LATHAM&WATKINS

Client Alert

Financial Regulatory News Flash

Latham & Watkins Financial Regulatory Practice | 5 July 2017 | Number 2173

MiFID II – Second Policy Statement and Further Consultation

The FCA has published its second Policy Statement on MiFID II implementation, plus a further Consultation Paper on residual issues.

Key Points:

- The FCA has made significant changes to some proposals, particularly in relation to inducements and research.
- There remain a number of points of uncertainty, and areas where EU-level guidance is required.

The FCA has published its second Policy Statement (PS17/14) on MiFID II implementation, following publication of its first Policy Statement (PS17/5) at the end of March. The paper includes almost all of the FCA's final rules implementing MiFID II. Some of the rules were published in near-final form in PS17/5 earlier this year, but could not be finalised until HM Treasury had made its MiFID II implementing legislation. The FCA has also published a sixth Consultation Paper (CP17/19), covering some small technical issues that it was not able to consult on prior to the publication of the implementing legislation.

Implementation: 3 January 2018.

Key Points in the Policy Statement

Inducements and Research

The FCA has introduced a number of helpful clarifications in this area.

The FCA has amended its guidance to allow greater flexibility over how quickly research charge deductions should be passed into a research payment account (RPA) (the so-called "sweep period"). It sets a minimum standard of 30 calendar days from a transaction taking place, although the FCA stresses that it expects firms to consider moving funds more quickly than this, particularly where, for example, a significant amount of charges are generated in a short time.

The FCA also clarifies that investment managers need not have a single RPA per research budget, and that use of a "virtual" RPA may be acceptable, although it continues to view a single account as a more efficient solution. However, the FCA does not clarify whether a client omnibus account could be used as one or more of these linked accounts, or whether a virtual RPA must be made up of multiple individual accounts.

The FCA thinks it acceptable for firms to use a combination of research payment account funding and own resources to pay for external research. However, it makes clear that it does not consider payment netting of RPA monies to be acceptable.

Helpfully, the FCA has chosen to use its limited discretion to add two new types of acceptable minor non-monetary benefits to the list. Research trial periods may be acceptable, subject to strict conditions. For example, the service must be limited in duration to no more than three months, and the firm must not receive another free trial from the same provider within a 12-month period. The FCA highlights that firms providing free trials must also consider their own inducements obligations. This concession will no doubt be helpful for firms needing to judge the quality and value of research purchased, allowing them to do so before committing to a particular service.

The FCA believes that connected research in the context of a primary market capital raising event such as an IPO should also be acceptable as a minor non-monetary benefit. The FCA views this type of research as comparable to issuer-commissioned research, which is listed explicitly as a minor non-monetary benefit in the EU text. The FCA may be open to adding other types of research to its list, stating that it is open to considering further clarifications to support SME research, where robust evidence can be provided to show that this would help support the functioning of the market.

The FCA has provided an additional concession for private equity firms (see *Concessions for Private Equity Firms*, below).

The FCA has allayed the concern that post-trade delegated reporting services could be considered an inducement, by clarifying that such services may be viewed as part of the overall execution service provided, rather than a separate non-monetary benefit. This was a particular concern for firms intending to opt-in to the SI regime early. In order to be acceptable, the services must not influence best execution, and should be offered as a standard term of business, not a special service for some firms only.

There is also some additional clarification (often on old rules, as well as the MiFID II requirements) as to what would *not* constitute execution-related services. Firms subject to the enhanced rules on inducements will still need to pay for services such as trade analytic tools, order management systems and RPA services from their own resources.

For firms providing both research and execution services, the FCA has provided some helpful clarifications on particular points of confusion. In the FCA's view, such firms do not need to price research separately when providing research to third country firms, although they may choose to do so if they wish. However, firms must price research separately when it is being provided to any MiFID investment firm, regardless of whether or not that firm is performing portfolio management or independent investment advisory services and is thus subject to the enhanced rules on inducements.

