# Briefing: MiFID II – Corporate Governance and Organisational Requirements

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*MiFID II will enter into force in the UK 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 focuses on the provisions of MiFID II that relate to firms' internal organisation and the resultant changes to FCA rules as set out in the FCA's recent Consultation Paper CP16/19 (**CP16/19**). We also consider the practical impact of these proposals for UK 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. MiFIR is a regulation and therefore is directly applicable in each member state. MiFID II itself as a directive requires implementation at a national level. The corporate governance provisions are set out in MiFID II (article 9 (management body), article 23 (conflicts of interest) and article 16 (organisation requirements)). The MiFID II implementing regulation C(2016) 2398 (delegated regulation) also includes provisions relating to organisational requirements and conflicts of interest.

Corporate governance and controls within financial services firms have been under scrutiny ever since the financial crisis of 2008. There has been a consensus that systemic management failures within the industry contributed in no small measure to the events of 2008, and that, in particular, checks and balances and risk control processes that might have acted as a brake on senior management at affected firms were often lacking, and that customers' interests were prejudiced as a result.

It is against this backdrop that the MiFID II and its associated regulation, the Markets in Financial Instruments Regulation (600/2014) (**MiFIR**), seek to recast and strengthen the corporate governance and related provisions in MiFID I.

This briefing examines the provisions of MiFID II relating to the following areas:

- corporate governance, and the new obligations that MiFID II places on firms' management bodies;
- the strengthening of the existing MiFID I conflicts of interest regime;
- new rules relating to complaints handling; and

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- MiFID II's expansion of remuneration rules to firms' sales forces.

## 2. Corporate Governance

### 2.1 What's Changing?

MiFID I required that management bodies of firms be composed of members who were:

*"….. of sufficiently good repute and sufficiently experienced as to ensure the sound management of [the firm].*"

Unsurprisingly, MiFID II provides a significantly more detailed regime for corporate governance within firms to which it applies. Article 9 of MiFID II requires that firms' management bodies must define, oversee, and be accountable for the implementation of governance arrangements that ensure effective and prudent management of the firm, including the segregation of duties in the firm and the prevention of conflicts of interest, and in a manner that promotes the integrity of the market and the interests of clients.

Management bodies must also "define, approve and oversee":

- the organisation of the firm for the provision of investment services and activities and ancillary services, including the skills, knowledge and expertise required by personnel, the resources, the procedures and the arrangements for the provision of services and activities, taking into account the nature, scale and complexity of its business and all the requirements the firm has to comply with;

- a policy as to services, activities, products and operations offered or provided, in accordance with the risk tolerance of the firm and the characteristics and needs of the clients of the firm to whom they will be offered or provided, including carrying out appropriate stress testing, where appropriate; and

- a remuneration policy of persons involved in the provision of services to clients aiming to encourage responsible business conduct and fair treatment of clients, as well as avoiding conflicts of interest in the relationships with clients.

MiFID II further requires that national regulators deny authorisation to firms that do not meet these standards.

### 2.2 Implications for Firms

The FCA states in CP16/19 that it proposes to meet the MiFID II requirements by extending the corporate governance requirements in SYSC 4.3A, which at present only apply to firms subject to the Capital Requirements Regulation, to all common platform firms. The SYSC 4.3A requirements arguably go further than the direct requirements of MiFID II, and include certain requirements (such as an expanded scope of responsibility for the management body, individual requirements for members of such bodies, and requirements around recruitment to such bodies) that have their origins in the Capital Requirements Directive.

Smaller firms in particular may need to undertake significant work ahead of January 2018 in order to be able to demonstrate that they can meet these requirements as of that date.

## 3. Conflicts of Interest

### 3.1 What's Changing?

CP16/19 stated that:

"*The effective management of conflicts of interest is a central tenet of the financial services regulatory framework in the UK. It is considered to be at the heart of maintaining fair, orderly and efficient financial markets.*"

MiFID I took a relatively high-level approach to achieving that goal. In summary, firms were required to:

- "take all reasonable steps" to identify conflicts of interest between (i) the firm and its clients; and (ii) one client and another client. What might constitute "all reasonable steps" was essentially left to firms' discretion;

- maintain and operate effective organisational and administrative arrangements with a view to taking all reasonable steps to prevent conflicts of interest from constituting or giving rise to a material risk of damage to the interests of their clients. Again, no further guidance on what "all reasonable steps" might constitute has been provided;

- where they were not reasonably confident that their arrangements to manage conflicts of interest were sufficient to ensure that risks of damage to the interests of a client will be prevented, to clearly disclose the general nature and/or sources of conflicts of interest to the client before undertaking business for the client; and

- to establish, implement and maintain an effective written conflicts of interest policy appropriate to the firm's size and organisation and the nature, scale and complexity of their business.

