

# MiFID II Overview

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*MiFID II will be implemented into UK law on 3 January 2018 and will replace Directive 2004/39/EC (MiFID I). MiFID II aims to enhance the efficiency and integrity of the financial markets across the European Union and we have prepared a suite of briefings on key areas of change. This briefing examines where we are in terms of MiFID II implementation, in particular focussing on the FCA's second MiFID II implementation consultation paper ([CP16/19](#)) and its impact on firms.*

## 1. Background

MiFID II is made up of two parts, the MiFID II directive (2014/65/EU) and the MiFIR regulation (2014/600/EU), which together are referred to as MiFID II in this briefing. MiFID II will replace MiFID I and will form the legal framework for the following types of firm providing investment services or activities in the EU:

- investment firms;
- trading venues;
- data reporting service providers;
- third-country firms providing services in EU.

The key areas covered by MiFID II regulation include:

- authorisation and organisational requirements;
- investor protection and provision of investment services;
- market transparency;
- OTC Derivatives and Commodities;
- Supervision;
- market structures.

## 2. How is the UK implementing MiFID II?

MiFIR is a regulation and therefore is directly applicable in each member state. In general, the Financial Conduct Authority (FCA) will not be copying out MiFIR into the Handbook but will signpost MiFIR obligations and update the readers guide so affected firms will need to be aware that their regulatory obligations may no longer mostly be contained in the Handbook. There will be some exceptions to this approach, for example where the FCA is implementing a discretion allowed for in MiFIR itself.

MiFID II itself as a directive requires implementation at a national level and this

implementation has so far been subject to consultation by HM Treasury (**HMT**), the Prudential Regulation Authority (**PRA**) and the FCA.










The HMT consultation published in March 2015 confirmed that HMT's approach was to emphasise continuity in the implementation process and that it would be updating the FSMA architecture accordingly.

Also in March 2015, the FCA issued its discussion paper on its implementation approach regarding the conduct of business elements of MiFID II. In December 2015, the FCA's first implementation consultation paper was published which dealt primarily with market related issues which included proposed rules in relation to:

- **Trading Venues** – including the introduction of a new type of regulated trading venue – Organised Trading Facility (OTF) and new obligations on trading venues within regulatory framework;
- **Systemic Internalisers** – wider definition of these types of firms which pose systemic risk, and stricter obligations to publish quotes;
- **Trade Transparency** – greater transparency requirements across trading venues including OTF's, SI and certain investment firms and across wider categories of financial instruments;
- **Market Data** – including the introduction of Data Reporting Service Providers as a category of regulated firms;
- **Transaction reporting** – extension of scope of transaction reporting requirements to ensure consistency with the Market Abuse Directive;
- **Algorithmic and High Frequency Trading (HFT)**– new safeguards to be introduced, including the requirement for HFT firms to be authorised and their traders supervised;
- **Passporting and UK branches of 3rd country firms** – set out how the FCA intends to harmonise passporting rules for such branches and technical changes to update references to MiFID II;
- **Principles for Business** – the CP addressed how the FCA intends to deal with the increased scope of MiFID II's conduct rules and the extension of some Principles to firms dealing with Eligible Counterparties;
- **Perimeter Guidance** – the FCA will be introducing revised guidance in PERG 13 in light of MiFID II's wider scope of investment services and activities.

This year, the PRA issued its first consultation in March 2016 (CP 9/16) which focussed on the changes to prudential requirements for PRA designated firms.

The FCA issued its second CP on MiFID II implementation in July. This CP has a very wide remit and this briefing gives an overview of the 9 areas covered in the CP:

Topic	Impact
<ul style="list-style-type: none"> <li>Commodity derivatives</li> </ul>	
<ul style="list-style-type: none"> <li>Supervision</li> </ul>	
<ul style="list-style-type: none"> <li>Prudential rules</li> </ul>	
<ul style="list-style-type: none"> <li>Senior Management Systems and Controls</li> </ul>	
<ul style="list-style-type: none"> <li>Remuneration</li> </ul>	
<ul style="list-style-type: none"> <li>CASS</li> </ul>	
<ul style="list-style-type: none"> <li>Complaint handling</li> </ul>	
<ul style="list-style-type: none"> <li>Whistleblowing</li> </ul>	
<ul style="list-style-type: none"> <li>Fees manual</li> </ul>	

The FCA intends to publish a further consultation paper in the autumn to cover the remaining conduct of business issues.

