCA considering extending retail client classification of local authorities to non-MiFID business

Create **new documentation** to go in ECP opt-up pack (may look similar to professional client opt up pack)

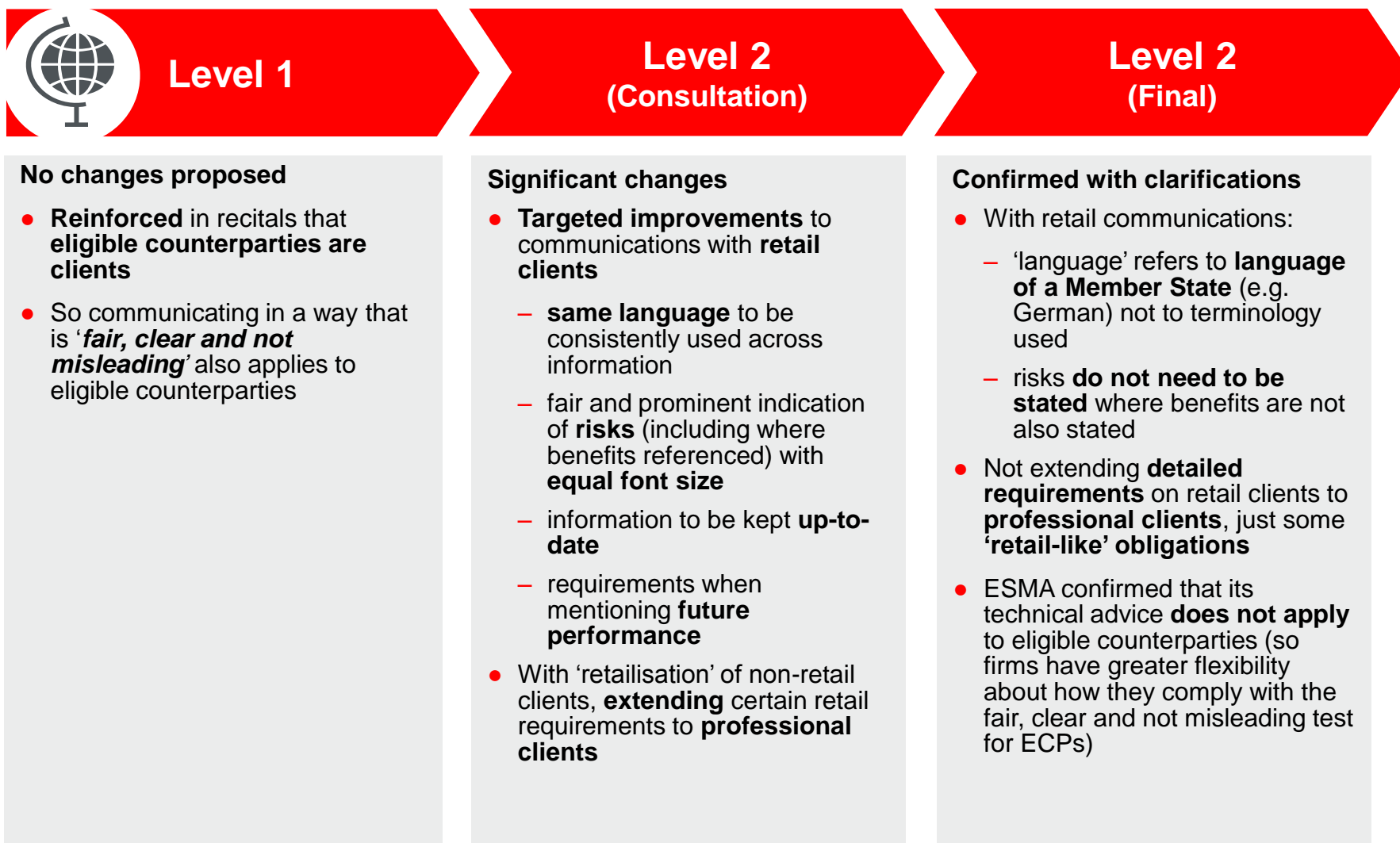
## ISSUE

Ensuring all staff know when a client has requested ECP status generally or **only** in relation to one or more specific trades / services / products.

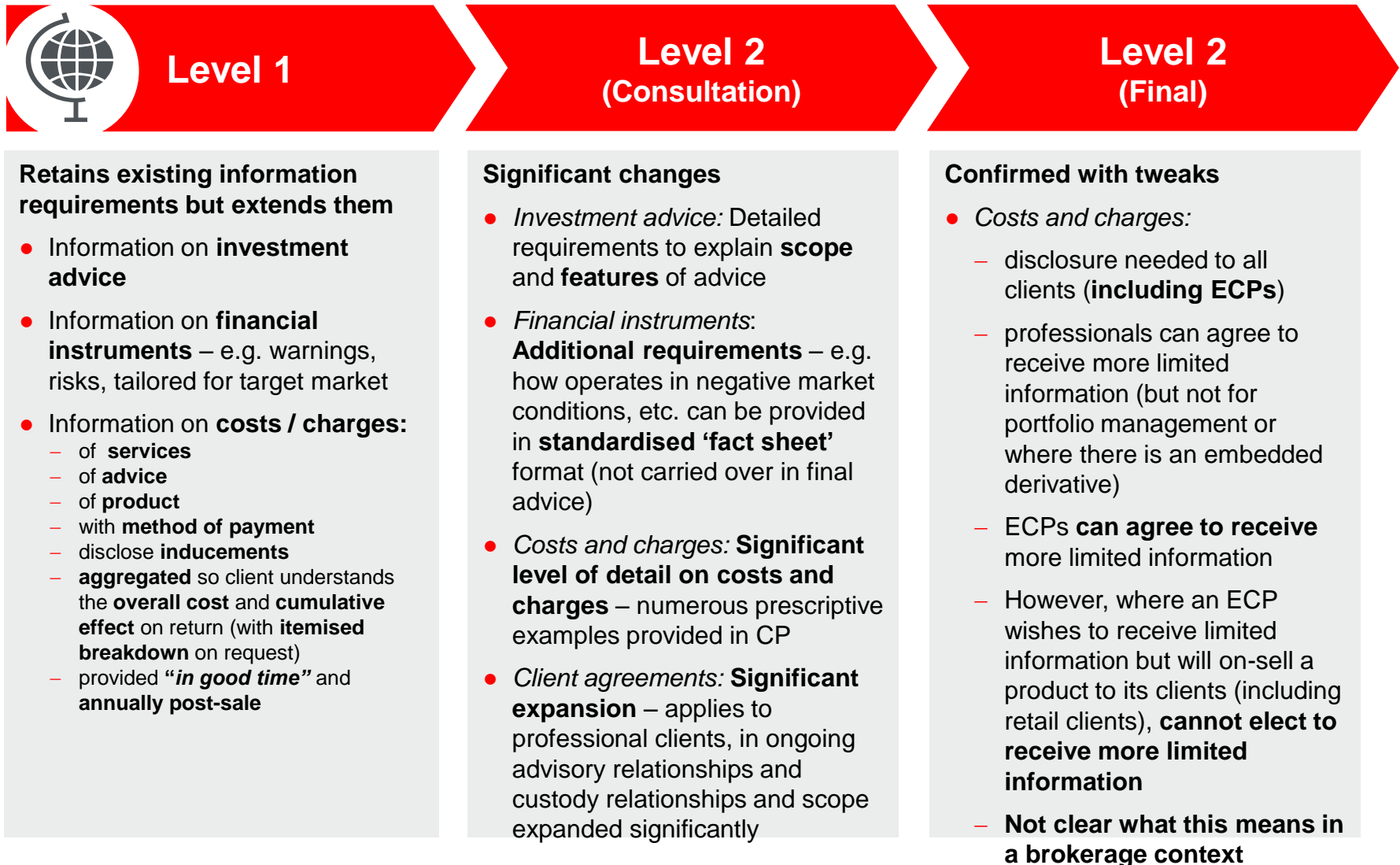
May need to **cease business** with local authorities / municipalities and small undertakings (previously categorised as ECP) if a firm's permissions do not extend to dealing with retail clients

