On 15 May 2014, the European Parliament adopted the legislative proposal on the second Directive on Markets in Financial Instruments (MiFID II) and the Regulation on Markets in Financial Instruments (MiFIR). Together, MiFID II and MiFIR significantly enhance the requirements which govern in-scope investment firms, trading venues, data reporting providers and third party firms providing investment services or activities in the European Union (EU). MiFID II and MiFIR will be applicable in all member states, including the UK, from 3 January 2018.

Building on rules already in place, MiFID II and MiFIR are designed to take account of developments in the trading environment since the enactment of the first MiFID in 2007 (MiFID I). In light of the financial crisis, the EU aims to improve the functioning of financial markets and increase efficiency, resilience and transparency.

MiFID II sets out:

- Conduct of business and organisational rules for investment firms;
- Authorization requirements for regulated markets;
- Regulatory reporting to avoid market abuse;
- Trade transparency obligations for financial instruments;
- Rules on the admission of financial instruments to trading.

Brexit

On 23 June 2016, the UK voted to leave the EU. Once the UK government formally notifies the European Council that the UK wants to leave the EU, the two year period for the negotiation for exit under Article 50 of the Treaty of the European Union may commence. Uncertainty about the legislative impact of Brexit, including MiFID II, will continue until the exact terms of the exit negotiation are finalised and published.

On 24 June 2016, the FCA confirmed in a press release that EU law will remain applicable to UK firms until any changes are made, which is a matter for the UK government and Parliament. The FCA instructed UK firms to continue to abide by their obligations under UK law, including those derived from EU law. We will continue to monitor the situation and will update you of developments that provide industry some certainty. You can also visit our Brexit page here for more insights.

Next steps
The FCA is expected to publish a fourth Consultation Paper later in 2016. We will continue to monitor developments and update you as they arise. It is important that all investment firms are ‘MiFID II ready’ by 3 January 2018 and compliant with the enhanced regulatory regime. If you need particular advice on how the UK implementation of MiFID II will impact your business, please contact Michael McKee, Mark Dwyer (derivatives), Tony Katz and/or Ian Mason.

Summary of key changes

1. Markets

MiFID II creates a new category of trading venue called Organised Trading Facilities (OTFs). The rationale for creating OTFs was to counter the development of broker-crossing networks (BCNs) and other ‘dark’ trading which evade the pre-trade transparency requirements of MiFID I by allowing anonymous and non-referenced off market trades Over The Counter (OTC). MiFID II aims to close BCNs out of equity trading and drive all equity and OTC derivatives trading onto regulated trading venues, a move which follows the introduction of the EU Regulation on OTC Derivatives, Central Counterparties and Trade Repositories (EMIR).

MiFID II introduces new market microstructure rules for regulated trading venues including minimum tick sizes for equities and 'equity-like' financial instruments as well as permitting higher fees on market participants with a high ratio of cancelled to executed orders, impacting participants who typically engage in High-Frequency Trading (HFT). The rules on both pre and post-trade transparency will apply to a larger number of financial instruments including those with 'equity-like' characteristics.

Whilst the reforms are positive in terms of market stability, questions arise regarding the limitation of both liquidity and business flexibility and freedom. It is anticipated that increased transparency and market consolidation may come at the cost of reduced market liquidity given the reduced choice of trading venues and the trading of fewer bespoke financial instruments.

2. Reporting

MiFID II extends the scope of transaction reporting to financial instruments admitted to trading or traded on any trading venue (currently only those admitted to trading or traded on a regulated market (RM) needs to be reported). Position reporting and disclosure requirements of commodity derivatives, emissions allowances and emission allowances derivatives have also been introduced. Double reporting of the same information under MiFIR and EMIR will be avoided. Investment firms should consider updating their reporting system functionality and leverage existing EMIR reporting infrastructure to the greatest extent.

3. Corporate governance and conduct of business requirements

MiFID II seeks to address perceived weaknesses in corporate governance in the financial services sector which has 'been a contributory factor to the financial crisis', a view on which 'there is agreement among regulatory bodies at international level' (Recital 5, MiFID II).

MiFID II requires the management body (typically the board) of investment firms to define, approve and oversee:

- A policy as to services, activities, products and operations offered or provided in accordance with the risk tolerance of the firm, ensuring appropriate stress testing of services or products;
- A remuneration policy for persons involved in the provision of services to clients.