MiFID II retains the broad structure of the MiFID I framework, but makes some important incremental changes. The first of these is an explicit statement that conflicts are to be actively *prevented* by firms, rather than simply being "identified" and "managed". The standard for the steps to be taken to this end is also changed from "reasonable steps" to the more stringent "appropriate steps".

Secondly, there is an explicit statement that conflicts may be caused by the receipt of inducements from third parties and the firm's own remuneration structures, which ties in with the more stringent requirements in MiFID II around these areas.

The third is that guidance issued by European Securities and Markets Authority (**ESMA**) in December 2014 specifically discourages overreliance on disclosure as a means of managing conflicts, stating that it should be used only as a measure of last resort where arrangements established by the firm are insufficient to ensure with reasonable confidence that risk of damage to clients' interests will be prevented. Where disclosure is used, ESMA's view is that it must include a specific description of the conflict, must be tailored to the position as it affects the client in question, and must include an explanation of why the firm's conflict management procedures have proved insufficient in the particular instance.

Finally, ESMA has stated that it expects Member States to require that conflicts of interest policies are reviewed at least annually. Senior management must also receive on a frequent basis – and at least annually – written reports on the situations contained in the conflicts of interest record.

### 3.2 Implications for Firms

CP16/19 reflects the FCA's view that most of the MiFID II requirements, incremental as they are, are likely to reflect what is already good practice, and that many firms will not find the somewhat more robust approach a difficult transition. However, the obligation to prevent conflicts from arising so far as is possible will require firms to redouble their efforts to be proactive, and firms that currently rely on disclosure as a means of conflict management will clearly need to review both the scope of their reliance on this method and the content of disclosures that are given.

## 4. Complaints Handling

### 4.1 What's Changing?

MiFID I's approach to complaints handling was, again, high-level. It required that firms institute effective and transparent procedures for the reasonable and prompt handling of complaints made by retail clients, as well as requiring that records of such complaints be kept.

The MiFID II complaints handling provisions are derived from article 26 of the delegated regulation and the FCA intends to use a "copy out" approach transferring the requirements into DISP1, while retaining the current headings to ease navigation of the section.

The extent of the application of the new rules will depend on whether the firm is UK authorised and where the investment activity is taking place. DISP1 will contain an annex setting out how the rules apply to each type of firm. The scope of parties covered by the complaints regime will also expand as under MiFID II the regime will apply to retail, professional clients and eligible counterparties as opposed to merely eligible complainants.

The new rules require firms to:

- ensure that consumers are aware of firms' complaints management procedures;

- have appropriate complaints handling policies with sufficient senior management responsibility in place. These requirements refer to the joint guidelines issued by the European Banking Authority and ESMA;

- include complaints from professional clients and eligible counterparties (in relation to eligible counterparty business) when reporting complaints about MiFID business.

### 4.2 Implications for Firms

Equivalents to many of the requirements imposed under MiFID II in this area already apply to UK firms via the FCA's DISP Sourcebook. The key provision is the expansion of the complaints handling regime to professional clients and eligible counterparties, whereas at present the provisions of DISP apply only to retail clients. It remains to be seen how ready such clients will be to use complaints processes when many of them are already professionally advised and experienced market participants with ready recourse to other avenues for enforcement. It is also worth noting that the jurisdiction of the Financial Ombudsman Service will be amended to allow it to consider complaints about advice in relation to, or sales of, structured deposits where such services are provided by CRD credit institutions or MiFID investment firms.

## 5. Remuneration

### 5.1 What's Changing?

Whereas MiFID I did not explicitly address remuneration, the basic premise of the remuneration rules set out in Article 24 of MiFID II and Article 27 of MiFIR is to ensure that sales staff are not incentivised in ways which conflict with the firm's duty to act in the best interests of its clients, especially in terms of making inappropriate sales. The relevant text ties back to the provisions discussed elsewhere in this note that explicitly refer to remuneration as being capable of giving rise to conflicts of interest, and to the obligations of management bodies to define, approve and oversee a remuneration policy for persons involved in the provision of services to clients aiming to encourage responsible business conduct and fair treatment of clients, as well as avoiding conflicts of interest in the relationships with clients.

Restrictions on the quantum and form of remuneration will be nothing new for many firms who are already subject to the various Remuneration Codes (and specifically that applying to BIPRU firms) already set out in SYSC. In order to implement the MiFID II requirements, the FCA proposes in CP 16/19 to insert a new SYSC 19F. For further information regarding the MiFID II remuneration provisions please see our briefing MiFID II – Remuneration of Sales Staff.

## 6. Conclusion

While many of the MiFID II requirements are already good practice, firms will need to review their governance policies, conflict of interest provisions, complaints procedures and remuneration structures applicable to sales staff to ensure they will meet the MiFID II standards by 3 January 2018. Compliance teams, particularly in smaller firms will have a busy time ahead of them.