Client categorisation

Categorising local authorities as 'retail' or 'elective professional' clients

It is a MiFID II requirement that local authorities are categorised as 'retail' clients. The FCA have chosen to exercise a discretion they have to set 'alternative or additional quantitative criteria' for local authorities requesting to be opted-up to professional client status.

To ensure legal consistency with MiFID II, the FCA will not introduce the FCA's own definition of 'local public authority or municipality'. It is the FCA's view that firms should be able to distinguish between treasury management and pension fund administration, given the need for pension funds to be separately recorded and funds held in segregated accounts.

The FCA have also confirmed that for non-MiFID business, local authorities should still be categorised as retail in the first instance.

The FCA's clarification of the opt-up process

It is a MiFID II requirement that local authorities are categorised as 'retail' clients, with the ability to opt-up upon satisfying a set of qualitative and quantitative criteria. The FCA recognise that having to opt-up to a professional client status, rather than automatically being a professional client, will involve some extra work from investment firms and their local authority clients.

The qualitative test

MiFID II requires the qualitative test to be applied to local authorities seeking to opt-up to professional client status, with the test itself unchanged from MiFID. It is important that an investment firm is confident that a client can demonstrate their expertise, experience and knowledge such that the firm has gained a reasonable assurance that the client is capable of making investment decisions and understanding the nature of risks involved in the context of the transactions or services envisioned.

COBS 3.5.4 requires that the qualitative test should be carried out for the person authorised to carry out transactions on behalf of the legal entity. 'Person' in this context may be a single person or a group of persons. The FCA understand that the persons within a local authority who invest on behalf of pension funds are elected officials acting as part of a pensions committee. In those circumstances, firms may take a collective view of the expertise, experience and knowledge of committee members, taking into account any assistance from authority officers and external advisers where it contributes to the expertise, experience and knowledge of those making the decisions. The FCA also understand that typically the person(s) within local authorities who invest the treasury reserves of those authorities are likely to be officers of the authorities, who are delegated authority from elected members and act under an agreed budget and strategy.

Given different governance arrangements, the FCA stress the importance of firms exercising judgement and ensuring that they understand the arrangements of the local authority and the clear purpose of this test. It remains a test of the individual, or
respectively the individuals who are ultimately making the investment decisions, but governance and advice arrangements supporting those individuals can inform and contribute to the firm's assessment. Adherence to CIPFA Codes or undertaking other relevant training or qualifications may assist in demonstrating knowledge and expertise as part of the qualitative test.

**The quantitative test**

The FCA has amended its rules on client categorisation specifically for local authorities. A fourth criterion has been added to the quantitative test for local authorities whom are subject to the local government pension scheme (LGPS) Regulation for their pension administration business.

Local authorities must continue to meet the size requirement, as well as one of the two previous criteria or the new fourth criterion.

For the 10 transactions per quarter test, the FCA is making no changes however it will remain vigilant of local authorities attempting to 'game' the system by churning transactions to be the threshold. The quantitative test assessing employment in the financial sector for at least 1 year in a professional position has been amended by COBS 3.5.3R(b)(ii) to note that '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, which requires knowledge of the provision of services envisaged'. This allows local authorities to delegate authority to make investment decisions on their behalf to professional staff with at least one year's experience.

Firms may reasonably assess that a professional treasury manager has worked in the financial sector for at least one year, if their role provides knowledge of the provision of services envisaged. This meets the purpose of the test, to ensure the person acting on behalf of a client has the expertise, experience and knowledge necessary in relation to the investment or service being sold and the risks involved.

The FCA have changed the portfolio size threshold to £10m. £10m is closer to the FCA's policy goal of restricting the ability of the smallest, and by implication the least sophisticated, local authorities (town and parish councils, and the smallest county and district councils) to opt-up, but giving larger ones the ability to do so more readily, (provided they meet the other criteria).

**Transitional arrangements**

Firms may re-assess the categorisation of local authority clients between the 3 July 2017 implementation deadline and 3 January 2018 but will not be expected to re-consider categorisation of existing clients other than local authorities, where MiFID II rules are the same as existing MiFID rules transposed at COBS 3.