**Staff training**

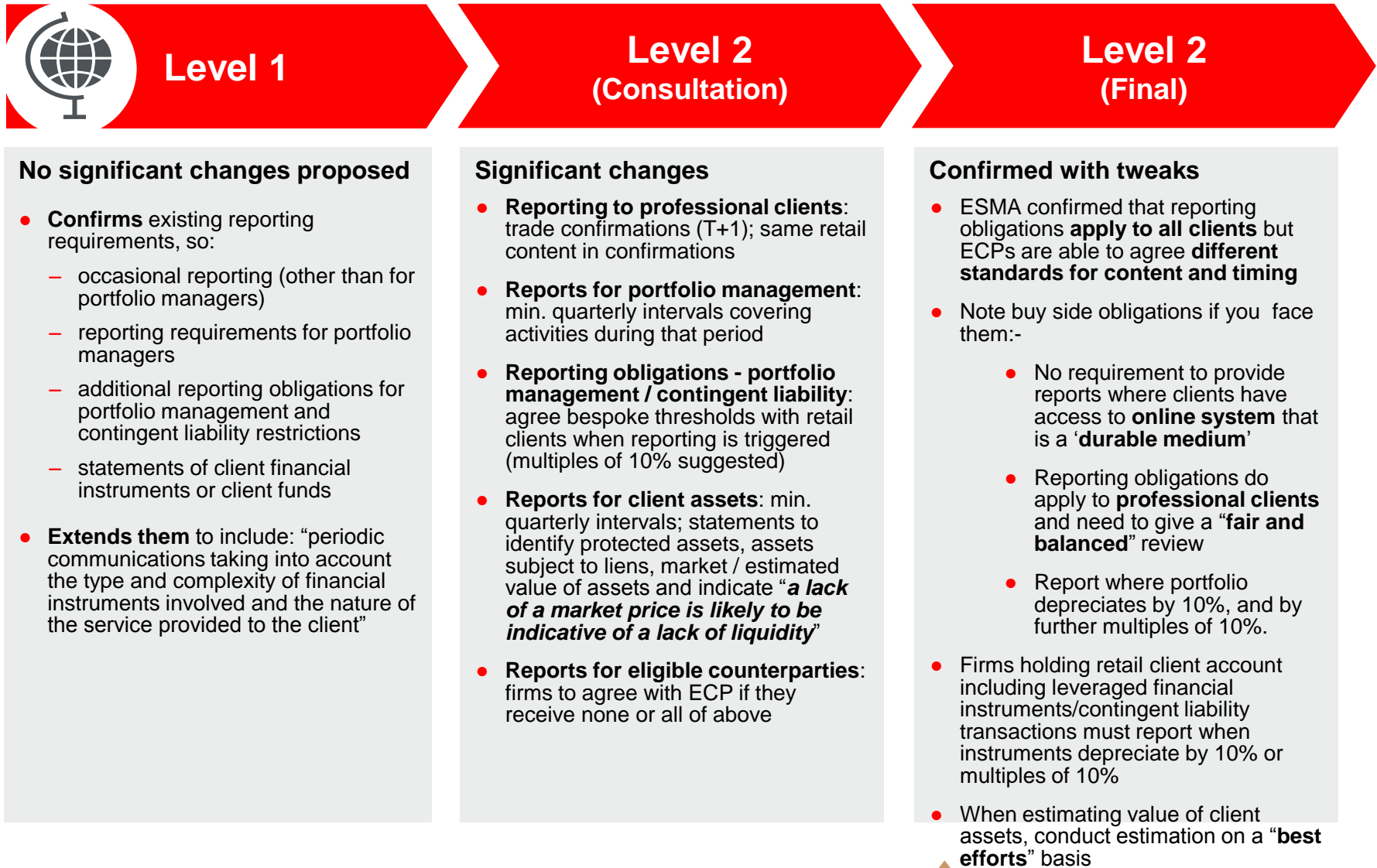
# Clear, fair and not misleading



# Information to clients



# Reporting



# Dealing with professional clients



## Moderate impact

Ensure communications with professional clients include **new “retail-like” requirements**

If wish to provide reports online, assess if website meets strict **test of being a “durable medium”** – need to keep record when clients view online records

Firms need to extend current reporting to retail clients to **also go to professional clients** (notwithstanding that professional clients may often ask for reports **tailored to their needs**)

Do firms’ **systems** need to be **updated** to allow for reports to be provided more frequently, under the new rules, (e.g. trade confirms to professional clients on a T+1 basis)?

Do **terms of business** need to be updated? Will firms agree with professional clients to apply a different standard?

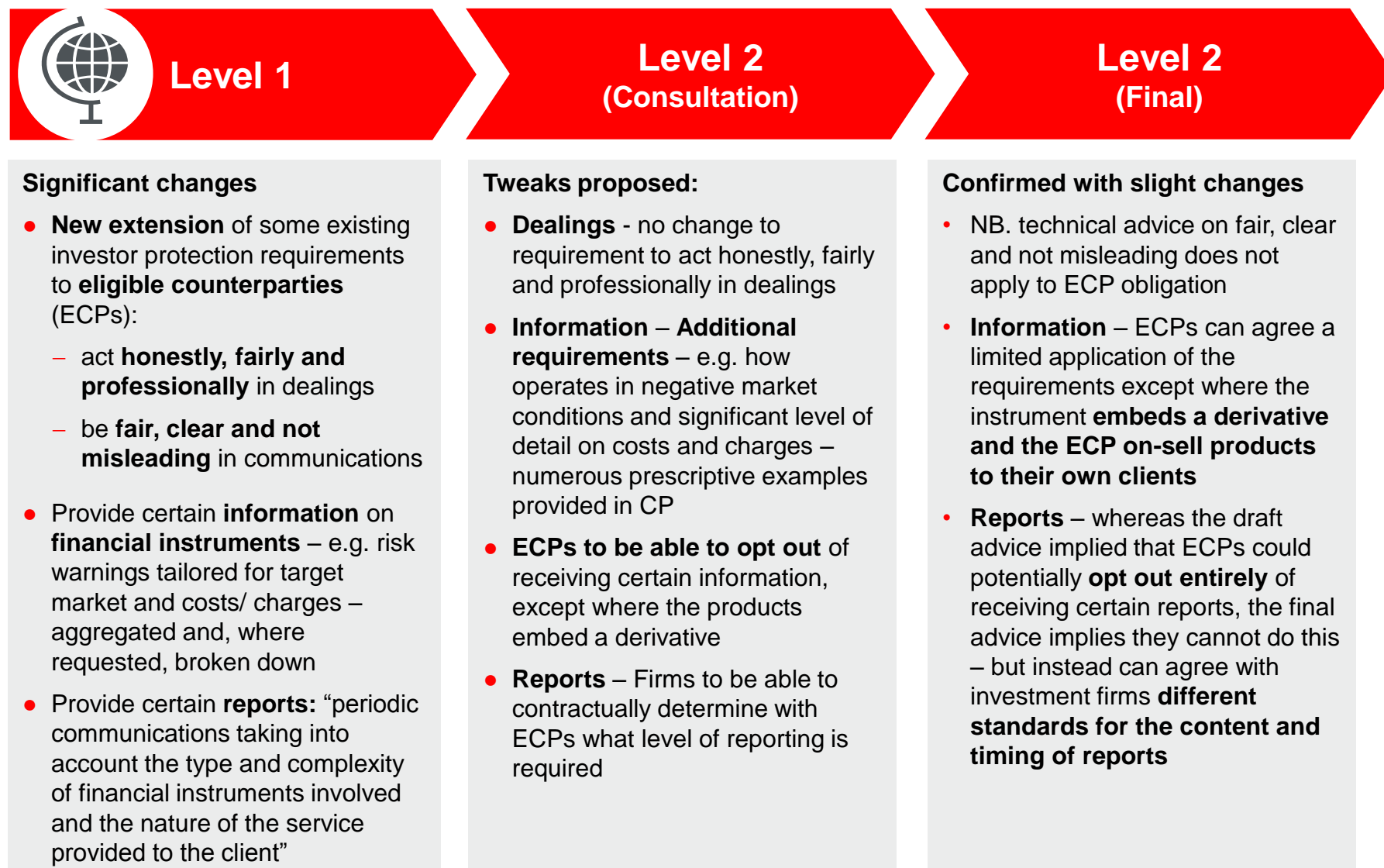
### ISSUE

Firms will need to aggregate costs and charges which may be challenging.

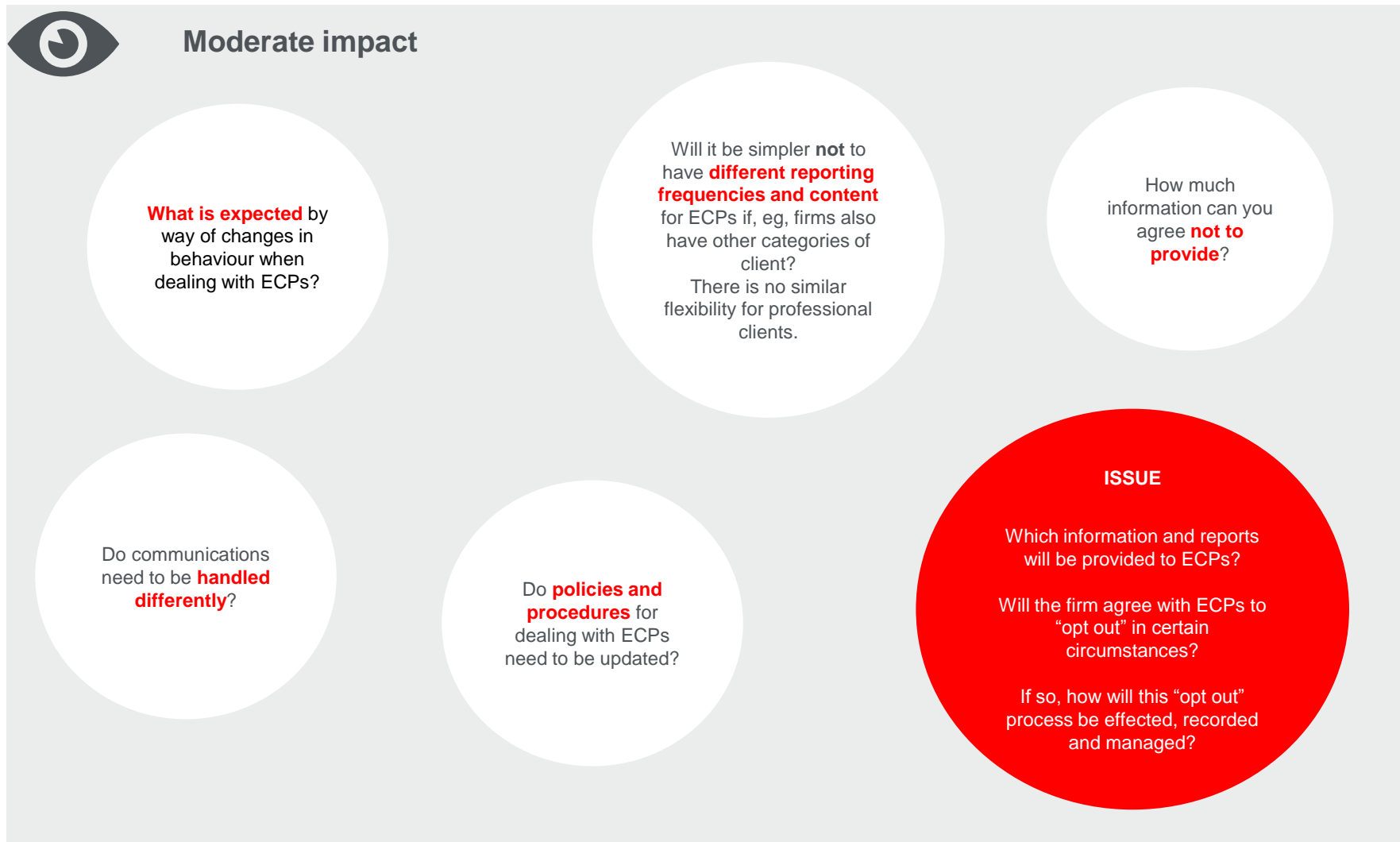
In the DP, FCA sought views on the technical challenges faced by aggregation and on how much standardisation it should prescribe – especially in costs disclosures to consumers.



