



## SPECIAL REPORT SERIES: INVESTOR PROTECTION UNDER MiFID II

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This Special Report is the fifth in FIA and FIA Europe's series covering specific areas of the European Securities and Markets Authority's ("ESMA") consultation process for the implementation of the recast Markets in Financial Instruments Directive ("MiFID II") and the new Markets in Financial Instruments Regulation ("MiFIR"). This Special Report provides a brief overview of the key proposals relating to Investor Protection, set out in the recently published Consultation Paper<sup>1</sup> and Discussion Paper<sup>2</sup> containing draft technical advice measures and proposed Draft Regulatory Technical Standards ("RTS") and Implementing Technical Standards ("ITS"). The strengthening of measures protecting investors is one of the key aims of the MiFID II/MiFIR package.

### PRODUCT GOVERNANCE

Under Articles 16 and 24 of MiFID II, investment firms which "manufacture" financial instruments for sale to clients must maintain a product approval process, which identifies the correct target market and ensures that all relevant risks to that target market are assessed, and that the intended distribution strategy is consistent with the identified target market. This should be subject to periodic review. Investment firms that offer or recommend financial instruments, which they do not manufacture ("distributors"), must ensure that they understand the features of those products, including the target market, identified by the manufacturer.

ESMA has made specific proposals for detailed product governance arrangements in relation to both manufacturers and distributors. For manufacturers, these include: maintaining procedures and arrangements to ensure that conflicts of interest are properly managed as part of the product design, creation and development process; ensuring effective oversight and control over the design and manufacture process; assessing the potential target market to limit the risk of unsuitable financial instruments being sold to investors; enabling distributors to understand and sell products correctly; and reviewing and assessing the risks of poor investor outcomes in relation to financial instruments. ESMA also proposes placing an affirmative duty on investment firms to check that their financial instruments function as intended.

For distributors, there must be: clear product governance processes to ensure that suitable financial instruments and services are offered to the correct target market; periodic review of these arrangements to ensure such arrangements remain fit for purpose; delivery of sales information to manufacturers to assist in meeting their post-sale product governance responsibilities; and involvement of the compliance function and management in the development and review of the products and governance arrangements. Where a chain of firms exists in the distribution of a financial instrument any intermediate distributor firm must ensure that the relevant information on the financial instrument is passed from the manufacturer to the final distributor in the chain.

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<sup>1</sup> ESMA Consultation Paper (ESMA/2014/549)

<sup>2</sup> ESMA Discussion Paper (ESMA/2014/548)

## **PRODUCT INTERVENTION**

Articles 40 to 43 of MiFIR introduce a framework for product intervention in order to enable National Competent Authorities (“NCAs”), ESMA and the European Banking Authority (“EBA”) to prohibit or restrict the marketing, distribution or sale of certain financial instruments. ESMA sets out further detail on criteria and factors that should be taken into account when determining whether one of these bodies should intervene.

Flexibility is key, since the three bodies must be able to respond to a range of exceptional situations, some of which may relate to new instruments that do not meet any of the established criteria. As a result, ESMA believes there should not be specific quantitative thresholds for intervention and such powers should be used sparingly. ESMA comments on the criteria set out in Articles 40 to 43 of MiFIR and provides further guidance as to how the authorities should consider them. It notes that the factors and criteria should not apply cumulatively and that they do not represent an exhaustive list, but are simply elements that should be taken into account.

## **SUITABILITY AND APPROPRIATENESS**

Suitability requirements apply to advised services and portfolio management. When an investment firm offers such services it must obtain sufficient information from its customer to be able to demonstrate the advice it is providing is suitable. ESMA proposes that the original MiFID suitability rules be expanded to incorporate the ESMA guidelines published in July 2012 on suitability. In addition, ESMA recommends that firms now assess both a client’s ability to bear losses and its risk tolerance when undertaking a suitability assessment. The ESMA advice also specifies that client suitability reports should include an outline of the advice provided, together with an explanation of why the recommendation is suitable and how it meets the client’s objectives as well as any disadvantages.