### 3. Consultation Paper CP16/19

Turning now to CP 16/19, we set out below the key changes the FCA is proposing, and our view as to the impact of these changes on affected firms.

#### 4. Commodity Derivatives

##### ***What's changing?***

MiFID II is designed to harmonise the commodity derivative trading regime by requiring trading venues to have arrangements in place to monitor and manage positions held by persons trading in such instruments. The key changes introduced by MiFID II include:

- limits on size of positions that can be held (these will be set by FCA);
- daily reporting to regulator by trading venues;
- FCA power to request information to ensure position limits are being complied with.

These changes will be implemented via Treasury legislation and Handbook amendments which will include FCA guidance on the Treasury legislation. The overall aim is to prevent market abuse and to support orderly markets.

##### ***Implications for firms and trading venues***

Every person (whether authorised or not) will need to comply with position limits. This will mean that some unauthorised firms will need to apply for exemptions from the regime.

Firms will need to have arrangements for daily position reporting, depending on the how the trade is carried out this will involve reporting to the operator of the trading venue (for commodities traded in this manner) and direct reporting to the competent authority, if the commodity is traded outside a trading venue (eg OTC commodity derivatives).

Trading venues will need arrangements to monitor and manage positions within the designated position limits and will need to ensure that reporting arrangements meet the standards required under this regime. There is daily obligation to report to the FCA, with a weekly obligation to report to ESMA.

#### 5. Supervision

*The FCA is planning to make some minor changes to SUP in order to clarify firms' obligation to report breaches of directly applicable regulations, i.e. MiFIR. The proposed changes also include transactional arrangements to assist firms in understanding their reporting obligations following the repeal of the MiFID I obligations on 2 January 2018 and the introduction of the MiFID II obligations on 3 January 2018. The proposed changes to SUP also update the passporting provisions for MiFID investment firms so that they are consistent with information and application requirements as set out in ESMA's RTS on passporting.*

While these changes may require firms to review their breach procedures and how they apply for a MiFID passport (pre-Brexit) we do not believe that these changes will have a significant impact on firms.

## 6. Prudential rules

A number of the FCA Handbook's prudential rules use terms that appear in MiFID I and so a tidying up exercise needs to be carried out to update or remove certain references. These include the addition of a new glossary definition of an "Organised Trading Facility" which will be classified as an IFPRU 730K firm, the removal of "local" firm from the Handbook as this exemption is not being carried across into MiFID II and some other minor changes.

The FCA's view is that these changes are merely consequential, and while the changes are not extensive for firms who find themselves designated as Organised Trading Facilities there may be more than minor changes as consider their prudential category and the implications this may have on their regulatory capital together with other obligations as a result of such a designation.

## 7. Senior Management Systems and Controls

MiFID II is strengthening the governance arrangements of MiFID investment firms by prescribing the responsibilities of the management body, ensuring such bodies are diverse and that the members devote sufficient time to their responsibilities. The FCA is updating its SYSC sourcebook to deal with the changes that require transposition; these include updating conflicts of interest rules and organisational requirements.

The changes will affect a wide range of firms, common platform firms, third-country branches, UCITS and AIFM investment firms (to the extent of their MiFID business). In addition, because of MiFID II's requirement that Article 3 MiFID exempt firms are subject to "at least analogous requirements" these firms will also be affected and the FCA will be amending SYSC 4 to SYSC 9 to reflect this.

In the FCA's view the impact for Article 3 exempt firms is expected to be limited as most Article 3 exempt firms should already be meeting the standards required and CP 16/19 includes tables setting out how the new rules will apply to Article 3 MiFID exempt firms.

In terms of common platform firms, the changes required should not be significant. MiFID I had the management of conflict of interests as a central tenet and the FCA created a unified high level set of requirements to implement this, the "common platform approach". The FCA has confirmed that it will retain the common platform approach when implementing MiFID II requirements, transposing the relevant MiFID II requirements into the SYSC sourcebook, while it will signpost the relevant MiFIR obligations.

