

## *Stand out for the right reasons* Financial Services Risk and Regulation

# *MiFID II*

## *Delegated Directive brings welcome clarity*

### **Highlights**

*The European Commission published its MiFID II Delegated Directive on 7 April 2016. The legislation contains vital information for firms seeking to implement MiFID II successfully. After considering ESMA's Technical Advice in December 2014, the European Commission has made some small but significant changes to the requirements. We highlight the differences, and the likely impacts for firms in this briefing.*

Uncertainty surrounding the finer details of MiFID II has been a thorn in the side of firms' attempts to make the necessary changes to become compliant with the new regime. The European Commission (EC)'s delegated legislation will offer welcome clarity and allow next steps to be taken ahead of the 3 January 2018 go-live date. The EC published its Delegated Directive (DD) on 7 April 2016.

The DD contains further information on:

- Scope
- Inducements
- Safeguarding of client assets; and
- Product governance requirements.

The DD does not represent a carbon copy of ESMA's December 2014 Technical Advice. But in the vast majority of cases, the changes made by the EC are not likely to be of material consequence to most firms – though some will be important. In this briefing, we highlight the key differences between ESMA's TA and the EC's conclusions, and comment on the likely consequences of changes for firms.

The EC has opted to publish the secondary legislation in at least two tranches, a Directive with two regulations to follow. While the DD will provide some useful clarification for firms, the majority of topics subject to delegated legislation will be contained within the delegated regulation. However, the DD contains topics that have been some of the most contentious in MiFID II. Not least of these is inducements. Here, the EC has expanded the list of minor-non monetary benefits to include certain written material received from a third party. Importantly, amendments made through the DD appear to relax the requirements on the operational arrangements regarding the collection of the research charge. This should open the door for commission sharing agreements (CSAs), provided they are amended to meet new requirements, including increased transparency.

Also covered in the DD are details on safeguarding of client instruments and product governance requirements. There are no significant changes from ESMA's Technical Advice in

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these areas, though the EC appears to have relaxed the requirements on title transfer collateral arrangements for non-retail clients.

Our analysis sign-posts where the changes are between the Technical Advice and DD, and provides a high-level overview of the likely impacts. It will be important for firms to go beyond this and conduct deeper analysis considering what the changes will mean for their particular circumstances, and incorporate this analysis into their compliance efforts and strategic decision making .

As we all know, the release of the DD is not the end of the story. The protracted nature of the timeline, the back and forth between ESMA and the EC on the technical standards, and the remaining areas of uncertainty create a risk that firms can become fatigued and lose focus on MiFID II. It is important to make sure this does not happen.

MiFID II remains the single most significant package of legislation to impact EU financial markets, and firms must ensure they stay close to these latest and future developments; not doing so risks losing strategic and competitive advantage. Next on the horizon are of course the two delegated regulations, the RTS and very soon after hopefully some guidance from ESMA on several key topics like product governance. We will also need to pay close attention to Member State implementation measures, especially in the case of the DD.

Remaining vigilant to next steps and keeping up the tempo on implementation efforts will reap rewards in the post-MiFID II world.

## Delegated Directive comparative analysis

Our analysis below highlights the differences between ESMA's Technical Advice (TA) and the DD. It also gives an indication as to the relative importance of the differences, and their main impacts for firms.

### 1. Scope

This section describes scope of the DD, area which was not explicitly covered by the ESMA's TA.

#### Main differences with ESMA's TA

**UCITS management companies and AIFs:** The EC has made it explicit that the DD will apply to UCITS management companies and AIFs when such entities are authorised to perform MiFID investment services such as management of portfolio of investments, investment advice and safe keeping of UCITS and reception and transmission of orders.

#### Importance of these differences

LOW

#### Main impacts of these differences

The clarification regarding AIF and UCITS management companies, though not completely new, should be helpful for asset managers as it offers greater clarity on the extent of their obligations. Strictly speaking the product governance arrangements will only apply to AIFs and UCITS management companies when performing portfolio management and investment advice. However, the alleviation of their burden in terms of targeting may actually be very limited in view of the information that distributors will require from them to meet their targeting obligations.

### 2. Inducements

MiFID II prohibits the ability to receive third party inducements (or requires these to be paid out to the investor) in case of portfolio management and independent advice. It also restricts this possibility when other services are provided by strengthening the conditions of the quality enhancement test. The DD sets out clear rules as to when firms are not allowed to accept and retain inducements and what constitutes an inducement.

#### Main differences with ESMA's TA

**Quality enhancing for client service:** Overall, the measures in the DD are written using positive statements. This is a contrast to the negative statements ESMA put forward in the RTS. While this does not change the meaning or content it provides for easier reading.