There is no progress regarding the much-publicised clash between the MiFID II rules on research unbundling and the US regulatory framework, but the FCA does at least acknowledge the issue. It states that it understands US broker dealers are in discussions with the US SEC and looking to find a way to allow such firms to accept separate payments for research from EU firms. This follows reports last week that the SEC is looking into what sort of relief it may be able to offer US firms. However, the FCA also states that it is not clear whether this will provide a solution and so it will continue to monitor the situation. So it is still "watch this space" for EU recipients of US research services.

Investment Research

The FCA mentions some additional expectations for producers of non-independent research, reminding such firms that although they are not subject to the rules on physical separation between research analysts and others under MiFID II, they should be considering their general conflicts of interest obligations under SYSC 10. This suggests that the FCA may expect such firms to introduce, or justify the lack of, physical separation in some circumstances.

Product Governance

The FCA provides little further clarification on this difficult area. It has not provided any additional guidance on the application of the principle of proportionality. The FCA has made the following changes to its draft rules:

- The FCA has conceded that draft PROD 3.2.15 referring to stress testing is super-equivalent, and has deleted it in favour of leaving in the MiFID II concept of scenario analysis.

- The FCA has dis-applied PROD 3.3.1 (general distribution requirements) in relation to eligible counterparty business. The remaining provisions in PROD (including PROD 3.3) that are relevant to transactions with eligible counterparties will apply (albeit in a proportionate and appropriate manner).

- The FCA has deleted draft PROD 3.2.12 (which was guidance to the effect that firms should ensure the complexity of an instrument is a reasonable match to the level of financial sophistication and understanding of the instrument's target market). This was in response to concerns raised during the consultation that the rule "*could mean that the manufacturer cannot design a complex instrument for retail clients even where it may be suitable… [because] … the guidance does not account for decisions taken on a client's behalf by discretionary advisors*".

Client Categorisation

The FCA has made some adjustments to its rules on the categorisation of local authorities, following feedback about the perceived difficulty of opting-up local authorities to professional client status and ensuring larger authorities can access appropriate investment opportunities.

The FCA has adjusted the quantitative test for local authorities in two ways. First, it has added in a new criterion relevant to local government pension schemes. This means that, where the portfolio size requirement is met, an authority can be opted up if it is an "administering authority" of the local government pension scheme within the meaning of The Local Government Pension Scheme Regulations 2013.

The FCA has also revised the portfolio size requirement down from £15 million to £10 million, as it considers this to be a more appropriate threshold for ensuring that the smallest local authorities cannot be opted-up, but that larger and more sophisticated authorities can do so more easily.

Further, the FCA provides some clarifications about how to apply the tests to local authority clients, particularly where a test needs to be applied in respect of a natural person. However, the FCA stresses the importance of firms exercising their judgment and ensuring they understand the governance arrangements of the local authority in question.

Taping

As previously indicated, the FCA has decided that it will not apply telephone taping requirements to all investment services and activities carried out in relation to corporate finance business, recognising that some activities are beyond the scope of MiFID II, and conduct or market abuse risks are not as prevalent in these areas. Communications occurring during corporate finance business are in scope in so far as they are in scope of the MiFID II rules.

The FCA will remove the current partial exemption for discretionary investment managers as proposed, but with a few tweaks such as adjusting the scope to exclude communications relating to financial instruments not linked to trading on a trading venue. The FCA will tighten the rules for Article 3 firms, by requiring them to include more details when they take a note rather than record a telephone conversation.

Concessions for Private Equity Firms

Despite having initially aimed to extend many of the MiFID II conduct requirements to collective portfolio management firms (including UCITS management companies and most AIFMs), the FCA has changed its position on a few aspects, which will be welcome news to private equity firms.

The FCA has decided not to extend the MiFID II rules on inducements and research specifically to activities relating to private equity or venture capital business.

