Monday, 3 July 2017

Countdown to MiFID II: Second FCA Policy Statement and Consultation

On 3 July 2017, the Financial Conduct Authority (FCA) published its second policy statement (PS 17/14) on the implementation of the recast Markets in Financial Instruments Directive (MiFID II). The policy statement (PS) contains feedback on all of the proposals not addressed in the FCA's first policy statement (PS 17/5) which was published in April 2017. The FCA has also published a consultation paper (CP) (CP 17/19) covering certain markets issues and minor consequential amendments.

The publication of the PS marks the last significant stage in the development of the rules underpinning the implementation of MiFID II. Firms now have the vast majority of the final form EU legislation (including the regulatory and implementing technical standards adopted by the European Commission), as well as the final UK domestic implementing rules.

In light of the size and complexity of the PS, firms will need to spend time considering the final rules in detail and identifying their impact upon implementation plans. In the meantime, we have set out in this briefing a summary of some of the more important issues in relation to which firms were hoping for more clarity.

WHAT THE PS COVERS:

- Inducements and research
- Investment research
- Client categorisation
- Investor disclosures
- Adviser independence
- Suitability and appropriateness
- Dealing and managing (including best execution and client order handling)
- Underwriting and placing
- Product governance
- Telephone taping
- Knowledge and competence requirements
- FCA Perimeter Guidance
- Client asset rules
- Complaints handling
- SME regimes
- Structured deposit rules
- Specialist regimes

TELEPHONE TAPING

- As consulted upon, the expanded taping requirements will apply to a wide range of activities, including portfolio management (and the current qualified exemption for discretionary investment managers will be deleted).

- In its narrative, the FCA has said that it is not its intention to require that all conversations and electronic communications should be taped. In the context of the activity of managing an AIF, the rules will capture communications that relate to transactions undertaken, or intended to be undertaken, as part of the discretionary management activities of the AIFM and not to all those activities which form part of the wider concept of what "managing" an AIF means.

- The FCA says in the narrative of the PS that the scope of the regime is similar to the existing domestic rules and that calls that are linked to a reasonable prospect of the firm bringing about a transaction by its own volition are in scope and must be taped, whereas conversations "where the firm is merely feeling its way and reserving its decision" will fall outside the regime. However, subject to the change mentioned below, there has been no change to the rules as consulted upon and no additional guidance – by itself, the narrative comments from the FCA possibly raise more questions than they answer. It is likely that the FCA's comments are intended to be helpful, but given that the regime extends to capture the activity of arranging, it is not clear how far these comments will help firms to draw the line. There may be scope for further dialogue between industry associations and the FCA on this issue.

- The FCA has added a new provision which states that the telephone taping requirements will not apply to activities relating to financial instruments that are not admitted to trading on, or traded on, a trading venue where those activities are carried out by a non-MiFID firm.

- The FCA will not, after all, be extending the taping regime to capture all aspects of corporate finance business, and instead only those communications within corporate finance activity that would in any event be subject to the rules by virtue of the extended scope of the MiFID II taping requirements will be caught.

CLIENT CLASSIFICATION RULES FOR LOCAL AUTHORITIES

- The new opt-up test for UK local public authorities or municipalities will apply for the categorisation of such clients in relation to both MiFID and non-MiFID business.

- The FCA has confirmed that it is not introducing a specific definition of a "local public authority or municipality" for the purposes of the local authority opt-up rules.

- As the FCA had proposed in its original consultation, the relevant opt-up rules for non-UK local authorities will be those applied by the jurisdiction in which the local authority is located. If the relevant jurisdiction has not exercised its discretion to apply modified opt-up criteria, or if it is a non-EU jurisdiction, the general non-local authority MiFID opt-up test in the FCA rules will apply.

- For the purposes of applying the "qualitative" element of the opt-up test – i.e. that the client is capable of making its own investment decisions and understanding the relevant risks – the FCA has clarified in the narrative discussion in the PS that where a local authority has a pensions committee, the firm may take a collective view of the expertise, experience and knowledge of committee members, taking into account any assistance from other local authority officers or external advisers, where relevant.

