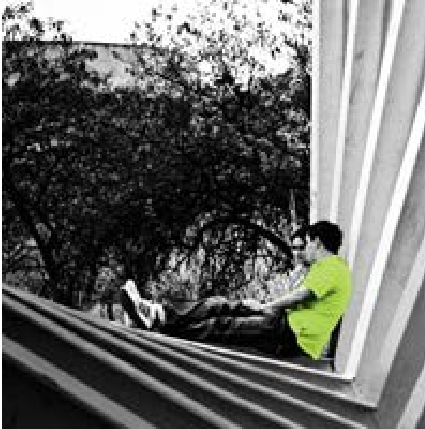

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MiFID II – Key aspects

I. Introduction

Yesterday the final texts of the revised Markets in Financial Instruments Directive were published in the Official Journal of the European Union. The texts consist of two legislative instruments, a revised directive (MiFID II) and a directly applicable regulation (MiFIR) (together hereinafter referred to as "**MiFID II**"). MiFID II will enter into force beginning of July 2014. MiFID II will be effective as from January 2017, but the directive will have to be enacted into Luxembourg law by June 2016 at the latest.

A number of aspects of MiFID II will have to be further specified in "level 2" delegated and implementing acts as well as technical standards. On 24 April 2014, the European Commission sought ESMA's technical advice on several aspects of MiFID II in view of possible delegated acts[1]. The "level 2" texts are expected to be adopted by the European Commission by June 2015.

MiFID II is interrelated with other recent legislative acts and proposals, *eg.*, CRD IV, EMIR, UCITS V, PRIPS, AIFMD and IMD. It aims at establishing a safer, sounder, more transparent and more responsible financial system by extending market transparency, improving competition in trading and clearing of financial instruments, moving organised trading to multilateral and regulated platforms, adapting rules to technological developments, strengthening investor protection, providing partially harmonised rules for the access of third country firms to the EU market as well as ensuring harmonised administrative sanctions and effective cooperation between authorities.

This newsflash reflects the status of MiFID II as of 13 May 2014 and only aims at presenting the key aspects of MiFID II with respect to credit institutions providing investment services or performing investment activities and investment firms (both hereinafter referred to as "**Firms**").

II. Scope of MiFID II

1. Emission allowances, recognised for compliance with the requirements of the Directive 2003/87/EC on Emissions Trading Scheme, are now in the scope of MiFID II as they are classified as financial instruments.

2. Regarding the safekeeping and administration of financial instruments, the European Commission had initially proposed to upgrade this service to an investment service. However, under MiFID II, this service remains a mere ancillary service.

[1] ESMA's consultation paper on MiFID II of 22 May 2014, for the purpose of producing the advice to the European Commission, already contains draft technical advice on a number of MiFID II aspects.

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3. Under MiFID II, selling self-issued financial instruments, with or without providing other investment services, falls within the scope of the investment service of “execution of orders”.

4. Certain MiFID II rules will apply to the selling or advising of clients in relation to structured deposits.

5. Operating an “organised trading facility” (OTF) becomes a new investment service. An OTF is a new trading venue, which is defined as a multilateral system (but not a regulated market or MTF), in which multiple third-party buying and selling interests in bonds, structured finance products, emission allowances or derivatives are able to interact in a way resulting in a contract (*eg.*, broker crossing systems). The OTFs’ scope is thus limited to non-equity instruments.

6. Certain MiFID provisions will apply to persons which are not subject to authorisation as an investment firm. For example, certain rules on algorithmic trading will apply to all members or participants of regulated markets and MTFs.

7. Furthermore, the scope of MiFID II is extended through the restriction of certain MiFID I-exemptions, in particular, regarding commodity firms and treasury activities.

III. Provision of services by third country firms

Currently, under the MiFID regime, access by non-EU firms providing investment services or performing investment activities (hereinafter referred to as “**Third Country Firms**”) to the EU market is not harmonised, but governed by Member States’ national third country firm regimes. There is no EU passport available for a Third Country Firm that establishes a branch in a Member State.

Third Country Firms’ access to the EU market was controversially discussed throughout the MiFID II legislative process. MiFID II now contains a harmonised regime regarding the cross-border provision of services by Third Country Firms in respect of eligible counterparties and professional clients.

