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The FCA and MiFID II: Early Considerations for Asset Managers

Although it is not limited to asset managers, the FCA "s Discussion Paper on developing its approach to implementing the MiFID II conduct of business requirements (**"DP 15/3"**) published in late March, highlights certain aspects of MiFID II which will be of particular interest to asset managers as they prepare for MiFID II implementation.

The following, in our view, represent the most important areas for asset managers in DP 15/3:

- Commissions and other benefits for discretionary investment mangers
- Client categorisation and the treatment of local public authorities and municipalities
- Recording of telephone conversations and electronic communications
- Costs and charges disclosure
- Revised inducements standards generally
- Complex and non-complex products and application of the appropriateness test

In some cases, the FCA seeks comment. In others, it merely provides comment – almost akin to guidance. Moreover, certain MiFID II conduct of business requirements, such as those governing product governance, are not mentioned in the context of asset management – although, product goverannce is mentioned in other contexts. DP 15/3 does not, therefore, cover all topics. It is, however, a useful, albeit early indicator, of the FCA's views and highlights areas that asset managers need to be considering as part of their MiFID II implementation programmes.

Receipt of commissions and other benefits for discretionary investment mangers

The FCA highlights the fact that, unlike its Retail Distribution Rules ("**RDR**") rules, the restrictions in MiFD II on accepting and retaining third party commissions, fees and monetary and non monetary are not limited to investment advisers. The restriction also applies to discretionary investment managers.

The FCA also highlights the fact that, unlike the RDR rules, MiFID II allows discretionary investment managers to receive payments from third parties, if these are passed on to clients in full. The FCA notes, however, that accepting payments could still allow the potential for advice to be biased, create the potential for regulatory arbitrage and create confusion among clients about the true cost of both the product invested in and the discretionary investment management ("**DIM**") services. The FCA also notes that any cash or unit rebates are likely to be subject to income tax, so may also be unfavourable to clients without a tax-efficient wrapper.

The FCA is, therefore asking whether it should develop rules banning rebates in the context of DIM services, in effect gold-plating MiFID II. Firms will need to consider whether to respond.

Client categorisation and the treatment of local public authorities and municipalities

MiFID II gives Member States the discretion to adopt specific alternative or additional criteria for the assessment of the expertise and knowledge of local authorities requesting to be treated as elective professional clients.

The FCA is considering amending its rules to the effect that local authorities are categorised as retail clients in respect of non-MiFID business, given that the same risks may apply. Firms will need to consider whether to respond.

Recording of telephone conversations and electronic communications

Unlike MiFID II, the FCA ”s current rules do not require discretionary investment managers to record their conversations and electronic communications with:

- other firms that are subject to the taping rules (since these should be captured through the obligations on those “sell-side” firms); and
- firms that are not subject to the taping rules (such as overseas brokers) if such conversations and communications are infrequent and constitute only a small proportion of the total relevant conversations and communications made by a discretionary investment manager.

The FCA proposes to remove the duplication exemption that currently applies to firms offering DIM services and apply the MiFID II recording rules. Firms will need to consider whether to respond.

Costs and charges disclosure

MiFID II introduces a new costs and charges disclosure requirement. This requires firms to disclose all costs and charges associated with an investment service and financial instrument, which are not caused by the occurrence of underlying market risk, at the point of sale and, as appropriate, on an annual basis.

In parallel to MiFID II which covers disclosure of costs and charges associated with both products and services, a separate pre-contractual disclosure is being developed as part of the PRIIPs Regulation.

The FCA notes the importance of ensuring consistency between the MiFID II costs and charges requirement, the PRIIPs Regulation and the UCITS Directive but notes that the UCITS KIID does not currently require firms to provide information about transaction costs. However, if the Commission adopts ESMA's MiFID II technical advice, firms will be required to include information about transaction costs in the MiFID II costs and charges disclosure.

The FCA is asking whether there are technical challenges that firms are likely to meet in meeting the disclosure requirements above that it might be able to address and, if so, what solutions it might propose. Firms will need to consider whether to respond.

The FCA also notes that MiFID II does not prescribe how information on costs and charges should be presented but leaves it to Member States to allow this information to be presented in a standardised format. The FCA notes that it will seek to draw on insights from behavioural economics to ensure the information presented to consumers delivers the intended outcomes.

The FCA asks whether it should investigate developing a standardised format for disclosing costs and charges for both point-of-sale and post-sale disclosures. Firms will need to consider whether to respond.

Revised inducements standards more generally

As above, the FCA notes that MiFID II imposes requirements which are stricter than the existing UK regime in that it bans those offering DIM from accepting and retaining fees, commissions or any monetary or non-monetary benefits from third parties, apart from certain minor non-monetary benefits.

The FCA notes that it is appropriate to copy across the likely more restrictive inducements regime to firms providing restricted advice as well as those offering DIM services.

The FCA also notes that MiFID II's inducements rules apply to both retail and professional clients.

Firms will need to consider the implications of the ban on payments applying to business conducted for professional clients, in contrast to the RDR

commission ban, which only applies to retail clients.

Complex and non-complex products and application of the appropriateness test

The FCA notes that MiFID II has restricted the types of products that are classified as "non-complex". Any products which are not non-complex are deemed complex. The FCA notes that all complex products can only be sold to a consumer either through an advised sale or through a sale following an appropriateness test. The FCA also notes that, in future, it is likely that any shares and bonds that embed a derivative, structured UCITS, non-UCITS collective investment undertakings ("NURSs") will be considered complex.

The FCA observes that some complex products have exotic underlyings, a significant degree of leverage increasing the risks for the average investor, or come with complicated penalties for exiting early. Other complex products may be more straightforward – perhaps they are complex because they embed a single derivative that is relatively straightforward for the potential investor to understand, or they comprise a NURS with more "vanilla" underlying funds or assets. The FCA expects the appropriateness assessment to be particularly rigorous if a firm was offering more complex financial instruments to less experienced customers who may be less likely to understand the risks.

The FCA takes the view that it is unlikely that a firm offering products through a direct offer will be able to meet the requirements of the appropriateness test. This is because the obligation to perform the appropriateness test is on the firm, not the client, or potential client. This may have a particular impact on firms distributing non-UCITS collective investment schemes in the UK.

The FCA notes that firms may also want to consider the impact on their online distribution models and want to develop a way of collecting relevant information from consumers to allow them to assess whether they have the knowledge and experience to understand the risks of a particular product. The FCA expects this to be proportionate in relation to the complexity of the particular product and emphasises that simply collecting this information is insufficient in itself – firms are required to make an assessment of the client's knowledge and experience before a particular type of product can be sold.

The FCA's observations highlight the fact that the changes in MiFID II on "non complex" products will require those who manage any types of fund, other than a non-structured UCITS funds, to look carefully at their distribution models and the types of person at whom they direct their marketing.

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