4 December 2015

InfoNet



MiFID II/R Seminar **Investor Protection**

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- 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 Infrastructure, mining and commodities Transport Technology and innovation Life sciences and healthcare

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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

2 July MiFID II and MiFIR entered into force 19 December Level 2 Consultation of technical standards commenced. ESMA provided final report of technical advice to the Commission on deleg acts	28 Se Level e techn e subm	ptember 2 regulatory cal standards tted to hission	3 January Level 2 implementing technical standards to be submitted to Commission	3 July Member States to adopt and publish measures transposing MiFID II into national law	3 January MiFID II and MiFIR Level 1 and Level 2 implementation date subject to any delay
2014 2015				2016	2017
Level 2 Consultation on advice on delegated acts			December FCA to publish consultation paper on implementing MiFID II and MiFIR – markets issues April FCA to publish consultation pap implementing M – conduct issue	per on liFID II and MiFIR	95



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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



Moderate changes

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

Level 2 (Consultation)

Moderate extension

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

Level 2 (Final)

Confirmed with extensions

- Confirmation that who can qualify as an elective eligible counterparty is essentially investment firms and large undertakings
- New opt up procedure recommended by ESMA for elective ECPs:
 - request to opt-up must be made in writing and indicate whether it is general or specific to a transaction or instrument
 - firms must warn ECPs which protections they will lose
 - ECPs to provide written confirmation and acknowledgment that they are aware of consequences
 - Relevant to brokers dealing with buy side and end user firms

Client categorisation

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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

> 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

New procedures

for opting up professional / retail clients to ECP status

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

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

ISSUE

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

ISSUE

DP: FCA considering three options for optingup 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

Staff training



Clear, fair and not misleading



No changes proposed

- Reinforced in recitals that eligible counterparties are clients
- So communicating in a way that is '*fair, clear and not misleading*' also applies to eligible counterparties

Level 2 (Consultation)

Significant changes

- Targeted improvements to communications with retail clients
 - same language to be consistently used across information
 - fair and prominent indication of risks (including where benefits referenced) with equal font size
 - information to be kept up-todate
 - requirements when mentioning future performance
- With 'retailisation' of non-retail clients, extending certain retail requirements to professional clients

Level 2 (Final)

Confirmed with clarifications

- With retail communications:
 - 'language' refers to language of a Member State (e.g. German) not to terminology used
 - risks do not need to be stated where benefits are not also stated
- Not extending detailed requirements on retail clients to professional clients, just some 'retail-like' obligations
- ESMA confirmed that its technical advice **does not apply** to eligible counterparties (so firms have greater flexibility about how they comply with the fair, clear and not misleading test for ECPs)



Information to clients



Retains existing information requirements but extends them

- Information on investment advice
- Information on financial instruments – e.g. warnings, risks, tailored for target market
- Information on costs / charges:
 - of services
 - of advice
 - of product
 - with method of payment
 - disclose inducements
 - aggregated so client understands the overall cost and cumulative effect on return (with itemised breakdown on request)
 - provided "in good time" and annually post-sale

Level 2 (Consultation)

Significant changes

- Investment advice: Detailed requirements to explain scope and features of advice
- Financial instruments: Additional requirements – e.g. how operates in negative market conditions, etc. can be provided in standardised 'fact sheet' format (not carried over in final advice)
- Costs and charges: Significant level of detail on costs and charges – numerous prescriptive examples provided in CP
- Client agreements: Significant expansion – applies to professional clients, in ongoing advisory relationships and custody relationships and scope expanded significantly

Level 2 (Final)

Confirmed with tweaks

- Costs and charges:
 - disclosure needed to all clients (including ECPs)
 - professionals can agree to receive more limited information (but not for portfolio management or where there is an embedded derivative)
 - ECPs can agree to receive more limited information
 - However, where an ECP wishes to receive limited information but will on-sell a product to its clients (including retail clients), cannot elect to receive more limited information
 - Not clear what this means in a brokerage context

