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MiFID2 – UK implementation update

As the MiFID2 juggernaut rolls into the national implementation phase the UK authorities are now in fourth gear on the production of UK implementation measures. While MiFIR and most of the accompanying Level 2 delegated acts and technical standards will apply directly in Member States, requiring no national implementation, the MiFID2 Directive itself is not directly applicable and will require amendment of national laws. The MiFID2 delegated Directive (dealing with the safeguarding of financial instruments and client funds, product governance and fees and commissions) also requires national transposition measures. Here we provide an overview of the changes the UK will make in order to implement the MiFID2 package of reforms and focus in particular on key aspects of the new conduct of business regime where the changed UK landscape is likely to have a significant impact for a wide range of firms.

How will the UK implement MiFID2?

UK implementation measures fall into three main areas:

- changes to the Financial Services and Markets Act 2000 (FSMA) and related secondary legislation;
- amendments to the Financial Conduct Authority (FCA) Handbook; and
- the UK Prudential Regulation Authority (PRA) will implement the prudential elements of MiFID2 that apply to the MiFID investment firms for which the PRA is the prudential regulator (beyond the scope of this briefing).

The FCA has already published three consultation papers on UK implementation: CP15/43 (December 2015, dealing mainly with market structure and secondary trading of financial instruments – see Text Box on page 7); CP16/19 (July 2016, covering a wide range of issues including important aspects of the commodities regime – See Text Box on page 8); and CP 16/29 (September 2016, dealing mainly with conduct of business questions – see *'Key changes to UK conduct of business rules'* below).

Scope and perimeter issues

The various scope and perimeter changes introduced by MiFID2 will be implemented in the UK by amendment of FSMA and related secondary legislation. In March 2015 HM Treasury (HMT) consulted on draft statutory instruments for example, to ensure that operation of an organised trading facility (OTF) will be a UK regulated activity and that structured deposits will fall within the UK regulatory perimeter. Statutory changes are also required in order to create the UK's position limits regime for commodities, to transpose exemptions under MiFID2 and to align the UK definition of "advising on investments" with its MiFID analogue. The key scoping/perimeter elements of the new statutory instruments are summarised below.

Draft Financial Services and Markets Act 2000 (Markets in Financial Instruments) Regulations 2016

- Creates UK position limits regime for commodities.
- Provides for exercise of optional exemptions under Article 3 of MiFID2 (see further below).
- Amends the 2001 Recognition Requirements Regulations on investment exchanges and clearing houses to lay down rules on the organisation and operation of trading venues (including MTFs and OTFs)

Draft Financial Services and Markets Act 2000 (Data Reporting Services) Regulations 2016

- Requires the re-authorisation of persons operating data reporting services.

Regulated Activities Amendment Order

- Makes operating an OTF a regulated activity.
- Covers exemptions from Article 2 of MiFID2 (remaining commodities exemptions).
- Brings structured deposits within the scope of relevant specified activities.
- Makes emissions allowances a specified investment.

Investment advice

In a consultation published in September 2016 HMT proposed amending the Regulated Activities Order (RAO) to align the current definition of "advising on investments" in the RAO with the MiFID definition of "investment advice". The MiFID definition requires advice to be of a personal nature but the current RAO definition does not. The RAO definition also extends to non-MiFID services such as insurance.

HMT's proposal to align the RAO definition with MiFID follows the August 2015 Financial Advice Market Review (FAMR) which found evidence of uncertainty among firms and clients as to where the boundary lies between simple guidance and regulated investment advice. The proposed change will mean that only advice that makes a personal recommendation will fall within the UK regulatory perimeter. The MiFID concept of investment advice also requires the recommendation to be presented as suitable for the person to whom it is made and for it to relate to taking certain steps in respect of a particular investment which is a MiFID financial instrument (i.e. to buy, sell, subscribe for, exchange, redeem, hold or underwrite a particular financial instrument).