Appropriateness requirements apply to non-advised services. Under these requirements, investment firms must obtain enough information from their clients to assess whether they have the necessary knowledge and experience to understand the risks connected with the services or financial instruments being provided. However investment firms do not have to assess the appropriateness of the service or product offered or demanded under specific circumstances identified within Article 25(4) MiFID II, including where the financial instrument is considered “non-complex”. ESMA proposes a more specific definition of a non-complex financial instrument to ensure that fewer instruments fall within the definition. It also recommends that any financial instruments described within Article 25(4)(a) of MiFID II that do not meet the specific requirements of the criteria be considered “complex”.

## **INDEPENDENT ADVICE**

Under Article 24 of MiFID II, investment firms must inform their clients as to whether their advice is being provided on “an independent basis” and whether the advice is based on a broad or more restricted analysis of different types of financial instruments. Whether advice is deemed to be “independent” or “non-independent” depends on the investment firm’s ability to assess a “sufficiently diversified” range of financial instruments.

ESMA believes firms offering independent advice must implement a selection process which offers a fair and appropriate comparison of different financial instruments. This must not be influenced by any interest the firm, its close links or its advisors may have in relation to a specific financial instrument. Where no comparison of financial instruments is possible, a firm may not claim itself to be independent.

ESMA also states that where a firm offers both independent and non-independent advice, it must ensure that it has adequate disclosure and organisational procedures in place to facilitate both services. It comments that it will be providing further guidance on independence in future.

### **PROVISION OF CLIENT INFORMATION**

Under Article 24 of MiFID II, information provided by investment firms to clients must be fair, clear and not misleading. ESMA advises that information provided to retail clients should be consistently presented in the same language throughout all forms of material provided to that client. Further, there should be a fair and prominent indication of any relevant risks, and a requirement that information is up-to-date and relevant to the method of communication used. In addition, the measures should extend some of these principles to non-retail clients, including that information should be accurate and not reference any potential benefit, without giving a fair and prominent indication of any relevant risks. It must not disguise, diminish or obscure important statements and it must be up-to-date.

In addition, appropriate information should be provided to clients or potential clients in good time. ESMA considers that, with the inclusion of independent and non-independent categories of advice, firms must properly explain the scope and features of the advice they provide to clients. They must indicate whether the advice is independent or not in a clear and concise way, and whether the advice is based on a broad or restricted analysis of different types of instrument. It must also explain that it will provide a periodic assessment of suitability. With regard to information about financial instruments, ESMA considers that firms must provide clients with information on:

- their functioning and performance in different market conditions;
- whether there are divestment restrictions;
- the legal nature and status of financial instruments composed of two or more different financial instruments; and
- instruments incorporating a guarantee or capital protection.

### **FEES AND INDUCEMENTS**

Article 24 of MiFID II states that appropriate costs information should be provided to clients in good time. ESMA believes that increased transparency on costs should be extended to cover all categories of client, including non-retail clients. However, non-retail clients should have the opportunity to opt-out of these requirements provided they are not receiving the services of investment advice and portfolio management, and the financial instruments concerned do not embed a derivative.

ESMA also provides clarity on when full point of sale disclosure of information is required and the scope of post-sale periodic disclosure. It sets out details on when costs and charges should be aggregated and on the timing and format of disclosure, including the methodology for calculation of “ex-ante” figures and how the cumulative effect of costs will affect any return.

Under Article 24(7) and (8), investment firms that provide advice on an independent basis or portfolio management will be banned from accepting or receiving fees, commissions or any monetary benefits paid or provided by any third party, or person acting on behalf of a third party, in connection with the provision of services to clients. ESMA specifies that independent investment advisors and portfolio managers must return monetary or non-monetary third party payments to clients as soon as possible after receipt. Clients should be informed of this via their bank account statements. The technical advice also sets out what ESMA considers to be minor non-monetary benefits and the disclosure requirements for other investment services (i.e. not independent investment advice or portfolio management). ESMA recommends that the European Commission

align the relevant costs provisions under the UCITS and AIFMD with those under MiFID II. ESMA also clarifies the requirement of “quality enhancement” for services to client.

## **BEST EXECUTION**

Investment firms are required to provide all clients with a best execution service when executing orders under Article 27 of MiFID II. Markets are required to publish information on the quality of the execution provided. Firms will be required to publish information annually on the top 5 venues that they have used. ESMA sets out in the Discussion Paper the specific types of data that firms and trading venues must report to fulfil their obligations to publish quality of execution data and order flow information. Data provided by trading venues should be precisely defined, published in a standardised format and appropriate for firms using the venue. Firms providing data should ensure it is transparent in relation to the venues chosen and easily understandable for clients.