**Disclosure requirements**

In order to implement MiFID II disclosure requirements, the FCA has decided to amend disclosure provisions within General Provisions (GEN) and the Conduct of Business sourcebook (COBS). In particular, the FCA proposed new provisions in: COBS 2.2A, COBS 4.5A, COBS 6.1ZA, COBS 14.3A and COBS 16A in relation to MiFID business. The revised
disclosure framework provides for appropriate investor protection, detail the information to be provided to clients and potential clients, and detail how firms should report to clients.

New rules on disclosure will be applicable to:

- firms doing MiFID business
- Article 3 firms

The FCA clarify it will not, for now, consider proposing a standardised format setting out how firms should calculate and disclose point-of-sale or post-sale information, including information on costs and charges (so firms will need to develop their own approach to disclosure that will meet the needs of their clients and reflect their business propositions).

Information to clients and potential clients

The FCA has not applied the revised MiFID II disclosure provisions to all investment firms, instead favouring separate regimes. For firms doing MiFID business, new disclosure provisions will apply in relation to:

- cross-selling/bundled products or services
- some more detailed post-sale reporting requirements
- a revised requirement to retain records for at least five years

For firms doing non-MiFID business, the rules that apply in relation to cross-selling/bundled products or services, and record-keeping are unchanged; the rules in relation to post-sale reporting obligations are also substantially unchanged.

Firms may need to review their business models in order to ensure they comply with the new requirements and give their clients the information required. In particular, the FCA recognise that firms will need to make changes if they have clients who transact using only paper and telephone communications.

Unless a firm is an Article 3 firms carrying on MiFID-scope business, the FCA’s existing disclosure rules will continue to apply to firms doing non-MiFID business in the same way they do now. However, these rules may have been re-cast slightly to ensure consistency with the equivalent rules that apply to firms carrying on MiFID business, and some flexibility will now apply in relation to periodic statements provided online.

Fair, clear and not misleading information requirements

New provisions contain the conditions with which firms must comply in order to ensure the information they disclose is fair, clear and not misleading, including information disclosed in relation to the past and future performance rules. These provisions largely reflect technical changes made by MiFID II. New provisions on fair, clear and not misleading information requirements will not apply to non-MiFID firms’ communications to ECPs. At present all firms need to ensure that their communications to ECPs are not misleading, and this is the position that will continue to apply to firms doing non-MiFID business.

Information disclosure, timing, and costs and charges
In relation to information disclosure, timing, costs and charges the FCA have decided to impose, align with, or reference the new requirements in MiFID II Article 24(4) first and last paragraphs, 24(4)(b) and (c), applying different requirements to firms doing MiFID business and firms doing non-MiFID business. In particular, the FCA will require firms doing MiFID business to provide, in good time, more detailed, aggregated and on-going information about costs and charges that go beyond what is currently required. The FCA have not applied similar detailed costs and charges disclosure and timing requirements to firms doing non-MiFID business.

The FCA recognised that many firms carry out both MiFID and non-MiFID business. The FCA confirmed that firms may want to consider an approach that involves complying with the MiFID disclosure requirements in relation to both the MiFID and non-MiFID aspects of its business. A firm should only apply a MiFID disclosure requirement to its non-MiFID business where it is satisfied that it imposes an equivalent requirement or a higher standard compared to the otherwise applicable non-MiFID disclosure requirement, and compliance with the MiFID disclosure requirement would also entail compliance with the otherwise applicable non-MiFID requirement.

**Comprehensible information about a firm, its services and investments: standardised format**

Firms must provide information referred to in MiFID II Article 24(4) and (9) in a comprehensible form and in such a manner that clients are reasonably able to understand the nature and risks of the investment service and of the specific type of financial instrument that is being offered and, consequently, to take investment decisions on an informed basis. The FCA have confirmed that this information does not need to be disclosed in a standardised format, as there is no industry or MiFID II standard as to how such information should be presented.

**Changes to reporting to clients and periodic statements**

The FCA has confirmed that it will continue forward with proposed rules implementing or reflecting MiFID II requirements for the provision of reports to clients on the service provided, including the costs and charges incurred, and the new 10% depreciation reporting requirements applying to a client's managed portfolio, or position in leveraged financial instruments or contingent liability transactions. These changes also include a consequential amendment to the FCA's rules so that, regarding reporting obligations, the FCA's rules would apply to firms carrying on non-MiFID business as they do now.