Reporting



No significant changes proposed

- **Confirms** existing reporting requirements, so:
 - occasional reporting (other than for portfolio managers)
 - reporting requirements for portfolio managers
 - additional reporting obligations for portfolio management and contingent liability restrictions
 - statements of client financial instruments or client funds
- Extends them to include: "periodic communications taking into account the type and complexity of financial instruments involved and the nature of the service provided to the client"

Level 2 (Consultation)

Significant changes

- Reporting to professional clients: trade confirmations (T+1); same retail content in confirmations
- Reports for portfolio management: min. quarterly intervals covering activities during that period
- Reporting obligations portfolio management / contingent liability: agree bespoke thresholds with retail clients when reporting is triggered (multiples of 10% suggested)
- Reports for client assets: min. quarterly intervals; statements to identify protected assets, assets subject to liens, market / estimated value of assets and indicate "a lack of a market price is likely to be indicative of a lack of liquidity"
- Reports for eligible counterparties: firms to agree with ECP if they receive none or all of above

Level 2 (Final)

Confirmed with tweaks

- ESMA confirmed that reporting obligations apply to all clients but ECPs are able to agree different standards for content and timing
- Note buy side obligations if you face them:-
 - No requirement to provide reports where clients have access to **online system** that is a '**durable medium**'
 - Reporting obligations do apply to professional clients and need to give a "fair and balanced" review
 - Report where portfolio depreciates by 10%, and by further multiples of 10%.
- Firms holding retail client account including leveraged financial instruments/contingent liability transactions must report when instruments depreciate by 10% or multiples of 10%
- When estimating value of client assets, conduct estimation on a "best efforts" basis

Dealing with professional clients

Moder

Moderate impact

Ensure communications with professional clients include **new "retaillike" requirements**

> 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)

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 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



Significant changes

- New extension of some existing investor protection requirements to eligible counterparties (ECPs):
 - act honestly, fairly and professionally in dealings
 - be fair, clear and not misleading in communications
- Provide certain information on financial instruments – e.g. risk warnings tailored for target market and costs/ charges – aggregated and, where requested, broken down
- Provide certain reports: "periodic communications taking into account the type and complexity of financial instruments involved and the nature of the service provided to the client"

Level 2 (Consultation)

Tweaks proposed:

- **Dealings** no change to requirement to act honestly, fairly and professionally in dealings
- Information Additional requirements – e.g. how operates in negative market conditions and significant level of detail on costs and charges – numerous prescriptive examples provided in CP
- ECPs to be able to opt out of receiving certain information, except where the products embed a derivative
- Reports Firms to be able to contractually determine with ECPs what level of reporting is required



Confirmed with slight changes

- NB. technical advice on fair, clear and not misleading does not apply to ECP obligation
- Information ECPs can agree a limited application of the requirements except where the instrument embeds a derivative and the ECP on-sell products to their own clients
- Reports whereas the draft advice implied that ECPs could potentially opt out entirely of receiving certain reports, the final advice implies they cannot do this – but instead can agree with investment firms different standards for the content and timing of reports

Dealing with eligible counterparties

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Moderate impact

What is expected by way of changes in behaviour when dealing with ECPs? Will it be simpler **not** to have **different reporting frequencies and content** for ECPs if, eg, firms also have other categories of client? There is no similar flexibility for professional clients.

How much information can you agree **not to provide**?

ISSUE

Which information and reports will be provided to ECPs?

Will the firm agree with ECPs to "opt out" in certain circumstances?

If so, how will this "opt out" process be effected, recorded and managed?