# Dealing with eligible counterparties

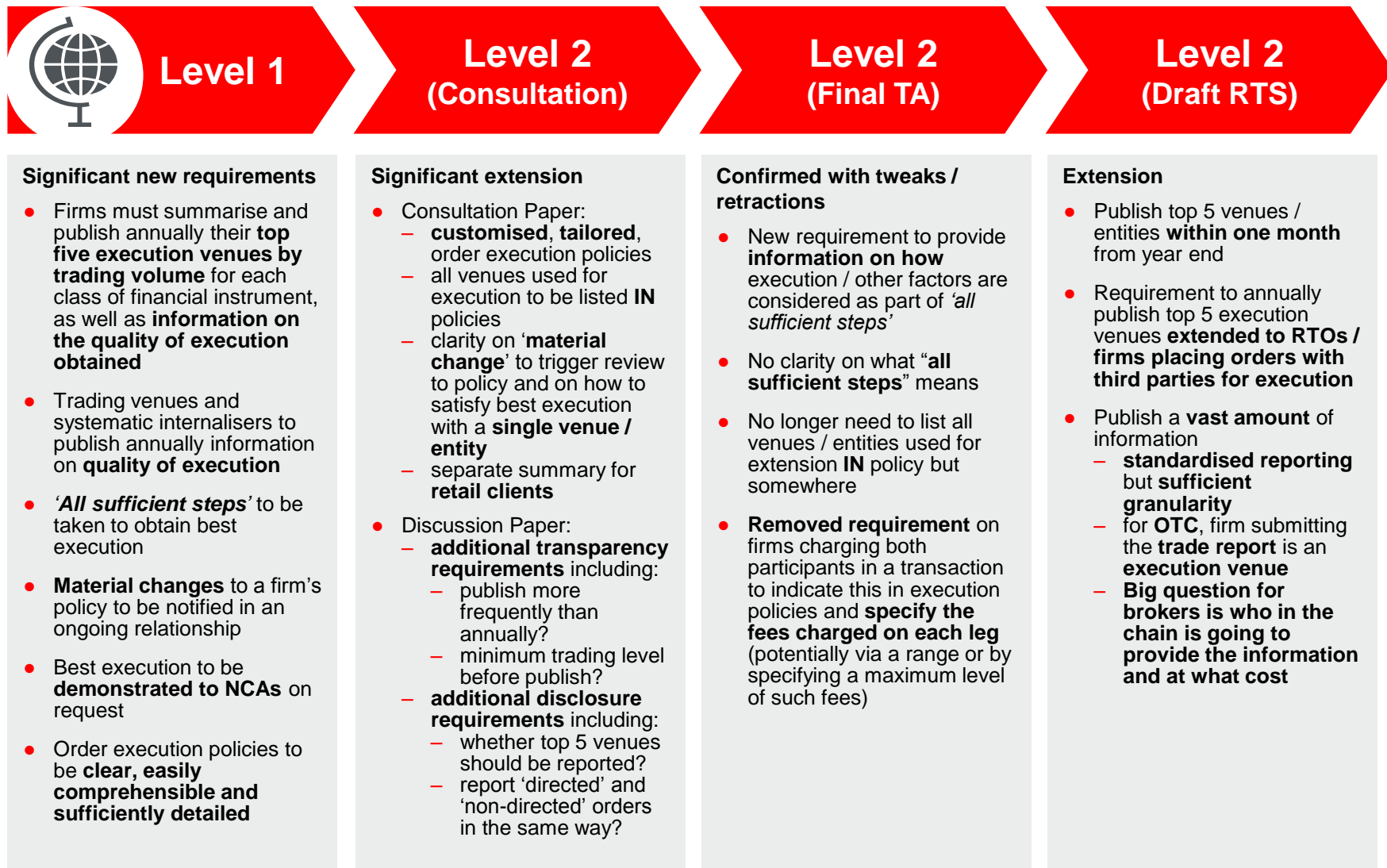


# Dealing with eligible counterparties



# Information/ analytics

# Best execution



# Publication of information – final draft RTS

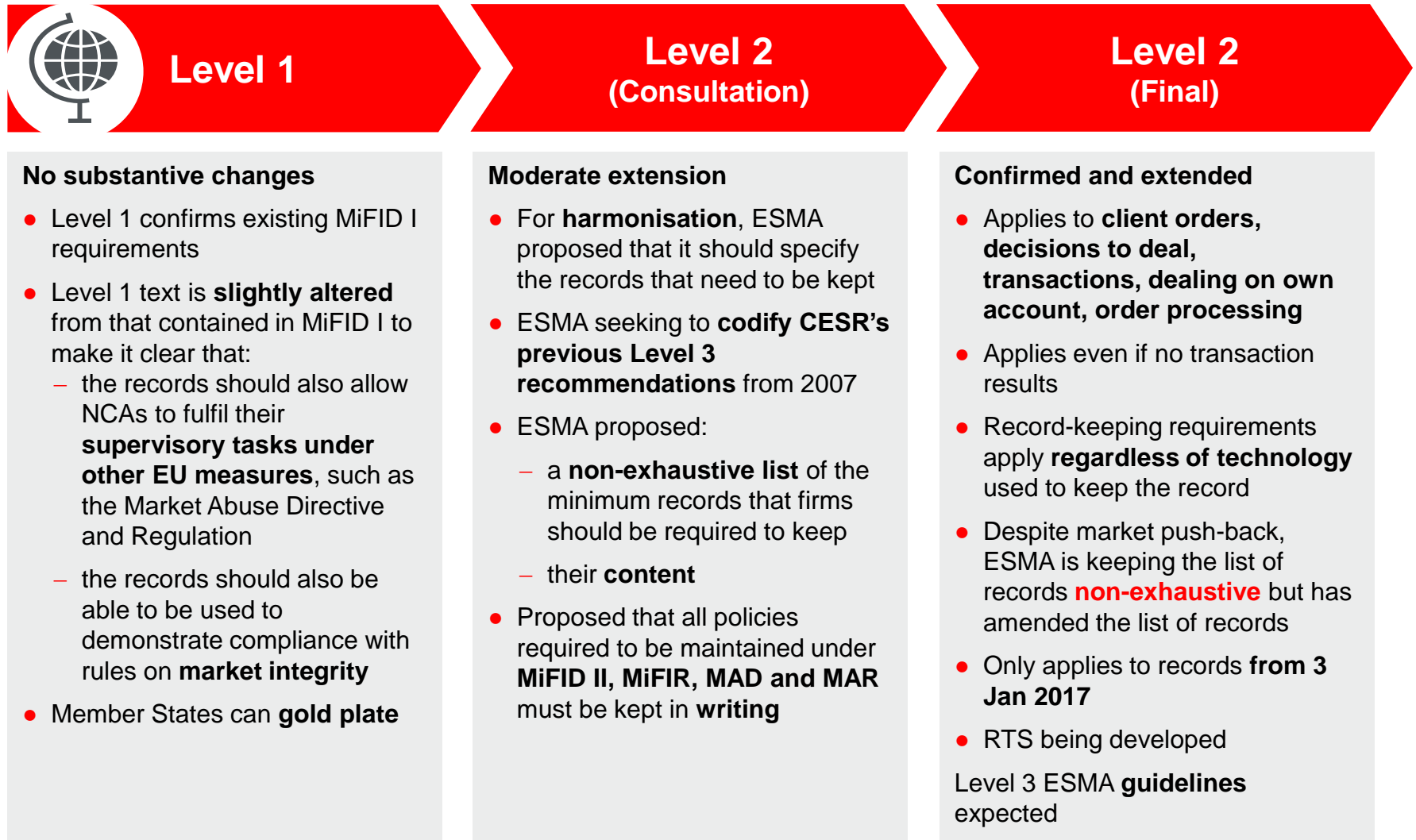
## Execution venues

- Publication by TVIs and SIs only for financial instruments subject to the trading obligation, not all execution venues
- Publication of data for each financial instrument for each market segment it operates, rather than single report
- Reduction in the quantity and simplification of data to be published
- Frequency of publication reduced to within three months, from within one month
- Requirement to calculate and record for each trading day has been maintained

## Investment firms

- Definition of execution venue maintained to include market makers, SIs and third country entities performing a similar function
- Separation of information relating to retail clients, professional clients and securities financing transactions to prevent distortion
- To protect commercially sensitive information, number and volume is expressed as a percentage of the firm's total
- Information on order flow and quality of execution now clearly separated to ensure easy processing by users

