King & Spalding

Client Alert

Financial Services Regulation Practice Group

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The King & Spalding Guide to MiFID II Conduct of Business Requirements

MiFID II, which is a package of measures consisting of a revised Directive (the Markets in Financial Instruments Directive), a new regulation (the Markets in Financial Instruments Regulation) and subsidiary implementing legislation, will come into force in the UK and throughout the EU on 3 January 2018. This represents a far reaching overhaul of EU legislation and regulation governing firms who provide services to clients linked to financial instruments and the venues on which those instruments are traded.

Changes to market structure and transparency under MiFID II are expected to have fundamental impacts on the way markets for financial instruments operate. Though less fundamental, MiFID II's reforms of conduct of business requirements upon financial services firms operating in the EU are also driving some firms to reassess and amend their business models. The impact is not just upon firms based in the EU but also on cross border groups and cross border trading and services. Some key conflict of laws issues and cross border impacts, such as differences between the way asset managers in the US pay for research compared with MiFID II requirements, are still being worked out.

The purpose of this client note is to provide an overview focussed on key changes to the conduct of business requirements under MiFID II to assist firms who are finalising their implementation work.

We cover:

(a) client categorisation;
(b) best execution;
(c) conflicts of interest;
(d) inducements and payment for research;
(e) transaction reporting;
(f) suitability and appropriateness; and
(g) product governance and distribution.

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A. Client Categorisation

The financial crisis demonstrated that even supposedly sophisticated clients were not able to fully appreciate investment risk. As a result, one key objective of MiFID II is improving the treatment of non-retail clients. To achieve this there have been a number of noteworthy changes to the client categorisation regime:

1. New treatment for municipalities and local public authorities

Municipalities and local public authorities (MLPA) that do not manage public debt have been specifically excluded from the list of eligible counterparties and the list of investors considered to be per se professional clients and will need to be classified as retail clients unless they can be opted up to 'elective' professional clients.

The opt-up criteria in MiFID II (as was the case in MiFID I) take the form of qualitative and quantitative tests. In the case of MLPA, MiFID II provides Member States with the discretion to modify the default quantitative opt-up criteria and the FCA has exercised its discretion to do so.

The FCA has confirmed that the following criteria will need to be satisfied for MLPA to be opted-up to professional client status (in addition to the current procedural requirements)[i]:

Qualitative test (unchanged from MiFID I): Firms must undertake an adequate assessment of the expertise, experience and knowledge of the client to give reasonable assurance in light of the nature of the transactions or services envisaged, that the client is capable of making his own investment decisions and understanding the risks involved;

Quantitative test: the criteria in (a) and either (b), (c) or (d) below must be satisfied. In finalising the criteria, the FCA has taken on board a number of concerns raised by local authorities, which administer pension funds:

(a) The size of the client's financial instrument portfolio, defined as including cash deposits and financial instruments, exceeds £10,000,000.
(b) The client has carried out transactions, in significant size, on the relevant market at an average frequency of 10 per quarter over the previous four quarters.
(c) The person authorised to carry out transactions on behalf of the client works or has worked in the financial sector for at least one year in a professional position, which requires knowledge of the provision of services envisaged.
(d) The client is an 'administering authority' of the Local Government Pension Scheme and is acting in that capacity.[ii]

The FCA has clarified that the opt-up test will need to be applied separately to an MLPA depending on the capacity in which it acts i.e., its role as pension scheme administrator vs other business it conducts such as treasury management. Investment firms need, therefore, to identify such clients in their client base that may have been treated as eligible counterparties or per se professional clients in the past and consider whether they can satisfy the elective professional client tests.

2. Other sectoral legislation

Firms will need to be alive to other regimes that depend on the definition of client contained in MiFID II (such as the Alternative Investment Fund Managers Directive and the Packaged Retail and Insurance-based Investment Products Regulation) and the consequences of a client being categorised/re-categorised as a retail client.

3. The responsibilities of eligible counterparties

The general standards that investment firms must act honestly, fairly and professionally and communicate in a way which is fair, clear and not misleading have been expressly extended to eligible counterparties.

4. Opt-up to eligible counterparty status

MiFID II no longer allows firms to opt-up elective professional clients into eligible counterparties, which will mean firms will need to re-categorise eligible counterparties who have been opted-up from professional client status. For firms wishing to opt-up per se professional clients to eligible counterparties (which is permissible), there are new procedural requirements.

5. Disclosures

Under MiFID I much of the mandated disclosures to clients were focused on retail clients. Under MiFID II, these disclosure obligations have been extended to apply to all clients, albeit with some scope to agree the limited application of specific requirements with professional clients and eligible counterparties. Accordingly investment firms may agree with professional clients and eligible counterparties to limit the information to be provided on costs and associated charges (including illustrations of the cumulative effect of costs on returns), except (in the case of professional clients) when providing investment advice or portfolio management services or where the financial instruments concerned embed a derivative (i.e., a structured product) and except (in the case of eligible counterparties) irrespective of the investment service being provided where the financial instruments concerned embed a derivative and the eligible counterparty intends to offer them to its clients.