In particular, MiFID II requires management bodies to have access to good quality management information and be composed of members of 'sufficiently good repute’. MiFID II also builds on the 'client's best interests' provisions of MiFID I, requiring product manufacturers to maintain adequate review processes and to ensure that investment products are ‘consistent with the needs’ of identified target markets. It should be noted that MiFID II empowers regulators to ban specific products, services or practices where there are threats to investor protection, financial stability or the orderly functioning of markets.

MiFID II expands on existing conduct of business requirements for investment firms. Currently, firms merely have to take 'reasonable' steps to identify and manage conflicts of interest, but under MiFID II, firms will be required to take 'appropriate' steps to identify, prevent and manage conflicts of interest. Firms that hold themselves out as...
independent' will be prohibited from retaining any fees, commissions and monetary or non-monetary benefits received from third parties. These firms are required to establish a policy to ensure third party payments are allocated and transferred to clients. For UK advisory firms, this change will not be as significant given that the UK already banned firms from receiving commission for both independent and restricted advice (the UK's Retail Distribution Review [RDR]).

UK implementation process

Member states have until 3 July 2017 to implement MiFID II, with the implementing legislation applying from 3 January 2018. MiFIR is a directly applicable regulation and will therefore apply without implementing legislation from 3 January 2018. Work is well underway by the European Securities and Markets Authority (ESMA) to produce level 2 measures including regulatory technical standards and implementing technical standards. For example on 7 April 2016, the European Commission adopted the first level 2 measure under MiFID II, a Delegated Directive on investor protection. Articles from this Delegated Directive are addressed in this Alert under the discussion of CP16/29. The Delegated Directive will need UK implementing legislation to come into force. On 20 April 2016, the European Commission endorsed draft regulatory technical standards on non-equity transparency, the ancillary test and position limits provided that certain changes are made. Further level 2 measures will be forthcoming.

In March 2015, Her Majesty's Treasury (HM Treasury) consulted on the implementation of MiFID II. HM Treasury will produce a policy statement in due course before presenting an implementation Bill to Parliament. HM Treasury consulted on third-country regime, data reporting services, position limits for commodity derivatives and reporting, unauthorised persons, structured deposits, the power to remove board members and OTFs.

In December 2015, the FCA published its first Consultation Paper 15/43 on the implementation of MiFID II and MiFIR (CP15/43). The FCA consulted on new rules governing the secondary trading of financial instruments and the conduct of business and organisational requirements for investment firms.

In March 2016, the Prudential Regulation Authority (PRA) published its first Consultation Paper (CP9/16) on the implications for PRA regulated credit institutions and designated investment firms on the UK implementation of MiFID II. CP9/16 addressed passporting and algorithmic trading issues only. The PRA is expected to consult on the remainder of its proposals in due course.

On 29 July 2016, the FCA published its second Consultation Paper (CP16/19) on the UK implementation of MiFID II and MiFIR. CP16/19 addressed a number of issues including commodity derivatives and systems and controls requirements. The closing date for responses to CP16/19 is 28 October 2016. Please refer to our Finance Update for an overview of CP16/19. This article outline the key points of CP16/19 in more detail below.

On 29 September 2016, the FCA published its third Consultation Paper (CP16/29). CP 16/29 includes proposals on conduct of business issues as well as a range of issues not covered in the previous consultations. The closing date for responses to CP16/29 is 4 January 2017, except for responses to Chapter 16 - 'Supervision manual, authorisation and approved persons', which should reach the FCA by 31 October 2016. The key points of CP16/29 are also outlined below.

The FCA expects to publish a fourth Consultation Paper later in 2016. The FCA will publish its own Policy Statement covering all aspects of the FCA's implementation of MiFID II in the first half of 2017.

