MiFID II

FCA Discussion Paper and HM Treasury Consultation Paper

March 2015

Hogan Lovells

Key Points

- The FCA has released a Discussion Paper (DP15/3) on its approach to implementation of MIFID II conduct of business and organisational requirements.
- HM Treasury published a Consultation Paper in March 2015 on the transposition of MiFID II.

The UK's approach to MiFID II

In this briefing note, we set out some of the implications of the implementation of MiFID II in the UK. In particular, we describe:

- the FCA's recent discussion paper (DP 15/3) on certain conduct of business and organisational requirements; and
- HM Treasury's consultation on the transposition of MIFID II into UK legislation.

FCA Discussion Paper on conduct of business and organisational requirements (DP 15/3)

In March 2015, the FCA issued a Discussion Paper (DP 15/3) on certain conduct of business and organisational requirements under MiFID II (see here). This was intended by the FCA as a preliminary discussion focusing on retail conduct issues before it consults more extensively on rule changes in Q4 2015.

The discussion paper closed for comments on 26 May 2015.

The topics covered by the FCA's Discussion Paper are set out below.

Insurance-based investment products and pensions

Insurance-based investment products and pensions are not investment products for the purposes of MIFID I. However, acting in the interests of consumer protection, the FCA applies the same conduct of business rules to these products as to MiFID investment products.

MiFID II will not bring insurance-based investment products and pensions within the scope of MIFID investment products. However, MiFID II will require the FCA to amend its conduct of business rules, so the FCA must decide whether these revised rules will apply to insurance-based investment products and pensions.

In DP 15/3, the FCA proposes to continue to apply its conduct of business requirements to insurance-based investment products and pensions as if they were investment products for the purposes of MiFID II.

The FCA has also discussed how insurance-based investment products may be affected by the forthcoming Insurance Distribution Directive, and how this would interact with a conduct of business regime based on the MiFID II rules.

Structured deposits

Firms selling or advising on structured deposits will be subject to many of the investor protection and organisational requirements in MiFID II. These new obligations include rules on assessing suitability and appropriateness, inducements, product governance, remuneration, the disclosure of costs and charges, and requirements for reporting to clients.

In the UK, the promotion and sale of structured deposits is currently subject to the Banking Conduct of Business sourcebook ("**BCOBS**"). However, MiFID II will bring structured deposits within the scope of the rules in the Conduct of Business sourcebook ("**COBS**") which apply to investment business.

The FCA has asked for views on its approach to structured deposits, and which of the following three options is preferred:

- the FCA could copy out the MiFID II provisions on structured deposits into

BCOBS, where they would only apply to structured deposits;

- the FCA could insert the relevant provisions into COBS, but only apply them to structured deposits; or
- apply all of the COBS requirements to structured deposits.

Third party rebates for discretionary investment management firms

MiFID II bans discretionary investment managers from accepting and retaining third party commission, fees and monetary and most non-monetary benefits. This is similar to the UK's existing Retail Distribution Review ("**RDR**") rules applicable to investment advisers.

However, unlike the RDR, MiFID II permits firms to accept third party commissions and payments, provided these are rebated back to the customer as soon as possible after receipt.

The FCA has asked whether this third party rebating should be banned for discretionary investment management firms. In the FCA's view, allowing rebates would distort consumer outcomes and risk confusion.

Local authorities that request professional client status

MiFID II has increased protections for local authorities in the aftermath of the financial crisis and several prominent mis-selling scandals. As part of these protective measures, MiFID II categorises local authorities as retail clients.

Like other retail clients, local authorities would have the option to request an opt-up to professional client status. However, MiFID II allows member states discretion to adopt specific criteria to assess the expertise and knowledge of local authorities requesting an opt-up.

DP 15/3 sets out the different options for the assessment of local authorities requesting to be treated as professional clients. The FCA has suggested that the options are:

- no change to existing criteria but additional guidance on aspects of it;
- the introduction of new rules; or
- changing rules to strengthen the opt-up regime.

The FCA has also proposed that local authorities should be treated as retail clients in respect of non-MiFID business.