Third Country Firms wishing to provide investment services to or to perform investment activities with respect to eligible counterparties and professionals, may freely provide those services throughout the EU (without establishing a branch) if specific conditions are complied with (in particular, an equivalence decision rendered by the European Commission and the registration of the Third Country Firm in the ESMA register of permitted Third Country Firms).

On the other hand, a Third Country Firm that has established an authorised branch in a Member State and that is established in a country for which an equivalence decision has been rendered may provide services throughout the EU to eligible counterparties and professionals without establishing further branches. In this case, the Third Country Firm does not need to be registered with the ESMA register.

As regards retail clients/ clients to be treated as professionals upon request, which are established in a Member State, the relevant Member State may require that a Third Country Firm wishing to provide investment services to those clients on its territory establishes a branch in that Member State. If a Member State requires the establishment of a branch in its territory to service those clients, harmonised MiFID II authorisation rules will have to be complied with. As each Member State may require the establishment of a branch on its territory to service those clients, there is no “EU passport” for Third Country Firms available in this respect.

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Furthermore, MiFID II expressly sets out for all clients that a Third Country Firm may, without any specific requirements and on a pure cross-border basis, provide investment services to a client established in a Member State at the client's exclusive initiative, provided that these services are then rendered.

IV. Corporate governance

MiFID II, as CRD IV, provides a number of additional requirements (many of them are still to be specified by "level 2" measures), in order to increase the management's accountability, in particular regarding the composition and qualification of the management body of Firms both on an individual and collective level (*eg.*, "sufficient time" commitment of management body members, "adequate collective knowledge, skills, experience" of management body, "honesty, integrity, independence of mind" of members). Firms are required to devote adequate human and financial resources to the induction and training of management body members.

Under MiFID II and CRD IV, management body members of "significant" Firms in terms of size, internal organisation, nature, scope and complexity of activities must further comply with rules on the limitation of (executive or non-executive) directorships they may hold at the same time. However, directorships held, *eg.*, in the same group count as one directorship and the CSSF has, in addition, the power to allow one additional non-executive directorship.

Diversity is to be taken into account for the selection of management body members. An explicit requirement for Firms to implement gender quota is however not provided for under MiFID II.

Furthermore, significant Firms are required to establish a nomination committee, composed of management body members who do not perform executive functions in the relevant Firm.

V. Whistleblowing

Under MiFID II, competent authorities must establish effective mecanisms to "enable" external reporting by employees of financial institutions of "potential or actual breaches" of the provisions of MiFIR and of national provisions implementing the MiFID II directive, *i.e.*, specific procedures for the receipt of reports and their follow-up. MiFID II provides that the identity of both the whistleblower and the individual who is allegedly responsible for the breach must be protected at all stages of the procedure unless disclosure is required by national law in the context of further investigations or subsequent proceedings. Furthermore, employees who report breaches committed within the financial institution, must have appropriate protection against retaliation, discrimination or other types of unfair treatment at a minimum.

Firms must have appropriate procedures in place in order for employees to report potential or actual breaches internally through a specific independent and autonomous channel.

VI. Recording of telephone conversations and electronic communications

Under MiFID II, Firms have the obligation to record telephone conversations and electronic communications relating to, at least, the provision of client order services relating to the reception and transmission of orders, the provision of client order services relating to the execution of orders or transactions concluded when dealing on own account.

The records must include conversations or communications intended to result in transactions or in the provision of client order services, even if the transactions are not concluded or the said services are not rendered.

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New and existing clients must be notified in advance about the recording and the Firm may not provide, by phone, services or activities relating to reception, transmission and execution of client orders to clients who have not been notified in advance about the recording. MiFID II provides a retention period of usually 5 years (up to 7 years, where this is requested by the relevant competent authority). Firms must take reasonable steps to prevent an employee or contractor from making, sending or receiving telephone conversations or electronic communications on private equipment which the Firm is unable to record or copy. MiFID II also specifies that client orders must be placed in durable medium, whereby orders placed during face-to-face conversations and duly documented (*eg.*, by using written minutes or notes) are considered equivalent to orders received by phone.