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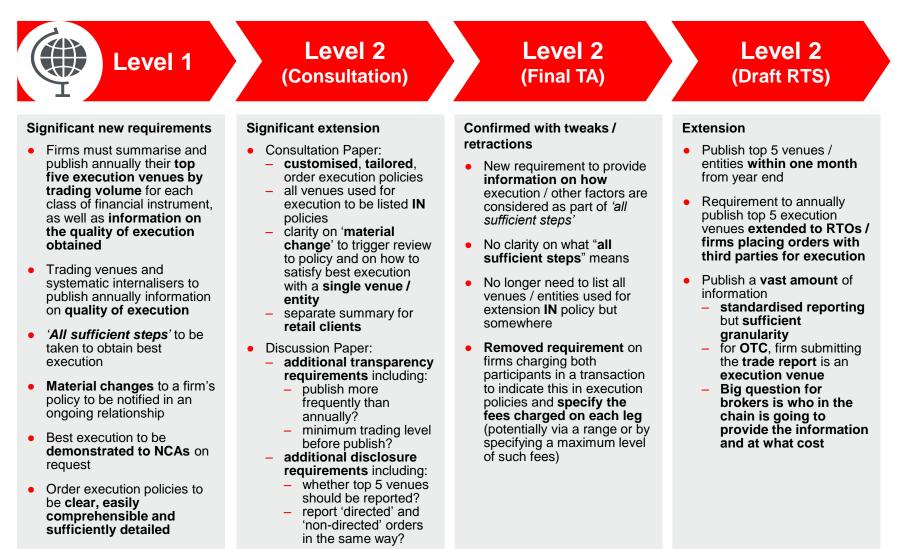
Do communications need to be **handled differently**?

Do **policies and procedures** for dealing with ECPs need to be updated?

Information/ analytics



Best execution



Publication of information – final draft RTS

Execution venues

- Publication by TVs 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



No substantive changes

- Level 1 confirms existing MiFID I requirements
- Level 1 text is **slightly altered** from that contained in MiFID I to make it clear that:
 - the records should also allow NCAs to fulfil their supervisory tasks under other EU measures, such as the Market Abuse Directive and Regulation
 - the records should also be able to be used to demonstrate compliance with rules on market integrity
- Member States can gold plate

Level 2 (Consultation)

Moderate extension

- For harmonisation, ESMA proposed that it should specify the records that need to be kept
- ESMA seeking to codify CESR's previous Level 3 recommendations from 2007
- ESMA proposed:
 - a non-exhaustive list of the minimum records that firms should be required to keep
 - their content
- Proposed that all policies required to be maintained under MiFID II, MiFIR, MAD and MAR must be kept in writing

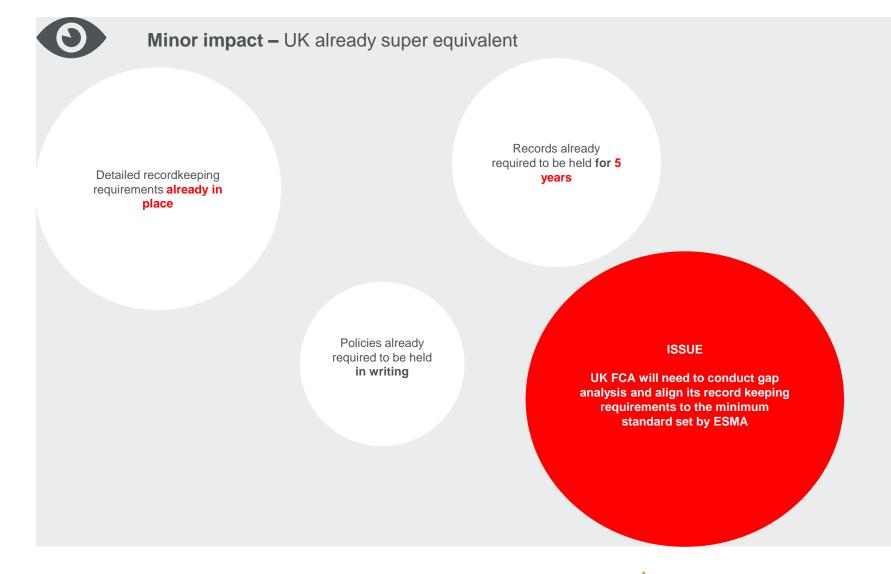
Level 2 (Final)

