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*FCA, Markets in Financial
Instruments Directive II
Implementation -
Consultation Paper III*

(CP16/29)

Hogan
Lovells

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Introduction

Key Points

- The FCA's latest consultation on the Markets in Financial Instruments Directive II ("**MiFID II**") mainly covers conduct of business issues.
- The new rules will toughen the UK regime on inducements, including in relation to the requirement to unbundle execution fees from investment research.
- The FCA is considering whether to extend the MiFID II rules on the recording of telephone calls to all "Article 3 firms", which includes financial advice firms.

Background

On 29 September 2016, the Financial Conduct Authority ("**FCA**") issued its third consultation paper (the "**Consultation Paper**") on the implementation of MiFID II in the United Kingdom.¹

The Consultation Paper follows two previous FCA consultations on MiFID II:

- CP15/43, which covered issues related to the FCA's regulation of the secondary trading of financial instruments.²
- CP16/19, which covered a range of issues including position limits and position reporting for commodity derivatives, systems and controls requirements, and protection for client assets.³

The latest Consultation Paper mainly covers the MiFID II conduct of business requirements, together with some other issues. During the summer of 2016, the European Commission published delegated acts containing detailed rules for the conduct requirements. This has allowed

the FCA to prepare draft rules and guidance to implement these requirements, including in relation to the following issues:

- inducements;
- recording of telephone calls and e-mails;
- the assessment of suitability and appropriateness;
- conflicts of interest; and
- product governance.

The FCA's approach to MiFID II

The MiFID II package will contain two EU Directives:

- the MiFID II Directive; and
- the MiFID II Delegated Directive.

The Consultation Paper sets out how conduct and other requirements in these Directives will be transposed into the UK regulation as rules in the FCA Handbook. The UK is required to ensure that the Directive requirements are transposed into UK national law by 3 July 2017.

The remainder of the MiFID II legislation, including much of its detail, is contained in EU Regulations, including the Markets in Financial Instruments Regulation ("**MiFIR**") and the MiFID II Delegated Regulation.

When these Regulations come into effect on 3 January 2018, they will be deemed to be directly effective in EU Member States. This means that they do not strictly need to be transposed into national law or regulation. For example, the FCA does not intend the requirements in MiFIR to be transposed into the FCA Rules.

However, the FCA has recognised that firms make extensive use of the Conduct of Business Sourcebook ("**COBS**") in the FCA Handbook, and that market participants would prefer to be able to access a single source containing all of the MiFID II conduct requirements. The FCA therefore proposes to copy out the conduct requirements from the relevant Regulations, and collate them in COBS.

¹ FCA, *Markets in Financial Instruments Directive II Implementation Paper – Consultation Paper III (CP16/29)* (September 2016), available at <https://www.fca.org.uk/publications/consultation-papers/cp16-29-mifid-ii-implementation>.

² FCA, *Markets in Financial Instruments Directive II Implementation – Consultation Paper I (CP15/43)*, available at <https://www.fca.org.uk/publications/consultation-papers/cp15-43-markets-financial-instruments-directive-ii-implementation-%E2%80%93>

³ FCA, *Markets in Financial Instruments Directive II implementation proposals – Consultation Paper II (CP16/19)* (July 2016), available at <https://www.fca.org.uk/publications/consultation-papers/markets-financial-instruments-directive-ii-implementation-proposals-cp16-19>.

Goldplating MiFID II

When MiFID was implemented in 2006-7, the Financial Services Authority "goldplated" its requirements by applying MiFID standards to certain financial institutions and products that were outside the scope of the Directive.

The Consultation Paper considers whether the FCA should continue with this approach by goldplating the MiFID II rules, both in relation to the existing UK requirements that goldplated MiFID and in relation to new requirements under MiFID II.

In particular, the FCA has invited comments on its proposals in the following areas:

Non-MiFID products

The current COBS rules apply MiFID standards to insurance-based investments and certain other non-MiFID products that are strictly outside the scope of MiFID. The FCA proposes that it should continue to apply the existing COBS rules to these products, rather than the more rigorous MiFID II standards, in order to await more clarity on how the Insurance Distribution Directive ("**IDD**") will affect these products. The FCA intends to review this topic in 2017.