Exemptions

Another important perimeter issue concerns so-called "Article 3" firms. Article 3 of MiFID2 is an optional exemption that allows Member States to choose not to apply the Directive to local firms that lack permission to hold client assets and whose activities are limited to investment advice and reception and transmission of orders. This opt out is inherited from MiFID1 and the UK has applied the existing exemption to a large number of UK financial advisers, corporate finance firms and venture capital firms. However, MiFID2 will require the national rules that apply to Article 3 firms to be "*at least analogous*" to the rules that apply to the authorisation, conduct of business and organisational requirements of firms that are within the MiFID2 perimeter.

Under the UK's proposed implementation of MiFID2 the value and effect of the Article 3 opt out looks set to be diluted. In CP 16/19 the FCA indicated that Article 3 firms will have to comply with substance of MiFID2 rules and in CP 16/29 the FCA has signalled a number of areas where MiFID2 rules will be imposed directly on Article 3 firms in order to satisfy the "at least analogous" requirement. The UK's implementation of a number of MiFID2 conduct of business requirements will also extend to UCITS management companies and AIFMs.

Key changes to UK conduct of business rules

Telephone recording

The FCA proposes to extend the UK's telephone recording regime to a wider range of activities and persons than MiFID2 requires, including: portfolio management (removing the current qualified exemption for discretionary investment managers); corporate finance business; energy and oil market activity; and the activities of collective portfolio managers (full-scope UK AIFMs, small authorised UK AIFMs and residual CIS operators, incoming EEA AIFM branches and UCITS management companies). The FCA also proposes to apply MiFID2 telephone recording requirements to UK investment advisers who are otherwise outside the scope of MiFID2 as exempt Article 3 firms. These changes imply a degree of operational upheaval and financial cost for some firms who have not previously had to conduct telephone recording.

Best execution and order handling

The UK plans to extend MiFID2 best execution rules to non-MiFID business and to financial advisers under Article 3 of the Directive. The UK also plans to bolster the best execution standards to which UCITS and small authorised UK AIFMs are subject, in order to bring them in line with MiFID2 standards.

The basic obligation for best execution is contained in the MiFID2 delegated regulation and will apply directly to MiFID business in the UK. However the FCA plans to copy out its provisions in the Handbook to indicate how they will apply to non-MiFID business. The FCA also proposes to apply MiFID2's enhanced client order handling rules to both MiFID and non MiFID business.

Client categorisation

The FCA proposes a number of changes to the COBS sourcebook to reflect new client categorisation requirements under MiFID2, including the default retail categorisation of public authorities. These changes include new tests for controlling whether local authorities can opt up to professional client status (for example, raising the portfolio size requirement from EUR 500,000 to GBP 15 million). Firms will have to review their existing local authority clients against the new criteria and local authorities currently opted up to professional client status that do not satisfy the new criteria will have to be recategorised.

The FCA has also said that it will extend the default retail categorisation for local authorities to non-MiFID business. Lack of grandfathering provisions for existing clients and the MiFID2 restriction against opting up elective professional clients to eligible counterparty status mean that firms will need to recategorise existing elective professional clients.

Inducements and adviser charging

MiFID2 bans independent advisers and portfolio managers from receiving any monetary or non-monetary benefit from third parties (except for certain minor non-monetary benefits) when dealing with retail and professional clients (but allows pass through / rebating to clients). The UK will implement this basic restriction (derived from Article 24 of MiFID2) for MiFID investment firms, equivalent third country firms and Article 3 firms via a new section 2.3A of the COBS sourcebook (which will also include examples of what constitute minor non-monetary benefits such as non-substantive material or services consisting of short term market commentary on the latest economic statistics or company results).