Adviser independence

MiFID II requires firms offering investment advice to state whether their advice is given on an independent or a restricted basis. For an adviser to be independent for the purposes of MiFID II, it must assess a "sufficient range" of providers' products. The intention of the MiFID II independence standard is to discourage product and provider bias.

The UK already requires firms to state whether advice is given on an independent or restricted basis. However, the UK's independence standard, which was brought in by the RDR rules, differs from MiFID II. For the purposes of the UK rules, an independent adviser must carry out a thorough search of the whole market. The intention of the UK rules was to ensure that advisers consider a wide range of products in order to produce a comprehensive and fair analysis.

In addition, MiFID II will require advisers to state whether their advice is independent in relation to shares, bonds, structured deposits and derivatives, none of which are covered by the existing UK rules.

The FCA has requested views on the implementation of adviser independence, and whether the existing UK standard for independence advice should be maintained, and in relation to which instruments.

Remuneration in non-MiFID firms

MiFID II introduces rules on the remuneration of sales staff and advisers. The FCA has asked whether these MiFID II rules should be applied to non-MiFID firms, and how this would

interact with existing UK rules on remuneration, which consist of the Remuneration Code (SYSC 19), the AIFM Remuneration Code (SYSC 19B) and the BIPRU Remuneration Code (SYSC 19C). The FCA also notes the growing body of EU legislation in this area, including Solvency II, the Insurance Distribution Directive, the Mortgage Credit Directive and CRD IV.

Telephone and email recording for certain exempt firms

Under article 3 of the MiFID I Directive, certain categories of firm are exempt from the requirements of MIFID ("**Article 3 firms**"); this exemption typically includes independent financial advisers and corporate finance boutiques.

MiFID II will require these Article 3 firms to meet certain authorisation, supervision, conduct of business and organisational requirements for the first time.

The UK already applies a domestic regime that meets most of these requirements. However, MiFID II includes a new requirement for firms to record certain telephone conversations and electronic communications. The FCA has asked for views on the impact of the enhanced MiFID II regime, including telephone and email recording requirements, on Article 3 firms.

The FCA also proposes to remove certain recording exemptions for discretionary investment managers in the existing UK regime.

Costs and charges disclosure

MiFID II introduces new requirements for firms to disclose costs and charges to clients.

The FCA has noted that firms are likely to face technical challenges in meetings these requirements, particularly given the existence of separate obligations for disclosure arising in relation to the key information document ("**KID**") as a result of the PRIIPs Regulation and the key investor information document ("**KIID**") for UCITS. The FCA has asked firm to comment on what practical challenges they may face in meeting MiFID II's requirements on disclosing costs and charges.

Inducements

MiFID II bans the receipt and retention of all monetary and non-monetary benefits (other than minor non-monetary benefits) by independent advisers and portfolio managers.

The UK rules in COBS 6 state that advisers (whether independent or restricted) can only be remunerated for advice by adviser charges.

The FCA anticipates that the MiFID II rules for independent advisers will tighten standards domestically. In addition, although the MiFID II regime only applies to independent advisers, the FCA believes it appropriate to apply the MiFID II inducements ban to firms providing restricted advice.

Furthermore, the ban will apply to discretionary investment managers (for further details, see above on Third party rebates).

The existing RDR commission ban only applies to business conducted for retail clients, whereas the prohibition in MiFID II will apply to business conducted for retail clients or for professional clients.

Complex and non-complex products

MiFID I distinguishes "complex" and "non-complex" products. This distinction is important principally because it determines whether or not a firm is required to assess if a particular product or service is appropriate for a customer; if the product is non-complex, there are certain circumstances set out in COBS 10 when the firm is not required to carry out the appropriateness test.

MiFID II has sought to enhance investor protection by restricting the range of products that can be classified as non-complex. According to the FCA, it is likely that in the future, few instruments other than plain vanilla shares and bonds, (non-structured) UCITS funds and certain structured deposits will be regarded as non-complex, and hence able to be sold to retail clients without an appropriateness test.

HM Treasury consultation on transposition of MiFID II

On 27 March 2015, HM Treasury published a consultation paper on the transposition of MiFID II into UK law and regulation (see here). The consultation requests responses by 18 June 2015.