The FCA has also confirmed its introduction of an exemption that allows firms doing non-MiFID business to avoid the need to provide periodic statements. This exemption applies if the firm provided its clients with access to an online system containing their up-to-date statement, and had evidence that the client accessed the online statement at least once during the previous quarter.

**Independence**

New MiFID II rules on independence are similar to current FCA rules resulting from its Retail Distribution Review (RDR) i.e. that personal recommendations must be based on a
comprehensive and fair analysis of the relevant market and be unbiased and unrestricted. There are certain nuances, however of the new MiFID II standard that depart from the RDR.

**The scope of application of the new MiFID II standard on independence**

The FCA will apply the new MiFID standard on independence across the board to advice on financial instruments, structured deposits and other non-MiFID RIPs (when advising retail clients in the UK). This means that for advice that falls outside the scope of MiFID II, with certain limited exceptions, the FCA will apply as rules the provisions of the MiFID II delegated regulation. This will be relevant to, amongst others, non-MiFID (including Article 3) firms and MiFID firms providing advice to retail clients on RIPs which are not financial instruments. In order to ensure that firms interpret guidance consistently, the FCA will import such guidance from the current COBS 6.2A into new COBS 6.2B.

**The application of detailed MiFID II delegated regulation requirements**

The FCA recognise that the MiFID II requirement preventing an adviser providing both independent and restricted advice is likely to be an issue for firms who give both types of advice and a particular difficulty for firms with only one adviser. However, since this requirement is stipulated in the MiFID II delegated regulation, the FCA are required to implement it. As the FCA explained in the CP16/29, the FCA are limiting the impact of the requirement as far as possible, by not applying it to non-MiFID business more broadly. This will allow advisers who do not advise on MiFID Financial Instruments or structured deposits to continue to provide both independent and restricted advice.

**Suitability**

MiFID II expands on existing suitability provisions and adds some new requirements. Most of the suitability requirements are contained in regulations, making them directly applicable, with limited scope for us to exercise any discretion in the FCA’s implementation. The FCA has proposed including the new requirements in a separate chapter (COBS 9A) for MiFID business, and leaving the current requirements in place for non-MiFID business pending consultation on implementation of the IDD. New COBS 9A should apply in full to Article 3 firms.

**Suitability rules for MiFID and non-MiFID business**

The FCA will finalise the rules on the basis of the split Handbook approach – i.e. a new suitability COBS chapter for MiFID business, and leaving the existing requirements in place for non-MiFID business at least until the FCA consult on the implementation of the IDD and will also apply the new COBS 9A to Article 3 firms.

Stakeholder concerns have also been raised by the FCA around the practicalities of complying with the new switching requirements (Article 54(11) of the MiFID II delegated regulation), and the more general need for guidance on the suitability provisions, with ESMA. ESMA is updating its existing suitability guidelines, and the FCA expect these matters to be covered. ESMA is aiming to consult on these updated guidelines in the summer, and to finalise them around the time MiFID II comes into force in January 2018. The FCA have encouraged all stakeholders to respond to ESMA’s consultation.
Appropriateness

Under MiFID, there is a distinction between ‘complex’ products and other ‘noncomplex’ products. The appropriateness test (for non-advised sales) must be carried out when a firm executes, or receives and transmits, a client order in relation to a complex product. Because MiFID II narrows the scope of products deemed automatically non-complex, the appropriateness test needs to be carried out in relation to a wider range of products.

Firms will also need to record the results of a test, including:

- when a warning has been given, but the client wishes to proceed with the transaction regardless, and whether the firm decided to carry out the client’s request in spite of its warning

Updated rules on the appropriateness test

In the FCA’s view, investment trusts and non-UCITS retail schemes (NURS) are neither automatically non-complex nor automatically complex, but must be assessed against the criteria set out in the MiFID II delegated regulation. A cautious approach should be adopted if there is any doubt as to whether a financial instrument is complex. a cautious approach if there is any doubt as to whether a financial instrument is non-complex.

New provisions for MiFID products were set out in a COBS 10A, while the current rules will continue to apply to a non-MiFID firm when it arranges or deals in a non-readily realisable security, derivative or warrant for a retail client and (through COBS 22.2) where a retail client wishes to buy mutual society shares.

