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Adoption of the position of the European Parliament on the MiFID II proposal

On 26 October 2012, the European Parliament has voted amendments (the “Parliament’s Position”) to the initial proposal for a directive of the European Parliament and of the Council on markets in financial instruments repealing Directive 2004/39/EC of the European Parliament and of the Council (recast) that the European Commission released on 20 October 2011 and that we presented to you during our seminar on MIFID II of 8 March 2012 (the “MiFID II Proposal”).

The text approved by the Parliament contains material differences to the MiFID II Proposal as well as to the draft report of the *Rapporteur of the Parliament* that we presented to you in our newsflash of 24 April 2012.

In the following paragraphs you will find an overview of the key changes brought by the Parliament’s Position and that will directly impact the private banking sector¹ but also the way some financial instruments -like investment funds will be sold.

I. Scope of MiFID II

1. The application of certain MiFID requirements (such as organisational rules and rules of conduct) is extended to insurance undertakings and insurance intermediaries, including tied insurance intermediaries when selling or advising clients in relation to insurance-based investments, *i.e.* insurance contracts where the amount payable to the client is exposed to the market value of an asset or payout from an asset or reference value, and where the client does not directly hold the asset.
2. The MiFID II Proposal initially upgraded the safekeeping and administration of financial instruments from an ancillary service to an investment service. According to the Parliament’s Position, this service is maintained as a mere ancillary service.

II. Free provision of services by third country firms

The MiFID II Proposal provided for a harmonised regime of the provision of investment services by third country firms on a cross-border basis or through the establishment of a branch in a Member State.

1. Pursuant to the MiFID II Proposal, the provision of investment services on a cross-border basis to retail clients is prohibited, whereas it is possible under certain circumstances towards eligible counterparties. Ambiguities remained as regards the provision of services on a cross-border basis to professional clients. The Parliament’s Position clarifies the question: the

¹ Our Newsflash is based on the provisional edition of the Parliament’s Position available on 26 October 2012 on the website of the European Parliament

provision of services to professional clients on demand is prohibited whilst it is possible under certain conditions towards professional clients *per se*.

2. Concerning the establishment of a branch in a Member State, the requirements that must be complied with at the level of the third country itself (existence of MiFID-like organisational requirements, cooperation agreement with Member State, tax cooperation, equivalence decision from the Commission, mutual recognition) and at the level of the firm (authorised, regulated, comply with MiFID rules) in the MiFID II Proposal remain basically untouched.

The Parliament's Position has added a new condition pursuant to which the competent Member State authority must be satisfied that the third-country firm intends to provide a significant proportion of investment services or to perform a significant quantity of its investment activities in the Member State where it is seeking to establish a branch.

The European Parliament also proposes that the equivalence decision vis-à-vis a third-country that is to be taken by the Commission may be limited to certain activities.

III. Corporate governance

The MiFID II Proposal strengthened the requirements pertaining to corporate governance. The Parliament's Position softens certain of the new requirements and goes further in relation to others.

1. The MiFID II Proposal strictly limited the number and categories of directorships that a member of the management body of an investment undertaking could hold at the same time. Pursuant to the Parliament's Position, these limitations now only apply in relation to management bodies of investment undertakings which are significant in terms of size, internal organisation, nature, scope and complexity of their activities.
2. Furthermore, investment firms will be required to implement gender quota by a certain date to be provided by the competent authorities.
3. The Parliament's Position further introduces specific requirements applicable to "non-executive directors". It is, however, unclear whether all investment firms must have "non-executive directors" and, if so, how many.

IV. Whistleblowing

The MiFID II Proposal provided for mechanisms to « encourage » the external reporting of breaches. However, there was no clear articulation between such rules and confidentiality rules to which an employee may be subject to. Pursuant to the Parliament's Position, an employee may not be prevented from disclosing breaches committed within the financial institution by any confidentiality rules and such disclosure will not trigger any liability of any kind. In addition, the Parliament's Position provides for sanctions in case a member of the management body of the investment firm does not report a breach that he is aware of.

V. Recording of telephone conversations and electronic communications

The MiFID II Proposal provided for the obligation for investment firms to record telephone conversations and electronic communications regarding at least the services of reception and transmission of orders, execution of orders and dealing on own account.

1. According to the Parliament, this obligation may be waived by Member States in relation to the recording of telephone conversations when the investment firm does not, as its main business, provide the services of reception and transmission of orders or execution of orders.

2. Furthermore Member States may instead of the telephone record also recognise as adequate documentation of the content of the telephone conversations, minutes of calls where such minutes are signed by the client.
3. Finally the retention period of such records provided for in the Parliament's Position is reduced to one year after the end of the investment against three years in the initial MiFID II Proposal².