This does not limit the overriding obligations on investment firms under Article 24(4) of the MiFID II Directive to give clients relevant information about the investment firm, its services and investment strategies, the financial instrument(s) and execution venues, and all costs and related charges.

6. National and regional governments and public bodies dealing with debt – clarification

In addition to the above, MiFID II clarifies the wording of two existing categories:

(a) the per se eligible counterparty category "national governments and their corresponding offices including public bodies that deal with public debt" now reads "national governments and their corresponding offices including public bodies that deal with public debt *at national level*; and
(b) the per se professional client category of "National and regional governments, public bodies that manage public debt" now reads "National and regional governments, *including* public bodies that manage public debt *at national or regional level*"

The FCA has interpreted these changes to mean that:

(a) only a national government or a public body dealing with public debt **at national level** can be categorised as a per se ECP; and
(b) only a national or regional government or a public body which manages public debt **at national or regional level** can be categorised as a per se professional client.

Impact on non-MiFID business

The FCA is extending a number of the client categorisation changes to non-MiFID scope business:

(a) the narrowing of the scope of clients who can be ECPs;
(b) the prohibition on opting up elective professional clients to ECP status and the procedure for opting up per se professional clients; and
(c) the changes to the categorisation of MLPAs.

B. Best Execution

Firms executing client orders are required to take "all sufficient steps" to obtain, when executing orders, the best possible result for their clients taking into account the execution factors (price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order). This sets a higher bar for compliance than the MiFID I standard of "all reasonable steps". In addition, the information which firms must provide to their clients about their order execution policy must explain clearly, in sufficient detail and in a way that can be easily understood by the clients, how orders will be executed by the firm for the client.

Furthermore, execution policies now need to be bespoke for each class of financial instrument and investment service and are required to contain additional prescriptive detail including:

(a) a list of factors used to select an execution venue, including qualitative factors such as clearing schemes, circuit breakers, scheduled actions, or any other relevant consideration, and the relative importance of each factor. The information about factors used to select an execution venue for execution must be consistent with the controls used by the firm to demonstrate to clients that best execution has been achieved in a consistent basis when reviewing the adequacy of its policy and arrangements;
(b) how the execution factors of price costs, speed likelihood of execution and any other relevant factor are considered as part of the "all sufficient steps" obligation to get the best possible result for the client;
(c) where the firm executes orders outside a trading venue, information to this effect and the consequences, for example, counterparty risk arising from execution outside a trading venue, and where the client requests, additional information about the consequences of this means of execution; and
(d) (in what is clearly an overlapping provision with an earlier requirement in MiFID II) a summary of the venue selection process and execution strategies used, and the procedures and process used to analyse the quality of executions obtained. Firms need to review their best execution policies and procedures and amend them appropriately to meet the enhanced requirements. Clients of brokers who are portfolio managers or receivers and transmitters of customer orders are also under an obligation to ensure that best execution is delivered and will be reviewing their own policies and procedures regarding broker selection and monitoring in light of the enhanced standards.

Firms must not only ensure that they are in a position to demonstrate to clients that they have executed orders in line with the execution policy, but must now be able to demonstrate compliance to the FCA at its request.

What is the impact of the enhanced standard?

According to Q&A from the European Securities and Markets Authority,[iii] the enhanced standard means that when designing their execution policies and establishing their execution arrangements, firms will have to ensure that the intended outcomes can be successfully achieved on an on-going basis. This is likely to involve the strengthening of

front-office accountability and systems and controls according to which firms will ensure that their detection capabilities are able to identify any potential deficiencies. This will require firms to monitor not only the execution quality obtained but also the quality and appropriateness of their execution arrangements and policies on an ex-ante and ex-post basis to identify circumstances under which changes may be appropriate. An example of ex-ante monitoring would be to ensure that the design and review process of policies is appropriate and takes into account new services or products offered by the firms. An ex-post monitoring may be to check whether the firm has correctly applied its execution policy and if client instructions and preferences are effectively passed along the entire execution chain when using smart orders routers or any other means of execution. There should be channels in place to ensure that the results of ongoing execution monitoring are escalated to senior management, and fed back into execution policies and arrangements to drive improvements in the firm's processes.

The enhanced overarching standard does not mean that a firm must obtain the best possible results for its clients on every single occasion. Rather, firms will need to verify on an on-going basis that their execution arrangements work well throughout the different stages of the order execution process. ESMA expects firms to take all appropriate remedial actions if any deficiencies are detected so that they can properly demonstrate that they have taken "all sufficient steps" to achieve the best possible results for their clients.