The FCA have not made any substantive changes to the draft rules the FCA consulted on in CP16/29. The question of consistency for insurance-based investment products is being left until the FCA consult on the Insurance Distribution Directive. Regarding the second issue, the distributor is responsible for ensuring compliance with the relevant rules.

Best Execution

FCA’s proposals for implementing the MiFID II best execution rules to both MiFID and non-MiFID business.

Implementing MiFID II best execution standards for MiFID firms

The FCA intend to implement the MiFID II best execution rules for MiFID business, subject to very limited changes to address the minor inconsistencies. The best execution rules will be implemented in the new handbook chapter COBS 11.2A. The FCA have also re-ordered the sequencing of the provisions for greater clarity and readability of the new COBS 11.2A and have moved the provisions relating to UCITS management companies to a separate section COBS 11.2B. As a consequence, the provisions relating to the obligation on investment firms to produce RTS 27 reports on execution quality when acting as market makers or liquidity providers has been re-numbered as COBS 11.2C.

To clarify how some of the MiFID II requirements apply to firms that do not directly execute client’s orders but rather place or transmit client orders for onward execution (i.e. they do not directly execute on a venue), the FCA note that the relevant provisions should
be interpreted in light of Article 65 of the MiFID II delegated regulation. This provision imposes best execution requirements on portfolio managers and firms that receive and transmit orders for execution, and places an obligation on them to provide disclosures in relation to the entities or intermediaries to which they pass orders in the chain of execution. This is consistent with Article 65(6) of the MiFID II delegated regulation, which obliges firms to provide information on the entities it selects for the execution of orders.

The FCA also clarify that Article 27(3) of MiFID II, requiring a firm to inform the client where an order was executed, does not impose a further reporting obligation. Instead, it is referring to the existing reporting obligations in Article 25(6) of MiFID II. New guidance will be included within the Handbook on best execution, and some provisions on COBS 11.2 will be redacted whilst others maintained as applicable to non-MiFID firms.

Application to non-MiFID business

The FCA clarified that best execution obligations already apply to non-MiFID firms and business where it involves the execution of orders, placing orders for execution as part of portfolio management activities, or the reception and transmission of orders to other entities for execution in MiFID financial instruments. As a result, no new provisions have been made by the FCA in relation to such.

Article 3 firms

The FCA previously consulted on extending some of the improved MiFID II best execution standards to financial advisers exempt from MiFID II under Article 3. However, the FCA proposed to do this on a modified basis by exempting them from the obligation to produce an annual report consistent with the RTS 28 publication requirements (under Article 65(6) of the MiFID II delegated regulation).

The FCA will now extend the MiFID II best execution regime to Article 3 financial advisers, as consulted in cp16/29. This means that Article 3 firms will be subject to the enhanced MiFID II best execution standards, aside from the requirement to produce an annual report on execution quality and order routing activities consistent with RTS 28.

Firms should already comply with their current best execution obligations. Going forward, firms must consider how they reflect the enhanced standards, particularly in relation to execution arrangements and polices in their practices, as relevant. Article 3 firms will need to update their execution arrangements to meet the strengthened overarching best execution obligation on firms to take all sufficient steps to obtain the best possible results for clients. Firms will also need to include additional disclosures in their execution policies in relation to costs, fees and venue selection. Article 3 firms are already required to review annually their execution arrangements and policies, so they can reflect any updates in the course of this review. However, given the nature of their services and activities, some of the enhanced best execution requirements will not be relevant to their activities e.g. the obligation to check the fairness of price in relation to OTC products.

Collective portfolio management (CPM) firms

The FCA will continue forward on levelling up non-MiFID CPM firms to the enhanced MiFID II best execution standards where these firms perform economically equivalent activities to MiFID portfolio managers. In this regard, the FCA will:
- apply the MiFID II best execution standards to UCITS management companies subject to some modifications to tailor the provisions for collective portfolio management

- apply the MiFID II best execution standards to small authorised UK AIFMs and operators of residual CISs subject to the modifications as consulted on for UCITS management companies and retaining the current concession in COBS 18.5.4R (which does not apply the best execution rules for non-retail funds for these firms)

- supplement the existing best execution obligations for full-scope UK AIFMs and incoming EEA AIFM branches with the MiFID II best execution reporting requirements on execution quality and order routing behaviour (as set out in RTS

