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MiFID II

Conflicts of interest

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Hogan Lovells

Key Points

- The managing of conflicts of interest by means of disclosure will become a "measure of last resort" which can only be used when the firm's organisational and administrative arrangements to manage conflicts are inadequate.
- Where disclosure of conflicts is made, it will be subject to additional mandatory requirements (including the fact that the firm's organisational and administrative arrangements were inadequate to manage the conflict).
- Each firm's conflicts of interest policy (which they are required to have under MiFID I) will have to be reviewed at least annually.

Background

Under MiFID I:

- There is a high level obligation on firms to take all reasonable steps to identify conflicts of interest.[1]
- A firm must maintain and operate effective organisational and administrative arrangements with a view to taking "all reasonable steps" designed to prevent conflicts of interest from adversely affecting the interests of its clients.[2]
- Where the organisational or administrative arrangements made by the firm to manage those conflicts are not sufficient to ensure, with reasonable confidence, that risks of damage to client interests will be prevented, the firm must clearly disclose the general nature and/or sources of conflicts of interest to the client before undertaking business on its behalf.[3]
- Firms are required to put in place a written conflicts of interest policy which is appropriate to the size and organisation of the firm and the nature, scale and complexity of its business. The conflicts policy must identify the circumstances that give rise to a conflict and specify procedures to be followed and measures to be adopted in order to manage conflicts.[4]

The relevant provisions from MiFID I will remain intact, but they will be supplemented by the following requirements under MiFID II.

Disclosure as a last resort

Article 34 of the MiFID II Delegated Regulation[5] says that firms must ensure that disclosure to clients of conflicts is a measure of last resort that can be used only where the organisational and administrative arrangements established by the firm to prevent or manage its conflicts of interest are not sufficient to ensure, with reasonable confidence, that the risks of damage to the interests of the client will be prevented. Overreliance on disclosure will be seen as evidence that the conflicts of interest policy in place is deficient and inadequate.[6] If disclosure can only be made as a last resort, firms are likely to be expected to do more to prevent and manage the conflicts before relying on this provision.

Detailed disclosure in a durable medium

Where the disclosure of conflicts to clients is permitted, Article 23(3) of the MiFID II Directive states that the disclosure must:

- be made in a durable medium; and
- include sufficient detail, taking into account the nature of the client, to enable that client to make an informed investment decision with respect to the service in the context of which the conflict of interest arises.

Article 34 of the MiFID II Delegated Regulation supplements this by saying that the disclosure should:

- include a specific description of the conflict of interest in question;
- explain the general nature and/or sources of conflicts of interest, as well as the risks to the client that arise as a result of the conflict

1 Article 18(1), MiFID I Directive.
2 Article 13(3), MiFID I Directive.
3 Article 18(2), MiFID I Directive.
4 Article 22, MiFID Implementing Directive.
5 Article 34(4) of the Delegated Regulation of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive (the "**MiFID II Delegated Regulation**"). For earlier advice on this issue, see ESMA, Final Report: Technical Advice to the Commission on MiFID II and MiFIR, 19 December 2014 (ESMA/2014/1569) (the "**Technical Advice**"), Chapter 2.9.
6 Article 34(5), MiFID II Delegated Regulation.

and the steps undertaken to mitigate these risks; and

- explain that the firm's organisational and administrative arrangements are not sufficient to protect the client – which may suggest to clients for the first time that the firm may not be doing enough to manage its conflicts effectively.[7]

Firms are expected to keep a record of conflicts of interest which present a risk to their clients, including senior management reports. These records will assist with meeting the above disclosure requirements.[8]

Conflicts of interest policy

In relation to the conflicts of interest policy, Article 34 of the MiFID II Delegated Regulation says that Member States will require investment firms to assess and periodically review - at least annually - the conflicts of interest policy and to take all appropriate measures to address any deficiencies.[9]

When designing the policy, special attention should be paid to the following activities:

- investment research and advice;
- proprietary trading;
- portfolio management; and
- corporate finance activities, including underwriting or selling when offering securities, or advising on mergers and acquisitions.[10]

The MiFID II Delegated Regulation gives further guidance that:

- where a firm is a member of a group, the policy should take into account the structure and business activities of other group members that could give rise to a conflict of interest;[11]
- procedures must be included to prevent or control the exchange of information where there is a risk that the exchange would harm the interests of one or more clients;[12]
- relevant persons must be supervised separately where their principal activities or service provision could lead to a conflict;[13]
- measures must be included to remove any direct links between the remuneration of different relevant persons engaging in different activities, where the remuneration arising from such activities could lead to a conflict of interest;[14]
- limits must be included to prevent inappropriate influence over the way in which a relevant person carries out investment or ancillary activities;[15] and
- measures must be included to prevent the simultaneous or sequential involvement of a relevant person in separate investment or ancillary activities where their involvement could impair proper management of conflicts.[16]

Timescales for Implementation

The MiFID II Directive and the Markets in Financial Instruments Regulation ("**MiFIR**") came into force on 3 July 2014, and most of their provisions will come into effect in member states from 3 January 2018. Member states have until 3 July 2017 to transpose the MiFID II Directive into national law.

The changes to the MiFID Implementing Directive will be made by way of the MiFID II Delegated Regulation which will become effective by 3 January 2017. The MiFID II Delegated Regulation will have direct effect and the member states will not need to implement these changes into national law.

7 For earlier advice on this issue, see the ESMA Technical Advice.
8 Article 35, MiFID II Delegated Regulation
9 For earlier advice on this issue, see the ESMA Technical Advice.
10 Recital 47, MiFID II Delegated Regulation
11 Article 34(1), MiFID II Delegated Regulation
12 Article 34(3)(a), MiFID II Delegated Regulation
13 Article 34(3)(b), MiFID II Delegated Regulation
14 Article 34(3)(c), MiFID II Delegated Regulation
15 Article 34(3)(d), MiFID II Delegated Regulation
16 Article 34(3)(e), MiFID II Delegated Regulation

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