Publication of execution quality

MiFID II imposes an onerous requirement for a firm executing client orders to summarise and make public on an annual basis, for each class of financial instruments, the top five execution venues in terms of trading volumes where it executed client orders in the preceding year and information on the quality of execution obtained. Portfolio managers and firms transmitting orders are under a similar obligation to publish information regarding the top five investment firms where they placed client orders for execution in the preceding year and information on the quality of execution. Regulatory Technical Standard 28[iv] mandates the specific presentation of these details. Firms will also need to become familiar with interpreting data published under Regulatory Technical Standard 27,[v] which requires execution venues to provide quarterly reports on execution quality since this information will assist them with delivering best execution for their clients.

FCA scrutiny

In light of the FCA's findings earlier this year of significant failings in relation to investment managers' compliance with the UK's existing best execution requirements (and the FCA's statement that it is ready to take action against firms if necessary),[vi] firms should be using MiFID II implementation as an opportunity to review their existing policies, procedures and governance arrangements to ensure any gaps are addressed.

Impact on non-MiFID business

The FCA's approach to application of the enhanced best execution regime to firms undertaking non-MiFID business depends on the type of firm in question:

(i) the regime will apply to financial advisers exempt from MiFID II under Article 3 except that RTS 28 reporting will not apply;

(ii) the changes in the regime will not be applied at this stage to full scope AIFMs (Alternative Investment Fund Managers under the Alternative Investment Fund Managers Directive) in order to provide the FCA with an opportunity to ensure any proposed changes to the regime better reflect the characteristics of this sector. A

delay will also allow the FCA to consider the impact of the European Commission's review of the Alternative Investment Fund Managers Directive ("AIFMD").

(iii) there will be no impact on small authorised UK AIFMs of unauthorised AIFs and operators of residual collective investment schemes who only deal with professional clients and where the fund documents state that best execution requirements are disapplied.[vii] The planned application of the MiFID II changes to all other small authorised UK AIFMs and residual CIS operators is also being delayed, which will ensure that this group of firms is not subject to a higher standard than full scope AIFMs.

(iv) the enhanced regime will apply in full to UCITS management companies subject to modifications to tailor the provisions for collective portfolio management.

C. Conflicts of Interest

MiFID II makes a number of slight but nonetheless important changes to the conflicts of interest regime.

1. New standard + prevention is better than cure

As with the best execution requirements, there is a change in the standard that informs the regime; there is also a broadening of focus. Firms will now be required to take all "appropriate" steps to identify, prevent or manage conflicts of interest, which sets a higher bar for compliance than the current "reasonable" steps standard and hard wires the concepts of prevention and management of conflicts into the regime - previously the overarching requirement referred simply to identification of conflicts. There are also now specific references to receipt of inducements from third parties and the firm's own remuneration and other incentive structures.

2. Risk of damage – not just material

The conflicts of interest policy must identify circumstances which constitute or may give rise to a conflict of interest entailing a risk of damage to the interests of one or more clients. Under MiFID I, the level of risk of damage to a client or clients had to be material; MiFID II has removed the materiality element.

3. Procedures and measures

In keeping with the focus on prevention, MiFID II now requires that the procedures followed and measures adopted, which need to be set out in the firm's conflict of interest policy, relate to *preventing* as well as managing conflicts. In relation to what goes into the procedures and measures, MiFID II uses more prescriptive language than MiFID I, replacing "such of the following as are necessary and appropriate" with "at least those items in the following list that are necessary" (although the express ability for Member States to add other criteria has been removed).

As a result of these changes, firms will need to review and revise their conflicts of interest policy and procedures to meet the new standards. The FCA has indicated that as a result of the heightened standard, it expects more internal monitoring and senior management oversight to ensure that the processes and policies of the conflicts of interest framework are appropriate and take into account any new services or products offered by the firm.

4. Disclosure requirements

MiFID II also bolsters the disclosure requirements that firms must adhere to in the event that they are unable to prevent a conflict from adversely affecting the interests of a client by:

(a) clarifying that disclosure is a measure of last resort to be used only where the firm's organisational and administrative arrangements established to prevent or manage its conflicts of interest are not sufficient to ensure, with reasonable confidence, that risks of damage to the interests of the client will be prevented;
(b) requiring the firm to state that its arrangements are not sufficient to ensure, with reasonable confidence, that risk to the client's interests will be prevented;
(c) requiring firms to include within their disclosure a specific description of the conflict of interest, taking into account the nature of the client to whom the disclosure is being made. The description must explain:
    (i) the general nature and sources of conflicts of interest;
    (ii) the risks to the client that arise as a result of the conflicts of interest; and
    (iii) the steps the firm took to mitigate these risks.

5. Obligations to review and report

Firms are required to assess and periodically review, at least annually, their conflicts of interest policy and take measures to address deficiencies. Not only is disclosure a last resort, over reliance on disclosure is considered to indicate a deficiency in a firm's conflicts of interest policy.

MiFID II also increases the explicit reporting obligations on firms and reviews to be carried out by senior management in relation to a firm's conflict of interests policy and procedures. Senior management are required to receive frequently, and at least annually, written reports of situations contained in the conflicts of interest record. Though these requirements are not explicit in the existing rules derived from MiFID I, the FCA believes that many firms already take this approach in practice.