- make consequential changes to the additional COBS best execution provisions (set out in COBS 18.5.4AR) that currently apply to full scope UK AIFMs to reflect the MiFID II changes (while noting that in substance these remain largely the same

**UCITs firms**

In order to maintain consistent standards across both MiFID and non-MiFID investment management activities the FCA has extended MiFID II best execution provisions to non-MiFID CPM activity. The FCA will therefore now level up UCITS management companies to the MiFID II standard in line with MiFID portfolio managers, with some technical modifications as a result of consulting feedback. To clarify further the provisions for UCITS management companies, the FCA have moved the UCITS-related best execution provisions to a separate section in COBS 11.2B.

UCITs management companies will now need to provide information in their execution policies to explain any differences in fees applied to different execution venues such that the advantages and disadvantages of a particular choice of venue are clear.

The FCA clarity that annual reporting requirements in line with RTS 28 under Article 65(6) of the MiFID II delegated regulation and Article 27(6) will apply (as a result of COBS 11.2B.36R) where a firm itself performs portfolio management activities. For delegated portfolio management activities, the burden of compliance with the incremental improvements to the best execution regime should be borne by the MiFID portfolio manager to which it delegates this activity, including the publication of the RTS 28 reports. The FCA note that the RTS 28 reporting requirements apply at the level of the firm rather than with respect to individual funds.

**Full-scope UK AIFMs, incoming EEA branches, small authorised UK AIFMs & residual CIS operators**

The FCA has decided not to extend the MiFID II best execution requirements to full-scope UK AIFMs, incoming EEA AIFM branches, small authorised UK AIFMs and residual CIS operators. This is because the FCA believe professional investors should be sufficiently sophisticated to scrutinise execution performance based on the existing standards that the FCA apply to these firms.

**Client order handling**
MiFID II adds the term ‘trading venue’ alongside ‘regulated market’, which slightly widens the scope of shares subject to the limit order rules, to reflect wider changes to market structure. But MiFID II also allows additional methods for making client limit orders public and clarifies that the choice of venue must be made in line with a firm’s execution policy. The FCA also noted that MiFID II applies client order handling rules when firms advise on or sell structured deposits.

In relation to client order handling, the FCA still finalising amendments to COBS 11.3 and COBS 11.4. The FCA also applied the updated client order handling provisions to certain non-MiFID firms to which COBS 11.3 already applies. This includes investment advisers exempt from MiFID under Article 3 and firms carrying out collective portfolio management, including UCITS management companies, small authorised UK AIFMs and residual CIS operators. It applies where their activity involves the execution of orders, or the transmission or placing of orders in MiFID financial instruments to other entities for execution.

The FCA consulted on maintaining the current disapplication of these rules for non-MiFID corporate finance business, non-MiFID energy and oil market activities and full scope UK AIFMs and incoming EEA AIFM branches.

In relation to record keeping of client orders and decisions to deal, and limit order display transactions, the FCA will:

- delete the existing text in COBS 11.5 and copy the text in the MiFID II delegated regulation into a new chapter entitled COBS 11.5A
- apply the MiFID II record keeping requirements for client orders, decisions to deal, transactions and order processing to Article 3 firms providing retail investment advice
- apply the MiFID II record keeping requirements for orders and transactions as rules to UK branches of third country firms

Applying the MiFID II transaction record keeping provisions to Article 3 retail investment advisers

The FCA will proceed to apply the core MiFID II requirements for the record keeping of client orders, decisions to deal and transactions to Article 3 financial advisory firms. The new measures will require firms to record more granular details on the client instruction, the security traded and the different parties involved in the execution of the order. Firms will also be required to record all necessary order references that will allow their records to be matched to the new transaction reporting requirements applicable to trading venues and the exact sequence of the order execution.

Applying the MiFID II transaction record keeping provisions to third country firms

The FCA have confirmed that UK branches of third country firms will be required to adhere to the same MiFID II record keeping requirements as will apply to MiFID investment firms.

Applicability of MiFID II transaction record keeping provisions to other firms subject to COBS 11.5

For the time being, the FCA have decided not to consult further on extending the MiFID II
requirements on record keeping of client orders, decisions to deal and transactions to firms subject to COBS 11.5. The current arrangements will therefore remain in place. For firms subject to COBS 11.5, the rules have moved to COBS 18 Annex 2.