ESMA advises that a firm’s execution policy should set out its strategy for obtaining the best possible result for the execution of its client orders and include an account of the importance the firm places on the execution factors when executing client orders or decisions to deal. It must also provide information as to how those factors affect the firm’s choice of execution venues. Retail investors need only be provided with a summarised policy.

ESMA also considers that permissible third party payments should be disclosed within execution policies. Clients should not be induced to select their own execution venues, but where invited to do so, they must have access to adequate and transparent information to support their choice. The advice also sets out ESMA’s further guidance and clarification on material changes which would trigger reviews of firms’ execution policies and arrangements.

The client order-handling rules remain unchanged under MiFID II.

## **CONFLICTS OF INTEREST MANAGEMENT**

Under Articles 16 and 23 of MiFID II, investment firms are required to take all appropriate steps to identify, prevent or manage conflicts of interest; and to maintain and operate effective organisational and administrative arrangements to prevent conflicts of interest. ESMA advises that the existing rules should be strengthened to:

- specify that placing an over-reliance on disclosure without adequate consideration as to how conflicts may be appropriately managed is not permitted;
- ensure that disclosure to clients is sufficiently detailed and meaningful to enable the client to make an informed decision as to whether to proceed; and
- introduce a requirement on firms to assess and periodically review their conflicts of interest policies and take all reasonable steps to address any deficiencies.

Investment firms will also be required to ensure specific disclosure of any potential conflicts to clients going forward.

ESMA also provides technical advice on conflicts of interest requirements in relation to the underwriting and placing process. It proposes supplemental requirements in relation to advising to undertake an offering, pricing, placing, retail advice and the provision of credit. It specifies that any measures introduced must be in accordance with the MiFID proportionality principle. There are also additional measures in relation to record-keeping and oversight of underwriting and placing operations.

## OTHER INVESTOR PROTECTION MEASURES

MiFID II requires tighter rules around remuneration for investment firms. ESMA advises that there should be specific requirements with regard to the governance of remuneration policies, the general criteria for the design of such policies and limits on the ratio of fixed to variable remuneration rewards. These principles should apply broadly to all relevant persons who could have an impact on the ability of the firm to comply with its obligations to act fairly, honestly and professionally in accordance with the best interests of clients (both retail and non-retail).

ESMA proposes to introduce additional requirements with regard to the safeguarding of client assets. Whilst the use of title transfer collateral arrangements (“TTCAs”) in connection with retail clients is banned, ESMA recommends restricting their use with regard to non-retail clients in specified circumstances. On safeguarding protections, it also sets out advice on proper and specific governance arrangements for firms increased disclosure requirements and additional proposals with regard to diversification of client funds.

MiFID II has also introduced new rules on recording of telephone conversations and electronic communications related to transactions that are concluded and those that are intended to conclude, but do not result in, a transaction ESMA advises that this requirement will cover some internal calls and face-to-face conversations. Investment firms must also take all reasonable steps to ensure that use of privately owned equipment, including mobile telephones, is properly restricted. ESMA provides technical advice on other topics including the compliance function, complaints handling and the specific MiFID II exemption for firms providing investment services in “an incidental manner”.

In addition, ESMA sets out the list of harmonised information, to be provided in RTS and ITS, which applicant firms would need to submit to Home State NCAs for authorisation. ESMA also proposes changes to the RTS regarding establishment of branches in other Member States, to take into account the new activity of operating an Organised Trading Facility and the obligation to provide the identity of any tied agents to NCAs.

## UPCOMING SPECIAL REPORTS

In the coming days, FIA and FIA Europe will issue special reports on the remaining topics addressed in the two papers:

- **Algorithmic and High-Frequency Trading** (defining terms and regulating activities)
- **Third Country Access** (treatment of third country firms accessing EU customers)
- **Transaction reporting of Instruments**
- **Transparency** Requirements for Instruments

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Additional MiFID II/MiFIR documents are available [here](#).

*Disclaimer: This report was drafted by the London office of Covington & Burling LLP on behalf of FIA and FIA Europe. The report is part of a series of reports intended to provide factual summaries of*

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