Impact on different types of firm

The FCA is continuing to apply the conflicts of interest requirements differently depending on the business the firm is undertaking and will:

(a) extend as a rule to all firms the new detailed disclosure obligations under MiFID II and the requirement to take all appropriate (as opposed to reasonable) steps to identify and to prevent or manage conflicts of interest;
(b) for non-scope firms, extend as guidance the obligation to assess and periodically review, at least annually, the conflicts of interest policy and the requirement for senior management to receive on a frequent basis. and at least annually, written reports on the situations contained in the conflict of interest record.

D. Inducements and Payment for Research

Even tighter rules on inducements

Under MiFID II, the inducements regime comprises:

(a) for investment firms that are portfolio managers or independent investment advisers, a ban on accepting and retaining fees, commission or any monetary or non-monetary benefits from third parties in relation to the provision of services to clients, with the exception of minor non-monetary benefits; and
(b) for investment firms providing other services, a general prohibition on receiving or paying/providing inducements subject to specific exemptions. While the substance of the prohibition and exemptions remains the same as that found in MiFID I, there are some important expansions: (a) when determining whether a payment or benefit is

designed to enhance the quality of the relevant service prescribed criteria must now be satisfied; and (b) there are more detailed organisational requirements around disclosure and record keeping.

FCA implementation

The FCA's regime goes further than MiFID II in two significant respects:

(a) the ban on inducements will be extended to restricted advice given to retail clients in line with the existing position under RDR. This means that the ban will apply to all advice provided to retail clients. This extension of the regime in respect of advice does not apply to professional clients (i.e. restrictive advice to professional clients will be outside of the commission ban); and

(b) while MiFID II permits investment advisers and portfolio managers that are subject to the ban to pass third party payments it may receive to clients, to ensure further alignment with the approach under RDR, the FCA will prohibit this i.e. firms subject to the ban (as extended) will be prohibited from the mere acceptance of inducements.

The FCA is applying the "minor non-monetary benefits" safe harbour to advice given on all retail investment products (RIPs) and not just those which are MiFID financial instruments and is also proposing to apply the ban on inducements to certain unregulated advisory activities for both RIPs and MiFID products which are not RIPs.[viii]

Research

Research provided by execution brokers or other third parties to portfolio managers is considered to be an "inducement" and so is banned unless strict conditions relating to the method of payment for the research are met. This applies not just to research related to equities but also to research related to fixed income or other non-equity instruments. The FCA has chosen to extend the application of the MiFID II research payment rules to MiFID exempt UK authorised firms carrying out investment management of collective investment schemes, including AIFMs and UCITS management companies, to ensure consistency with the current approach it takes to the use of dealing commission.

What is research?

Under MiFID II "research" is defined as:

> "*research material or services concerning one or several financial instruments or other assets, or the issuers or potential issuers of financial instruments, or closely related to a specific industry or market such that it informs views on financial instruments, assets or issuers within that sector. That type of material or services explicitly or implicitly recommends or suggests an investment strategy and provides a substantiated opinion as to the present or future value or price of such instruments or assets, or otherwise contains analysis and original insights and reaches conclusions based on new or existing information that could be used to inform an investment strategy and be relevant and capable of adding value to the investment firm's decisions on behalf of clients being charged for that research.*"

A distinction is drawn between "research" and "minor non-monetary benefits". Firms are permitted to receive "minor non-monetary benefits" that are capable of enhancing the quality of service provided to a client and are of a scale and nature such that they could not be judged to impair compliance with the investment firm's duty to act in the best interests of the client. The following are "minor non-monetary benefits":

(1) "non-substantive material or services consisting of short-term market commentary on the latest economic statistics or company results for example information on upcoming releases or events, which is provided by a third party and contains only a brief summary of its own opinion on such information that is not substantiated nor includes any substantive analysis such as where they simply reiterate a view based on an existing recommendation or substantive research material or services"; and (2) "written material from a third party that is commissioned and paid for by a corporate issuer or potential issuer to promote a new issuance by that company, or where the third party is contractually engaged and paid by the issuer to produce such material on an ongoing basis".

The fact that a research provider chooses to label its product as "non-substantive" or "market colour" will not automatically mean that it can be accepted as minor non-monetary benefit.

Research payment rules

A portfolio manager may only receive research if it is paid for:

- by direct payments by the investment manager out of its own resources; or
- by payments from a “research payment account” ("RPA") funded by a specific research charge to the client and controlled by the portfolio manager, provided that stringent conditions are met regarding the operation of the RPA.

Portfolio managers are required to set a budget for third party research and regularly assess it on the basis of a reasonable assessment of the need for third party research. The total amount of research charges received in the RPA should not exceed the research budget. Any surplus in the RPA at the end of a period must be rebated back to the client or offset against the research charge applicable to the next period.