Personal Account Dealing

MIFID II does extend these provisions to investment firms or credit institutions selling or advising clients in relation to structured deposits. MIFID II does not introduce any changes in the rules currently governing personal transactions compared with MIFID.

MiFID II introduces new requirements for firms carrying out underwriting and placing activities, linked to the MiFID II organisational and conduct requirements. Under the existing conflicts of interest provisions in SYSC 10, the FCA provide some guidance for firms on the management of securities offerings through SYSC 10.1.13G to SYSC 10.1.15G. The new specific MiFID II provisions on underwriting and placing are consistent with the FCA’s existing regulatory expectations under SYSC 10.

MiFID II provisions on investment research and non-independent research are consistent with those currently in COBS 12.2 and 12.3; albeit the following change:

An explicit requirement for firms to introduce a physical separation between financial analysts and other persons whose responsibilities or business interests may conflict with the interests of the persons to whom the research is disseminated.

In these circumstances, the firm is required to establish and implement appropriate alternative information barriers. That MiFID II explicitly applies certain conflicts of interest requirements to producers of non-independent research.

Dissemination of investment research

The FCA remind firms to carefully consider the application of the provisions set out in the new COBS 12.2, particularly in light of requests from some respondents for greater clarity on which provisions apply to producers of investment research and non-independent research. As set out in the new COBS 12.2, the requirement for firms to maintain physical separation between analysts and other persons, as well as the provision stating that analysts should not participate in investment banking activities, apply only to producers of investment research.

Producers of non-independent research should consider their general conflicts of interest obligations under SYSC 10. Firms should also be aware that, in CP17/5, the FCA are consulting on changes to COBS 12 to address conflicts of interest that arise during the production of research around the time that investment banking pitching efforts take place.

It is ultimately for firms to make a judgement on circumstances when it might not be proportionate to maintain physical separation of analysts from other persons and on the types of alternative information barriers that could be maintained when physical separation is not proportionate. Firms should be mindful of their obligations under SYSC 10.2 if establishing and maintaining a Chinese wall, which requires them to have policies in place permitting certain individuals to withhold information from other persons.
As stated in Article 36(2) of the MiFID II delegated regulation and the new COBS 12.2, an investment recommendation defined by Article 3(1) (35) of the Market Abuse Regulation that is not presented as objective or independent must be treated as a marketing communication (non-independent research in COBS 12). As such, any communication that meets the criteria of the definition of an investment recommendation, irrespective of its label (e.g. ‘sales note’) or the medium through which it is delivered, must be classified as investment research or non-independent research. Firms should make reference to section three of The FCA Q & A ESMA’s Q&A MAR.

Client Agreements

MiFID II requires firms to enter into a basic written agreement with professional as well as retail clients, and this must be done for each investment service or ancillary service, not just for new clients. It details what must be included in a client agreement, and simplifies the record keeping requirement, so that the record must be retained for ‘at least the duration of the relationship with the client’, so there is no obligation to keep records for at least 5 years, if longer than the relationship with the client.

Product Governance

The FCA will be publishing their new sourcebook relating to Product governance [PROD] which will contain criteria for manufacturers and distributors. MiFID II, in Article 16(3) and Article 24(2), introduced product governance obligations for manufacturers and distributors; obligations which were further specified in Articles 9 and 10 of the MiFID II Delegated Directive, with the objective of enhancing the level of protection of investors by way of requiring firms to take responsibility, from the beginning, that products and the related services are offered in the interest of clients. A Final report on product governance under MiFID II has been published by ESMA which is currently being reviewed by the FCA to establish what further steps to take to address the guidelines that the FCA have released. This final report which focuses on target market assessment guidelines by manufacturers and distributors can be found here.

PROD sets out our product governance requirements for manufacturers and distributors and applies to firms within the categories listed at PROD 1.3.1R. A firm that complies with PROD does not have to apply the guidance set out in the ‘Responsibilities of Providers and Distributors for the Fair Treatment of Customers (RPPD)’. This is because PROD is intended to achieve the same aims. However the RPPD will remain applicable for firms not within the scope of PROD.

Application of Product Governance rules to MiFID business and distribution firms using the Article 3 exemption.

