

MiFID II

Conflicts of interests: investment research

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Key Points

Firms which produce and disseminate investment research will have to:

- apply the organisational requirements for managing conflicts of interest in relation to a wider range of publications, including materials that would previously have been regarded as marketing materials; and
- put in place arrangements for the physical separation of financial analysts who produce investment research and anyone whose responsibilities or duties may conflict with the interests of the persons to whom the research is disseminated.

- the firms themselves and the financial analysts and other relevant persons must not:
 - accept inducements from those with a material interest in the subject-matter of the investment research;
 - promise issuers favourable research coverage; or
 - be permitted to review a draft of the investment research for the purpose of verifying the accuracy of factual statements made in that research, or for any other purpose other than verifying compliance with the firm's legal obligations, if the draft includes a recommendation or a target price.

Investment research in MiFID II

Articles 24 and 25 of the MiFID Implementing Directive contain detailed provisions regarding conflicts of interest for firms who produce "investment research".¹

Firms which produce and disseminate investment research will be subject to a number of additional organisation requirements, including in particular that:

- the conflicts of interest procedures that it is required to have under Article 22(3) of the MiFID I Directive are applied in relation to the financial analysts and other relevant persons at the firm involved in the production of the investment research;
- financial analysts and other relevant persons must not undertake personal transactions or trade (other than in limited situations) in financial instruments to which investment research relates, or in any related financial instruments; and

Under MiFID II, the relevant provisions from MiFID I will remain intact, but in addition they will be supplemented by the following requirements from the MiFID II Delegated Regulation² under MiFID II:

- The scope of the additional organisational requirements will be extended to cover recommendations³ which do not satisfy the criteria to be regarded as "investment research" under MiFID and which are instead identified as marketing communications.
- Firms will be subject to a new provision to require a physical separation between the financial analysts involved in the production of the investment research and other relevant persons whose responsibilities or business interests may conflict with the interests of the persons to whom the investment research is disseminated. Firms will be permitted to put in place appropriate

¹ "Investment research" means research or other information recommending or suggesting an investment strategy, explicitly or implicitly, concerning one or several financial instruments or the issuers of financial instruments, including any opinion as to the present or future value or price of such instruments, intended for distribution channels or for the public, and in relation to which the following conditions are met:
 (a) it is labelled or described as investment research or in similar terms, or is otherwise presented as an objective or independent explanation of the matters contained in the recommendation; and
 (b) if the recommendation in question were made by a firm to a client, it would not constitute the provision of "investment advice" under MiFID.

² Article 36 of the Delegated Regulation (EU) No .../.. 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 (April 2016) (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.

³ The definition of "recommendation" in this case means research or other information recommending or suggesting an investment strategy, explicitly or implicitly, concerning one or several financial instruments or the issuers of financial instruments, including any opinion as to the present or future value or price of such instruments, intended for distribution channels or for the public (following the definition in Article 1(3) of Directive 2003/125/EC).

alternative information barriers where having full physical separation is not appropriate to the size and organisation of the firm and the nature, scale and complexity of its business.

The ESMA Technical Advice also suggests that national regulators will be encouraged to conduct checks to assess the situation on the ground and not to rely on the rules allowing disclosure of conflicts (even though those arrangements are being strengthened under MiFID II). This points towards a more intrusive regulatory regime in relation to conflicts.

Marketing communications

Article 36 of the MiFID II Delegated Regulation requires recommendations to contain clear and prominent wording which:

- clearly identifies them as a marketing communication;
- states that they have not been prepared in accordance with any legal requirements which promote the independence of investment research; and
- states that they are not subject to any dealing prohibition ahead of investment research being disseminated.⁴

Trading and physical separation

The MiFID II Delegated Regulation specifies that firms must design and implement arrangements to ensure financial analysts and other relevant persons:

- do not trade for themselves or others where the trade relates to financial instruments⁵ covered by research, and they are aware of the likely timing or content of that research, until the recipients of that research have had the opportunity to act;⁶
- do not trade for themselves in investments related to research they have helped produce, unless there are exceptional circumstances and the firm's compliance or legal team has given prior approval;⁷
- are physically separated, or an information barrier put in place, where the production of

investment research and other business responsibilities or interests could lead to a conflict of interest with research recipients;⁸

- do not accept inducements from those with a material interest in the investment research;⁹
- do not promise favourable research coverage to issuers;¹⁰ and
- with the exception of financial analysts, are not permitted to review draft investment research which includes a recommendation or target price, unless for the purpose of compliance with the firm's legal obligations.¹¹

Conflicts of interest policy

Article 22 of the MiFID Implementing Directive requires firms 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.

Article 34 of the MiFID II Delegated Regulation specifies certain procedures and measures to include in this policy. Their purpose is to ensure activities which could give rise to a conflict of interest are carried on at a level of independence appropriate to the size and activities of the firm, in particular where financial analysts are involved in the production of investment research.¹²

These measures do not need to be implemented if:

- the producer of the investment research is not a member of the same group as the firm;
- the firm does not substantially alter the recommendations in the research;
- the firm does not represent itself as having produced the research; and
- the firm has either verified the producer of the research is subject to requirements equivalent to MiFID requirements, or has a policy in place setting such requirements.¹³

⁴ Article 36(2), MiFID II Delegated Regulation.
⁵ For the purposes of Article 37, "financial instrument" includes related financial instruments which have a price affected by an instrument subject to investment research.
⁶ Article 37(2)(a), MiFID II Delegated Regulation.
⁷ Article 37(2)(b), MiFID II Delegated Regulation.

⁸ Article 37(2)(c), MiFID II Delegated Regulation.
⁹ Article 37(2)(d), MiFID II Delegated Regulation.
¹⁰ Article 37(2)(e), MiFID II Delegated Regulation.
¹¹ Article 37(2)(f), MiFID II Delegated Regulation.
¹² Article 37(1), MiFID II Delegated Regulation.
¹³ Article 37(3), MiFID II Delegated Regulation.

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 the Commission 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.

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