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MIFID II – Conduct Of Business Rules

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This is the second part in a series of Legal Longs on the MiFID II Directive [2014/65/EU] and the Markets in Financial Instruments Regulation (MiFIR) (together, “MiFID II”), which will come into effect on 3 January 2017. This second part provides a brief overview of the key changes to the conduct of business rules affecting investment firms and will focus on independent advice, conflicts of interest, inducements and commissions, research and remuneration.

Independent advice

Article 24 of MiFID II imposes new requirements on investment firms that provide investment advice on an independent basis. For a firm to claim to be independent, it must be able to advise on a diversified selection of ‘adequately representative’ financial instruments. (Please note that a firm specialising solely in complex products will not be able to meet this definition.) The instruments must not be limited to those issued or provided by the firm itself or any firm with which it has close links, which could impair the independent basis of the advice provided. The firm must be able to easily confirm whether its service is appropriate for each new client i.e. that its business model matches the client’s needs and objectives and the range of financial instruments that are suitable for the client. If this is not the case the firm must not provide such a service to the client.

An investment firm offering investment advice on both an independent basis and on a non-independent basis has to comply with certain obligations, including that it should not hold itself out as “independent” for its business as a whole, although it may hold itself out as acting independently in respect of the services for which it provides independent advice, and it should have adequate organisational requirements and controls in place to ensure that both types of advice services and advisers are clearly separated from each other. It follows, therefore, that a relevant person within such a firm will not be allowed to provide both independent and non-independent advice. The firm’s requirements and controls must also ensure that clients are not confused about the type of advice that they are receiving and are given the type of advice that is appropriate for them.

With regard to the payment of fees, commissions or any monetary or non-monetary benefits to independent advisors, please see ‘Inducements and Commissions’ for further details below.

Conflicts of interest

Article 23 of MiFID II addresses conflicts of interest and requires investment firms to take all appropriate steps to identify and prevent or manage conflicts of interest arising in the provision of its services, including those caused by receipt of inducements from third parties or by a firm’s own remuneration and other incentive structures. The latter conflicts are a new addition to the current MiFID rules. Also new is a stricter requirement on firms to prevent conflicts of interest arising in the first place as opposed to merely managing conflicts which have been identified and a tightening of the rules allowing firms to mitigate the risk of a conflict by disclosure. In response to the European Commission’s request that ESMA clarify the extent to which firms can rely on disclosure to manage conflicts, ESMA stated in its final report [ESMA/2014/1569] that disclosure to clients is a measure of last resort and that placing an over-reliance on disclosure without adequate consideration as to how the conflicts can be appropriately managed should not be permitted. ESMA considers that firms should first determine whether other reasonable measures could effectively mitigate the conflict, and that it would be reasonable for regulators to request evidence from firms to demonstrate that they have complied with this requirement. Further, ESMA’s view is that, for disclosure purposes, the use of generic conflicts of interest warnings would not comply with the disclosure requirements, irrespective of the type of client.

Inducements and commissions

The payment of fees or commissions and other non-monetary benefits are currently permitted under MiFID provided that they have been assessed by the firm to ensure that they do not impair the firm's duty to act in the best interest of its clients and do not create any conflicts between the firm and its clients.

Article 24(7) of MiFID II imposes strict rules on fees and commissions paid to or by a third person and distinguishes between the rules which apply to investment services related to independent investment advice and portfolio management and all other investment services.

Firms providing independent investment advice or portfolio management services will generally be prohibited from retaining any fees, commission, monetary or non-monetary benefits received from third parties, as they will not be regarded as fulfilling their duties to manage conflicts of interest or their duty to act in the clients' best interests if they do so. Firms can receive such payments to pass onto clients, but are not permitted to retain them. The ban does not apply to minor non-monetary benefits, provided that:

- the benefits are capable of enhancing the quality of service to the client;
- the benefits are not judged to be of a scale and nature to impair compliance with the firm's duty to act in its clients' best interests; and
- the benefits are clearly disclosed to the client before the service is provided.

In its final report, ESMA has given further guidance on what "enhancing the quality of service to the client" might mean. Third party payments will need to be justified by reference to additional services, or a higher level of service. Examples given by ESMA are non-independent advice on a "wide range of suitable instruments including an appropriate number from third parties" and the provision of non-independent advice combined with either an annual review or an on-going service. There is a further reference to the fact that on-going inducements, such as trail commissions, must be justified by the provision of an on-going service. According to ESMA, payments can only be made if they cannot give rise to the potential of bias or distortion in the service provided to clients. Furthermore, disclosure is required in three ways: in advance; immediately after the payment is received; and annually.