The FCA have confirmed that a firm must comply with the PROD rules in a way that is proportionate. In such respect firms must comply to the provisions of PROD in a manner that is both appropriate and proportionate, taking account of the nature of the instrument/service and the target market. Firms must take account of the size and nature of the instrument or service and PROD will apply to firms providing portfolio management as this investment service is within the definition of distributing, in accordance with Recital 15 and Article 10(1) of the MiFID II delegated directive. There is no exemption for such a service in MiFID II, but firms should apply these requirements in a proportionate manner that is appropriate to the underlying service. For firms dealing with mass retail products
PROD 3.2.12G sets out how firms should determine target market needs. The FCA have emphasised that firms should take a proportionate and appropriate approach to meeting the PROD requirements. Distributors must take all reasonable steps to obtain adequate and reliable information from non-MiFID manufacturers (PROD 3.3.5R). This obligation applies proportionately depending on the degree to which publicly available information is obtainable and the complexity of the instrument (PROD 3.3.6R).

Product Governance for Non-MiFID firms

The FCA have taken the view that the product governance provisions will apply to Non MiFID II firms as guidance for the purposes of requiring proportionality and appropriateness in the manufacture and or distribution of MiFID products.

The FCA will reflect the FCA’s view that in order to ensure a proportionate application of knowledge and competence requirements, firms should ensure that relevant individuals have the necessary levels of knowledge and competence to fulfil their obligations, reflecting the scope and degree of the relevant services provided.

In addition, the FCA will:

- provide an update to both TC and SYSC content on the FCA website, to reflect the FCA’s guidelines
- introduce a maximum time period of four years during which relevant individuals providing advice or information in a MiFID context need to acquire knowledge and competence
- introduce a minimum time period of six months for such relevant individuals to be considered eligible to have acquired appropriate experience

The extent of which supervision is required by virtue of the guidelines stipulated by the FCA has been a matter of question during the MiFID II consultation 16/29. The level and intensity of supervision should reflect the relevant qualification and experience of the staff member being supervised and this could include, where appropriate, supervision during client meetings and other forms of communication such as telephone calls and e-mails. The FCA’s existing rules within the TC and SYSC are consistent with this principle of proportionate supervision.

Firms should note that compliance with the FCA guidelines require that those individuals who supervise relevant individuals should attain an appropriate qualification as defined by these guidelines and the FCA have amended their new rule in SYSC that implements Article 25(1) of MiFID, to make this clear. On the matter whether such supervision can be completed through outsourcing a third party the FCA are clear of the following view:

Due diligence must be completed prior to a firm outsourcing supervision

Regular risk based evaluation to be conducted by the regulated business as to the effectiveness of the supervision to prevent standards below best practice guidelines. Here the risk based evaluation must take into account the nature, scale and complexity of the firm’s operation

Whilst permitted, outsourcing does not by any way negate the firm’s responsibility and
accountability to ensure all regulatory responsibilities are discharged. Firms cannot delegate any part of this obligation.

Recording of telephone conversations and electronic communications (taping)

The FCA’s domestic taping regime will be replaced by an EU-wide harmonised requirement on firms to record telephone calls and electronic communication when providing specific client order services that relate to the reception, transmission and execution of orders, or dealing on own account.

MiFID II extends the reach of the type of activities and types of firms caught by the taping regime.

FCA’s response on feedback on extending the taping regime to all corporate finance business

MiFID II requires in-scope firms to record telephone and electronic conversations that occur when providing client order services that relate to the reception, transmission or execution of client orders, or when dealing on own account. There will also be an analogous requirement on MiFID optionally exempt firms.

In response to the feedback received, the FCA will not extend the MiFID II taping regime to capture all aspects of corporate finance business, however, the communications occurring during corporate finance business would be in-scope of the taping requirement as long as they are automatically captured by MiFID II.

The focus lies on whether the communication leads to a transaction or reasonable prospect of the transaction being agreed. Firms providing underwriting and placing services are not within the scope of the taping requirement, unless the firm provides client order services alongside these services.