FCA's second Consultation Paper

1. Commodity derivatives

MiFID II will bring a significant change to commodity derivative markets in the UK by requiring the FCA to set position limits of commodity derivatives trading on UK trading venues. CP16/19 consults on a new section of the FCA’s Market Conduct sourcebook, MAR 10, that will set out guidance and directions on the MiFID II Directive regime relating to position limits, position management and position reporting for commodity derivatives contracts. Position limits will be set in due course and position reporting will apply to both trading venues and investment firms. Unauthorised firms may need to apply for exemptions from reporting position limits and authorised firms will need to put in place systems for recording, controlling and reporting commodity derivative positions.
2. Supervision

The FCA proposes to update the FCA Handbook’s Supervision Manual ([SUP](#)) in order to:

- Ensure that notifications of breaches and relevant information directed to the FCA are accurate and take into account MiFIR and non-Financial Services and Markets Act 2000 HM Treasury implementing regulation;
- Include a transitional provision in SUP to ensure transaction reporting obligations incurred from 2 January 2018 continue as such following the repeal of a MiFID I implementing regulation;
- Update application forms for investment firms seeking passporting permission to ensure information required by the MiFID II level 2 regulations is provided.

3. Prudential standards

Firms operating an OTF will be required to hold €730,000 of base own funds capital in line with the requirement of the EU Capital Requirements Directive IV. CP16/19 also proposes updating the Prudential Handbook in light of MiFID II’s removal of the ‘local’ exemption from MiFID I and removing outdated references to MiFID I where the matters are now dealt with in the EU Capital Requirement Regulation.

4. Senior management arrangements, systems and controls

As stated above, MiFID II revises current requirements requiring firms to take all ‘appropriate’ steps to identify, prevent or manage conflicts of interest from arising as well as increasing reporting obligations for firms. CP16/19 proposes to incorporate these requirements in the FCA’s Senior Management Arrangements, Systems and Controls sourcebook ([SYSC](#)). Updated conflict of interests rules will require investment firms to update their existing organisational and administrative arrangements, and particularly their approach to disclosure. Whilst the FCA notes that this should not necessitate a ‘material change in firms’ systems and controls’, a higher degree of sophistication will be required by firms to recognise and prevent conflicts before they arise. The FCA also sets out its proposed approach of how the management body and organisational requirements will apply to branches of non-EU firms and firms exempt under Article 3 of the MiFID II Directive.

5. Remuneration requirements for sales staff

The FCA proposes to make changes to SYSC to implement the remuneration requirements for sales staff in MiFID II. Built on existing ESMA guidelines, the rules seek to ensure that sales staff are not incentivised to act in ways which are detrimental to the interests of clients. At this stage, the FCA is only proposing to apply MiFID II’s remuneration standards for sales staff and advisers who work for:

- Common platform firms (which include MiFID investment firms but exclude collective portfolio management investment firms);
- Article 3 firms;
- Branches of third-country firms (but only where their activities are carried on from an establishment in the UK).

6. Client assets

CP16/19 provides for incremental changes to the FCA’s Client Assets Sourcebook ([CASS](#)). Many of the changes introduced by MiFID II are already part of the FCA rules. MiFID II will be implemented in CASS through ‘intelligent copy out’ meaning closely using the MiFID II wording but adapted, where appropriate, to align with UK law and practice. The FCA proposes to maintain the single rulebook approach by implementing MiFID II for all designated investment businesses to ensure the same standards and investor protections apply.

CASS will also incorporate a more extensive prohibition against Title Transfer Collateral Arrangements ([TTCAs](#)) with retail clients. TTCAs transfer credit risk from the firm to clients by treating client assets or monies as collateral. Retail clients are less likely to have the resources or experience to understand this risk and therefore they will benefit from CASS protections in line with the FCA’s consumer protection and integrity objectives. TTCAs for retail clients are already banned for contracts for difference, spreadbetting and rolling spot forex. They will now be banned in respect of all MiFID II financial instruments for retail clients.

7. Complaint handling

The FCA proposes to update the FCA’s Dispute Resolution: Complaints sourcebook ([DISP](#)) with a new definition of...
MiFID Complaint covering complaints that use the new MiFID II complaint handling requirements. MiFID II extends record keeping and reporting requirements for MiFID Complaints to professional clients and eligible counterparties. This may have cost implications to investment firms who will be required to update systems in order to reflect the enhanced compliant handling requirements.

In line with the requirements of MiFID II, the FCA also proposes to extend the jurisdiction of the Financial Ombudsman Service to complaints about sales and advice in relation to structured deposits. The FCA proposes an additional rule which will require branches of UK MiFID investment firms to adhere to the relevant Alternative Dispute Resolution entities in the relevant European Economic Area State in which they are established.