Structured deposits

The FCA proposes to apply MiFID II rules to activities of advising on or selling structured deposits.

Non-MiFID firms

The FCA has considered whether it should apply MiFID II standards to non-MiFID firms.

- Article 3 firms. Article 3 of MiFID allows a firm to be exempted from the scope of the Directive if it:
 - does not hold clients' funds or securities;
 - only provides the investment services of the reception and transmission of orders and/or investment advice in relation to funds;

- sends orders only to specified categories of financial institution.

The FCA has proposed that the enhanced conduct requirements under MiFID II should in general be applied to such firms.

- UCITS managers, Alternative Investment Fund Managers ("**AIFMs**"), and other non-MiFID firms. The UK currently applies COBS requirements to certain non-MiFID firms. The FCA has recognised it would not always be appropriate to apply the MiFID II conduct requirements to these firms uniformly, and has instead proposed a tailored approach based on the type of entity concerned.

Conduct of Business

Inducements, including adviser charging

MiFID II will enhance the existing inducements regime. In particular, it will ban independent advisers and portfolio managers from receiving and retaining monetary and non-monetary benefits from third parties, other than minor non-monetary benefits.

The FCA proposes to implement the MiFID II inducements regime by revising its core inducements rules in COBS 2.3. It also intends to revise the adviser charging rules in COBS 6, which were created as a result of the Retail Distribution Review ("**RDR**") in 2012.

In particular, the FCA proposes that:

- The MiFID II inducements regime will not be applied to insurance-based investments. Instead, the existing rules in COBS 2.3 will continue to apply until the IDD is implemented.
- The MiFID II regime will be extended to the MiFID business of Article 3 firms.
- The MiFID II prohibition on accepting and retaining commission for firms providing investment advice on an independent basis will be extended to firms providing restricted advice.

The existing RDR rules on adviser charging will be retained, but will be amended to clarify their relationship with the MiFID II requirements.

Inducements and research

MiFID II recognises that third party research may be a useful resource for firms. Consequently MiFID II allows research not to be treated as an inducement provided that it is paid for:

- directly by the firm from its own resources; or
- via a separate research payment account, funded by specific research charges to the client.

The FCA intends to replace its existing rules on the use of dealing commission in COBS 11.6 with a new section in COBS 2.

The FCA also intends to apply these MiFID II requirements to UCITS management companies and AIFMs, which are outside the scope of MiFID II but are currently subject to the COBS rules on dealing commission.

Client categorisation

MiFID II seeks to protect non-retail clients by amending how clients are categorised. In particular, it will specify that local authorities should automatically be treated as retail clients.

The FCA intends to use its discretion to issue specific criteria for the opting up of local authorities and local authority pension schemes from retail client status to elective professional client status.

Disclosure requirements

The FCA has proposed significant changes to COBS in order to implement the wide variety of disclosure requirements in MiFID II. These include information about the firm and the products it sells, disclosure of costs and charges, and the provision of periodic reports to clients.

Independence

MiFID II will require firms which describe their advice as "independent" to assess a sufficient range of financial instruments.

In the UK, the RDR rules already apply to firms providing "independent" advice on retail financial products, but this will need to be amended and extended under MiFID II. The FCA proposes to apply the MiFID II independence standard to personal recommendations relating to MiFID financial instruments, structured deposits, and non-MiFID retail investment products.

Suitability

Firms are required to assess the suitability of an investment for a client when making a personal recommendation or a decision to deal on a discretionary basis.

MiFID II will make a number of changes to the requirement to assess suitability, for example by

specifying how firms should ensure that information collected from clients is reliable, and what should be included in a suitability report. The FCA will update the suitability rules in COBS 9 in order to apply the changes required by MiFID II.

The FCA proposes that the changes should be applied to MiFID business and to Article 3 firms carrying on MiFID business. The current COBS rules will continue to apply to non-MiFID business until the IDD is implemented in 2018.

Appropriateness

The MiFID appropriateness rules require a firm, before carrying out a deal for a client in a complex instrument (such as a non-readily realisable security, a derivative, or a warrant) to request information on the client's knowledge and experience and to assess the appropriateness of the investment for the client.

MiFID II will widen the scope of products that are classified as "complex". This means that the requirement to assess appropriateness will apply to a wider range of products.