UK implementation of MiFID2 ban on inducements		
	Retail client	**Professional client**
Independent advice	Ban Minor non-monetary benefits permitted Research permitted provided paid by client through research account or by managers as an expense	Ban Minor non-monetary benefits permitted Research permitted provided paid by client through research account or by managers as an expense
Portfolio management	Ban (both inducement and rebating) Minor non-monetary benefits permitted Research permitted provided paid by client through research account or by managers as an expense	Fees permitted provided rebate to client Minor non-monetary benefits permitted Research permitted provided paid by client through research account or by managers as an expense
Other MiFID investment activities, equivalent third country and Article 3 firm (optional exemption) business	Ban Minor non-monetary benefits permitted Research permitted provided paid by client through research account or by managers as an expense	Fees permitted provided rebate to client Minor non-monetary benefits permitted Research permitted provided paid by client through research account or by managers as an expense
Restricted advice	Ban Minor non-monetary benefits permitted Research permitted provided paid by client through research account or by managers as an expense	No ban
Other non-MiFID business	Ban Minor non-monetary benefits permitted, unless personal recommendation re RIP or P2P agreements or unless firm is RIP provider, platform service provider, operator of electronic lending system, in which case existing domestic adviser charging rules still apply) Research permitted provided paid by client through research account or by managers as an expense	No ban

The UK proposes to extend the basic MiFID2 restriction on inducements in at least two important respects. First, by applying the ban to both restricted and independent advice (though not to restricted advice to professional clients), and secondly by banning the rebating of inducements to retail clients.

For firms that currently provide independent advice to professional clients the changes could significantly restrict the kinds of payments that they are able to accept from third parties in relation to that independent advice. Portfolio managers will still be able to accept fees, commissions and monetary benefits for services provided to professional clients, as long as these are rebated to clients. However, they will not be able to accept non-monetary benefits unless they are minor in nature or they take the form of research (see below).

Inducements and research

Article 13 of the MiFID2 delegated Directive creates an exemption from the basic inducements rule discussed above. This exemption provides that research received from third parties is not regarded as an inducement for an investment firm if the firm receives it in return for direct payments by the investment firm out of its own resources or payments from a separate research payment account controlled by the investment firm. The use of this exemption is subject to various account operating conditions as well as client disclosure obligations.

The UK proposes to implement this qualified exemption in a new section 2.3B of the COBS sourcebook. For MiFID investment firms providing portfolio management or independent investment advice, using this exemption will be the only way they can receive third party research in relation to their services to clients without breaching the basic inducement rule. Firms providing other MiFID investment services will also be able to use this qualified exemption as a means of receiving third party research.

CP 16/29 contains some useful information on how the inducements and research rules may operate in practice. For example, the FCA has said that it thinks firms will be able to set research budgets at a desk-level or strategy level provided that the individual and collective portfolios subject to the research budget share sufficiently similar research needs. On minor non-monetary benefits the FCA has warned that firms must consider the substance of any content they receive rather than any label applied by the provider.

The new UK rules on research and inducements will mean that portfolio managers and independent advisors that currently receive research from third parties in connection with client services will need to adapt their internal systems and controls to ensure that they can satisfy the requirements of the exemption. Firms that pay for research directly will need to be able to provide evidence of direct payments and demonstrate that the amount is not reflected in execution costs or fees and charges paid to brokers.

Product governance

MiFID2 imposes a range of product governance requirements on MiFID investment firms, including requirements to establish procedures to assess the target market and risks for new products and to choose appropriate distribution channels. Some obligations are specific to manufacturers (e.g. stress testing products, checking the appropriateness of charging structures and providing relevant information to distributors) while others are relevant to distribution (e.g. providing information to manufacturers to aid their regular product reviews). For all firms, especially those involved in both manufacturing and distribution in the wealth management sector, the new regime could add significantly to their compliance burden and smaller firms in particular may find that burden harder to bear.

Existing UK standards in this area take the form of guidance rather than binding rules, under the Regulatory Guide on the Responsibilities of Providers and Distributors for the Fair Treatment of Customers (RPPD) chapter of the Handbook. The FCA proposes to replace the RPPD guidance with binding rules on product governance (in the form of a new sourcebook PROD in the Handbook) for MiFID investment firms, for firms that manufacture structured deposits and for Article 3 firms. The FCA proposes to apply the same provisions as guidance for non-MiFID firms that are involved in the manufacture or distribution of MiFID products (for example a fund involved in the distribution of a structured deposit).

