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Asset Management

July 4, 2017

FCA publishes final policy statement on MIFID II implementation

Attorneys
Monica Gogna
Michelle Moran
John Young

The Financial Conduct Authority ("FCA") has published its final policy statement on implementation of the revised EU Markets in Financial Instruments Directive ("MiFID II"), which takes effect in the EU in January 2018.

The statement includes some significant policy decisions by the FCA, affecting the impact of MiFID II on UK asset managers. The key decisions are as follows.

Inducements in relation to research

MiFID II introduces a requirement for full "unbundling" of investment research received from brokers from dealing commission, requiring separate payment for investment research. As expected, the FCA will apply these rules more widely to collective portfolio managers that are not subject to MiFID II, and not only to investment firms that are subject to MiFID II by virtue of conducting activities such as segregated account management. The FCA has also clarified that the requirement on brokers to price research and other services separately will apply to all services performed by MiFID investment firms. It also gives limited guidance on other aspects of this part of MiFID II, such that the transfer of research charges into a "research payment account" should take place within 30 calendar days, and that a limited trial period for a research service could constitute an acceptable minor non-monetary benefit. The FCA also gives its view that a MiFID firm could accept transaction reporting offered by a broker as part of the execution service provided to its clients, provided it does not influence best execution and is offered as a standard term of business by the broker. In response to industry lobbying on the impact of the MiFID II reforms on firms that receive research from US broker-dealers (in particular, as to whether US broker dealers are willing to receive separate payments for research due to restrictions under the Investment Advisors Act), the FCA makes a limited comment – that it understands that US brokers are in discussions with the SEC in the US to explore the potential for arrangements that would allow US broker-dealers to accept research payments by EU firms, that it is not yet clear whether this will provide a solution, and that the FCA will continue to monitor the situation and provide an update in due course. This should allow the industry to collectively gather thoughts on best practices to comply these provisions.

Client categorisation

One key change under MiFID II is the regulatory treatment of local authorities as clients. MiFID II classifies local authorities as retail clients, meaning that they will need to opt up if they want to be treated as professional clients. The FCA recognises that, in practice, most larger local authorities (in respect of their both treasury management and pension funds) wish to be opted-up. As the opt-up has been mainly performed on individuals to date, many firms asked the FCA to clarify how various aspects of the test (such as an assessment of the client's expertise and experience) would apply to a local authority. The FCA provides some indication of how firms perform this test, such as by taking "a collective view of the expertise, experience and knowledge of committee members", and, in relation to the criterion that the client has worked in the financial sector for at least one year in a professional position, the FCA clarifies that this should be applied to "the person authorised to carry out transactions on behalf of the client works or has worked in the financial sector for at least one year in a professional position". For local government pension schemes, the FCA adds a new criterion as part of the test, which is that the client is subject to the Local Government Pension Scheme Regulation for their pension business. In relation to the portfolio size threshold

criterion for the opt-up, the FCA has set this at £10 million (and confirms that firms cannot combine the local authority's own assets with its pension scheme assets for this purpose).

Best execution

Contrary to its earlier proposal, the FCA will not apply the new best execution rules in MiFID II to asset managers authorised under the Alternative Investment Fund Managers Directive (AIFMs), citing the "diversity in nature and scale of this set of firms" and respondents' concerns about applying these obligations to certain types of business models. The FCA is also mindful of the planned review of the AIFMD over the next two years, which may well incorporate aspects of the MiFID II regime into a revised version of AIFMD. In an interesting policy distinction, the FCA has decided to apply the changes to best execution rules to UCITS managers, in view of the investor protection and market integrity benefits.

Telephone taping

MiFID II revises the requirement on firms to record internal and external telephone conversations. In its earlier consultation, the FCA signalled its intent to apply this requirement to firms carrying out corporate finance business (that are generally exempt from MiFID) and to portfolio managers widely. In response to concerns raised on the very broad scope of the proposal, the FCA announced that it will only apply the obligation to communications during corporate finance business that would be in scope of the MiFID requirement - in other words, only insofar as they result in (or that are intended to result in) transactions concluded when dealing on own account and the provision of client order services that relate to the reception, transmission and execution of client orders. The FCA gives examples of relevant conversations. In relation to portfolio managers, the FCA confirmed that it will remove the current exemption for portfolio managers (given the FCA's difficulty to date in market abuse investigations in relying on sell-side records) and gives its views on the scope of the obligation, stating that the focus of the regime is on the transactional side of portfolio management, where conversations that relate to transactions undertaken are required to be recorded. In both cases, considerable work will be required by firms to ensure that in-scope conversations are recorded and retained. For private equity managers, the FCA helpfully clarifies that telephone taping only applies to MiFID financial instruments – unlisted equity and loans will generally be outside the scope of MiFID.