### 7.1 Conflicts of interest

#### *What's changing?*

While MiFID II does not drastically alter conflicts of interest requirements, it does strengthen certain elements and therefore some change will be required as a result of the introduction of MiFID II. Key requirements include:

- effective organisational arrangements to prevent and manage conflicts;
- quality of disclosure required when these arrangements fail;

- requirement to review Conflicts of Interest Policy on a periodic basis;
- senior management to review at least annually written reports on situations contained in the Conflicts of Interest record.

### ***Implications for firms***

The onus will remain on firms and their senior management to ensure their conflicts of interest policy is appropriate and effective. In particular, it is worth noting that disclosure remains an option of last resort, although the level of content and quality of disclosure is new and more extensive, including:

- the requirement that the disclosure made to clients explicitly states that the firm's organisational arrangements are not sufficient to prevent or manage the conflict;
- specifically describe the conflict, the steps taken by the firm to mitigate the risk and the risks to the client.

These new disclosure regulations apply as rules to all firms, including Article 3 MiFID exempt firms. Given the already robust rules surrounding conflicts of interest already in place in the UK, we do not think that these changes will have significant implications for most firms. However, the obligation to prevent as well as manage conflicts (which is introduced as a result of MiFID II) and the other changes designed to strengthen the conflicts of interest obligations on firms mean that conflicts of interest will remain a high priority for firms.

## **7.2 Management Bodies Composition**

### ***What's changing?***

MiFID II aims to solve weaknesses identified in the management of investment firms following the financial crisis of 2007/2008 by enhancing effective oversight and control provided by the firm's management body over the firm's activities.

MiFID II incorporates corporate governance requirements set out in the Capital Requirements Directive (Directive 2013/36/EU, **CRD IV**) by extending SYSC 4.3A to all common platform firms and Article 3 MiFID exempt firms as a rule. Under this rule, the management body will be required to assume clear responsibilities across the business cycle of the firm. This will include responsibilities for strategic objectives, the risk strategy financial objectives communication and disclosure to customers and internal governance.

### ***Implications for firms***

While, the FCA does not expect that implementing these changes will have a significant impact on firms' systems and controls, our view is that management bodies will need to review their corporate governance arrangements not least as they will be preparing for the implementation of the Senior Managers Regime. In addition to the responsibilities mentioned above, there will be obligations to on the management body to define the firm's risk profile and appetite and to ensure that the management body is sufficiently diverse regarding age, gender, geographic provenance and educational and professional background.

Further, MiFID II will restrict the number of directorships that members of management body of a "significant" investment firm can hold in order to ensure that they can devote sufficient time to their membership of the management body. Such members will be obliged to restrict their directorships to no more than one of the following combinations:

- one executive directorship with two non-executive directorships; or
- four non-executive directorships

Although it is worth noting that non-commercial directorships, such as directorships in charitable or not for profit organisations will not count towards the above limits.

Further work will be carried out in this area with ESMA and EBA to consult on joint guidelines on assessment of suitability of the management body and key function holders under CRD IV and MiFID II.

## 8. Remuneration

### *What's changing?*

In order to prevent sales staff from being incentivised to sell products inappropriately, MiFID II introduces certain remuneration requirements for such staff and the FCA is making changes to SYSC to incorporate these requirements.

The FCA has already done significant work in this area – most recently a thematic report in 2014. Interestingly the FCA is not proposing a cross-cutting measure (to implement these requirements across all firms including non-MiFID businesses as had previously been proposed) at the moment as the FCA believes that it would be premature to include such measures at the moment as there are European-wide initiatives afoot. MiFID II sales staff remuneration code will apply to relevant staff in:

- common platform firms
- MiFID Article 3 exempt firms
- third-country branches

### *Implications for firms*

As the FCA has previously carried out substantial work in this area, firms should already have put in place appropriate systems and procedures to meet the requirements set out in MiFID II and these changes should not materially impact on firms. For further information on the new remuneration requirements please see [Remuneration of Sales Staff](#).

## 9. CASS

MiFID II also has an impact of CASS, this includes certain client asset rules which the FCA intend to include in CASS through use of "intelligent copy-out". These rules will apply to all designated investment business (and will extend to non-MiFID business within such firms).

The single CASS sourcebook is being retained, and professional clients of non-MiFID firms will continue to be able to opt-out of CASS 7 (client money rules).

