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Countdown to MiFID II: the impact on OPS firms

Occupational Pension Scheme (OPS) firms are exempt from the existing Markets in Financial Instruments Directive. They are however subject to a number of existing FCA conduct of business rules which implement elements of that Directive. The FCA now proposes to build on its existing approach and to impose on such firms a number of additional enhanced standards derived from a revised version of that Directive – MiFID II.

The FCA's proposals are set out in [CP17/8: Market in Financial Instruments Directive II Implementation – Consultation Paper V \(including changes to conduct rules for Occupational Pension Scheme firms\)](#) (the CP) which was published on 31 March 2017.

INTRODUCTION

THE PROPOSALS IN OUTLINE

In outline, the FCA proposes to apply the following aspects of the MiFID II regime to OPS firms by way of the Conduct of Business (COBS) rules as if they were carrying on MiFID business, despite the fact that such firms are exempt from the Directive:

- inducements and research;
- best execution; and
- taping of telephone conversations and electronic communications.

THE KEY HEADLINES

- There will be a ban on receiving inducements from third parties (except for minor non-monetary benefits) – payment for substantive research will only be permitted if the firm pays for it itself or it establishes a research payment account (RPA) and complies with strict requirements as to the operation of that account, with full disclosure to, and consent from, the OPS trustee
- Best execution rules will become more onerous – amongst other things, firms will need to collect detailed data in order to publish an annual report, with granular information on the top five execution venues by instrument class
- "Telephone taping" will be mandatory when carrying out certain activities – the discretionary investment management exemption will be deleted and, if they do not have it already, firms will need to invest in appropriate technology

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While OPS firms are already subject to rules governing the above issues, the MiFID II standards will introduce some significant changes.

In addition to the new, MiFID II standards, the FCA proposes broadly to continue to apply the following COBS requirements to OPS firms:

- COBS 11.3 – client order handling
- COBS 11.7 – personal account handling
- COBS 16.2 and COBS 16.3 – reporting information to clients.

The carried forward rules and the new MiFID II rules will be the only COBS rules which will apply to OPS firms. All other COBS rules which currently apply will be switched off.

We look at the new MiFID II requirements in more detail below.

THE MIFID II RULE PROPOSALS

INDUCEMENTS AND RESEARCH

OPS firms are currently subject to MiFID-derived inducements rules under COBS 2.3. The FCA proposes to carry these requirements forward in relation to OPS activities carried on in relation to non-MiFID investments (such as life policies), and also in relation to the activities of safeguarding and administering investments and/or receiving and holding client money.

However, in respect of *all other OPS activities* an OPS firm will be subject to the same MiFID II rules which will apply to MiFID portfolio managers. These new rules will also replace COBS 11.6 (use of dealing commission) to which OPS firms are currently subject.

Critically, the new rules will mean that an OPS firm will be subject to a ban on accepting and retaining *any* inducements (i.e. fees, commissions or monetary or non-monetary benefits) from third parties. Certain minor non-monetary benefits will be exempted from the ban; but only if they are capable of enhancing the quality of the service provided to the occupational pension scheme, are of a scale and nature such that they could not be judged to impair compliance with the OPS firm's duty to act in the best interest of the scheme and are clearly disclosed to the scheme.

It will be possible for the OPS firm to receive "research" from a third party (e.g. a broker or independent research provider) without it amounting to an inducement (and therefore not subject to the ban), but only if the firm pays for that research out of its own pocket or otherwise complies with heavily prescribed conditions. These conditions include the following:

- a specific research charge to the occupational pension scheme will have to be based on a *research budget* by the OPS firm;
- the OPS firm must ensure that the specific charge to the occupational pension scheme, and the corresponding research budget that the charge is contributing towards, does *actually* pay for research which can assist its investment decisions;
- the OPS firm will be required to disclose to the occupational pension scheme its estimated client-specific charge upfront, based on the relevant research budget;
- the OPS firm will be required to open a research payment account (RPA), into which client-specific charges are paid and over which it retains sole, full and absolute discretion over its use and the making of payments or rebates (even if it appoints a third party to administrate the account);

- while it will be possible to collect research charges alongside transaction (i.e. execution) costs, any research charge must be collected into the relevant RPA without undue delay and monies in the RPA must be ring-fenced from the assets of any third party administrator of the account;
- the OPS firm will be required to comply with a number of other detailed conditions in relation to the maintenance and operation of the RPA arrangements.

Certain very limited forms of research material – essentially material which has been commissioned for and paid for by a corporate issuer or potential issuer to promote a new issue or non-substantive material or services consisting of short term market commentary – may amount to minor non-monetary benefits and would therefore not be subject to the ban (and therefore would not have to be subject to the RPA arrangements). However, this is unlikely to help with most forms of research which the OPS firm may have been benefitting from and, in any event, careful analysis would be required in each case to ensure that such research material amounts to a minor non-monetary benefit.

Any delegate that is subject to MiFID II will itself also be subject to the ban and, if it intends to use RPA arrangements to pay for research, it will have to agree those arrangements with the OPS firm as one of its clients. The OPS firm will then have to consider whether or not it would be in the interests of the OPS trustee client to agree to such arrangements and/or whether the agreement between the OPS firm and its OPS trustee client allows. If the OPS firm does permit its delegate to enter into such arrangements, it will receive information on research spending from the delegate in accordance with the MiFID II rules: the OPS firm should take such data into account as part of its overall assessment of the performance of its delegate(s).