**Research:** In order for research not to qualify as an inducement, investment firms may set-up a research account, funded via a specific research charge. The DD

opens the door for the research charge to be charged as part of the transaction costs. If research is charged as part of the transaction costs and is not collected separately, the amount of the charge that funds the research account (i.e. the research charge) has to be identified. In addition, the increase in the research budget does not according to the DD require the explicit agreement of the client.

**Minor non-monetary benefits:** The EC has extended the non-exhaustive list of benefits qualifying as "minor non-monetary benefits" by adding the following item: *"written material from a third party that is commissioned and paid for by a corporate issuer or potential issuer to promote a new issuance by the company, or where the third party firm is contractually engaged and paid by the issuer to produce such material on an ongoing basis, provided that the relationship is clearly disclosed in the material and that the material is made available at the same time to any investment firms wishing to receive it or to the general public"*. ESMA did not include any third-party material in the list of acceptable benefits in its TA. The EC has also tasked ESMA with developing further guidelines to assess other minor non-monetary benefits across the Union.

#### Importance of these differences

MEDIUM

#### Main impacts of these differences

The DD is more open about operational arrangements regarding the collection of the research charge. This should be welcome by the industry as it should make CSAs possible provided that they are adapted, among other things, to be more transparent for the client. The DD is also more explicit with regard to "implied" research charges by requiring firms to disclose which part of the transaction charge is funding the research account. Operationally, this requires a clear separation of the charges even if an all-in fee is charged for execution services. Specifically, how much of the all-in fee is funding the research account has to be evidenced to the client. The form of such disclosure is left open, but should most likely be done as part of the transaction fee disclosure.

The EC's inclusion of a further example of acceptable minor non-monetary benefit does not materially alter the scope of the definition, but provides further guidance towards the interpretation of the clause.

### 3. Safeguarding client assets

The DD lays out the provisions aiming at safeguarding client's funds and financial instruments in particular by prohibiting certain title transfer collateral arrangements (TTCA). The requirements in the DD are a combination of the MiFID I framework, and language from ESMA's TA.

## **Main differences with ESMA's TA**

**Quality enhancing:** Overall, the measures in the DD are written using positive statements. This is a contrast to the negative statements ESMA put forward in the RTS. While this does not change the meaning or content it provides for easier reading.

**Qualifying money market funds:** The DD contains new requirements on qualifying money market funds that were not contained in the TA. Compared to the MiFID I framework, the DD alters the requirements on qualifying money market funds. Under both the MiFID Implementing Directive and the DD, firms are able to deposit client funds into a qualifying money market fund if, inter alia, it invests in high quality money market instruments. However, the MiFID I framework and the DD differ on what constitutes high quality money market instruments. Under the MiFID I framework, money market instruments are only considered high quality if they are awarded the highest level credit rating. Under the DD, money market instruments are considered to be high quality if the management/investment company performs its own documented assessment that it allows it consider the instrument as high quality. While the DD does set out that this assessment should have regard to external credit ratings, this represents a more flexible approach. However, the DD affords more protection to clients than the MiFID I framework in this regard, requiring that clients give their explicit consent to placing funds in a qualifying money market fund. Under the MiFID I framework only provided that clients have a right to oppose the placing of funds.

**Securities financing transaction definition:** The DD contains a new definition of securities financing transaction for the purpose of Article 5 of the DD.

**TTCA:** The DD mentions three factors that an investment firm "shall take into account" when considering and documenting the appropriateness of the use of TTCA arrangements with professional clients and eligible counterparties, namely: (a) a weak connection between client's obligation and use of TTCA; (b) the amount of assets subject to TTCA far exceeds secured obligations; (c) all assets of the client are subject to TTCA, without consideration of the client's obligations). ESMA's TA was more affirmative, indicating that TTCA were "not appropriate" if any of these three conditions were met.

**External audit requirement:** The DD has added a requirement for firms to ensure that their external auditors report at least annually to the NCA on compliance with the safeguarding of client asset requirements in the DD and MiFID II.

## **Importance of these differences**

**MEDIUM**

## **Main impacts of these differences**

More flexibility is provided to investment firms wishing to use TTCA towards non-retail clients.

Further clarifications may be made in relation to the modification of article 4(3), 2nd paragraph DD apparently widening the scope of qualifying money-market fund in which an investment firm may place client funds.

The addition of the requirement on external audit should not be of significance for firms. Although this was not contained within ESMA's TA, the MiFID I framework contained a similar external audit requirement on safeguarding of client assets.

## **4. Product governance requirements**

The DD defines the requirements applicable to manufacturers and distributors of financial instruments regarding the creation and launch of new products.