***What's changing?***

- Prohibition on TTCAs with retail clients (this follows on from work already carried out by the FCA).
- Appropriateness test for TTCAs entered into with non-retail clients.
- Further restrictions on general custody liens.
- Further restrictions in relation to the delegation of safekeeping duties to a third party.
- Internal firm assessment when depositing client money in a QMMF. Firms will no longer be able to solely rely on credit rating agency rating of a QMMF. Firms will also require express consent from clients when placing these assets in QMMFs.
- Depositing money in a group bank – the 20% restriction is being retained, but a minor exemption is being introduced.
- Further restrictions to prevent unauthorised use of client assets including robust procedures to ensure adequate collateral is taken when arranging securities lending for clients.

***Implications for firms***

Most of the above MiFID II requirements are already in place. In our view the most significant impact MiFID II will have in relation to will be with regard to TTCAs, in particular the new appropriateness assessment of TTCAs when dealing with non-retail clients. Further where clients have approved the use of their assets for stock lending purposes, firms should review their arrangements for triggering a request for additional collateral to ensure they meet the standards required. For further information on these proposed changes, please see our article [Safeguarding of financial instruments and funds belonging to clients](#).

**10. Complaint handling*****What's changing?***

MiFID II contains certain complaint handling requirements and the FCA intends to amend DISP to incorporate these changes. This means that the FCA will create a new glossary definition "MiFID complaint" and a new section in the Handbook will contain all the complaint handling requirements for MiFID complaints. There are some changes to customer awareness requirements and record keeping. The most interesting change is that MiFID II obligations apply to retail clients, professional clients and eligible counterparties rather than eligible complainants. It is also worth noting the FCA's intention to amend the jurisdiction of the Financial Ombudsman Service to ensure that it can consider complaints about advice or sales of structured deposits.

***Implications for firms***

Most firms will already have a complaints policy in place and there is considerable similarity between current DISP requirements and those introduced by MiFID II. Again, we believe that these changes, while they may prompt a review of a firm's complaints policy and procedures and a review of its' terms and conditions, should not have a



significant impact on firms.

### 11. Whistleblowing

MiFID II, like many recent pieces of EU legislation, contains whistleblowing obligations for firms. Given the differences between the whistleblowing obligations across the various pieces of EU legislation, the FCA does not think that it can create a set of common standards. Instead the FCA is proposing a new chapter in SYSC which will set out the MiFID II obligations and which will signpost whistleblowing obligations which arise from other EU legislation.

Firms will need to ensure that they meet another whistleblowing obligation; however, given the FCA's previous work in this area there should not be a significant additional burden for firms.

### 12. Fees

This part of the Handbook needs to be updated as a result of MiFID II. The changes will affect OTF and MTF operators, especially in relation to variation of permission fees. Firms undertaking new regulated activities in structured deposits will also have additional fees to pay. Further the FCA intends to consult in relation onboarding fees for establishing technical conformity with FCA's market data processing system.

These changes will result in additional expenses for affected firms.

### 13. Conclusion and next steps

CP 16/19 remains open until 28 October 2016 for feedback.

The FCA is to publish the policy statement on MiFID II implementation during the first half of 2017 which should further assist firms with their implementation plans. Member states are obliged to adopt and publish measures transposing the MiFID II Directive into national law by 3 July 2017, so that firms can prepare for MiFID II will coming into force on 3 January 2018. However implementation planning if not already underway in affected firms should begin now with firms analysing where any gaps arise between current obligations and their MiFID II obligations.

While the FCA has stressed that it has previously carried out significant work on many aspects of regulation covered by MiFID II and that overall there should not be material changes to firms' obligations, we are of the view that MiFID II will require additional work by firms in reviewing policies, processes and documentation to ensure they conform with the changes in regulation imposed by MiFID II.

We shall continue to update our clients and contacts on MiFID II through our briefings and seminars. If you would like to be included on our seminar invitation list please email [christina.cronin@farrer.co.uk](mailto:christina.cronin@farrer.co.uk).

If you require further information on anything covered in this briefing please contact [Grania Baird \(grania.baird@farrer.co.uk; +44\(0\)203 375 7443\)](mailto:grania.baird@farrer.co.uk), [Fiona Lowrie \(fiona.lowrie@farrer.co.uk; +44\(0\)203 375 7232\)](mailto:fiona.lowrie@farrer.co.uk) or your usual contact at the firm on 020 3375 7000. Further information can also be found on the [Commercial and Regulatory](#) page on our website.

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