The FCA has also decided that the changes in the best execution rules under MiFID II should not, as originally proposed, apply to full-scope UK AIFMs and incoming EEA AIFM branches. The FCA wishes to take better account of the diverse range of business models in this sector and will consider the outcome of the EU level review of the AIFMD, which is due to take place later this year. The FCA believes this may seek to introduce enhanced best execution requirements for AIFMs.

Areas Lacking Clarification

There are various areas where the FCA has chosen not to provide further clarification or defers to the EU authorities. There are also several occasions where the FCA confirms its views in the front end of the Policy Statement, but maintains the position that it will not reflect this in guidance.

In particular, the FCA does not provide guidance on the meaning of “multilateral system”, choosing instead to rely on the ESMA Q&A. However, the FCA does state that it may make perimeter guidance on this at a later stage.

The FCA is also not going to propose a standard format for costs and charges disclosures, although it remains open to engaging with an industry-led solution.

On suitability, the FCA highlights the fact that ESMA is updating its existing suitability guidelines and expects to consult on them this summer, with a view to finalising them around the MiFID II implementation date.

Further Consultation

The FCA’s additional consultation covers a few technical issues that it was not able to consult on previously, as it either needed to wait for HM Treasury to make the necessary secondary legislation implementing MiFID II before it could do so, or because the changes are consequent upon HM Treasury’s final versions of the legislation. As the final legislation was only published on 22 June, there has not been an opportunity for the FCA to consult on these issues previously.

The FCA is proposing to:

- Bring recognised investment exchanges operating MTFs and OTFs into the scope of the Financial Services Compensation Scheme. MiFID II requires such exchanges to be part of an investor compensation scheme, closing the loophole under MiFID I that required only investment firms operating MTFs to be part of investor compensation schemes. The FCA is proposing a base costs levy of £1,000 for exchanges operating MTFs or OTFs, and to put such exchanges into the same funding class as investment firms that operate these venues. However, the FCA notes that due to the nature of their members and participants, it does not expect that MTFs or OTFs run by exchanges are likely to carry out business that may be compensated under the Financial Services Compensation Scheme.

- Make changes to its proposed amendments to the Decision, Procedures and Penalties Manual and the Enforcement Guide. This is to align with the final version of the UK implementing legislation, which made some changes to the scope of certain enforcement powers.

- Make some technical changes to the Prospectus Rules and Glossary, to align with the final version of the UK implementing legislation, which amends the definition of "qualified investor" for the purposes of when an approved prospectus is required.

Responses to the consultation are due by 7 September 2017; the FCA plans to publish its final rules in November 2017.

Next Steps

The FCA is now expecting firms to ready themselves for 3 January 2018. It reminds firms that the deadline for submitting authorisation applications for MiFID II permissions (3 July 2017) has now passed. It also highlights that industry testing is open for its new Market Data Processor (MDP) system, the system through which firms will be able to fulfil data submission obligations under MiFID II, and that firms needing to use the system should start the on-boarding process now.

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

Rob Moulton
rob.moulton@lw.com
+44.20.7710.4523
London

Anne Mainwaring
anne.mainwaring@lw.com
+44.20.7710.1018
London

Nicola Higgs
nicola.higgs@lw.com
+44.20.7710.1154
London

Ella McGinn
ella.mcginn@lw.com
+44.20.7710.4649
London

Charlotte Collins
charlotte.collins@lw.com
+44.20.7710.1804
London

Frida Montenius
frida.montenius@lw.com
+44.20.7710.1161
London

Becky Critchley
becky.critchley@lw.com
+44.20.7710.1000
London

Jonathan Ritson-Candler
jonathan.ritson-candler@lw.com
+44.20.7710.1815
London

Stuart Davis
stuart.davis@lw.com
+44.20.7710.1821
London

Emily Torrens
emily.torrens@lw.com
+44.20.7710.1883
London

You Might Also Be Interested In

ESMA Final Report on MiFID II Product Governance Requirements

Significant Updates to ESMA's Q&A on MiFID II Market Structures

FCA's Latest Papers on the Implementation of MiFID II

MiFID II Product Governance – Proportionality: Rules of the road