# Record keeping



# Record keeping



Minor impact – UK already super equivalent

Detailed recordkeeping  
requirements **already in  
place**

Records already  
required to be held **for 5  
years**

Policies already  
required to be held  
**in writing**

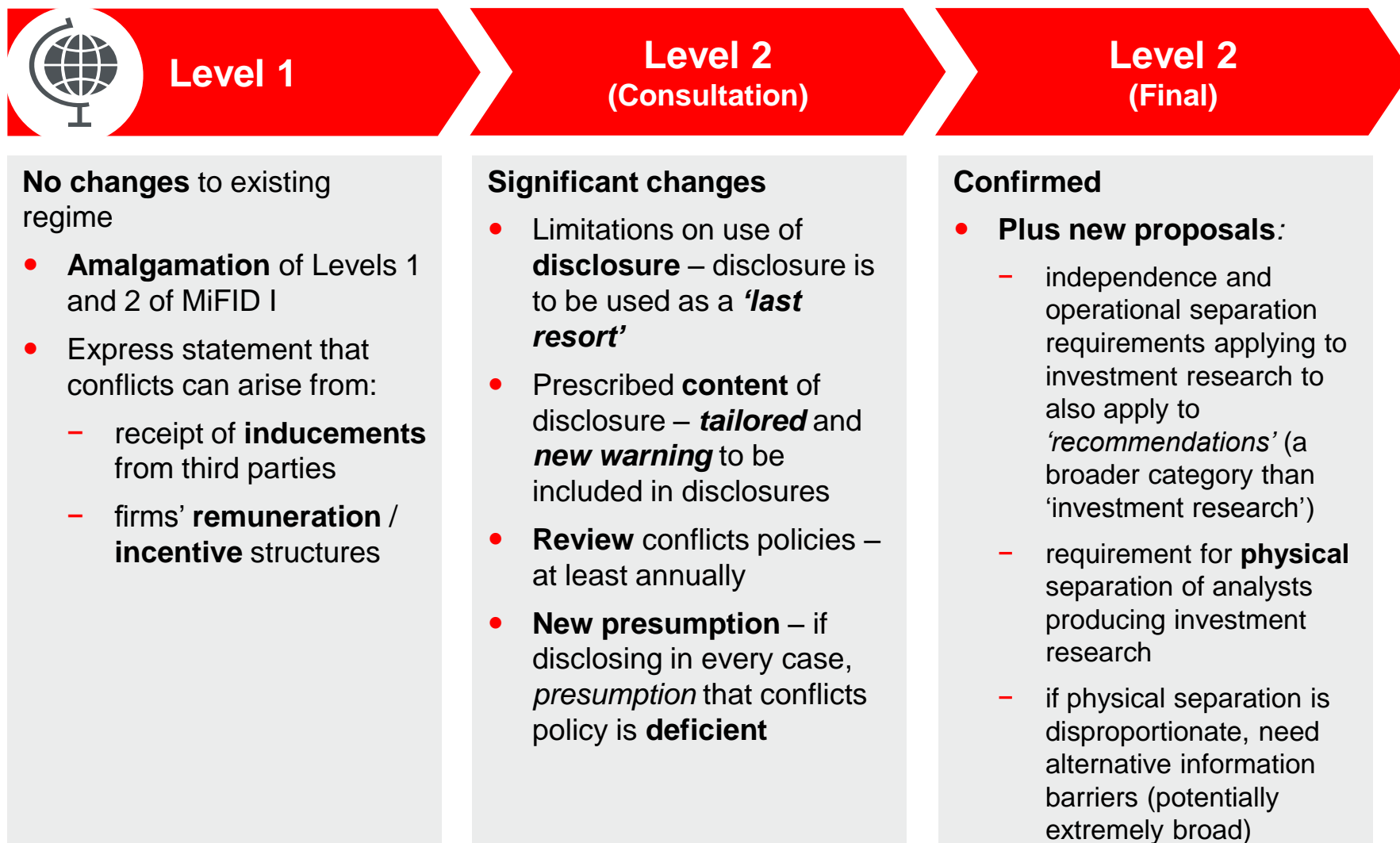
## ISSUE

UK FCA will need to conduct gap  
analysis and align its record keeping  
requirements to the minimum  
standard set by ESMA

# Systems and controls



# Conflicts of interest



# Conflicts of interest



**Significant impact** – although some sectors already quite compliant, key impacts around disclosure: needs to be considered for IBs, EBs and CBs

## **Reassess conflicts**

that arise from business activities (bearing in mind different client categories – retail, professional, ECP) and put in place / update structural and governance arrangements to try to address conflicts which should be monitored, documented and updated

Reassess  
**when and how**  
disclosure  
is made  
to clients

Ensure  
compliance  
monitoring  
programme  
requires policies  
to be **updated at  
least annually**

## **Maintain records**

of what disclosure was made to what client so as to show that the disclosure was tailored, identified specific likely conflicts and was not simply made to every client

**Review** current  
operational  
arrangements for staff  
producing investment  
research – is there  
**physical separation?**  
**What operational  
separation is there  
of those producing  
'recommendations'?**

## **Reassess steps**

that need to be taken to prevent and manage conflicts

**Focus**  
on prevention  
of damage

**Reassess  
financial  
incentive  
arrangements**

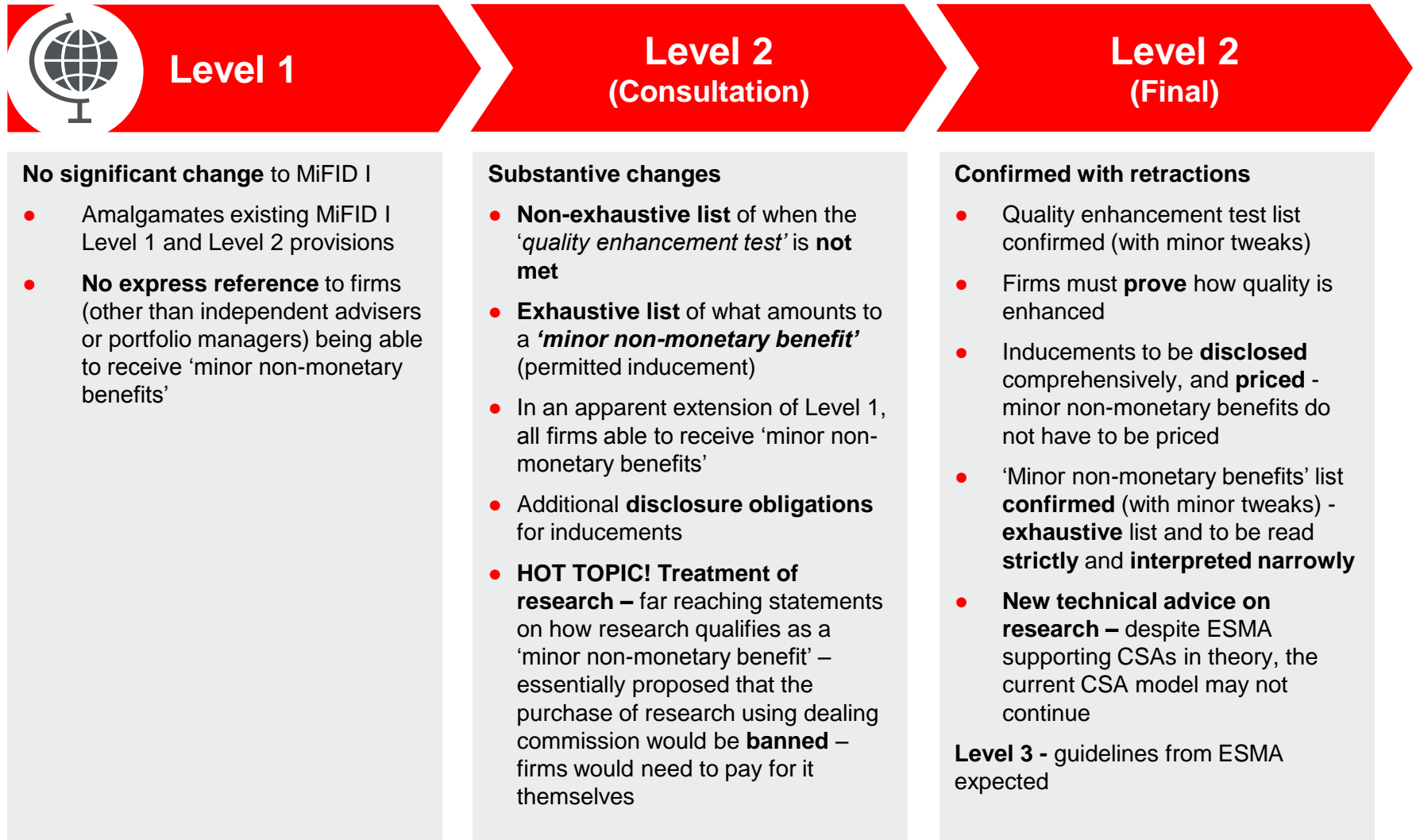
## **Update conflicts of interest policies**