Although the RPPD covers similar subject matter to the MiFID2 requirements, the latter go beyond the RPPD in some areas. For example, MiFID2 will require manufacturers to consider carefully whether a product design and associated product charges actually meet the needs of the target market. They will also need to be able to specify or identify the market in question and will be required to have regard to the possible impact any new product might have on the orderly functioning of the market.

Where firms collaborate in the manufacture of a single product they will be required to have a written agreement setting out their share of these responsibilities. The FCA will perhaps be more concerned with the substance of a firm's contribution to the creation of new products than the form of their agreement with other firms involved in the process. However the extent to which the FCA will refer to the commercial agreement between the parties and pursue only one of the parties where a particular product does not meet adequate standards remains unclear. A scenario in which a firm employs another party to design a new product in line with very specific design criteria already specified by the firm poses difficult questions as to who is the manufacturer.

Manufacturers are never completely divorced from the distribution process and among the rules applicable to manufacturers will be a requirement to ensure that the distribution strategy eventually employed meets the needs of the identified target market. The compliance function of manufacturers will also have to actively monitor product governance, subject to effective control and oversight by the firm's management board. Sufficient systems and controls to permit senior management approval of a product is already a feature of the RPPD but the requirement for constant review is new.

Similar oversight requirements apply to distributor firms. These firms will also have to consider target market needs and conduct regular reviews to verify that products continue to satisfy target market requirements and to adapt distribution strategies as necessary. Distributors may face significant operational hurdles both in providing information to manufacturers on sales and in obtaining information from manufacturers, particularly where the distributor is part of a chain.

The FCA say that the new rules will build on the existing RPPD and that the FCA will apply the rules in a proportionate manner, taking into consideration the type of investment product, investment service and target market in any given scenario. For example, target markets for more straightforward products will likely require less detailed definition by firms. By contrast, for more complex products, firms will have to be able to identify and specify their target market in greater detail.

For third country firms, the MiFID2 product governance requirements would apply to any product manufacturing and distribution from a UK branch, not products developed by the parent entity and marketed solely in its home state. The distributor product governance requirements would apply to products developed by the parent entity but marketed in the home state and in the UK/EU.

Once the Insurance Distribution Directive begins to apply later in 2018, the new PROD sourcebook will also accommodate product governance rules for insurance products.

Next steps

The FCA is expected to publish its fourth and final consultation paper on UK implementation before the end of 2016. In spring 2017 the FCA will publish a single, consolidated Policy Statement covering the matters dealt with in all four of the FCA consultation papers.

FCA – first consultation (CP 15/43)