Confirmed and extended

- Applies to client orders, decisions to deal, transactions, dealing on own account, order processing
- Applies even if no transaction results
- Record-keeping requirements apply regardless of technology used to keep the record
- Despite market push-back, ESMA is keeping the list of records non-exhaustive but has amended the list of records
- Only applies to records from 3 Jan 2017
- RTS being developed

Level 3 ESMA guidelines expected

Record keeping



Systems and controls



Conflicts of interest



No changes to existing regime

- Amalgamation of Levels 1 and 2 of MiFID I
- Express statement that conflicts can arise from:
 - receipt of inducements from third parties
 - firms' remuneration / incentive structures

Level 2 (Consultation)

Significant changes

- 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
- **Review** conflicts policies at least annually
- New presumption if disclosing in every case, presumption that conflicts policy is deficient

Level 2 (Final)

Confirmed

- Plus new proposals:
 - independence and operational separation requirements applying to investment research to also apply to 'recommendations' (a broader category than 'investment research')
 - requirement for physical separation of analysts producing investment research
 - if physical separation is disproportionate, need alternative information barriers (potentially extremely broad)

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

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

Update conflicts

of interest

policies to set out

more clearly how

the firm has tried to

mitigate conflicts

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

Ensure

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

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

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Reassess steps

that need to be taken to prevent and manage conflicts Focus on prevention of damage

Reassess financial incentive arrangements

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Inducements



No significant change to MiFID I

- Amalgamates existing MiFID I Level 1 and Level 2 provisions
- No express reference to firms (other than independent advisers or portfolio managers) being able to receive 'minor non-monetary benefits'

Level 2 (Consultation)

Substantive changes

- Non-exhaustive list of when the 'quality enhancement test' is not met
- Exhaustive list of what amounts to a 'minor non-monetary benefit' (permitted inducement)
- In an apparent extension of Level 1, all firms able to receive 'minor nonmonetary benefits'
- Additional **disclosure obligations** for inducements
- HOT TOPIC! Treatment of research – far reaching statements on how research qualifies as a 'minor non-monetary benefit' – essentially proposed that the purchase of research using dealing commission would be banned – firms would need to pay for it themselves

Level 2 (Final)

Confirmed with retractions

- Quality enhancement test list confirmed (with minor tweaks)
- Firms must **prove** how quality is enhanced
- Inducements to be disclosed comprehensively, and priced minor non-monetary benefits do not have to be priced
- 'Minor non-monetary benefits' list
 confirmed (with minor tweaks) exhaustive list and to be read
 strictly and interpreted narrowly
- New technical advice on research – despite ESMA supporting CSAs in theory, the current CSA model may not continue
- **Level 3 -** guidelines from ESMA expected

Inducements

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Overall, significant impact

Minor non-monetary benefits:

In the DP, the FCA has stated that it expects it will need to align its list of permitted benefits in the table to COBS 2.3 with ESMA's stricter table. This may see a reduction in the types of payments that UK firms are permitted to receive without breaching the inducements rules. This will likely have a significant impact on discretionary managers.

Is this the end of CSAs?

Note the flexibility for clients still to pay for research (albeit in in a different way) – will the Commission diverge from ESMA's advice on this point?

Quality enhancement:

Firms to take into consideration ESMA's list of when it is **not** met

Quality enhancement: Firms will need to keep records in order to prove how quality was enhanced. The test is to "clearly demonstrate"

Operational

difficulties with research requirements. How does a manager separate the benefit of research from those customers who pay for it and those who do not? Unworkable? In the DP, FCA proposing to also apply stricter MiFID II inducements tests on those selling non-MiFID products – namely insurancebased investments and pensions

ISSUE

ISSUE – Know what the buy side faces on research

Can only receive research if:

- Paid for from own funds or
- Paid for from a research payment account funded by clients
 Cannot be linked to execution volumes or value

ESMA wants it extended to apply to UCITS / AIF managers

Creation of new 'hard dollar' market for research

New policies on research payment accounts and agreements from clients on upfront charges for research

> FCA proposing to extend research restrictions to **fixed income** market

ISSUE

Disclosure: Firms to

review the ex ante

disclosures they make

in relation to

inducements, as these

will likely need to be

considerably enhanced

for compliance with the

new requirements.