In its consultation paper published in May 2014 [ESMA/2014/549], ESMA considered the potential for research to be permissible as a minor non-monetary benefit for portfolio managers and independent investment advisers (as to which, please see 'Research' below for further details). ESMA also proposed to introduce an exhaustive list of non-monetary benefits, but in response to concerns, it has modified its technical advice in its final report by introducing an element of flexibility whereby the exhaustive list could be supplemented through guidelines adopted by ESMA.

The rules applying to inducements in respect of all other investment services remain relatively unchanged under MiFID II. Thus, a payment or benefit that enables or is necessary for the provision of investment services, such as custody costs, settlement and exchange fees, regulatory levies or legal fees, and which, by its nature cannot give rise to conflicts with the firm's duties to act honesty, fairly and professionally in accordance with the best interests of its clients are permitted, save that firms, where applicable, must inform clients on the mechanism for transferring the fee, commission or non-monetary benefit to the client.

Research

In its May 2014 consultation paper, ESMA stated that all research had to be unbundled and paid for separately, as the current method of bundling research into transaction costs amounted to a material inducement. In its final report, as a result of respondent concerns, ESMA has now proposed that MiFID II should permit investment firms to accept third party research only where they pay for it directly or from a ring-fenced research account that is funded by a specific charge to their clients, subject to certain conditions. Payment for third party research linked to the payments made for execution of orders will not be permitted. ESMA considers that investment firms which spend limited amounts on research may prefer to pay for it directly in order to limit their administrative burden. The conditions for a separate research payment account include that:

- it must be funded in advance by the firm's clients;
- it must operate based on a research budget set by the firm;
- the use of the funds in the account must not be linked to the volume of transactions executed; and
- any surplus must either be rebated to the relevant funds or offset against future research budgets.

These requirements are aimed at ensuring that investment firms remain accountable to their clients. ESMA also suggests high-level provisions to indicate that brokers will need to price and supply execution and research services separately to enable portfolio managers (and independent investment advisors) to meet the new restricted approach to inducements. Further, those investment firms which offer execution of orders and research services should be required to price and supply these services separately to ensure transparency in the market and to allow firms to better demonstrate their compliance with the inducements requirements and wider conflicts of interest provisions.

Remuneration

MiFID II introduces new rules that apply to investment firms to ensure that remuneration requirements do not create unnecessary conflict with the firm's duty to act in the best interests of its clients. Article 9(3)(c) contains a new, explicit requirement on a firm's management to define, approve and oversee a remuneration policy for people involved in the provision of services for clients that is aimed at encouraging responsible business conduct, fair treatment of clients and avoiding conflicts of interest in the relationships with clients.

ESMA proposes that these rules should apply to "relevant persons who can have a material impact" on the "investment and ancillary services" or "corporate behaviour" of a firm. The resultant remuneration policy must be designed so that clients are treated fairly and there must be no incentives for staff to favour themselves or the firm over clients and their interests are not impaired by the firm's remuneration practices in the short, medium or long term. In particular, the policies and practices should not in any way create incentives that may lead people to favour their own interests or the firm's interests to the potential detriment of clients. The remuneration policy must be approved by the firm's management after taking advice from the compliance function and senior management should be responsible for the day-to-day implementation of the remuneration policy and related compliance risks. Further, remuneration and similar incentives must not be solely or predominantly based on quantitative commercial criteria and must take into account appropriate qualitative criteria reflecting compliance with the applicable regulations, the fair treatment of clients and the quality of services provided to clients. An appropriate balance between fixed and variable components of remuneration must be maintained at all times, so that the remuneration structure does not favour the interests of the investment firm or its relevant persons against the interests of any client. Finally, ESMA proposes that the definition of remuneration should be that provided in the ESMA remuneration guidelines [ESMA/2013/606].

In our next Legal Long in this series, we shall be looking in more detail at the new trading venues, dark pools and high frequency trading under MiFID II.

If you would like to discuss this further, please contact Claire Cummings at Claire.Cummings@cummingslaw.com or on 020 7585 1406.

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