- Deals with secondary trading of financial instruments. Described by FCA as 'legal carpentry' in areas where there is limited room for national discretion.
- No copy out of directly applicable Regulations but instead Handbook cross-references added to new, directly applicable rules under MiFIR and RTS/ITS (e.g. on transparency).
- *Changes to Perimeter Guidance (PERG 13)*: on scope of investment services, activities and financial instruments. Guidance on MiFID2 definition of a "multilateral system".
- *Principles for Business (PRIN): because MiFID2 expands scope of some conduct of business obligations the scope of the Principles will e*xpand to cover firms dealing with eligible counterparties.
- *Passporting*: MiFID1 passports remain valid under MiFID2 but firms will need to re-assess adequacy of existing passports in view of new MiFID2 instruments (e.g. emissions allowances) and investment services (e.g. OTF operation). New harmonised templates and notification forms for passporting established by ITS will replace existing national forms / notifications in Handbook (in chapter SUP).
- *Algorithmic and High Frequency Trading*: new Handbook chapter MAR 7A will transpose requirements on persons engaged in high frequency and algorithmic trading as well as firms providing direct electronic access and general clearing services.
- *Market data*: new Handbook chapter MAR 9 governing process for gaining authorisation as a Data Reporting Service Provider (DSRP i.e. Approved Reporting Mechanisms (ARMs), Approved Publication Arrangements (APAs) and Consolidated Tape Providers (CTPs)). Existing ARMs and Trade Data Monitors will require re-authorisation.
- *Transparency*: FCA will delete existing Handbook provisions on transparency (e.g. MAR 7 on post trade transparency) because MiFIR and relevant RTS will apply directly.
- *Systematic internalizer regime*: FCA will delete most of MAR 6 (which implements existing MiFID1 rules for SIs) because key MiFID2 rules for SIs will apply directly.
- *Regulated Markets*: FCA will change the recognised investment exchanges sourcebook (REC) to align it with changes to the FSMA 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001 proposed by HMT.
- *Multilateral Trading Facilities*: FCA proposes to implement MiFID2 rules covering the trading processes of MTFs, compliance with MTF rules and trading suspensions via changes to chapter MAR 5.3 of the Handbook. The changes will align the framework for MTFs more closely with the one for RMs.
- *Organised Trading Facilities*: new Handbook chapter MAR 5A for rules specific to OTFs

FCA – second consultation (CP 16/19)

- *Commodity derivatives*: FCA proposes a new section of the MAR chapter of the Handbook to set out guidance and directions on the MiFID2 regimes on position limits, position management and position reporting for commodity derivatives contracts. Actual limits will be set in due course.
- Supervision: FCA proposes changes to SUP chapter of Handbook to address obligations of firms to notify FCA of breaches, transitional provisions for transaction reporting and further changes relating to passporting.
- *Prudential Standards*: FCA proposes amendments to prudential chapters of Handbook to reflect abolition of local firm exemption and addition of new investment service of operating an OTF.
- *Senior management arrangements, systems and controls*: the FCA's proposed changes to the SYSC chapter of the Handbook address how governance and organisation rules will apply to branches of non-EU firms as well as firms exempt under Article 3 of MiFID2.
- *Remuneration requirements for sales staff*: the FCA plans to implement MiFID2 rules designed to ensure that sales staff are not incentivised to act contrary to clients' interests via a new section 19F of the SYSC chapter of the Handbook. The FCA does propose to apply MiFID2 remuneration standards to common platform firms (so including MiFID investment firms and dormant account fund operators but excluding collective portfolio management investment firms), Article 3 firms and UK branches of third country firms). However, the FCA has said that it does not currently plan to extend MiFID2 remuneration standards to non-MiFID firms (many of which are already subject to specific requirements under other EU legislation such as AIFMD and UCITS).
- *Whistleblowing*: the FCA proposes a new, dedicated section in the SYSC chapter of the Handbook to address whistleblowing. This will supplement existing, national rules and will contain cross-references to other legislation containing whistleblowing provisions such as the Market Abuse Regulation.
- *Client assets*: The FCA indicates that existing UK standards are already largely compliant with new MiFID2 requirements relating to client assets. For example, the UK has already banned title transfer financial collateral arrangements with retail clients related to contracts for difference, spread betting and rolling spot forex. The UK will modify the CASS chapter of the Handbook to extend the ban to all other forms of retail title transfer financial collateral arrangement, in line with MiFID2. Other changes will address issues such as preventing the unauthorised use of client assets, capping the amount of client money that can be deposited intra-group and requirements for client consent when depositing client money in a qualifying money market fund.
- *Complaint handling*: the FCA proposes a new section in the DISP chapter of the Handbook to establish the new MiFID2 complaints handling rules that apply to a wider range of clients than under existing rules.
- *Fees*: the FCA will update the FEES chapter of the Handbook to address the initial and ongoing fees for firms applying to operate an OTF or an MTF as well as the onboarding fees for firms connecting to the FCA's Market Data Processor (MDP)

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