Use of the research budget to pay for third-party research must be overseen by senior management with appropriate controls to ensure that the research budget is managed and used in the best interests of the firm's clients. There must be clear records of all payments made for third party research. Portfolio managers must regularly assess the quality of the research purchased based on robust quality criteria and its ability to contribute to better investments decisions. A written policy, to be provided to clients, must specify the quality criteria and explain how research purchased through the RPA may benefit clients' portfolios, including taking into account investment strategies applicable to various types of portfolios and the approach the firm will take to allocate such costs fairly to the various clients' portfolios.

Portfolio managers must agree the research charge with the client, including the frequency of deducting the specific charge from the client’s account.

Where requested by a client or the FCA, a portfolio manager must provide a summary of the third parties paid from the RPA, including the amounts paid, an explanation of the benefits and services received by the firm, and how the actual spend compares with the budget set by the firm for that period.

Impact on brokers

Under MiFID II executing brokers must identify execution charges separately from any other services or benefits provided. The supply of other services or benefits and charges for them must not be influenced by the levels of payment for execution. Brokers will need, therefore, to establish a policy covering how they value and disseminate

research and how the research charge will be collected going forward. This will need to be discussed with their usual consumers of research and addressed in legal contracts with them.

Though the portfolio manager is responsible for operating the RPA, the administration of the account can be delegated to a third party. This could be a broker. However, the arrangements need to ensure that research is bought and paid for without undue delay in the name of the portfolio manager and in accordance with the portfolio manager's instructions and in its name.

A typical simple commission sharing agreement may not be sufficient to comply with the requirements for an RPA, so existing commission sharing agreements need to be reviewed and revised.

It is permissible for an RPA to be funded from amounts collected alongside a transaction commission, rather than separately provided the research charge is separately identifiable and is not linked to the volume and/or value of transactions executed. There must also be arrangements for a switch to execution-only charges when the budgeted research charge has been collected. Further MiFID II does not permit brokers to retain research charges directly. The research charge must always go first into the RPA before being paid out to the broker.

Cross border issues

An important issue which, at the date of first publishing this Guide, is unresolved concerns whether US-based asset managers will be blocked from sharing US research across their EU operations where that research has been paid for (as is standard in the US currently) using trading commissions. The FCA's current position is that this is not permitted. Urgent discussions to seek to resolve this issue are ongoing between US regulators, the FCA and industry bodies.

E. Transaction Reporting

While the UK's existing transaction reporting requirements are more exacting than those required under MiFID I, MiFID II creates an even more demanding regime making it one of the most technologically and operationally challenging aspects of MiFID II implementation. This has led some asset managers to change their business models and authorisation status in the UK so that they will no longer be authorised as MiFID firms but instead will be "collective portfolio management" firms. On the FCA's current stance regarding implementation (discussed further below) for such firms there will be no direct application of the MiFID II transaction reporting requirements.

<table>
<tr>
<td>Scope of instruments caught</td>
<td>The reporting obligation applies to investment firms which execute transactions in financial instruments:

• which are admitted to trading or traded on a trading venue or for which a request for admission to trading has been made;
• where the underlying is a financial instrument traded on a trading venue; or
• where the underlying is an index or a basket composed of financial instruments traded on a trading venue.

irrespective of whether or not such transactions are carried out on the trading venue.

The range of instruments now covered is almost all of those traded in European</td>
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</table>

	markets. ESMA has issued an opinion as to what the concept "**traded on a trading venue**" means in respect of OTC derivatives and has stated that in its view only OTC derivatives "sharing the same reference data details" as the derivatives traded on a trading venue[ix] should be considered to be traded on a trading venue and therefore subject to the transaction reporting requirement. It remains to be seen how useful this clarification will be for market participants in light of the complexity of OTC instruments. ESMA for its part has recognised that it may need to revisit this interpretation of the concept to reflect the evolution of markets after 3 January 2018 and plans to monitor the ratio of derivatives that are considered to be traded on a trading venue compared to overall OTC derivatives trading.
Executing transactions	Investment firms which execute transactions in financial instruments must report complete and accurate details of such transactions to the competent authority as quickly as possible, and no later than the close of the following working day. Regulatory Technical Standard 22 (RTS 22)[x] provides further detail on the concepts of **execution** and **transaction**. A firm has executed a transaction when the performance of any the following activities results in a transaction: • Reception and transmission of orders in relation to one or more financial instruments • Execution of orders on behalf of clients • Dealing on own account • Making an investment decision in accordance with a discretionary mandate given by a client • Transfer of financial instruments to or from accounts A transaction includes acquisitions and disposals defined as follows: Acquisition (a) a purchase of a financial instrument; (b) entering into a derivative contract in a financial instrument; or (c) an increase in the notional amount for a derivative contract that is a financial instrument. Disposal (a) sale of a financial instrument; (b) closing out of a derivative contract in a financial instrument; or