HM Treasury has stated that it will continue to follow the general approach to transposition used when implementing MiFID I. This broadly consists of the following principles:

- *Continuity*: MiFID II will be implemented by amendments to existing UK legislation, e.g. the Financial Services and Markets Act 2000, the Regulated Activities Order 2001, and related statutory instruments.
- *Copy out*: The wording of the new UK legislation and rules should mirror as closely as possible the original wording of MiFID II. The UK requirements should go no further than the requirements of MiFID II, except where there is a "clear justification and authority" to do otherwise.
- *Transparency*: The UK government intends to provide draft legislation to stakeholders as early as possible for their review and comment.

In addition to amendments to existing legislation, HM Treasury has proposed the following new draft statutory instruments:

- Financial Services and Markets Act 2000 (Markets in Financial Instruments) Regulations 2016;
- Financial Services and Markets Act 2000 (Data Reporting Services) Regulations 2016;
- Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) Order 2016; and
- Financial Services and Markets Act 2000 (Qualifying EU Provisions) (Amendment) Order 2016.

The Annexes to the consultation paper contain these draft statutory instruments (see here).

The consultation paper sets out HM Treasury proposals with regards to the following areas.

Third country firms' access to EU markets

Article 39 of the MiFID II Directive gives member states discretion to choose whether to permit a "branch passport" regime for third country (non-EEA) firms in their jurisdictions. This would mean that when a third country firm establishes a branch in that jurisdiction, it would be able to provide investment services into the other member states.

HM Treasury proposes to retain the current UK regime and not implement the branch passporting provisions of MIFID II.

Data reporting services

Under MiFID II, firms will require authorisation in order to provide data reporting services.[1] This means that the following data reporting services providers will need to be authorised:

- Consolidated Tape Providers ("**CTPs**");
- Approved Publication Arrangements ("**APAs**"); and
- Approved Reporting Mechanisms ("**ARMs**").

The UK government has proposed a specific regime for the data reporting services providers, which will be independent of the Regulated Activities Order 2001. Instead, the UK government has set out draft legislation in the form of the Financial Services and Markets Act (Data Reporting Services Regulations) 2016.

[1] Article 59(1), MiFID II Directive.

Position limits and reporting

The UK government intends the position limit regime required by MiFID II to be created as a "standalone" regime, through provisions in the Financial Services and Markets Act 2000 (Markets in Financial Instruments) Regulations 2016 ("FSMA Regulations 2016").

The government has stated that the MiFID II position management and position reporting requirements will be detailed in:

- FCA Rules in relation to investment firms and credit institutions; and
- amendments to the Financial Services and Markets Act 2000 (Recognition Requirement) Regulations in relation to recognised investment exchanges ("**RIEs**").

Unauthorised persons

MiFID II will apply to certain members or participants in regulated markets or multilateral trading facilities in circumstances where they are otherwise exempt from being authorised. HM Treasury is consulting on how this would be applied in UK legislation.

Structured deposits

There is no explicit requirement under MiFID II for investment firms or credit institutions to be authorised to carry on certain activities in relation to structured deposits. However, the UK government believes that these activities should be brought within the regulatory perimeter when carried on in relation to structured deposits. The government intends to amend the Regulated Activities Order 2001 to bring this about.

Power to remove board members

MiFID II provides for NCAs to have the power to remove members of the board of investment firms or market operators.[2] The UK government is consulting on how this power could best be introduced in UK legislation.

Organised trading facilities

The MiFID II requirements for organised trading facilities ("**OTFs**") operated by investment firms or credit institutions will be transposed through FCA rules. In order to ensure that the category of OTF is transposed into UK legislation, operating an OTF will be an investment service under the Regulated Activities Order 2001 and will require authorisation under the Financial Services and Markets Act 2000.

Binary options

Binary options are a form of financial contract which pay a fixed sum if the option is exercised or expires in the money, or nothing at all if the option is exercised or expires out of the money.

The UK government believes that binary options should be viewed as MiFID financial instruments, and proposes to bring activity in relation to these instruments within the UK regulatory perimeter.

[2] Article 69(2)(u), MiFID II Directive.

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Our offices
Associated offices

5486325

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