to set out more clearly how the firm has tried to mitigate conflicts

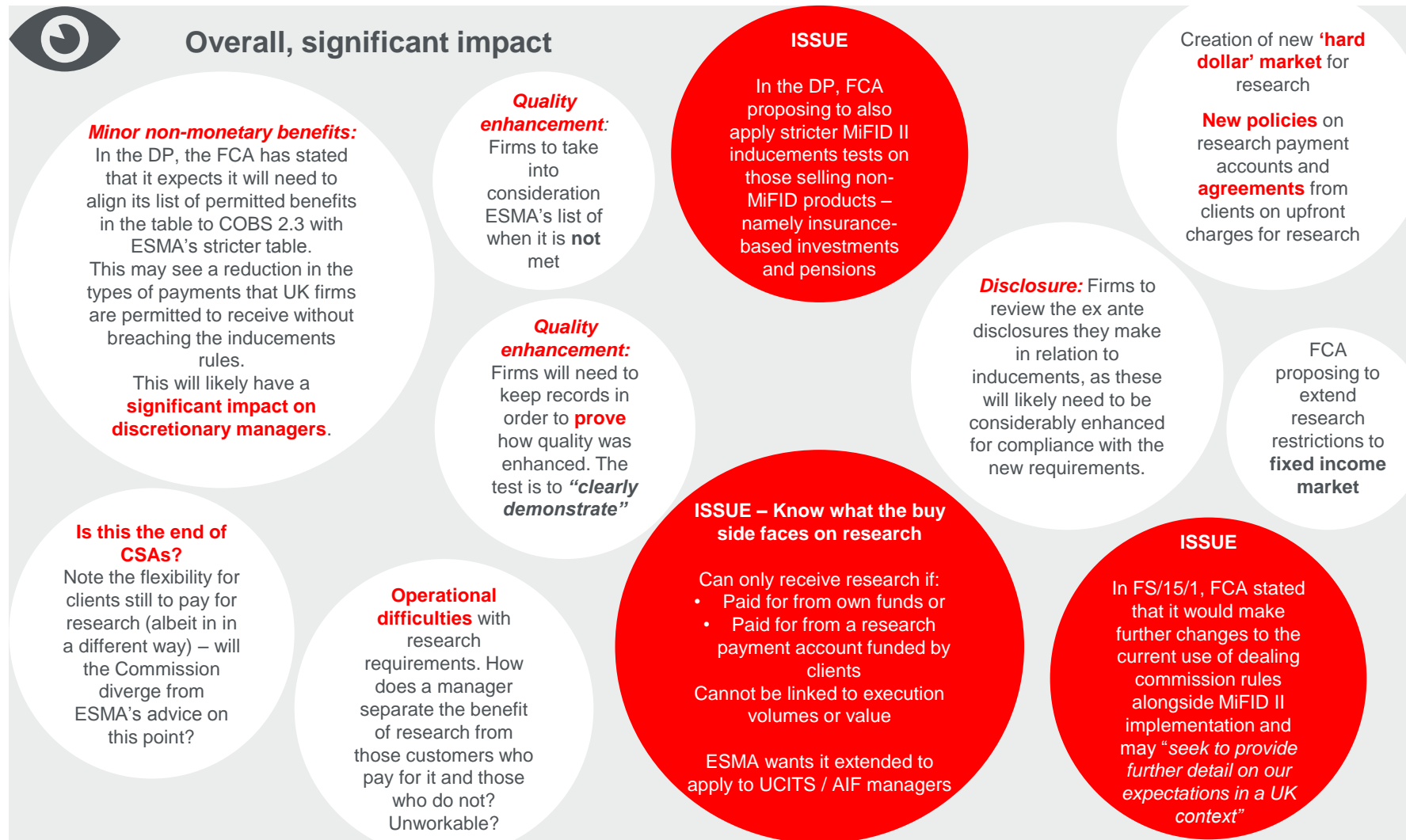
## **Issue:**

Balancing MiFID II requirements to not disclose in every case to ensure you can prove disclosure is a 'last resort' with need to disclose for protection from common law/ fiduciary duties

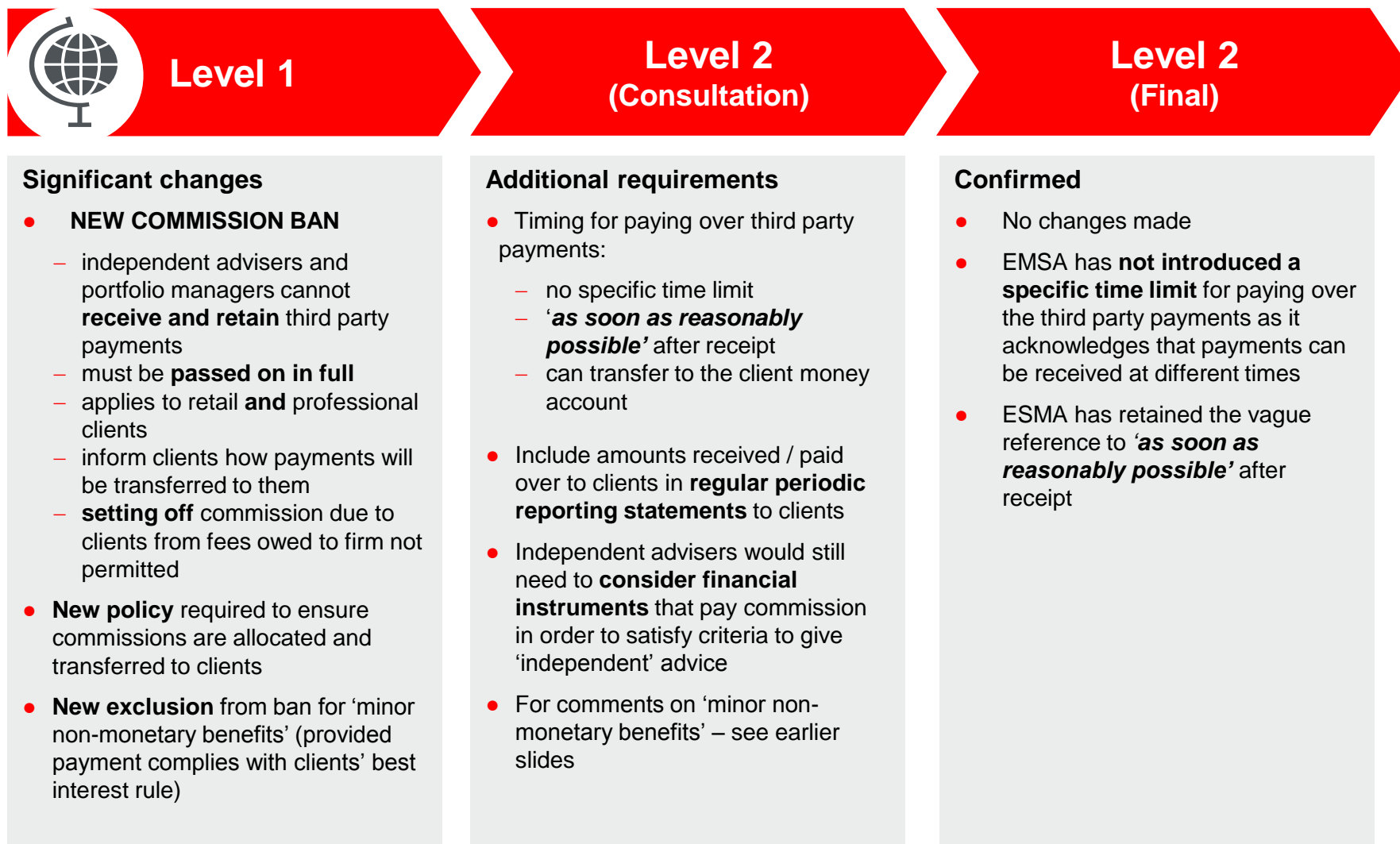
# Inducements



# Inducements



# Third party payment ban



# Impact in the UK



## Mixed impact – UK has already gold-plated MiFID II with the Retail Distribution Review

### **Independent advisors – minor impact:**

- Will need to extend RDR models to professional clients
- Discrete query on whether RDR 'facilitation' will be impacted (as set-off prohibited)
- Will need to extend RDR models to include 'structured deposits'

### **Product providers – impact when distributing to portfolio managers**

Not covered by UK RDR

### **Portfolio managers – impact!**

- UK RDR only relates to referral payments made by discretionary managers to advisors, not payments they receive
- Will apply to all clients of portfolio managers, not just retail clients

### **Platform service providers – no impact**

UK RDR goes further than MiFID II

### **Product providers – no impact when distributing to advisers**

UK RDR goes further than MiFID II but may apply to professional clients

### **Restricted advisory firms – no impact**

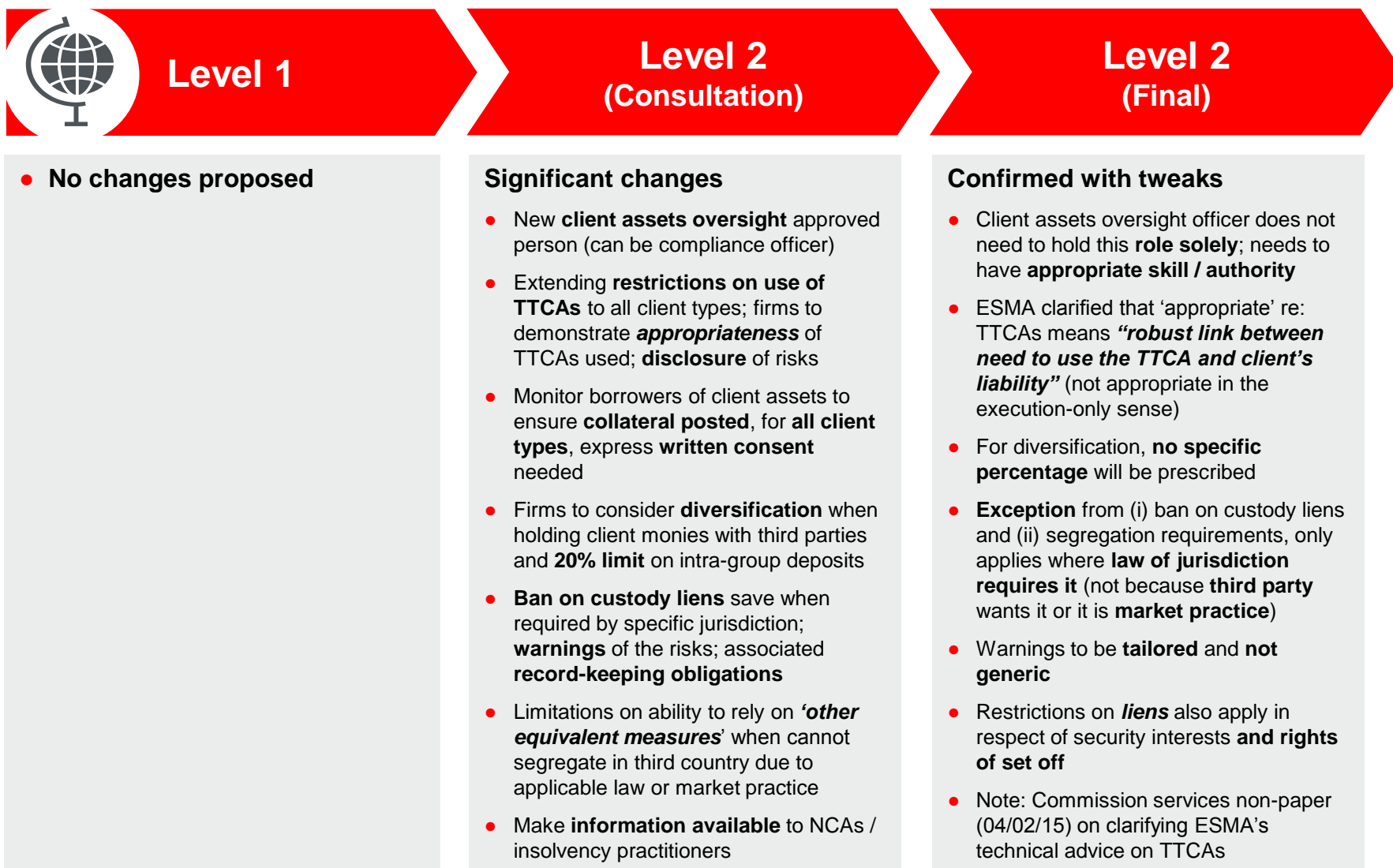
UK RDR goes further than MiFID II. In the DP, FCA expects to retain the strict inducements regime for restricted advisers.