VII. Rules of conduct

1. Inducements and remuneration of staff

Under MiFID II, Firms informing the client that advice is provided on an independent basis as well as Firms providing portfolio management are prohibited from "accepting" and "retaining" fees, commissions or any monetary or non-monetary benefit paid or provided by any third party or a person acting on behalf of a third party (*eg.*, issuer) in relation to the provision of the service to clients. "Minor non-monetary benefits", capable of enhancing the service quality and being of a scale and nature such that they could not be judged to impair compliance with the duty to act in the client's best interest are excluded from this prohibition and shall be clearly disclosed to the client.

The prohibition does not apply where an investment advice is not rendered on an independent basis.

Under MiFID II, Firms must ensure that they do not remunerate or assess the performance of their own staff in a way that conflicts with their duty to act in the clients' best interests. In particular, Firms shall not make any arrangement by way of remuneration, sales targets or otherwise which could provide an incentive to their staff to recommend a particular financial instrument to a retail client when the Firm could offer a different financial instrument which would better meet the client's needs.

Under MiFID II, Member States may, in exceptional cases only, impose additional requirements (gold plating) relating to remuneration and inducements.

2. Appropriateness and suitability/ independent investment advisors

Stricter requirements will in particular apply to portfolio management and investment advice. Under MiFID II, Firms must ensure and demonstrate to the competent authorities, upon request, that the individuals giving investment advice or information about financial instruments, investment services or ancillary services to clients on behalf of the Firm possess the necessary knowledge and competences and Member States shall publish the criteria to be used for assessing such knowledge and competences.

Investment advisers must inform the client, in good time before the advice is provided, in particular, (i) whether the advice is provided on an independent basis or not, (ii) whether the advice is based on a broad or more restricted analysis of different types of financial instruments, (iii) whether the range of financial instruments is limited to financial instruments issued or provided by entities having close links with the Firm (or other legal or economic relationships under certain circumstances) and (iv) whether the client will be provided with a periodic suitability assessment of the financial instrument recommended to that client.

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Furthermore, independent investment advisors shall 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 and must not be limited to instruments issued or provided by the Firm itself or by entities having close links with the Firm (or other entities with which the Firm has such close legal or economic relationships as to pose the risk of impairing the independency of the advice).

When providing investment advice, the Firm shall, before the transaction is made, provide the client with a statement on suitability in a durable medium specifying the advice given and how that advice meets the preferences, objectives and other characteristics of the retail client. In case of distance communication which prevents the prior delivery of the suitability statement, the Firm may provide the written statement on suitability in a durable medium immediately after the client is bound by an agreement subject to certain conditions such as, in particular, if the client has given its consent to receive the statement without undue delay after the conclusion of the transaction.

Where the Firm provides portfolio management services or has informed the client that it will carry out a periodic assessment of suitability (in case of investment advice), the periodic report to be provided to the client shall contain an updated statement on how the investment meets the client's preferences, objectives and other characteristics of the retail client.

Regarding the appropriateness assessment, the "execution-only" regime applies in relation to a more limited range of non-complex financial instruments. Structured UCITS as referred to in Article 36 paragraph 1 subparagraph 2 of Regulation (EC) 583/2010 are explicitly excluded from the definition of non-complex financial instruments. The "execution-only" regime shall not apply to "execution-only" services in conjunction with the ancillary service of granting of credits or loans to an investor to allow him to carry out a transaction in one or more financial instruments, in which the Firm is involved, that do not comprise of existing credit limits of loans, current accounts and overdraft facilities of clients.

"Level 2" measures will show whether the disapplication of the appropriateness requirement will continue to apply in relation to professional clients.

In the case of a package of services or bundled products, the suitability/ appropriateness, as the case may be, must be considered by the Firm on the basis of the overall bundled package.

VIII. Miscellaneous

Compared to MiFID, MiFID II contains various other new rules and requirements, which are not covered in the present newsflash, for example, a new trade transparency regime for non-equity markets, the prohibition of title transfer collateral arrangements with retail clients, new rules regarding algorithmic and high frequency trading, direct electronic access and commodity derivatives, harmonised rules regarding non-discriminatory access to trading venues, product intervention powers of regulators as well as harmonised sanctions.

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