



MiFID II/MiFIR most remarkable changes related to the investors protection and conduct of business rules. July 2014.

The new Directive on Markets in Financial Instruments (hereinafter MiFID II) and the Regulation on Markets in Financial Instruments and amending Regulation 648/2012 (hereinafter MiFIR) have been published in the Official Journal of the European Union on the 12 of June. (For more information on MiFID II/MiFIR processing and on ESMA consultations papers about level 2 development provisions, see first paragraph of the previous item on market structures).

The most relevant aspects of the new rules on investor protection are:

1. Extending the scope of MiFID II/MiFIR to cover financial products previously outside the scope of MiFID I. The sale of structured deposits is now subject to the conduct of business and conflict of interest rules, and investment products based on insurance will be subject to some of the information to clients and conflict of interest requirements.

2. Amendment of conduct of business requirements in order to grant additional protection to investors by:

- restrictions on the inducements regime
- allocation powers for the authorities to intervene products and services
- new obligations on government products
- improvements in the system of protection of client assets
- more detailed regulation of best execution
- more reporting requirements on fees and charges to customers
- new requirements for independent advice

3. Strengthening organizational requirements of the Investment Firms for the provision of services to investors. The involvement of senior management body in the design of products and services and the adoption of internal controls is enhanced. Criteria of good repute and experience are required from all board members regardless their functions. A mandatory common telephone and electronic record is established at European level. MiFID II/MiFIR regulate the designation, registration and supervision of tied agents, and the provision of services by third country entities through the establishment of branches including the procedure for equivalence and the passports register.

Below, we detail the **most important changes listed in paragraph 2 introduced in the rules of conduct to increase investor protection: Restrictions in the incentives (inducements) regime.**

Incentives are fees, commission or non-monetary benefits paid or provided to/by a third party which, in general, are not allowed unless it: a) increases the quality of service provided to the client (criterion of "increased quality") and; b) does not impair compliance with the investment firm's duty to act honestly, fairly and professionally in accordance with the best interest of its clients.

Independent adviser and portfolio managers must inform and return to clients any monetary third party payments received in relation to the provision of investment or ancillary services, except minor non-monetary benefits that are capable of enhancing the quality of the service provided. ESMA proposes an exhaustive list of non-monetary benefits of a minor nature and, therefore, acceptable that would include: the provision of information/documentation relating to a financial instrument (including financial research) or an investment service, participation in conferences and seminars, and hospitality of a reasonable *minimis* value. For non-independent advisers, ESMA proposes the assumption that the incentive increases the quality of service if the advice is provided on a broad range of suitable financial instruments or if it is provided on an ongoing basis so that the service is not affected by the perception of the incentive. For other investment services, ESMA proposes a non-exhaustive list of circumstances in which the incentive does not increase the quality of service: i) it is used to pay for goods or services essential for the recipient firm in its ordinary course of business; ii) it does not provide for an additional or higher quality service above legal requirements to the end user client; iii) it directly benefits the recipient firm, its employees or shareholders without tangible benefit to the end client; iv) in relation to an on-going inducement, it is not related to the provision of an on-going service to an end user client.

Allocation of intervention powers for the authorities on products and services.

MiFIR confers temporary intervention powers that consist of temporarily prohibit or restrict the marketing distribution or sale to: 1) ESMA on certain financial instruments and on a type of financial activity or practice; 2) EBA on certain structured deposits and on a type of financial activity or practice; 3) the competent authorities of the Member States on both previous cases in the State. ESMA points out that, as all three empowerments broadly share the same wording, the criteria and factors to be specified should generally be the same for all three provisions. Intervention should be based on a significant concern for the protection of investors, or a threat to the orderly functioning and integrity of financial markets or commodities markets and to the stability of the whole or part of the financial system.