May also apply to advice to professional clients which is currently not in RDR ban.

### **ISSUE – MiFID II ban v UK RDR**

UK RDR already gold plates MiFID II ban for advice to retail clients so FCA unlikely to reduce its current regime. FCA proposing to either apply RDR-style ban to portfolio managers or to apply the same rebate rules as currently apply to platforms to portfolio managers (which will allow rebates in limited circumstances). Either way, FCA's proposed implementation does not match what is proposed by MiFID II.

# Client money/ assets



# Client money/ assets



## Moderate changes

Further **restrictions** to use of **title transfer collateral arrangements** with **non-retail clients**

New requirements to **demonstrate the appropriateness** of TTCAs used

Tightening of not applying **segregation** requirements to firms in third countries where not required by **applicable law**

Tightening of use of **custody liens** requested by third country firms but not required by **applicable law**

### ISSUE:

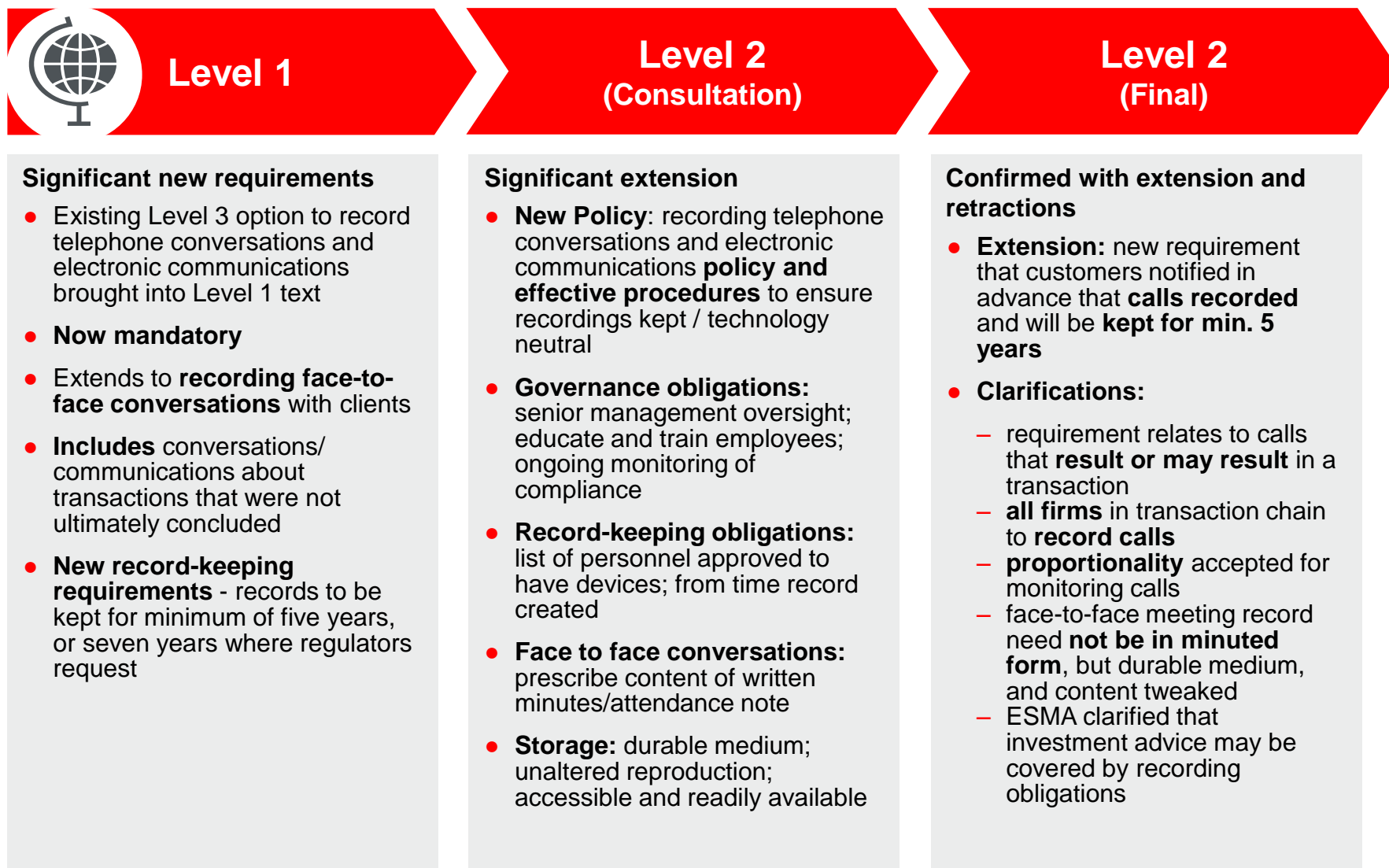
UK Regime already gold plated MiFID II – unlikely to reduce obligations.

UK firms facing more changes to client assets regime in 2 years' time.

20% limit for holding deposits intergroup and increased diversification requirements



# Recording phone calls and emails



# Recording phone calls and emails



**Significant impact** – significantly different from UK's current recording requirements

**Implement** policies and procedures (if not already) in writing and ensure compliance monitoring programme fit for purpose

Storage mechanism should be reviewed for **compliance** to ensure will allow unaltered reproduction up to 7 years later

Implement procedures so customers are not only **notified** that calls are recorded (widely done already) but also that recording **will be kept for 5 years**

Introduce a **new template attendance note** for face-to-face meetings?

## ISSUE

Now applies to firms not caught by UK rules – namely retail IFAs and boutique corporate broking firms. FCA considering whether to apply full MiFID II standard to these firms or a proportionate standard.

FCA also considering removing 'duplication' exemption for discretionary managers

**Technology neutral** – to extend to capturing all forms of communications with clients

## Areas of uncertainty

- Duplication of records?
- Difficult to identify which internal calls to record (without resorting to mass recording of all calls)
- Client status a factor for face-to-face meetings?

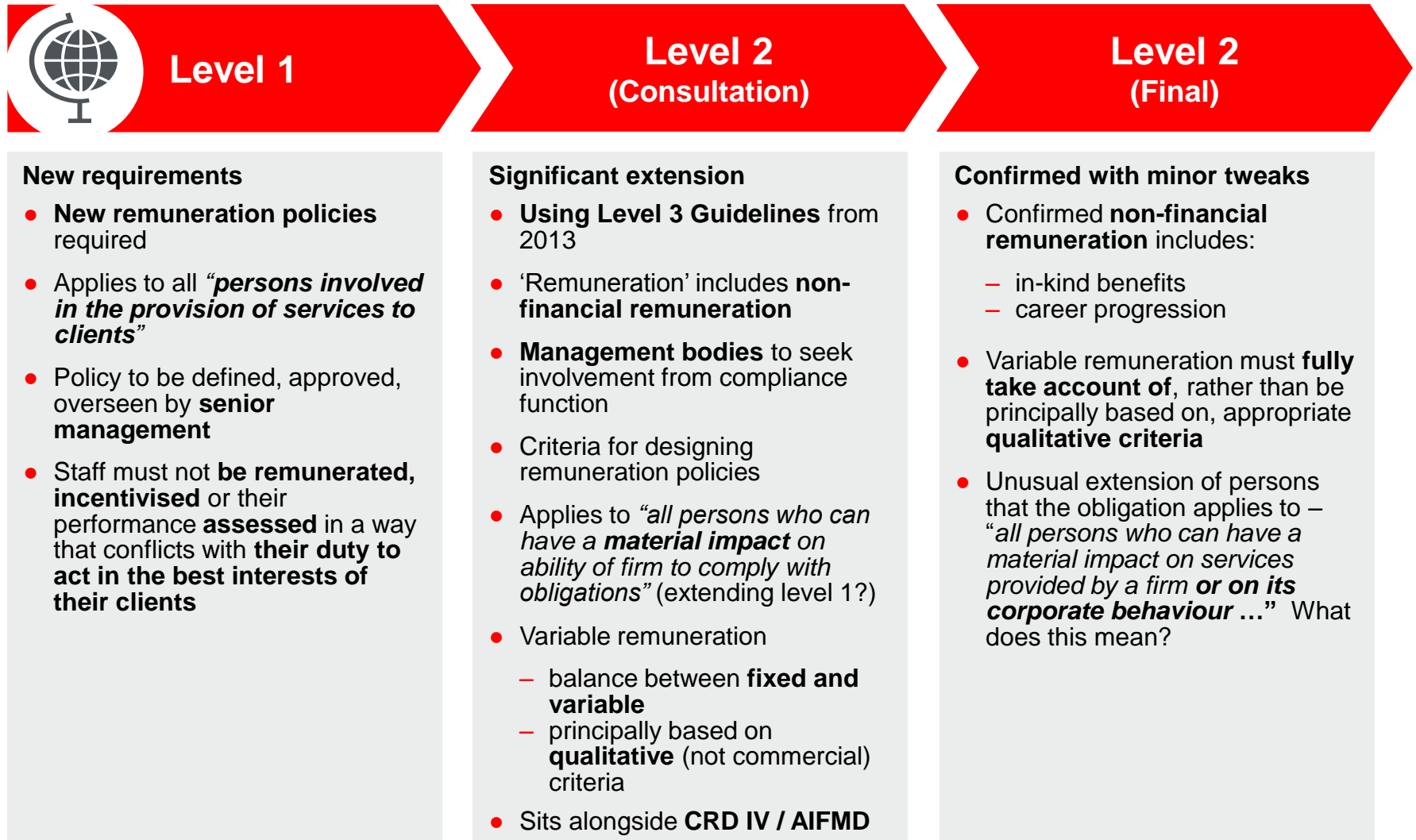
**Extend record-keeping** duration to 5 - 7 years (currently 6 months in UK) – tension with **data protection rules**

