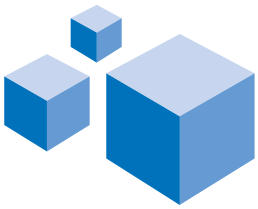

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The impact of MiFID II on AIFMD investment managers

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The impact of MiFID II on AIFMD investment managers

Introduction

The MiFID II Directive and the Markets in Financial Instruments Regulation (MiFIR) will repeal and recast MiFID with effect from 3 January 2018. Together, the MiFID II Directive and MiFIR ("MiFID II") will form the legal framework governing the requirements applicable to investment firms, trading venues, data reporting service providers and third-country firms providing investment services or activities in the EU. They are further developed by a series of regulatory technical standards, implementing technical standards and the EU Commission's delegated directive (the "Delegated Directive").

MiFID II does not only apply to MiFID II firms. On 3 July 2017, the FCA published its policy statement (17/14) which set out those parts of MiFID II which will impact non-MiFID firms, such as alternative investment fund managers ("AIFMs") and UCITS management companies. This note will consider the parts of MiFID II which impact AIFMs and then go on to consider practical steps which an AIFM may need to take to ensure their practices and documentation are MiFID II compliant.

1. Inducements and unbundling of research

As part of its aim to enhance investor protection, MiFID II will make changes to the current method of bundling research into transaction costs under MiFID, this being a practise which is considered to amount to a material inducement. The FCA has confirmed that the research and inducements requirements in MiFID II will apply to both full scope AIFMs and most small authorised AIFMS.

AIFMs providing independent investment advice or portfolio management will be prohibited from receiving and retaining any fees, commission, or monetary or non-monetary benefits from third parties. Under MiFID II, such payments and/or benefits may be received by the AIFM but they must be passed on in full to clients as soon as possible following receipt.

Under MiFID II, research may only be received if it is paid for either by the AIFM itself or from a separate research payment account ("RPA") that is funded by a specific charge to the AIFM's clients and operated in accordance with certain criteria. The new rules set out requirements on enhancement of service quality and compliance with existing duties which, if met, will allow: (i) an AIFM to receive third party research without it constituting an inducement; and (ii) AIFMs supplying both execution and research, to provide discrete pricing for each of those services (and any other services) to ensure greater transparency to recipient firms, particularly those that may wish to avail themselves of the option of paying for research from their own resources or through an RPA.

These new requirements will not apply not apply to any inducement considered to be a minor, non monetary benefit. These have been defined and include, for example, attendance at certain conferences and reasonable hospitality.

An AIFM which offers execution of orders and research services will therefore be required to price and supply these services separately to ensure transparency in the market and to allow it to better demonstrate its compliance with the inducements requirements and wider conflicts of interest provisions. The new rules will set out how the RPAs should be operated and time frames under which the firm's clients should be charged.

Practical Steps

- determine whether inducements meet the requirements of enhancement and

compliance set out in article 24(9) of MiFID and the extended requirements of the Delegated Directive;

- fund offering documents ("OMs") will need to disclose whether the AIFM will meet its own research costs or whether it will set up an RPA with the fund
- deletion of current disclosures in the OM relating to dealing commission
- amendment of the AIFM's FCA terms and conditions
- draft and resolve to adopt an RPA policy
- termination of any commission sharing agreement
- compliant RPA Agreements to be put in place which document the terms of the operation of the RPA, whether by a separate agreement or amending investment management agreements/ investment advisor agreements, as applicable

2. Taping and communications

MiFID II enhances record keeping requirements, such that firms are required to record telephone conversations and electronic communications relating to the reception, transmission and execution of orders as well as dealing on own account, and to keep such records for five years or, where requested by the FCA, for up to seven years. The FCA has extended this requirement to cover both full-scope AIFMs and small authorised AIFMs.

Meetings must also be recorded, either by taping if possible or, if not by making an "analogous" written note which captures all the main points of the full conversation that are relevant to the order, which would include the price, volume, type of order and when it shall be transmitted or executed. The note should also state the time, date and location of the meeting as well as who attended and on whose initiative the meeting was held. Each note must be retained in a durable medium and held in accordance with the timescale set out above for taped calls.

Additionally, firms will be required to periodically monitor the electronic records and the recordings of telephone conversations, though a "risk based and proportionate" approach may be taken, and records must be provided by the firm to the client involved upon request.