In FS/15/1, FCA stated that it would make further changes to the current use of dealing commission rules alongside MiFID II implementation and may "seek to provide further detail on our expectations in a UK context"

Third party payment ban



Significant changes

- NEW COMMISSION BAN
 - independent advisers and portfolio managers cannot receive and retain third party payments
 - must be passed on in full
 - applies to retail **and** professional clients
 - inform clients how payments will be transferred to them
 - setting off commission due to clients from fees owed to firm not permitted
- New policy required to ensure commissions are allocated and transferred to clients
- New exclusion from ban for 'minor non-monetary benefits' (provided payment complies with clients' best interest rule)

Level 2 (Consultation)

Additional requirements

- Timing for paying over third party payments:
 - no specific time limit
 - 'as soon as reasonably possible' after receipt
 - can transfer to the client money account
- Include amounts received / paid over to clients in regular periodic reporting statements to clients
- Independent advisers would still need to consider financial instruments that pay commission in order to satisfy criteria to give 'independent' advice
- For comments on 'minor nonmonetary benefits' – see earlier slides

Level 2 (Final)

Confirmed

- No changes made
- EMSA has not introduced a specific time limit for paying over the third party payments as it acknowledges that payments can be received at different times
- ESMA has retained the vague reference to 'as soon as reasonably possible' after receipt



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

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 RDRstyle 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.

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Product providers – no impact when distributing to advisers

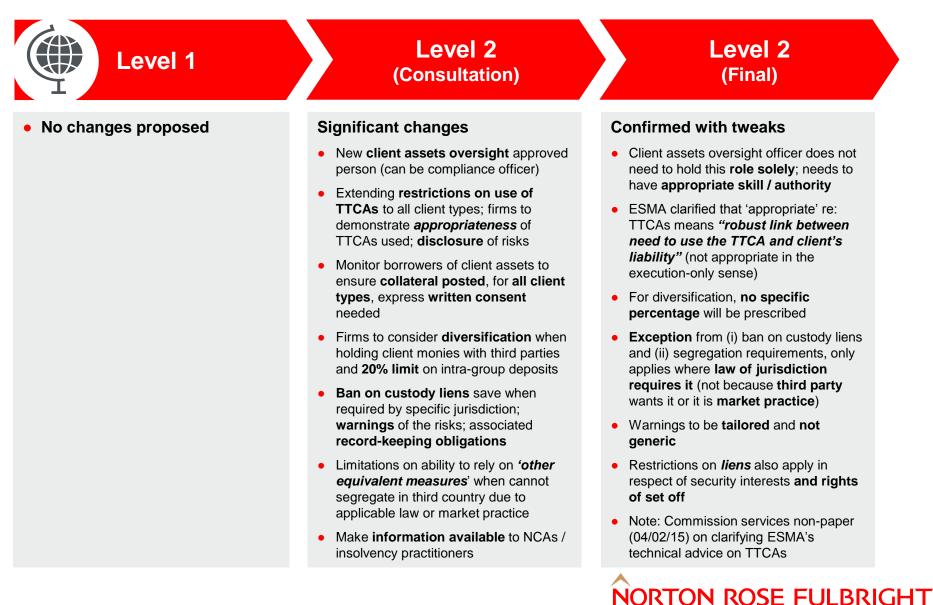
UK RDR goes further than MiFID II but may apply to professional clients