- In addition to the qualitative test, a UK local authority will need to satisfy the "quantitative test". This will require it to have a financial instrument portfolio that exceeds £10 million (reduced from £15 million in the original consultation) and to satisfy at least one of the following requirements:

    - The authority has carried out an average of at least 10 transactions per quarter in significant size in the relevant market;

- The person authorised to carry out transactions on behalf of the authority works, or has worked, in the financial sector for at least one year in a role that requires knowledge of the services envisaged; or

- The authority is an "administration authority" of the Local Government Pension Scheme (**LGPS**) and is acting in that capacity. The FCA has added this criterion following the consultation in order to make it easier for LGPS administrators to be opted up to elective professional status, provided that the qualitative test is also satisfied.

- We expect the effect of this to be that all LGPS administrators will fulfil the quantitative test. The focus will therefore be on the qualitative test, where trade associations are working on a standard form of opt-up process for LGPS administrators.

INDUCEMENTS AND INVESTMENT RESEARCH

- The MiFID II requirements on inducements and research will, as consulted upon, be extended to most forms of collective portfolio managers when executing orders (i.e. full-scope AIFMs, most small authorised UK AIFMs, UCITS management companies and residual CIS operators), as well as to Article 3 (i.e. optionally exempt) firms.

- The main exception is private equity and venture capital managers who fall within the "proxy" definition for these types of manager set out in AIFMD (AIFs which do not generally invest in financial instruments that can be registered with the depository or generally invest to potentially acquire control). The FCA has accepted the representations made by BVCA that applying the MiFID II inducements rules to these types of firm would not fulfil the policy intention behind the rules and could adversely impact the legitimate and market standard model for payment for due diligence. This will be welcomed by the private equity and venture capital community.

- In terms of how quickly research charge deductions must be moved to a research payment account (**RPA**) when a third party (e.g. broker) has been involved in deducting them, the FCA has amended its guidance to provide such transfer of the deducted research charge must be transferred into the RPA without undue delay but in any case with 30 calendar days of the transaction.

- The PS clarifies that portfolio managers may use a 'virtual' RPA with multiple underlying RPAs provided that each individual RPA is sufficiently protected in accordance with the rules.

- Mixed funding models (e.g. use of RPA methodology and payment out of the firm's P&L) across the firm's business will be permissible (for instance between different type of portfolio asset class), but firms will need to ensure that the use of these does not give rise to conflicts of interest.

- While not making any specific changes to its rules as consulted upon, the FCA accepts that certain activities may be considered as forming part of the provision of execution services and therefore would not be separate benefits subject to the inducements regime. Examples given in the PS narrative include post-trade delegated reporting services, working large orders, taking trades on risk and structuring a series of derivatives transactions.

- Again, while not making any specific changes to its rules as consulted upon, the FCA has confirmed that sell-side brokers will not be required to price execution and research services separately to non-EEA firms, but that this obligation applies when providing execution services to all MiFID investment firms (and collective portfolio managers) regardless of what activities they carry out.

- Two new examples of potentially acceptable minor non-monetary benefits have been added: free, short-term research trial periods (for no longer than 3 months and subject to other conditions) and connected research in the context of a primary market capital raising

BEST EXECUTION REGIME

- The FCA had originally proposed to apply the MiFID II RTS 28 best execution data publication obligations to full-scope UK AIFMs, but has now confirmed that it will not do so at the present time. Instead, it will await the outcome of the European Commission's AIFMD review, but will also carry out further monitoring of the sector to see if the extension of the data publication at an earlier stage would be justified.

- At the present time, the FCA is also not extending the RTS 28 data publication requirements to small authorised UK AIFMs and residual CIS operators on the basis that the level of retail investment in such funds is generally low.

- As the FCA proposed in its original consultation, the MiFID II best execution rules will apply to UCITS management companies, although with necessary modifications set out in the FCA rules.

- The FCA has confirmed that the MiFID II best execution regime will be extended to Article 3 (i.e. optionally exempt) firms, although it notes that in practice, the majority of such firms only undertake the reception and transmission of client orders in relation to units in collective investment schemes and therefore many of the rules may not be relevant.

CONSULTATION PAPER

- The CP primarily addresses some residual technical markets issues and therefore will mainly be relevant to:
  - Operators of multilateral trading facilities and/or organised trading facilities;
  - Data reporting service providers (i.e. approved reporting mechanisms, approved publication arrangements and consolidated tape providers);
  - Firms trading commodity derivatives and/or economically equivalent OTC contracts; and
  - Algorithmic traders who provide direct electronic access services to regulated markets.
- The CP also contains limited consequential amendments to the FCA Glossary and the Prospectus Rules.
- Firms have until **7 September 2017** to respond to the issues raised in the CP.

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