8. Whistleblowing

In CP16/19, the FCA notes that there are various pieces of EU legislation in respect of whistleblowing, including MiFID II. The FCA states that the differences in scope and application of the various whistleblowing provisions are too great to enable the creation of one set of provisions covering them all. Instead, the FCA proposes a new FCA Handbook chapter to act as a single ‘home’ for all the various whistleblowing requirements. The FCA would signpost all EU whistleblowing obligations not implemented in the Handbook.

9. Fees

In CP16/19, the FCA proposes rules on the initial and ongoing regulatory fees for firms that wish to apply to operate an OTF or vary their permission to do so, or to operate an MTF, and on the onboarding fee for firms that connect to the FCA's market data processor. MTFs are charged with the FCA's 'complex' authorisation application fee of £25,000, and they pay a two-tier periodic fee depending on whether they are supervised by a named ‘fixed portfolio’ supervisor or by a team of ‘flexible portfolio’ supervisors. The FCA proposes to charge these same fees for operators of OTFs.

FCA’s third Consultation Paper

On 29 September 2016, the FCA published its third Consultation Paper (CP16/29) on implementing MiFID II and MiFIR. The key proposals in CP16/29 are highlighted below.

1. Conduct of business proposals

1.1. Inducements, including adviser charging

Articles 24(7) to (9) of MiFID II enhances the existing MiFID inducement rules. Independent advisers and portfolio managers will no longer be able to pay and, or receive monetary and non-monetary benefits from third parties, other than ‘minor non-monetary benefits’ and those designed to enhance the quality of the service to the client and which do not impair the firm’s duty to act honestly, fairly and professionally and in the best interests of the client.

The MiFID II inducement requirements for firms undertaking portfolio management activities go beyond the existing MiFID I inducement rules and the FCA’s rules in the Conduct of Business Sourcebook (COBS).

Existing inducement rules in COBS apply to both MiFID and non-MiFID business, including business relating to insurance-based investments. The circumstances where inducements may be paid or received in relation to most types of non-MiFID business are less prescriptive.

In CP16/29, the FCA proposes to apply the MiFID II inducement rules:

- For MiFID businesses (including equivalent third country firms and Article 3 firms) while keeping the existing (less prescriptive) rules in place for non-MiFID businesses, such as insurance-based investments, until the FCA implements the Insurance Distribution Directive
- For professional clients as well as retail clients.

The FCA also plans to extend MiFID II’s inducement ban in relation to retail clients:

- To restricted advice as well as independent advice;
- To prohibit the acceptance of commission and benefits rather than their acceptance and rebating to retail clients;
- To broaden the adviser charging rules by applying the ban to the business of providing advice rather than only
to inducements provided in relation to the provision of a particular recommendation to a client.

The FCA proposes to define 'minor non-monetary benefits' as benefits clearly disclosed, reasonable, proportionate, capable of enhancing the quality of the service to the client and of a scale or nature that does not impair the firms behaviour nor compliance with its obligations (see COBS2.3A.15 R). Examples include written material that is commissioned and paid for by a corporate issuer to promote a new issuance, participation in training events on the benefits or features of a specific financial instrument and hospitality of a reasonable and minimal value whilst at such training.

1.2. Inducements and research

Article 13(1) of an EU Commission delegated directive supplementing MiFID II with regard to safeguarding of financial instruments and funds belonging to clients, product governance obligations and the rules applicable to the provision or receipt of fees, commissions or any monetary or non-monetary benefits (MiFID II Delegated Directive) acknowledges that third party research is an important tool for investment firms. It allows investment firms providing portfolio management or other investment or ancillary services, to receive research from third parties in a way that does not contravene the inducements rules where the research is paid for by the investment firm out of its own resources or via a separate research payment account controlled by the firm which may be funded from clients.

In CP16/29, the FCA propose a new COBS section 2.3B which transposes Article 13 of the MiFID II Delegated Directive. It will also transpose (as guidance) certain recitals of the MiFID II Delegated Directive on how firms should operate a research payment account and collect charges. Firms that wish to use client funds to obtain client-specific research reports should pay close attention to these requirements in COBS 2.3B, in particular the requirements of oversight, audit and controls regarding any research payment account. Clients must agree to any charges on the account and arrangements must be put in place to remit any unused funds back to the relevant clients.

1.3. Client categorisation

MiFID II continues with the existing MiFID I client classifications - 'retail', 'professional' or, for some types of business, 'eligible counterparty'. MiFID II extends the new conduct of business requirements to business with eligible counterparties.