ESMA proposes a list of non-exhaustive criteria/factors to be taken into account by the authorities when considering the possibility to exercise their product intervention powers and examples of situations included in each of these criteria. Authorities should consider the following criteria: the degree of complexity, the size of the potential problem or detriment, the type of clients involved, the degree of transparency, the particular features on underlying components including any leverage, the degree of disparity between expected return or benefit and risk of loss, the ease and cost for investors to switch and sell an instrument, pricing and associated costs, the degree of innovation, the selling practices and the situation (credit-worthiness) of the issuer. When assessing factors related to a potential threat to the integrity of the markets or the stability of the financial system, authorities should consider the following criteria: insufficient information, high risk to performance of transactions in the market or product in question, compromise of the integrity of the price formation process, susceptibility of being used for the purposes of financial crime, high risk to the resilience or smooth operation of markets and their infrastructure, artificial disparity between prices of a derivative and those in the underlying market, high risk of disruption to financial institutions relevant to the financial system, risk to the market or payment systems infrastructure including clearing and settlement systems, and threat to investor confidence. ESMA explains that authorities should be able to intervene in new instruments or services or activities that may not meet these factors or criteria or, conversely, not necessarily intervene if given criteria

are met but overall detriment is not foreseen or detected or the relevant proportionality test is not satisfied.

New obligations on government products.

ESMA develops new MiFID II obligations for manufacturers, that is, firms that create, develop and design investment products, and for distributors, that is, firms that sale and distribute those investment products. Among them, we highlight the following new obligations for manufacturers: i) to assess the product features and to identify the potential target market of end clients whose needs are compatible with the product; ii) identify *ex ante* the possible events that could change the product's compatibility with the identified target market; iii) review periodically the performance of the product; iv) establish policies and procedures for managing conflicts of interest in particular when developing new products; and v) provide the distributor with information of the product of an adequate standard. Some of the new obligations for distributors are: i) understand the product and the target market identified, and assess if the client is within the identified target market (product compatibility with the client); ii) provide to the manufacturer with sales information to support product reviews carried out by manufacturers; and iii) take, when products are manufactured by non-MiFID firms, all reasonable steps to ensure that the level of product information obtained from the manufacturer is similar to the information required in MiFID I /MiFIR. All this is without prejudice to existing obligations at the point of sale (assessment of suitability and convenience).

Improvements in the protection of client assets regime.

ESMA proposes that investment firms should appoint a single officer with specific responsibility for matters relating to the firm's compliance with its obligations regarding the safeguarding of client assets. MiFID II prohibits Title Transfer Collateral Arrangements (TTCA) for retail clients. ESMA proposes that firms, as part of their due diligence in the selection of credit entities where deposit clients funds, should consider the diversification of these funds, and that an intra-group deposit quantitative limit of 20% of clients funds should be imposed except if the firm is able to demonstrate that, in view of the nature, scale and complexity of the business and including the small balance of client funds it holds, the requirement is not proportionate.

More detailed regulation of best execution

MiFID II establishes that investment firms shall take all sufficient steps to obtain, when executing orders, the best possible result for their clients taking into account price, costs, speed, likelihood of execution and settlement, size or any other consideration relevant to the execution of the order. ESMA proposes a comparable and standardized content and the format of the information to be published by investment firms and considers that they should report the identity of the top five venues (including execution venues such as systematic internalisers, market makers, or other OTC counterparties) to which they direct their order flow. ESMA also proposes a comparable and standardized content, format and periodicity of data relating to the quality of execution to be published by each trading venue; data of all financial instruments will be published related to a uniform period of time on a minimum of specific details or quality metrics indicators (speed, probability, price and costs of execution) that allows comparison across platforms.

More reporting requirements on fees and charges

Investment firms should provide in good time to clients or potential clients information with regards to the financial instruments and proposed investment strategies, execution venues and all costs and related charges. ESMA proposes that firms should provide *ex ante* aggregated information about the costs related to the financial instrument and the investment or ancillary service when a) firms recommend or market financial instruments to clients, or b) firms provide any investment service and are required to provide clients with a Key Information Document (KID) or Key Investor Information Document (KIID). The method of calculation should be based on actual costs and, if not available, the investment firm should make reasonable estimations of these costs. Investment firms should be obliges to provide *ex post* annual post-sale information about all costs and

charges of financial instruments and investment or ancillary services in case a) and in case b) if the firm has also a continuing relationship with the client. The information should be based on actual costs incurred and be provided on a personalised basis.

New requirements for independent advice

When investment advice is provided, the investment firm must in good time before it provides investment advice, inform the client whether or not the advice is provided on an independent basis. When investment advice is provided on an independent basis, investment firms shall assess a sufficient range of financial instruments available on the market which must be sufficiently diverse to ensure that the client's investment objectives can be suitably met.

If you want to read the MiFID, please, click on:
http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:JOL_2014_173_R_0009&from=EN

If you want to read the Spanish version of MiFID, please, click on:
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