The new rules will also impose a set of record keeping requirements in relation to inducements.

For an OPS firm which has previously received research – whether or not linked to execution commissions (for instance, as part of a Commission Sharing Arrangement) - it will have to decide how it will receive and fund such research in future. It can either pay for it directly or consider moving to an RPA model. Pursuing the latter strategy will involve renegotiation of existing arrangements with research providers, drafting of new policies, procedures and processes capable of calculating and allocating a research budget and agreeing the new arrangements with the OPS trustee client.

BEST EXECUTION

The FCA will apply the new MiFID II best execution rules to OPS firms. The new rules will mean that, amongst other things, an OPS firm will be required:

- to **take all sufficient steps** to obtain the best possible result for their occupational pension schemes – currently OPS firms are required to take all *reasonable* steps to obtain the best possible result, which is a lower standard;
- to disclose certain new details to an OPS trustee client on its **execution policy** over and above existing requirements, including:
 - a list of factors used to select an execution venue and the relative importance of each factor;
 - how the execution factors of price costs, speed, likelihood of execution and any other relevant factors are considered as part of the best execution obligation;
 - a summary of the process the firm uses for selecting execution venues, the execution strategies used and the procedures and process used to analyse the quality of execution obtained, and how the firm monitors and verifies that the best possible result is obtained;
- to publish in an electronic format on its website an **annual report**, available for downloading, which sets out:

- the top five execution venues, in terms of trading volumes, to which client orders were sent in the preceding year – this exercise must be completed in respect of each separate class of financial instruments, as prescribed by a Delegated Regulation setting out technical standards ([RTS 28](#)), and separately in respect of client orders in securities financing transactions for each class of financial instruments;
- for each class of financial instruments, a summary of the analysis and conclusions that the OPS firm has drawn from its detailed monitoring of the quality of execution obtained on execution venues during the preceding year;
- in relation to customised, **bespoke OTC financial instruments**, to gather market data used in the estimation of the price of the product in order to check whether the price offered is fair – where possible, this must be done by comparing similar or comparable products.

The new best execution rules will mean that OPS firms will have to:

- **collect and compile relevant data by instrument class** in order to be able to prepare the top five execution venue information for the annual report – this will require potentially-significant system changes and changes to the firm's existing processes and procedures;
- **revisit the basis upon which OTC products are priced and agreed** and, if necessary, improve existing systems and controls in order to ensure that they can gather the necessary market data and comparable information;
- **review their existing execution policies** and the information they currently disclose to their OPS trustee client – these will need to be upgraded to improve the more granular requirements introduced by MiFID II.

TAPING OF TELEPHONE CONVERSATIONS AND ELECTRONIC COMMUNICATIONS

OPS firms are currently subject to COBS 11.8 which requires OPS firms to record telephone conversations and electronic communications when carrying out certain activities. However, the recording obligation is currently subject to a qualified exemption from the requirement to record for "discretionary investment managers" (a defined term that includes OPS firms). Such managers do not have to make recordings of communications sent to or received from a firm which the firm reasonably believes is subject to the recording obligation (or, where the firm is not subject to such obligation, the communications are infrequent and proportionally small in number).

COBS 11.8 will be deleted. Instead a new chapter SYSC 10A will set out recording rules derived from MiFID II. The FCA proposes that these will apply to OPS firms. The key points arising from these rules are that:

- there will be no discretionary investment management exemption from the requirement to record;
- there will be a number of requirements in the [Delegated Regulation regarding organisational requirements \(\(EU\) 2017/565\)](#) relating to the recording of telephone conversations and electronic communications which are either not in COBS 11.8 or are more granular, including the requirement:
 - for the management body to have effective oversight and control over the firm's recording policies and procedures;
 - to keep a regularly updated record of all individuals who have firm devices or privately owned devices;
 - to train employees;
 - to monitor compliance with the recording obligation against records of orders and transactions;

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- to record in a durable medium face-to-face conversations with clients;
- firms must keep records of the communications for five years (COBS 11.8 currently requires a period of at least 6 months) – the FCA can request that this is extended to up to seven years.

OPS firms will need to overhaul their existing systems, controls and procedures as regards recording. Perhaps more fundamentally, those firms that have hitherto relied on the discretionary management exemption and which do not currently have compliant recording technology will have to introduce such technology. This will involve time and expense.

WHAT NEXT?

Consultation on the proposed changes in relation to OPS firms closes on **23 June 2017**.

The FCA proposes that the rule changes will take effect on **3 January 2018** - this is the date on which the UK is required by MiFID II to transpose its provisions into law, which the FCA will be doing through its rule changes. OPS firms are expressly asked whether they agree with the proposal to apply the new provisions from 3 January 2018 and, if not, to indicate a more appropriate date. Given that the FCA launched the consultation with only 9 months until the proposed implementation date and (as the FCA acknowledges) the final rules will not be published until the second half of 2017, OPS firms should consider responding on this point specifically. This may be especially so if the preparations for compliance (including the systems and technological changes that will be necessary to meet the new best execution and taping requirements) are likely to prove onerous and will take time to put into effect.

HOW WE CAN HELP

Our dedicated team of Financial Services and Markets lawyers are advising a range of firms on their MiFID II implementation projects. We help firms assess the impact of the various changes on their business, analysing overall impacts as well as producing detailed line by line gap analyses. We can provide you with new policies and procedures and assist with training on the new requirements.

FOR FURTHER INFORMATION, PLEASE CONTACT

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