The FCA proposes to copy out the requirements in MiFID II, including the criteria for determining whether a product is "non-complex".

Dealing and managing

The FCA proposes to implement the new MiFID II requirements in relation to best execution, client order handling, personal transactions, and underwriting and placing.

In addition, the FCA has proposed that the MiFID II requirements for best execution rules should be applied to financial advisers that are exempt from MiFID under Article 3, UCITS management firms, and AIFMs.

Investment research

The FCA proposes to delete the existing COBS rules on the production and dissemination of investment research, and to copy out the new MiFID II requirements into a single chapter in COBS.

The FCA expects that the new requirements in relation to investment research will be largely unchanged from the existing UK regime.

Client agreements

Currently COBS 8 requires firms to enter into a written basic agreement with retail clients. Under MiFID II, this requirement will be extended to professional clients.

In line with MiFID II, the FCA intends to provide more specific detail regarding the content of these agreements.

Other matters

Product governance

The FCA currently provides non-binding guidance on product governance in the Responsibilities of Providers and Distributors for the Fair Treatment of Customers ("**RPPD**"). Under MiFID II, broadly similar requirements will become binding rules for MiFID business.

The FCA proposes to implement the MiFID II product governance provisions in the form of:

- Handbook rules for firms carrying on MiFID business; and
- Handbook guidance for non-MiFID firms that manufacture or distribute MiFID financial instruments.

Knowledge and competence requirements

MiFID II requires firms to ensure that individuals giving advice or information on financial instruments have the necessary knowledge and competence to meet investor protection requirements.

The FCA has stated that it intends to comply with the guidelines issued by the European Securities and Markets Authority ("**ESMA**") on the assessment of knowledge and competence in staff providing investment advice or information about financial instruments.

The FCA proposes to make minor amendments to the Training and Competence sourcebook ("**TC**") and the Senior Management Arrangements, Systems and Controls sourcebook ("**SYSC**") in order to implement the ESMA guidelines.

Telephone and email recording

MiFID II will introduce a mandatory requirement for the recording of telephone calls and the retention of electronic communications when staff are providing client order services or dealing on own account.

The UK already has a regime for the recording of calls and emails. The FCA will update its current rules in line with the new requirements. It also intends to apply the regime to a wider range of firms than is required by MiFID II. The FCA

proposes that the requirement to record calls should be extended to:

- discretionary investment managers;
- corporate finance business;
- UCITS management companies and AIFMs; and
- financial advice firms that are exempt from MiFID under Article 3.

The FCA has stated that, in relation to Article 3 firms, it is open to considering other proposals to address consumer protection concerns in this area.

Supervision, authorisation and approved persons

MiFID II will require firms seeking authorisation to provide regulators with additional information on a firm's organisational structure and management body. The FCA has proposed the introduction of a new Form A in order to obtain this information.

Unlike the FCA's other proposals, the consultation on this point will close early, at the end of October 2016, so that the FCA can have the forms in place when it opens the gateway for firms seeking to be authorised in early 2017.

Perimeter guidance

The FCA has proposed new perimeter guidance on the scope of MiFID II. In particular, the FCA intends to provide guidance on the application of the new rules to:

- foreign exchange derivatives;
- emission allowances; and
- commodity derivatives.

The FCA also intends to provide guidance on exemptions from the scope of MiFID II for:

- professional firms; and
- firms trading in commodity derivatives.

Consequential changes to FCA Handbook

Based on its proposals in CP16/19 on SYSC and the Client Assets sourcebook ("**CASS**"), the FCA has

proposed some consequential amendments to the FCA Handbook. It has also proposed updates to some references in the prudential rules.

Next steps

The FCA is considering whether to issue a further MiFID II consultation paper on consequential changes to the FCA Handbook.

The FCA intends to publish a policy statement covering all aspects of its implementation of MiFID II in the first half of 2017.

The FCA must transpose the rules in the MiFID II Directive and the Delegated Directive by 3 July 2017.

Most of the provisions in the MiFID II legislative package will become effective on 3 January 2018.

Further information

Please visit our MiFID II microsite at <http://www.hoganlovells.com/en/knowledge/topics-centers/mifid-ii>.

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