Keep in a **'durable medium'**

## ISSUE

In an attempt to clarify what services the recording obligations relate to, ESMA has unhelpfully noted that this could extend to investment advice: *"while the provision of investment advice is not subject to these obligations, conversations and communications that result or may result in the provision of [RTO / execution of orders] are, and by virtue of this, may include investment advice".*

# Remuneration



# Remuneration



Impact, but mainly for firms not already caught by CRD III, CRD IV or AIFMD

Firms to **review existing remuneration practices, identify gaps**, and implement carefully designed **remuneration policies** signed off by **senior management** and **advised on by compliance**

**New procedures** to ensure compliance involved before offers made to new personnel

Carefully consider **qualitative aspects** for variable remuneration, and **train staff** on these factors

## ISSUES

In the DP, FCA considering potentially extending MiFID II requirements to non-MiFID firms and business lines

Carefully consider **non-financial remuneration**

Keep a **list of all staff** within scope and keep it updated, consider who else might be caught as **non-staff**

## ISSUES

Clarity to know which staff are caught by the remuneration guidelines as there is a difference between the level 1 and level 2 terminology.

Who is caught by the “corporate behaviour” reference – delegates? contractors?

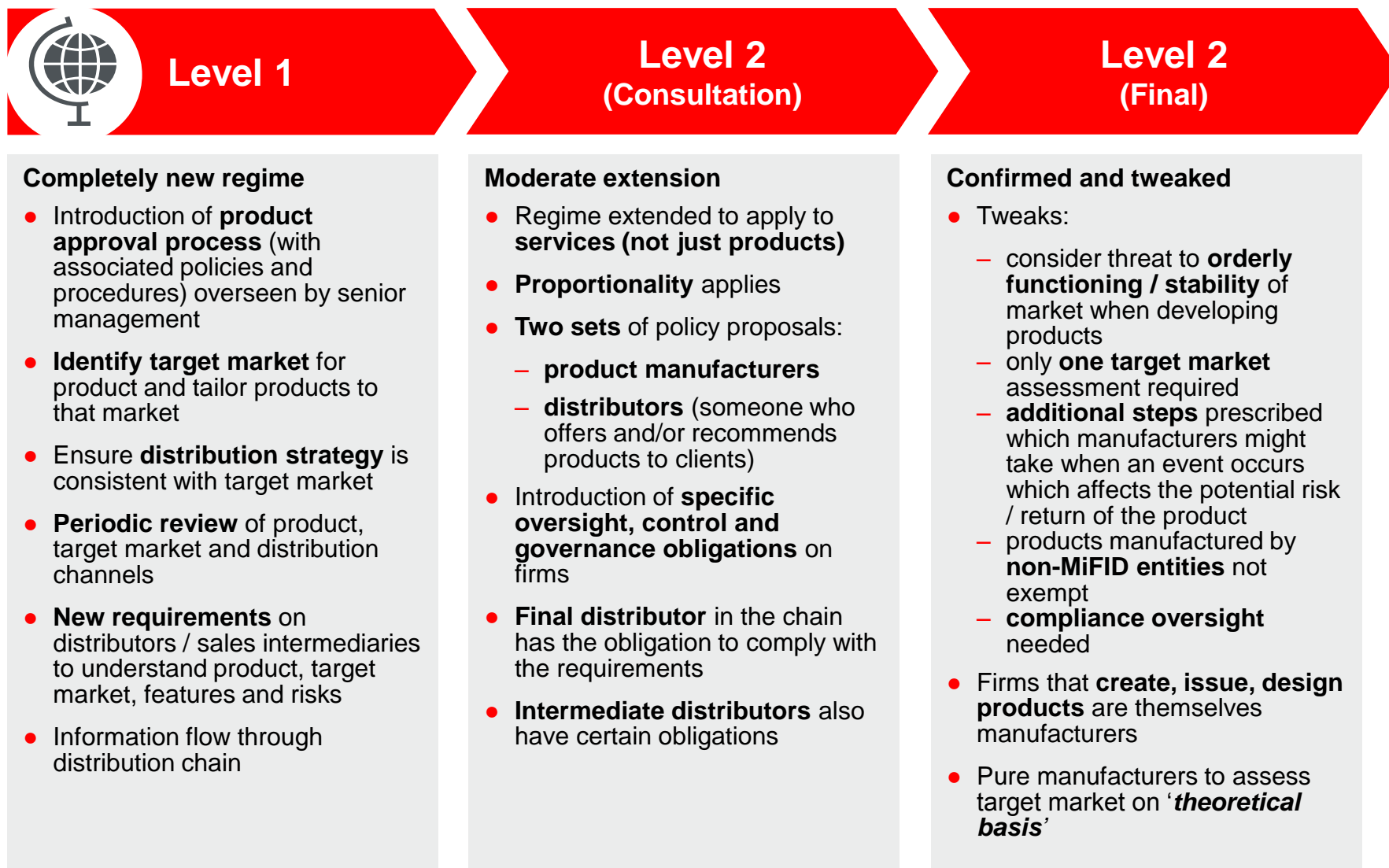
How will the differences between CRD III, CRD IV, UCITS V and AIFMD requirements be aligned?

What will the impact be on existing packages – retrospective application?

**Management information** on effectiveness of policies, impact on behaviour, etc.

# Product life cycle

# Product governance/distribution



# Product governance/distribution



Moderate impact in the UK - but what does this mean in the derivatives market?

Extension of the requirements to 'services' (not just products) is **not new** to the UK as the RPPD already applies to services

UK regime is focussed primarily where the end user is a 'retail client' whereas MiFID II **applies to all clients**

## ISSUE

Differences in EU and UK regimes to be aligned.

EU regime more detailed on:

- (i) Specific criteria for identifying target market;
- (ii) Clear management oversight of process
- (iii) New obligations on distributors to understand products before selling them, to assess compatibility of products with customer's needs and to ensure products only sold (advised or non-advised) when in customer's interests.

Apply to **all products developed**, not just when there is a retail client as the underlying investor

## ISSUE

The current UK guidance in RPPD and Product Governance Guidance to be elevated into formal rules to adopt MiFID II proposals (currently UK RPPD / Product Governance Guidance are technically non-binding)

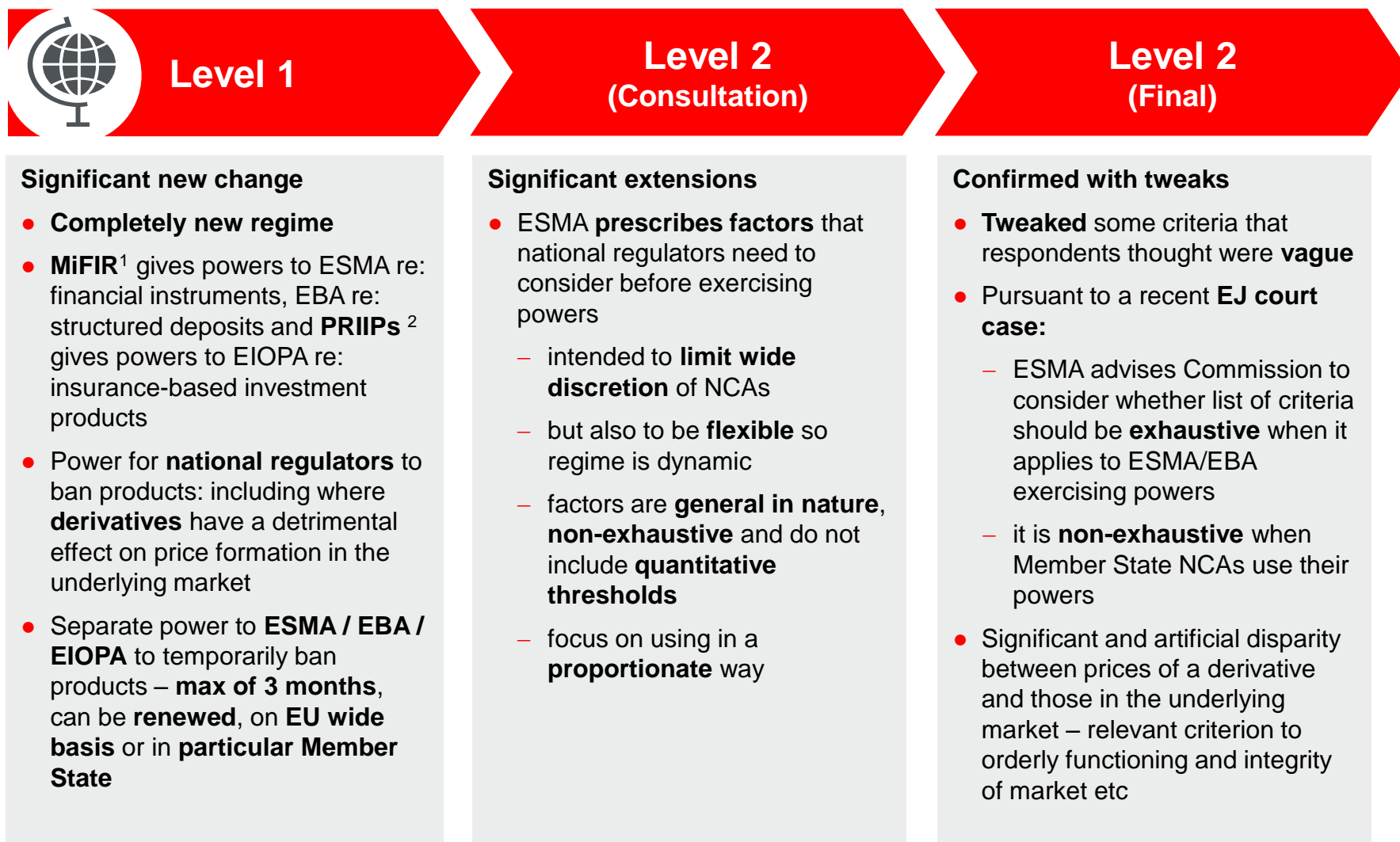
Differences in EU and UK regime to be aligned