Recital 104 of MiFID II notes that the "financial crisis has shown limits in the ability of non-retail clients to appreciate the risk of their investments". Claims by Italian public authorities relating to derivatives mis-selling highlighted this particular risk. Responding to these concerns, MiFID II categorises local authorities as retail clients with the ability to opt-up to elective professional status where they meet the qualifying criteria. However, MiFID II gives member states the discretion to adopt specific alternative or additional criteria for the assessment of the expertise and knowledge of local authorities requesting to be treated as elective professional clients.

The FCA proposes to exercise this discretion by introducing a requirement for investment firms to apply a qualitative test, a quantitative test and procedural requirements when opting-up local authority clients to professional client status. Investment firms that do business (MiFID business and non-MiFID scope business) with local authorities should reconsider their clients in light of these tests and procedural requirements. In summary, this requires a firm to undertake an assessment of the expertise, experience and knowledge of the local authority client and assess whether the client has either carried out a certain number of significant transactions within the previous four quarters or has worked in the financial sector for at least one year in a professional position.

Firms will also need to re-categorise their eligible counterparty clients who have been opted-up from elective professional client status. The differences in the way the COBS requirements apply to different client categories means firms should review the broader impact of this change on their business.

1.4. Disclosure requirements

MiFID II strengthens regulatory protections available to professional clients and eligible counterparties. Existing disclosure rules require firms to produce "fair, clear and not misleading information" in a comprehensible format and provide general and specific information about the firm, including its financial instruments, proposed strategies as well as its costs, safeguarding of client assets and reporting.
The FCA proposes to amend COBS in-line with the provisions in MiFID II and the MIFID II Delegated Directive. These changes will:

- Require firms to communicate with eligible counterparties in a way that is fair, clear and not misleading, taking into account the nature of the eligible counterparty and its business;
- Introduce more prescriptive rules on disclosures such as the font size of text identifying relevant risks, the consistency of the language used and the keeping information up-to-date;
- Require the disclosure of appropriate information to clients with regard to the investment firm and its services, the financial instruments and proposed investment strategies, execution venues and all costs and related charges (see new COBS 2.2A);
- Require information to be provided in a comprehensible form in such a manner that clients are reasonably able to understand the nature and risks (see new COBS 2.2A.5 R);
- Require a prescribed general list of information to be disclosed to clients (see new COBS 6.1-A);
- Require additional disclosures in respect of safeguarding client instruments and funds as well as information about costs and associated charges.

The new disclosure requirements are primarily applicable to firms doing MiFID business.

1.5. Independence

Current FCA rules on independence were introduced by the RDR and designed to ensure that independent advice is genuinely free from bias towards particular products. Currently, the rules apply firms making personal recommendations to retail clients in the UK on retail investment products (RIPs) - these include both MiFID (eg structured products) and non-MiFID investment products (eg insurance-based investments and personal pensions).

MiFID II introduces a EU-wide standard for "independent advice" which is broadly similar to current FCA rules. Firms providing independent advice will have to "assess a sufficient range of financial instruments available on the market which must be sufficiently diverse with regard to their type and issuers or product providers to ensure that the client's investment objectives can be suitably met". The FCA states that it intends to implement the MiFID II standards to all RIPs for UK retail clients. Rules in the MiFID II Delegated Directive in relation to the robustness of a firm's product selection process, will also be applied to non-MiFID II business. For professional clients and non-UK retail clients, the FCA will only apply the MiFID independence standard on MiFID financial instruments and structured deposits.

Given the already high standards required as a result of the RDR, the proposed changes will not have significant implications for investment firms. Some firms may need to consider MiFID II's organisational requirements, particularly in relation to MiFID II's prohibition on individual advisers providing both independent and non-independent advice.

1.6. Suitability

The existing requirements on suitability are set out in COBS 9 and apply to firms advising on, or managing portfolios in relation to, non-MiFID products as well as MiFID products. The current provisions will remain in place and will only apply to non-MiFID products.

Rules transposing the MiFID II suitability requirements will be set out in a new COBS 9A. The new rules include more specific requirements to ensure suitability of personal recommendations such as the obligation to ensure information about the client is up-to-date where the firm is providing ongoing advice or a discretionary management service. Additionally, the rules clarify that where advice or a discretionary management service is provided wholly or partly through an automated system, the firm remains responsible for the suitability assessment. Responsibility is not diminished by use of an automated system. In light of these rules, firms should consider their policies and procedures in respect of their clients and may need to establish more regular channels of obtaining client information. Firms should also consider any automated systems and satisfy themselves that system-generated advice or services are continuously suitable for client needs.