Other communications possibly caught by MiFID II taping requirements include but are not limited to:

- A bank and its corporate and between a bank and sellers related to purchases of securities in buy-back transactions
- A bank selling shareholder and between a bank and buyers relating to the purchase of a block of securities by the bank and the subsequent resale of the securities in a block trade ‘bought deal’ transaction.
- A bank and buyers relating to the re-selling of shares purchase by an underwriting bank when underwriting an issue of securities
- A bank and its clients and the bank and a third-party brokers or sellers in relation to the purchase of securities as part of a stake building exercise

PERG 13.3 and PERG 13 Annex 2 gives further detail on which activities may be within the scope.

Record-keeping obligations

Firms must create and maintain effective records, including when they are providing corporate finance business. SYSC 9 and COBS 11.5A set out the general record-keeping obligations.

On behalf of investment banking it is already common practice to record conversations
relating to market soundings. Conversations relating to material conduct risk are
couraged by the FCA to be recorded, especially if they are provided alongside corporate
finance business and not directly linked to the telephone recording requirements.

**Portfolio management and proposal to remove the qualified exemption available for
discretionary investment managers**

The FCA will extend the MiFID II taping requirements to portfolio management activity
and will remove the current qualified exemption available for discretionary investment
managers. According to the FCA, the current exemption causes many gaps in recordings
which makes it very difficult for the FCA to access the relevant recordings from the sell-
side counterparties as the order may have been placed by multiple brokers across different
venues. The FCA argue that many discretionary managers already record, and as a result
would only incur limited costs in applying these new rules.

The focus of the new regime is on the transactional side of portfolio management, where
conversations that relate to transactions undertaken, or intended to be undertaken, are
required to be recorded. This is similar to the focus of our current regime which defines a
relevant conversation with reference to transactions.

One of the more prescriptive organisational requirements that MiFID II introduces is the
extended retention period for taped records. The FCA do not believe that the increased
retention period will result in significant cost increases for firms who already have a taping
telephony system in place. As such, the FCA have confirmed the requirement to hold
records for a common period of five years after the creation of the record.

**Retail Financial Advisers (RFAs)**

The FCA once again mentioned that the cost of implementing systems would not be as
great as respondents think. Secondly the fact that the number of cases brought forward
to the Financial Ombudsman Service is so low essentially indicates that the wider reaching
power of the taping regime will capture more issues than currently is the case.

The FCA does accept that since the majority of conversations happen on a face-to-face
basis, RFAs should have the possibility to choose between making a written record or
record relevant conversations which would give those firms the opportunity to make cost
effective decisions whilst also preserving investor protection.

Article 3 RFA’s will be permitted by the FCA, irrespective of their size to comply with the
‘at least analogous’ requirement.

Analogous means situations where it would not be reasonable or practical for a client to
contact an adviser on a recorded line, a note could be taken instead which would cover
the relevant parts of a conversation between the firm and a client. In these particular
situations the approach must also be consistent and a call-by-call choice on whether to
record or take notes would not be allowed, eliminating any possible advantage in certain
situations.

**Analogous note**

Firms will not be allowed to rely solely on their current record keeping obligations in
meeting the analogous requirement. Certain details required by the MiFID II delegated
regulation (2017/565) are to be recorded.

In face to face meetings information should include at least; the date, time, location of the meeting, identity of attendees, price, volume, time of execution. These details should be included in the analogous note at least. Notes should capture all main points of the conversation relevant to the order. This will ensure firms do not omit relevant details from the note by providing an accurate record of the conversation. Anything mentioned that could have influenced the client’s decision must be captured. Additionally, sharing these notes with clients to ensure their accuracy would amount to good practice.

**Conversations in scope**

Those that result in transactions being undertaken or intend to be undertaken. It is the intention of the client that matters. They must not be reserving their decision for a later time but must have a clear idea of the actions they wish to take. The clients must know what order they want to undertake and have the capacity to convey this to the adviser. A conversation of an adviser telling a client to take some time to think about a number of factors with regards to a transaction does not need to be recorder, however if the client comes back and expresses their desire to act upon the advice given, the conversation had in this instance would need to be recorded or for analogous reasons, be taken note of as this constitutes a client order.

The details recorded must give an unambiguous account as to what led to the client’s decision, such as whether they thought the advice was appropriate to them and that they wish to continue on that basis. A taped record would capture these details, so a note must do so as well.


In particular, firms will need to assess their regulatory permissions and some Firms may need to assess their entire regulatory approach. CPA Audit can provide advice, help and support with any of these issues.