	(c) a decrease in the notional amount for a derivative contract that is a financial instrument.
Delegation of reporting	MiFID II does in principle permit an investment firm which transmits an order to another firm for execution to rely upon the receiving party to report the transaction if certain conditions are met, though the transmitting firm will still be legally responsible for the accuracy of the report. However, there are onerous requirements for compliant order transmission. The transmitting firm must send the receiving firm all relevant fields that are to be reported. There must be an agreement between the transmitting and receiving firm in which the receiving firm agrees to report. The transmitting firm must have systems and controls to ensure accurate and complete reports. Many buy side firms appear to be concluding that they do not wish to use the "order transmission" provisions, even where they currently use brokers to transaction report. Concerns include not wanting to send certain reporting fields to their brokers (for example, algo IDs, code for the person responsible for the investment decision, allocation between different underlying clients (for aggregated orders)). Reporting can be delegated to a third party service provider that reports on behalf of an investment firm where that service provider has been approved by competent authorities as an Approved Reporting Mechanism. Various vendors will be offering reporting services.
Data fields	Number of data fields increases from 24 to 65, including identification information for the person, entity or algorithm making the decision to carry out the transaction.
Managers of collective investment undertakings or pension funds	The FCA has decided not to apply the MiFID II transaction reporting regime to managers of collective investment undertakings (regulated under AIFMD or the UCITS directives) or pension funds (which continue to benefit from an exemption from MiFID) and as a result these will now no longer be within the scope of the regime. As a practical matter though, brokers and trading venues used by such managers could seek to impose similar data sharing obligations in order to enable those brokers and venues to satisfy their own direct transaction reporting obligations under MiFID II.

F. Suitability and Appropriateness

The changes made by MiFID II to the suitability regime (which applies when a firm is making a personal recommendation or undertaking portfolio management) and the appropriateness regime (which applies in respect of

sales not made through a personal recommendation or provided by a portfolio management service i.e. when a firm executes a client order or receives and transmits a client order) are summarised below:

Suitability	
Losses and risk tolerance	In the assessment that firms must make, there is now emphasis on the assessment of a client's ability to bear losses and their risk tolerance.
Bundled products or services	Where advice is provided on a package of bundled products or services, there is now a requirement for firms to assess the suitability of the overall package.
Automated systems	Where an automated or part-automated system is used to provide advice or portfolio management services to a client, the firm providing the service is responsible for undertaking the suitability assessment and its responsibility is not reduced by use of the automated system.
Information must be reliable	Firms must ensure that the information collected about clients is reliable. This includes taking steps, as appropriate, to ensure that client information is consistent, such as by considering whether there are any obvious inaccuracies in information provided by clients.
Ongoing relationship	Firms having an ongoing relationship with a client will need to have, and be able to demonstrate that they have, appropriate policies and procedures to ensure information about the client is adequate and up-to-date.
Suitability reports	A specific requirement for firms to provide a suitability report to clients when giving investment advice, which has wider application than the UK's current rules in this regard. Firms providing a portfolio management service will also need to provide a periodic suitability report.
Who is the subject of the suitability test?	Where the client is: (a) a legal person; (b) a group of two or more natural persons; or (c) one or more natural persons is represented by another natural person, firms will need to have a policy to determine: (i) in respect of whom the suitability assessment should be undertaken; and (ii) how the assessment will be undertaken in practice. In designing such a policy, firms will not have carte blanche as MiFID II mandates how certain aspects of the assessment must be conducted in particular scenarios.
Nothing suitable	When providing investment advice or portfolio management, a firm should not make a recommendation or decide to trade where none of the services or investments are suitable for the client.
Switching investments	When investment advice or portfolio management involves switching investments, the firm must gather information on the client's existing investments and the recommended new investments, so that it can analyse the costs and benefits of switching, in order that it can reasonably demonstrate that the benefits of switching are greater than the costs.
Periodic suitability assessments and reports	Where the firm provides a service which involves period suitability assessments and reports, the reports it produces after the initial report can be limited to changes in the services or investments involved, and changes in the client's circumstances.

<table>
<tr><td>ESMA guidelines</td><td>ESMA is currently consulting on new suitability guidelines, which will build on its 2012 guidelines. The consultation paper can be found here – comments are required to be made by 13 October 2017.</td></tr>
<tr><td colspan="2">Appropriateness</td></tr>
<tr><td>Non-complex instruments - narrowing of scope</td><td>The appropriateness test can be disapplied in relation to “non-complex” instruments where the client initiates the transaction, the client is clearly warned that it will forfeit protection under relevant conduct of business rules, and the firm has complied with its obligations in respect of conflicts of interest.