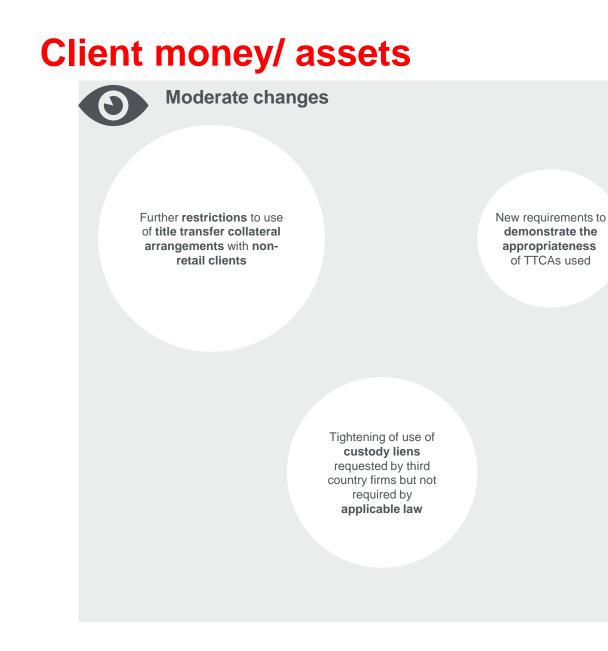
Restricted advisory firms – no impact

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.

Client money/ assets





Tightening of not applying **segregation** requirements to firms in third countries where 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



Significant new requirements

- Existing Level 3 option to record telephone conversations and electronic communications brought into Level 1 text
- Now mandatory
- Extends to recording face-toface conversations with clients
- Includes conversations/ communications about transactions that were not ultimately concluded
- New record-keeping requirements - records to be kept for minimum of five years, or seven years where regulators request

Level 2 (Consultation)

Significant extension

- New Policy: recording telephone conversations and electronic communications policy and effective procedures to ensure recordings kept / technology neutral
- Governance obligations: senior management oversight; educate and train employees; ongoing monitoring of compliance
- Record-keeping obligations: list of personnel approved to have devices; from time record created
- Face to face conversations: prescribe content of written minutes/attendance note
- Storage: durable medium; unaltered reproduction; accessible and readily available

Confirmed with extension and

Level 2

(Final)

retractions

- Extension: new requirement that customers notified in advance that calls recorded and will be kept for min. 5 years
- Clarifications:
 - requirement relates to calls that result or may result in a transaction
 - all firms in transaction chain to record calls
 - proportionality accepted for monitoring calls
 - face-to-face meeting record need not be in minuted form, but durable medium, and content tweaked
 - ESMA clarified that investment advice may be covered by recording obligations

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 faceto-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 Il standard to these firms or a proportionate standard.

FCA also considering removing 'duplication' xemption for discretionary managers

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".

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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 recordkeeping

duration to 5 - 7 years (currently 6 months in UK) - tension with data protection rules

neutral - to extend to capturing all

Technology

forms of communications with clients

Keep in a 'durable medium'

Remuneration



New requirements

- New remuneration policies
 required
- Applies to all "persons involved in the provision of services to clients"
- Policy to be defined, approved, overseen by senior management
- Staff must not be remunerated, incentivised or their performance assessed in a way that conflicts with their duty to act in the best interests of their clients

Level 2 (Consultation)

Significant extension

- Using Level 3 Guidelines from 2013
- 'Remuneration' includes **nonfinancial remuneration**
- Management bodies to seek involvement from compliance function
- Criteria for designing remuneration policies
- Applies to *"all persons who can* have a **material impact** on ability of firm to comply with obligations" (extending level 1?)
- Variable remuneration
 - balance between fixed and variable
 - principally based on qualitative (not commercial) criteria
- Sits alongside CRD IV / AIFMD

Level 2 (Final)

Confirmed with minor tweaks

- Confirmed non-financial remuneration includes:
 - in-kind benefits
 - career progression
- Variable remuneration must fully take account of, rather than be principally based on, appropriate qualitative criteria
- Unusual extension of persons that the obligation applies to – "all persons who can have a material impact on services provided by a firm or on its corporate behaviour ..." What does this mean?