1.7. Appropriateness

Investment firms, when considering distributing a product without personal advice, are required to assess whether the product sale is either 'non-complex' or 'complex'. Firms must then carry out an appropriateness test for all
complex products and products deemed complex (such products cannot be sold execution-only). The appropriateness test requires the assessment of a client’s knowledge and experience to determine whether the particular product or service is appropriate to the client.

Currently, the appropriateness requirements are set out in COBS 10 and apply to firms carrying on MiFID business. The current rules will continue to apply to both MiFID and non-MiFID business.

MiFID II permits firms to provide a limited range of investment services (execution or reception and transmission of orders) to a client without having to assess the appropriateness of the investment product for the client as long as certain conditions are met including that the product is ‘non-complex’:

- Does not contain a clause, condition or trigger that could fundamentally alter the nature or risk of the investment or pay out profile;
- Does not include exit charges that have the effect of marking the investment illiquid even though the client may have frequent opportunity to dispose, redeem or realize the product.

The FCA will also include in COBS 10:

- A rule that where a bundle of services or products is envisaged, the firm must consider whether the overall bundled package is appropriate;
- A specific requirement for firms to keep records of appropriateness assessments, including, where a warning was given to a client, whether the client decided to go ahead despite the warning and whether the firm accepted the client’s request to go ahead with the transaction.

Firms will need to carry out the appropriateness test for a wider range of products than at present. When offering bundled products and services, firms will need to consider the appropriateness of the overall bundle. They will also need to record the results of a test, including, when a warning has been given but the client still wishes to proceed with the transaction, and whether they decided to carry out the client’s request.

1.8. Dealing and managing

MiFID II enhances the MiFID I best execution requirements. Best execution rules are designed to increase transparency of order execution and order routing decisions and to facilitate better scrutiny of performance by clients.

The FCA proposes to amend COBS 11.2 by transposing the new MiFID II standards into a Dealing and Managing chapter as COBS 11.2A. Certain recitals of MiFID II will also be drafted in COBS as guidance. For example, recitals [100] and [108] clarify that firms may select a single venue for execution of client orders only where they can show that the venue consistently delivers the best possible results, which they reasonably expect are as good as results expected from alternative execution venues. This selection must be supported by quality data that is either published or used as part of the firm’s internal analysis. The FCA also proposes to extend the best execution rules to non-MiFID business (Article 3 firms and managers of collective investment undertakings) retaining certain exemptions and modifications.

Investment firms will need to update their existing execution arrangements, execution policies and monitoring procedures. Following the guidance, investment firms will also need to demonstrate reliance on data in exercising any trading venue decision-making.

1.9. Underwriting and placing

There are currently no specific FCA rules covering underwriting and placing activities. Article 38 of the MiFID II Delegated Regulation supplementing MiFID II as regards organisational requirements and operating conditions for investment firms (MiFID II Delegated Regulation) introduces new underwriting and placing provisions, linked to MiFID II’s organisational and conduct rule requirements. These provisions require information to be disclosed and conflicts managed in respect to underwriting and placing. For example, effective management of conflicts of interest arising when firms engage in the placement of financial instruments issued by themselves (or an entity in the same group) to their own clients is now covered. In the FCA’s view this is already be covered in SYSC 10.

However, the FCA proposes to introduce a new chapter in COBS to implement the MiFID II rules on underwriting
and placing. For example, COBS 11A.1.3 EU states that firms must, before accepting a mandate to manage an offering, have arrangements in place to inform the issuer client of:

- The various financing alternatives available;
- The timing and the process with regard to the corporate finance advice on pricing of the offer;
- Details of the targeted investors, to whom the firm intends to offer the financial instruments;
- Job titles and departments of the relevant persons involved in the provision of corporate finance advice on the price and allotment;
- Firm’s arrangements to prevent or manage conflicts of interest that may arise where the firm places the relevant financial instruments with its investment clients or with its own proprietary book.

The new requirement in COBS 11A for underwriting and placing will require firms to establish specific measures to ensure compliance, if they do not already exist. The FCA notes that there will be ‘resource implications, particularly around the new disclosure requirements’.