MiFID II narrows the scope of what is considered non-complex to the following:

• shares in a company admitted to trading on a regulated market or on an equivalent third-country market or on a MTF, excluding shares in non-UCITS collective investment undertakings or shares that embed a derivative
• bonds or other forms of securitised debt* admitted to trading on a regulated market or on an equivalent third-country market or on a MTF, excluding those that embed a derivative or incorporate a structure which makes it difficult for the client to understand the risk involved
• money-market instruments*, excluding those that embed a derivative or incorporate a structure which makes it difficult for the client to understand the risk involved
• shares or units in UCITS, excluding structured UCITS
• structured deposits*, excluding those that incorporate a structure which makes it difficult for the client to understand the risk of return or the cost of exiting the product before the term finishes
• other non-complex financial instruments</td></tr>
<tr><td>ESMA guidelines</td><td>In relation to the asterisked categories, ESMA has published final guidelines on the criteria to be adopted by regulators and market participants for instruments to be excluded, which can be found here. The FCA has informed ESMA that it will comply with these guidelines.</td></tr>
<tr><td>Non-complex – further tests to satisfy</td><td>The other “non-complex financial instruments” category has two additional limbs that an instrument must now satisfy:

(a) it does not incorporate a clause, condition or trigger that could fundamentally alter the nature or risk of the investment or pay out profile, such as investments that incorporate a right to convert the instrument into a different investment; and
(b) it does not include any explicit or implicit exit charges that have the effect of making the investment illiquid even though there are technically frequent opportunities to dispose of, redeem or otherwise realise it.

The broadening of scope of what products will now be subject to the appropriateness test means that firms will need to review their distribution strategies to ensure that where an assessment is required it can be made prior to a product being sold.</td></tr>
</table>

FCA's views on investment trusts and non-UCITS retail schemes	The FCA has confirmed that its position in relation to investment trusts and non-UCITS retail schemes is that these are neither automatically complex nor non-complex but must be assessed against the criteria for non-complex instruments using a cautious approach. The FCA's approach is at odds with the position set out in ESMA's Q&A on investor protection, which can be found here (see Question 1 of Section 10).
Record keeping requirement	Firms are now required to keep records of appropriateness assessments including the result of any assessment and the prescribed warnings provided to the client where the firm considered the investment proposition inappropriate or where insufficient information was provided by the client and the subsequent chain of events (i.e. whether the client asked to proceed and the firm's response).
Bundled products or services	As with the suitability assessment, where a bundle of services or products is envisaged the appropriateness assessment must consider whether the overall bundled packaged is appropriate.
Awareness – higher standard for both regimes	In respect of both regimes, there is a subtle yet noteworthy change to a firm's ability to rely on the information that a client provides it. The provision in the EU text remains the same: "An investment firm shall be entitled to rely on the information provided by its clients or potential clients unless it is aware *or ought to be aware* that the information is manifestly out of date, inaccurate or incomplete." Currently the FCA rules which implement this provision for each of the regimes lack the italicised wording thus limiting a firm's awareness to what it is actually aware of: "A firm is entitled to rely on the information provided by its clients unless it is aware that the information is manifestly out of date, inaccurate or incomplete." (COBS 9.2.5R, COBS 10.2.4R) Because the relevant EU provision is now contained in a regulation and not a directive, it is directly applicable on firms and the FCA has no discretion in how it implements this, resulting in a higher awareness standard on firms and the need for larger firms which have multiple service offerings to ensure that information about a client is appropriately shared across the business.
FCA Handbook changes	The FCA is creating new sections for the MiFID II regimes, while retaining existing provisions for certain types of non-MiFID business: **Suitability**: COBS 9A (which in addition to applying to MiFID-business will also apply to equivalent third-country business and Article 3 firms); existing provisions in COBS 9 will be retained although the FCA is proposing to move provisions relating to investment-based insurance products into COBS 9A. **Appropriateness**: COBS 10A (which in addition to applying to MiFID-business will apply to equivalent third-country business) and will retain existing COBS provisions in COBS 10. As part of its implementation of the Insurance Distribution Directive (IDD), the FCA

	is proposing to integrate the IDD provisions on suitability and appropriateness relating to investment-based insurance products into COBS 9A and COBS 10A respectively.

G. Product Governance and Distribution

Existing UK standards

In the UK, regulatory expectations regarding product governance controls have been clearly articulated since 2007, when the then Financial Services Authority issued its guidance under Section 157(1) of the Markets Act 2000 entitled "The Responsibilities of Providers and Distributors for the Fair Treatment of Customers" ("RPPD"). UK implementation of relevant provisions of MiFID II and the MiFID II delegated directive now mean that enforceable rules will apply in this area for MiFID firms. Though the MiFID II requirements cover much of the same ground as RPPD, there are differences and MiFID II covers some aspects not dealt with explicitly in RPPD. Firms will, therefore, need to perform a gap analysis on their existing procedures. Industry bodies such as the Investment Association have produced documents comparing RPPD against MiFID II requirements, which will be of assistance to firms in their gap analysis of their existing procedures.

New FCA sourcebook

The FCA's rules implementing the MiFID II requirements will be in a new sourcebook within the FCA's existing Handbook of Rules and Guidance. This will be called the Product Intervention and Product Governance sourcebook, referred to by the acronym PROD. The rules in PROD will apply to MiFID investment firms, CRD credit institutions, MiFID optional exemption firms and branches of third country investment firms. PROD applies when those firms are manufacturing financial instruments and structured deposits or distributing financial instruments, structured deposits and investment services.