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

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

ISSUES

Carefully consider nonfinancial 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 ackages – retrospective application

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

Product life cycle

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Product governance/distribution



Completely new regime

- Introduction of product approval process (with associated policies and procedures) overseen by senior management
- Identify target market for product and tailor products to that market
- Ensure **distribution strategy** is consistent with target market
- **Periodic review** of product, target market and distribution channels
- New requirements on distributors / sales intermediaries to understand product, target market, features and risks
- Information flow through distribution chain

Level 2 (Consultation)

Moderate extension

- Regime extended to apply to services (not just products)
- **Proportionality** applies
- Two sets of policy proposals:
 - product manufacturers
 - distributors (someone who offers and/or recommends products to clients)
- Introduction of specific oversight, control and governance obligations on firms
- Final distributor in the chain has the obligation to comply with the requirements
- Intermediate distributors also have certain obligations



Confirmed and tweaked

- Tweaks:
 - consider threat to orderly functioning / stability of market when developing products
 - only one target market assessment required
 - additional steps prescribed which manufacturers might take when an event occurs which affects the potential risk / return of the product
 - products manufactured by non-MiFID entities not exempt
 - compliance oversight needed
- Firms that create, issue, design products are themselves manufacturers
- Pure manufacturers to assess target market on '*theoretical basis*'

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Product governance/distribution

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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

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

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.

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

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

Product intervention



Significant new change

- Completely new regime
- MiFIR¹ gives powers to ESMA re: financial instruments, EBA re: structured deposits and PRIIPs ² gives powers to EIOPA re: insurance-based investment products
- Power for national regulators to ban products: including where derivatives have a detrimental effect on price formation in the underlying market
- Separate power to ESMA / EBA / EIOPA to temporarily ban products – max of 3 months, can be renewed, on EU wide basis or in particular Member State

Level 2 (Consultation)

Significant extensions

- ESMA prescribes factors that national regulators need to consider before exercising powers
 - intended to limit wide discretion of NCAs
 - but also to be **flexible** so regime is dynamic
 - factors are general in nature, non-exhaustive and do not include quantitative thresholds
 - focus on using in a proportionate way

Level 2 (Final)

Confirmed with tweaks

- **Tweaked** some criteria that respondents thought were **vague**
- Pursuant to a recent **EJ court** case:
 - ESMA advises Commission to consider whether list of criteria should be **exhaustive** when it applies to ESMA/EBA exercising powers
 - it is non-exhaustive when Member State NCAs use their powers
- Significant and artificial disparity between prices of a derivative and those in the underlying market – relevant criterion to orderly functioning and integrity of market etc

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

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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



No significant changes to MiFID I

- Member States required to notify ESMA of their out-ofcourt complaints and redress procedures implemented in that jurisdiction
- ESMA will **keep a list** on its website

Level 2 (Consultation)

Completely new requirements

- New complaints handling guidelines to mirror those introduced for banking / securities sector
- New complaints management policy and new complaints management function
- Applies to all clients and potential clients
- Not to charge for making complaints
- Respond to complaints without any unnecessary delay
- Final response to explain options and ADR service
- Regulatory reporting to NCAs
- Compliance function to analyse complaints data

Retained with minor tweaks

• **Compliance** able to carry out complaints function

Level 2

(Final)

- "Should" replaced with "shall" in technical advice (stronger requirement)
- No change in position so applies to all clients and potential clients
- Unhelpful clarity on what amounts to a 'complaint'

"A statement of dissatisfaction addressed to a firm by a client or potential client relating to the provision of investment services"

Level 3 – potential for future guidelines from ESMA



Complaints handling

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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 nonretail clients very carefully to avoid every niggle 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





Questions from the floor