VI. Rules of conduct

1. Inducements

- a. The MiFID II Proposal prohibits an investment firm which provides investment advice on an independent basis or portfolio management services from accepting or receiving fees, commissions or any monetary benefits paid or provided by a third party in relation to the provision of such service to the client.
- b. This prohibition is maintained with the Parliament's Position in relation to the provision of investment advice on an independent basis whilst the prohibition seems to cease in relation to discretionary portfolio management services³.
- c. Member States may elect to additionally prohibit or further restrict the offer or acceptance of inducements in relation to the provision of investment advice and/or discretionary portfolio management services.
- d. As regards inducements in general, in essence, the Parliament's Position introduces the requirements that were contained in the MiFID level 2 Directive (directive 2006/73/CE on organisational requirements and rules of conduct), *i.e.* that non-otherwise authorised fees, commissions or non-monetary benefits shall be designed to enhance the quality of the relevant service and not impair compliance with the firm's duty to act honestly, fairly and professionally and in accordance with the best interest of clients.

Member States have the option to provide that the requirements mentioned above are only satisfied where the value of the fee, commission or non-monetary benefit is transferred to the client.

2. Appropriateness assessment

The Parliament's Position waives the requirement of appropriateness assessment for structured undertakings for collective investment in transferable securities (UCITS) in case of execution only services.

3. Remuneration policies

The Parliament's Position provides for several obligations relating to the manner in which an investment firm remunerates its staff, appointed representatives or other investment firms which were not set out in the initial MiFID II Proposal.

In general, the manner in which an investment firm remunerates its staff, appointed representatives or other investment firms must not prevent these persons from complying with their obligation to act in the best interest of clients. Member States are required to ensure *i.a.* that the remuneration is not largely dependent on targets for the sale or profitability of investment

² The MiFID II Proposal did not specify the starting date of the period of three years

³ The drafting of the paragraph in relation thereto is rather unclear as it refers to the provision of investment advice given on an independent basis and then also refers to discretionary portfolio management services. Should the reader understand that inducements are also prohibited in relation to the provision of discretionary portfolio management services? Furthermore, the Parliament's Position seems to introduce the notion of discretionary portfolio management provided on an independent basis.

products or financial instruments and that the remuneration is not an incentive for staff to recommend a particular investment product at the expense of another investment product which would better meet the objective of the relevant retail client.

4. Pre- and post- service information obligation

The Parliament's Position subjects investment firms to more stringent information obligations, both prior and following the provision of the service.

By way of example, in relation to investment advice, prior to the provision of advice, appropriate information must be provided to clients which includes whether a fee is payable by the client for the advice, the range of investment products and financial instruments on which the recommendation will be based and whether the investment firm receives any inducements.

Once the investment service has been provided additional reporting obligations apply:

- in relation to discretionary portfolio management, the investment firm must provide to the clients, in a periodical report, information on the inducements paid or received in relation to the service during the preceding period ;
- in relation to investment advice, a record which specifies at least the client's objective, the recommendation and how the advice given meets the personal characteristics and objectives of the client must be provided to the latter ;
- in relation to portfolio management services (and investment advice if the investment firm so elects), the investment firm must inform the retail client of the frequency of its suitability assessment and the related report shall include information about the performance of the relevant financial product and an updated assessment of suitability of this investment product.

5. Investment products

The Parliament's Position provides for specific obligations in relation to "investment products", which are products where the amount payable to the client is determined with reference to the value of financial instruments or the product is a structured deposit or the product is an insurance-based investment or the product is a packaged retail investment product as defined in PRIPs.

Investment firms must ensure that an investment product designed by the firm for sale to clients meets the need of an identified target market and that investment firms marketing an investment product only market it to clients within the target group. Before investment products and financial instruments are placed or distributed on the market, they need to be approved according to the product approval process. The Parliament's Position provides for additional requirements as regards inducement and incentive schemes in relation thereto.

VII. Miscellaneous

Hereabove, we highlighted the main amendments to the initial MiFID II Proposal by the European Parliament that may be particularly relevant for private bankers and investment firms involved in the placement of financial instruments. However, the Parliament's Position also adds a series of requirements in relation to algorithmic and high frequency trading, regulated markets, position limits and checks and data reporting service providers.

Next steps

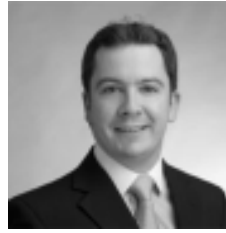
Following last Friday's vote, it is now for the Council to take position. If the Council were simply to approve the Parliament's Position this would mark the end of the legislative process and the recast would be adopted as such. If (as is more likely) this is not the case, there will be a second reading by the European Parliament and, possibly, a conciliation between the Parliament and the Council will be needed to find an agreement.

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