### **Main differences with ESMA's TA**

#### **Product governance obligations for manufacturers**

**Staff required to have necessary expertise:** ESMA's TA set out that staff shall "possess the necessary expertise or receive the appropriate training" to understand the characteristics of the products. In the DD, the reference to "receive appropriate training" has been removed. It is no longer required that this requirement is fulfilled before new products are manufactured.

#### **Removal of explicit wording on application of Article 24 MiFID II to distributors:**

In describing the requirements for manufacturers on the provision of information to distributors, ESMA's TA set out that "firms that distribute remain subject to the overarching disclosure requirements in Article 24 of MiFID II". This sentence has not been taken over in this provision of the DD.

**Reduced role for compliance:** Under ESMA's TA, a firm's compliance function is required to "oversee" the development and periodic review of product governance arrangements. The DD requires the compliance function to "monitor", rather than "oversee", which appears to be a softening of the requirement.

#### **Product governance obligations for distributors**

##### **Requirement to enter into agreement with non-MiFID firm removed:**

In contrast with ESMA's TA, there is no explicit requirement for a distributor to enter into an agreement with a manufacturer non-subject to MiFID or its agent to comply with the duty to take all reasonable steps to obtain adequate and reliable information from the manufacturer

**Staff required to have necessary expertise:** Similarly to the change under product governance changes for manufacturers, reference to “or receive appropriate training” has been removed in the DD.

**Reduced role for compliance:** Similarly to the change under product governance for distributors, the compliance function is required to “oversee”, rather than “monitor” the product governance arrangements.

### ***Importance of these differences***

**LOW**

### ***Main impacts of these differences***

The removal of the explicit requirement for distributors to enter into an agreement with a non-MiFID manufacturer or its agent is of importance for EU distributors and for non-EU manufacturers may simplify the interaction between manufacturers and distributors in the field of product governance

## **What's next?**

There are still some important pieces of the puzzle outstanding, and it is important that firms remain focused on the next developments. First, we can expect the delegated regulations, which together with the DD discussed in this paper, will form the entirety of the delegated acts. The forthcoming delegated regulations will contain important topics such as the definition of types of derivatives; systematic internaliser determination; clarity on what constitutes algorithmic and high-frequency trading; and the definition of a liquid market for equity instruments. The final details of many of these topics will be vital to firms in being able to move forward with their MiFID II programmes.

After that we can expect the Regulatory Technical Standards (RTS) to be finalised. The content of some of the RTS has been very contentious, and this is commensurate with the importance for firms. Details on the size-specific-to-the-instrument (SSTI) threshold, commodity derivative position limits regime, and transparency parameters for non-equity instruments are going to be areas to watch in particular.

Elsewhere we can likely expect some further guidance from ESMA on important areas, such as product governance. One of ESMA's top priorities is supervisory convergence, so we can expect areas of uncertainty to be priorities for Level 3 measures.

Firms should also now be paying close attention to their local regulator. Once the Level 2 measures have been finalised at the EU level, there will be little excuse for NCAs to delay in producing the necessary legislation to implement the revised MiFID II Directive and Delegated Directive. In some territories this process has already begun, such as Italy, Germany and the UK. It is likely that other Member States will soon follow suit.

## **What do I need to do?**

3 January 2018 may sound like it is still a long way off, but given the nature and scale of changes most firms still need to make, it will come round very quickly. The delay to the MiFID II go-live date has given firms a welcome opportunity to take stock of their MiFID II implementation efforts. The EC's publication of the DD means that there is now new work to do to, and it is time to move forward. It's therefore important that you quickly establish the impact of the latest developments on your organisation, and move to make the necessary changes to your implementation programmes and strategic thinking. For example, some firms will need to analyse the changes to the requirements on research payment accounts, and consider whether they can now maintain their CSAs, albeit with some modifications. Others will need to consider whether in light of the DD they are now more likely to be able to engage in increased TTCA with non-retail clients.

We have a vast amount of experience supporting firms across the sector with MiFID II gap analysis, impact assessment, programme management and strategic implementation. We have deep expertise in all areas of MiFID II, from investor protection and governance, through to transparency and market structure. We can also help you understand the strategic opportunities MiFID II brings, and help you establish the cumulative impact of the broader regulatory change agenda, across the EU and beyond. If you would like to discuss any of the issues described above in more detail, please contact us.

## **Contacts**

**Arthur Killian**  
**The Netherlands**  
arthur.kilian@nl.pwc.com  
Tel: +31 (0)88 792 3035

**Judith Boom**  
**The Netherlands**  
Judith.boom@nl.pwc.com  
Tel: +31 (0)88 792 3424

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