The FCA is applying the same material as guidance to other UK non-MiFID firms that manufacture or distribute financial instruments or structured products, thereby covering AIFMs and UCITS management companies acting as such when they distribute MiFID instruments during non-MiFID business. The requirements will apply as rules to AIFMs and UCITS management companies when they distribute MiFID instruments in the course of providing services that are also services under MiFID (individual portfolio management and non-core services).

PS17/14 confirms that discretionary portfolio management does constitute distribution of MiFID II instruments and so this activity will be covered by PROD. However, firms should "apply these requirements in a proportionate manner that is appropriate to the underlying service".

Core requirements for firms that manufacture financial instruments (for example, sponsor a fund) include:
Establish robust processes for the approval and oversight of the development of new products (including analysis of conflicts of interest) by the management body and compliance
Identify the potential target market for each financial instrument and the types of client with whose needs, characteristics and objectives the financial instrument is compatible (including identifying groups of clients for whom such a financial instrument is not suitable)

Undertake scenario analysis to assess the risks of poor outcomes for end clients (e.g., market, environmental, political events)
Consider the charging structures proposed for the financial instruments to ensure that such structures do not undermine the financial instruments' return expectations and are appropriately transparent for the target market
Make available to any distributors appropriate information on the financial instruments and the manufacturer's product approval process (including the target market) to enable the distributors to gain an appropriate understanding of the product

Core requirements for firms that act as distributor (i.e., firms that recommend or sell products which they do not manufacture) include:
Establish adequate arrangements to obtain sufficient and reliable information on the financial instruments and the product approval process (including the identified target market) from the manufacturer
Have in place adequate governance arrangements to ensure that the products and services they intend to offer or recommend are compatible with the needs, characteristics and objectives of an identified target market and that their intended distribution strategy is consistent with such target market
Ensure that the interests of the clients are not compromised as a result of commercial or funding pressures
Identify groups of clients for whose needs, characteristics and objectives the product or service is not compatible

MiFID II vs RPPD: how does MiFID II differ?
All types of client are covered, not just retail clients
Steps to prevent conflicts of interest adversely affecting end clients are required to be addressed; in particular, firms must assess whether the financial instrument creates a situation where end clients may be adversely affected if they take an exposure opposite to the one previously held by the firm itself or an exposure opposite to the one that the firm wants to hold after the sale of the product
Consideration whether the financial instrument may represent a threat to the orderly functioning or stability of the financial markets before deciding to proceed with the launch of the product
Staff involved in the manufacture of financial instruments must possess the necessary expertise to understand the characteristics and risks of the financial instruments they intend to manufacture

Compliance reports to the management body should systematically include information about the financial products manufactured by the firm, including information on the distribution strategy
The compliance function must monitor the development and periodic review of product governance arrangements in order to detect any risk of non-compliance by the firm
Where firms collaborate in developing/issuing a product their respective responsibilities should be outlined in a written agreement
More detailed requirements regarding: (i) target market identification and assessment of the financial instrument's suitability for that target market; (ii) scenario/stress testing which must be done from the perspective of the risk of poor outcomes for end clients; and (iii) information that a manufacturer should provide to distributors
Product governance policies and procedures should address the potential charging structure of a financial instrument, including that it is compatible with the needs, objectives and characteristics of the target market, does not undermine the financial instruments return expectations and is appropriately transparent for the target market

Demonstrating compliance

Firms will need product governance specific policies and procedures that address all of the MiFID II product governance requirements. Where firms already have product governance specific policies and procedures these, the policies and procedures including product approval forms may need adjustment to take into account the additional MiFID II requirements. A specific product governance compliance monitoring programme should be put in place if a firm does not already have this, and adjusted to take into account MiFID II requirements where firms already have such a programme.

For further information, please contact Angela Hayes, Partner or Daniel Hirschfield, Senior Associate in our London financial services regulation team.

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This alert provides a general summary of recent legal developments. It is not intended to be and should not be relied upon as legal advice. In some jurisdictions, this may be considered "Attorney Advertising."

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[i] See the FCA's Policy Statement PS17/14
[ii] 'Administering authority' is defined with reference to relevant local government pension scheme legislation.
[iii] ESMA's Q&A can be found here.
[iv] RTS 28 can be found here.
[v] RTS 27 can be found here.
[vi] See a summary of the FCA's findings here.
[vii] See COBS 18.5.4R
[viii] This latter proposal has been complicated by the change in the definition of regulated advice – see page 14 of the FCA's CP17/28.
[ix] This is taken to mean that the OTC derivatives should share the same values as those reported for derivatives admitted to trading or traded on a trading venue pursuant to Regulation 2017/585, with the exception of fields 5 to 12 (which relate to the trading venue and issuer respectively). The opinion can be found here.
[x] RTS 22 can be found here.