1.10. Investment research

The FCA proposes to incorporate the MiFID II investment research provisions into a single COBS chapter as well as adding guidance to clarify that the new rules will apply to both investment research and non-independent research. The current rules require firms to manage conflicts of interest in relation to the financial analysts involved in the production of investment research and other relevant persons whose responsibilities or business interests may conflict with the interests of the persons to whom research is disseminated.

The new rules put in place a number of requirements that require firms to put in place safeguards and arrangements on the production of investment research. For example, the following will need to be met:

- Financial analysts do not undertake personal trades in the investment to which the research relates;
- Physical separation exists between financial analysts who produce the investment research and others whose responsibilities may conflict with the interests of the recipients of the research putting in place appropriate information barriers;
- The firm itself as well as analysts do not accept any inducements from those with a material interest in the subject-matter of the research;
- The investment firms themselves, financial analysts, and other relevant persons involved in the production of the investment research do not promise issues favourable research coverage;
- Before dissemination of investment research issuers, relevant persons other than financial analysts, and any other persons, are not permitted to review a draft of the investment research for the purpose of verifying the accuracy of factual statements made in that research, or for any purpose other than verifying compliance with the firm legal obligations where the draft includes a recommendation or a target price.

1.11. Other conduct issues

The FCA proposes two additional changes to COBS:>

Firstly, the FCA proposes to require client agreements to be entered into for each investment service and ancillary service, not just for new clients. Firms already have to provide client agreements to retail clients. In the future they will also need to provide client agreements to professional clients and eligible counterparties.

The MiFID II Delegated Regulation goes into more detail of what should be included in a client agreement and includes:

- Detail of the services, and where relevant the nature and extend of the investment advice, to be provided;
- In the case of portfolio management services, the types of financial instruments that may be purchased and sold and the types of transactions that may be undertaken on behalf of the client, as well as any instruments or transactions that are prohibited;
- A description of the main features of any safeguarding services to be provided, including where applicable the role of the firm with respect to corporate actions relating to client instruments and the terms of which securities financing transactions involving client securities will generate a return for the client.

It also amends the record keeping requirement by reducing the retention period to ‘at least the duration of the
relationship with the client’, instead of also having a requirement for records to be kept for at least five years. This will mean firms may decide for themselves whether, and if so, for how long, they wish to keep records after the relationship with a particular client has ended.

The FCA proposes to retail the current COBS 8 provisions for non-MiFID business and implement the more detailed MiFID II requirements for MiFID business (retail and professional clients and eligible counterparties). The FCA will introduce a new record keeping requirement for non-MiFID business other than pension transfers, pension conversions, pension opt-outs or Free Standing Additional Voluntary Contributions, for which records will continue to be required to be kept indefinitely. So for both MiFID and non-MiFID business, the requirement will be to keep records for at least the duration of the relationship with the client.

The FCA suggests that this is not an onerous requirement because, in practice, these agreements are already mostly in place. Updates to client agreements would be required when there is a change to a MiFID business provided to a client but not seemingly where, for example, a new product is offered under an existing service. Investment firms should review their client agreements in light of these changes noting especially the requirements in respect of professional clients, and update these agreements if required as well as firm procedures in respect to client agreements.

Secondly, the FCA proposes to engage in minor changes to the specialist regime for collective portfolio managers in COBS 18 by reordering and clarifying the provisions.

2. Other matters

2.1. Product governance

MiFID II imposes a number of product governance requirements on investment firms including the requirement to establish procedures to assess the risks and target market as well as monitor products on an ongoing basis to check whether they function as expected. Firms that manufacture products must design them to meet market needs, stress test them and provide relevant information to distributors. Investment firms that distribute products must gather information from manufacturers, provide information to assist manufacturers in conducting product reviews and work with other distributor firms involved in the sale. The new rules broadly replicate existing rules on product governance introduced by the RPPD.

The FCA intends to revise their approach to product governance from one of standard setting to one where the FCA is “willing to intervene more directly in the market if [we] identify situations where the potential for customer harm is not sufficiently reduced”. The FCA assures readers that they will apply the rules "in an appropriate and proportionate way, taking into account the nature of the investment product, the investment service, and the target market for the product". The new rules will be introduced into a new sourcebook for Product Governance and Product Intervention (PROD). In light of these changes, firms that manufacture and/or distribute products should review policies and procedures, as well as systems and controls to ensure compliance with the enhanced product governance regime and regulatory scrutiny.