UK regime is focussed primarily where the end user is a 'retail client' whereas MiFID II **applies to all clients**

## Issue

FCA considering extended MiFID II product governance requirements to non-MiFID firms

# Product intervention



1 Regulation (EU) No 600/2014 on markets in financial instruments

2 Regulation for a key information document for packaged retail and insurance-based investment products



# Product intervention



## Minor impact

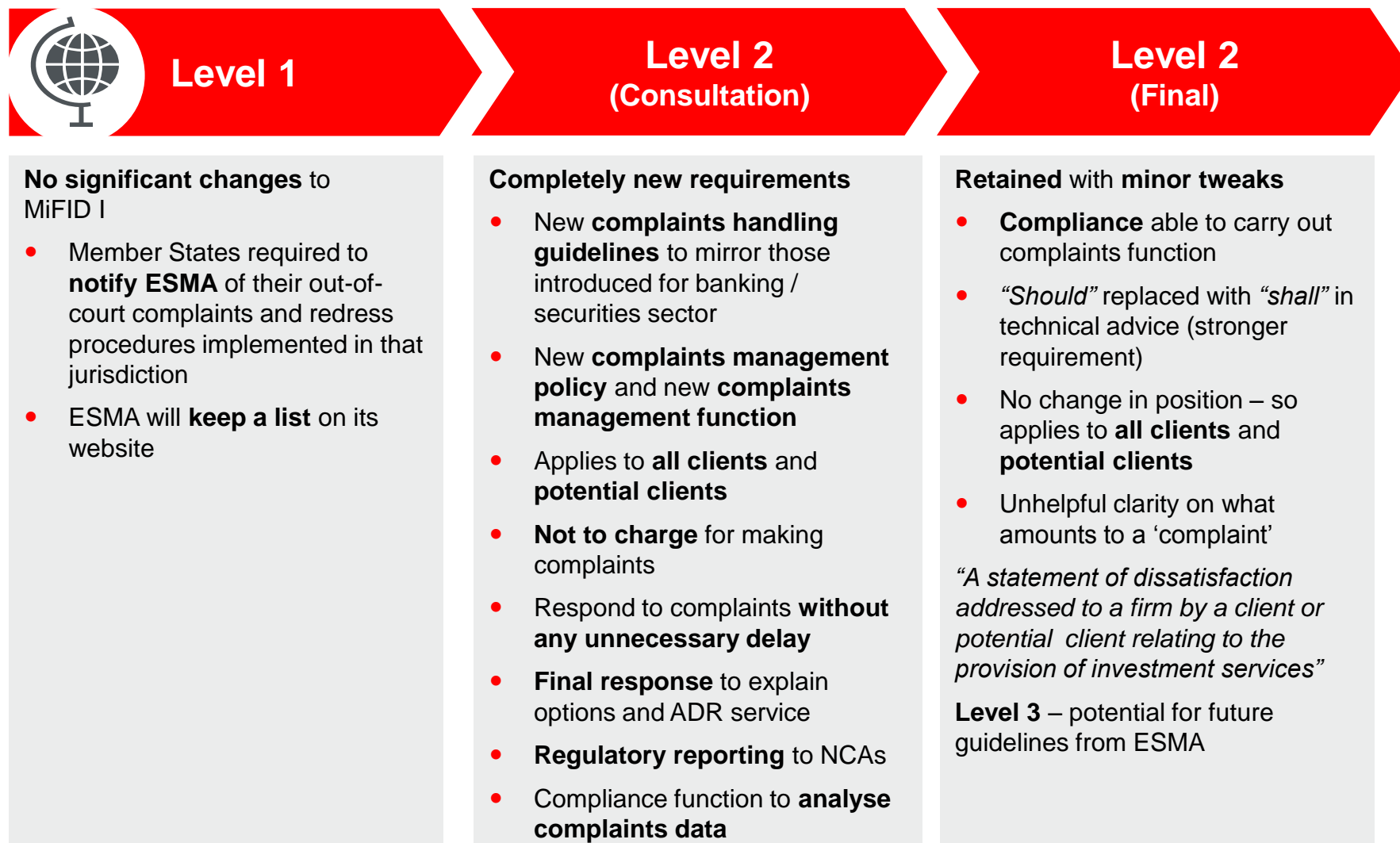
New regime will **impact FCA's powers**, does not require firms to do anything – but they will need to ensure they are **horizon-scanning** for any bans that may affect their products

**FCA will need to amend its product intervention rules** to align to EU's requirements

### ISSUE

Will be interesting to see how it is used in practice. Will it see Member States "tattle-telling" to ESMA on foreign products being sold in its jurisdiction it does not like? Essentially creates a federal power.

# Complaints handling



# Complaints handling



**Overall, moderate impact** - while UK regime already has a detailed complaints handling process for retail clients, the extension to all clients is new

Firms will need to **extend** current complaints processes to include **all clients**

Will **FOS** need to be expanded to allow redress for all clients' complaints?

**Define** in Terms of Business what amounts to complaint with non-retail clients **very carefully** to avoid every niggles needing to go through the formal process

Could be clarity from FCA on this point.

Appoint new **complaints handling manager**?

**Ensure compliance analyses complaints data** and feeds it back up to **senior management**

Given the **increased recordkeeping requirements** ensure records are kept of every complaint and the measures taken to address it

**Issue: Regulatory fees may increase** as the fees taken for FOS are based on how many retail clients a firm has which will presumably now be extended to be all clients?



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## *David Dudeney, Technical Specialist, Trading Compliance*

# Best Execution

Looking towards MiFID 2

# Best Execution

- Seeking to get the best outcome for your clients when you act on their behalf



# Best Execution – FCA Thematic Review 14/13

- A Significant risk that Best Execution was not being delivered to all clients on a consistent basis.
  - Most firms were not doing enough to deliver best execution through adequate management focus, front-office business practices or supporting controls
  - Firms need to improve their understanding of the scope of their best execution obligations, the capability of their monitoring and the degree of management engagement in execution strategy, if they are to meet the FCA's current requirements.
  - All firms also need to prepare for the challenges of MiFid II implementation in this area.
- (page 3)

# Best Execution – FCA Thematic Review 14/13

- Additional obligations in the recast Markets in Financial Instruments Directive (MiFID II) are intended to address some of the specific weaknesses observed in this work, in particular regarding the adequacy of monitoring...

(Page 6... Page 48.. Page 50)

# All Sufficient Steps

- MiFID II requires firms to take all 'SUFFICIENT' steps to achieve the best possible results, rather than all 'reasonable' steps as currently required.
- What does this mean?
- Clearly intends a raising of standards...

# Not Sufficient

- Overall, very few firms could provide evidence that the steps they were taking were sufficiently rigorous. (page 10)
- We found that monitoring was not sufficient to indicate that best execution was being provided on a consistent basis where firms relied on small samples. (page 28)

# Payment for Order Flow

- MiFID II makes an explicit prohibition on receiving payments from third parties when executing client orders where this breaches the rules on:
  - Conflicts of interest
  - Inducements

# Information

- New requirements for disclosure/publication of information:
  - Investment firms to provide additional information to clients on how their orders will be executed.
  - Investment firms to publish data on their top 5 execution venues in each of 21 specified categories – Annually
  - Execution venues to publish detailed information on execution – Quarterly

# Processing the information

- Information to be published by trading venues is:
  - With a view to provide... investment firms... with relevant data on execution quality to help them determine the best way to execute client orders.
- This information will need to be considered by investment firms in reviewing their execution policies and procedures.
- This is not a job for Compliance.
  - FCA expects senior management with responsibility for trading activities to take greater responsibility for ensuring that policies and arrangements remain fit for purpose.
- Information will be published quarterly

# Data to be Provided by Trading/Execution Venues

- Detailed information to be published for each calendar quarter – within three months of quarter end.
- Significant Data Capture – For each instrument. Including:
  - Intra-day price information, based on four two minute windows
  - Daily price information
  - Information on trading and related costs
  - Information on the likelihood of execution
  - Information on best bid and offer, and order book depth
  - Time taken for orders to be filled



# Best Execution

This presentation was intended to offer a high overview of some of the changes coming to the Best Execution regime with the implementation of MiFID II. It is not comprehensive, neither is it tailored to the circumstances of any particular firm.

If you would like to discuss the implications of MiFID II for your own business, please contact Trading Compliance Limited or your normal compliance advisors.

[www.tradingcompliance.com](http://www.tradingcompliance.com)

# Questions from the floor