Practical Steps

- all OMs will need to include a disclosure that telephone conversations and electronic communications will be recorded
- amendment of the AIFM's FCA terms and conditions
- drafting a non-exclusive pro forma for note taking at face-to-face meetings
- draft and resolve to adopt a record keeping policy

3. Conflicts of interest

MiFID II widens to scope of conflicts of interest and imposes more onerous obligations on firms to manage conflicts of interest, moving to conflicts requiring investment firms to:

- in order to adhere to primary objective of prevention, take all appropriate steps to identify conflicts of interest. The current requirement is to take reasonable steps in order to identify conflicts of interest
- also on the theme of prevention, put systems and controls in place to prevent, as well as manage, conflicts of interest that cannot be prevented
- in order to adhere to the secondary objective of disclosure, make an enhanced disclosure of the conflict and the steps taken to mitigate the risks before undertaking any business on the client's behalf where organisational arrangements are not sufficient to prevent conflicts from adversely affecting client interests

It is of interest that MiFID II has also dealt with the issue of materiality by not allowing firms to decide what amounts to materiality when considering whether a conflict should be addressed. SYSC 10.1.4 R reflects this by removing the previous reference to materiality. The new handbook which comes into force on 3 January 2018 refers to whether a conflict of

interest "may C:\instrument\2017\FCA_2017_38.pdfdamage the interests of a client" rather than whether it "may entail a material risk of damage to the interests of a client"

Practical steps

- following a review of the AIFM's conflicts of interest policy, update the summary/ disclosures in the OM and, where applicable, the AIFM's FCA terms and conditions with any amendments
- an AIFM must review its conflicts of interest policy at least annually

4. Product Governance

MiFID II introduces new product governance ("PG") rules, which require investment firms that manufacture (i.e. issue) or distribute financial instruments or services to clients to: (i) ensure those products are designed to meet the needs of the identified target market; (ii) ensure that the distribution strategy is compatible with the target market; and (iii) make appropriate information available to distributors and placement agents.

The new rules on PG will be found in a new sourcebook for Product Governance and Intervention which will be known as "PROD". For an AIFM or small authorised AIFM that is a "manufacturer" of MiFID products, the rules in PROD shall apply to such business, but not to other non-MiFID business it conducts.

In addition, for AIFMs and small authorised AIFMs which "manufacture" financial instruments which are not MiFID products, the PG provisions will apply as guidance. However, firms may decide to apply PROD as if it is a rule to ensure that they are fully compliant and also to mitigate any risks of not making equal disclosure to all clients or giving some clients an unfair advantage over other.

Practical steps

- all firms to consider and become familiar with the new PROD rules and ensure compliance with product governance under PROD 1.3;
- review and amendment of distribution agreements to include terms dealing with:
  - required controls to ensure suitability and appropriateness;
  - provision of flow of information mechanisms between manufacturers and distributors in order to allow manufacturers to monitor and assess whether their products are being distributed to target markets and whether the strategies remain appropriate; and
  - client consent issues.

5. Client order handling

MiFID II does not make any material changes to current provisions on client order handling and display of limit orders. MiFID II does add the term 'trading venue' alongside 'regulated market', which slightly widens the scope of shares subject to the limit order rules, to reflect wider changes to market structure. MiFID II also allows additional methods for making client limit orders public and clarifies that the choice of venue must be made in line with a firm's execution policy. These provisions apply when firms advise on or sell structured deposits.

The FCA will amend the current rules to align with the changes in MiFID II, principally by deleting provisions derived from MiFID and replacing those with provisions in MiFID II. While these changes do not apply to full scope AIFMs, they will apply to small authorised AIFMs where their activity involves the execution of orders, or the transmission or placing of orders, in MiFID financial instruments to other entities for execution.

Practical steps

- review of a small authorised AIFM's terms and conditions to ensure they comply with the new wording set out in the FCA's rules

How can we help?

As set out above, we anticipate that AIFMs will be required to amend certain of their fund documentation, including offering memoranda,

investment management agreements, investment advisory agreements, commission sharing agreements and distribution agreements. The relevant amendments will differ depending on the firm's business and a gap analysis may be required by the firm to analyse how its documentation will be impacted by MiFID II.

We are able to assist AIFMs in a number of ways. We can carry out a gap analysis, we can provide advice on the exact application of MiFID II to a particular firm, we can review and give our comments on a firm's contractual arrangements and we can help re-draft or negotiate revised documentation.

If you would like our assistance in this respect, please contact us on the email addresses and telephone numbers set out below.

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