2.2. Knowledge and competence requirements

Article 25(1) of MiFID II requires firms engaged in MiFID business to ensure, and be able to demonstrate to the FCA, that individuals giving investment advice or information about financial instruments or investment or ancillary services to clients possess the necessary knowledge and competence to fulfil their investor protection obligations. ESMA’s guidelines on the assessment of knowledge and competence focus on employees obtaining the appropriate qualifications and experience. The guidelines will apply in the UK from 3 January 2018.

The ESMA guidelines include some concepts new to the UK including:

- A maximum time period of four years during which employees need to acquire knowledge and competence;
- A minimum time period of six months for employees to be considered eligible to have acquired appropriate experience.

The FCA will transpose Article 25(1) of MiFID II into SYSC 5, to apply to all common platform firms. To achieve compliance with the ESMA guidelines, including the two new guidelines above, the FCA will amend the Training and Competence sourcebook (TC), SYSC and publish material on the FCA website. The FCA notes that the existing

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rules and guidance in TC and SYSC are well placed to help firms meet their guideline requirements.

2.3. Recording of telephone conversations and electronic communications (taping)

MiFID II introduces for the first time an EU-wide requirement for firms to record telephone conversations and electronic communications when providing specific client order services that relate to the reception, transmission and execution of orders, or dealing on their own account. The UK has had a taping regime in place since 2009, which is very similar to the new MiFID II regime. The FCA will consolidate the rules into SYSC.

The FCA proposes to apply the MiFID II taping regime to a wider range than those required by the MiFID II, namely:

- The service of portfolio management, including removing the current qualified exemption for discretionary investment managers;
- Corporate finance business;
- Energy market activity or oil market activity;
- 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 requirement for phone taping is not new to investment firms, however there are some key differences to be mindful of:

- The retention period is longer than the existing regime (six months). MiFID II requires records to be stored for five years, with the option for the Competent Authority to extend the requirement to seven years in specific cases;
- The MiFID II provisions require recording of conversations and communications with all clients where these relate to/intend to lead to the conclusion of a transaction, even where the transaction is not concluded. Under the current regime, only such conversations and electronic communications with professional clients and eligible counterparties are caught;
- The MiFID II provisions apply to all MiFID financial instruments rather than qualifying investments only;
- Unlike the current regime, MiFID II does not include any exemptions or exceptions to the requirement to record.

2.4. Supervision manual (SUP), authorisation and approved persons

The FCA proposes a new FCA Form, Form A, which incorporates the additional information on organisational structure and a firm's management body when applying for authorisation required by MiFID II and underlying technical standards. Form A will be available from the beginning of 2017 and will be used by:

- New firms applying for authorisation to undertake MiFID activities;
- Existing non-MiFID firms applying for a variation of permissions which will bring them within scope of MiFID;
- Prospective Article 3 firms applying for authorisation.

2.5. Perimeter guidance (PERG)

The FCA proposes to update PERG to clarify the scope of MiFID II by providing guidance on:

- The meaning of personal recommendation for the purposes of MiFID II;
- The scope of the expanded financial derivatives category, notably in relation to FX products (such as FX Forwards) as provided in Article 10 of the MiFID II Delegated Regulation. The FCA notes that 'derivatives' has been extended to derivative instruments relating to securities, currencies, interest, emission allowances or certain other things. This amendment represents a departure from the previous UK position that these derivatives did not fall under MiFID I. Spot foreign currency contracts and foreign currency transactions connected to a payment transaction continue to fall outside MiFID II;
- The scope of the amended commodity derivatives category;
- How are emission allowances treated under MiFID II;
- The scope of the exemptions for professional firms and commodity trading firms under MiFID II.

**How DLA Piper can help you**
DLA Piper advises some of the largest financial services companies and institutions on both their day-to-day operations and wider strategic objectives. We help our clients of all sizes contend with legal issues, including regulatory demands and the compliance costs that come with reform. Our specialist Europe-wide regulatory financial services lawyers offer market-leading insight into the development and implications of MiFID II and associated FCA regulatory change.

If you need particular advice on how the UK implementation of MiFID II will impact your business, please contact the authors.

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