KEY POINTS
- Detailed stipulations for organisational measures in MiFID II are intended to ensure an increased level of compliance in the investment services sector.
- Firms should consider how they embed the requirements for effective organisational measures within their business and review their compliance function, conflicts management processes, remuneration policies, and product development.
- Senior management and compliance assume greater responsibility for the effectiveness of their firm's organisational structures.

Feature

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MiFID II: regulating investment firms from the inside out

Though considered significant at the time, the organisational requirements of the first Markets in Financial Instruments Directive look today somewhat light touch. The latitude afforded to firms on how to implement a number of broadly posited governance requirements contrasts with the detailed requirements in the MiFID II package. This article looks back to MiFID I and examines some of the gaps investment firms will have to fill in order to comply with MiFID II.

When preparing for MiFID II, it is important to note that core organisational and governance requirements carry over from MiFID I, but execution of those requirements is spelt out in stronger terms and enhanced in certain material areas. A starting point is to consider MiFID I requirements alongside MiFID II.

MIFID I

The MiFID I Directive (2004/39/EC) and its related measures address three main areas:
- market fragmentation and inefficiencies;
- investor protection; and
- harmonisation necessary for passporting.

MiFID I built out these broad themes by talking to conduct of business and organisational requirements across topics that in retrospect look narrow. It requires firms to have:
- A permanent, independent and effective compliance function with policies and "appropriate and proportionate systems, resources and procedures" to ensure continuous and regular services.
- Systems and controls (eg administrative, control and risk assessment procedures) to limit risks when outsourcing critical functions.
- Measures to:
  - prevent and manage conflicts of interest (particularly emanating from investment research); and
  - safeguard clients' assets.
- Sound record keeping practices – so regulators can track compliance.

MiFID I was driven by the challenge of achieving a fully-integrated and open-access securities market alongside an effective passporting regime, with the presumption that once the architecture was in place, compliance and investor protection would follow.

MIFID II AND A POST-CRISIS WORLD

The MiFID II package of measures, made up of Directive 2014/65/EU and Regulation (EU) 600/2014, is the reaction of a legislature that, almost immediately, realised at least two major failings around MiFID I:
- keeping up in the face of rapidly innovating markets; and
- widespread non-compliance.

MiFID II is a more invasive suite of legislation that, in terms of organisational requirements, talks in a prescriptive way to roughly the same scope as MiFID I while also mandating additional requirements with organisational impacts, for example, in relation to senior management responsibilities, remuneration and product design and governance.

Some of these expanded and new organisational requirements are discussed below. The discussion is based on European Securities and Markets Authority (ESMA) consultation papers and technical advice to the European Commission from 19 December 2014 (Final Report). The final requirements are not available at the time of writing.

Conflicts of interest: general requirements

The relevant provisions of MiFID II are in the Directive at Arts 16(3) and 23. In the Final Report, ESMA recommends clarification and supplementation of Art 22 of the MiFID I Implementing Directive (2006/73/EC) (Implementing Directive).

Firms' primary obligations will remain centred on effective organisational arrangements to prevent conflicts of interest from arising in the first place, with disclosure as a tool of last resort. When there is an insurmountable conflict, ESMA recommends that Art 22 is clear that disclosure must include a statement that the firm's organisational and administrative measures are insufficient to prevent risk of damage to client interests.

Disclosure must take into account the nature of the client receiving it and be in a durable medium, regardless of the client's categorisation. It must include a specific description of the conflict as well as the risks it engenders and steps taken to mitigate that risk. These more detailed requirements mean that disclosure is unlikely to satisfy MiFID II's standards if it takes the form of a template notification of generic conflicts.

In the Final Report, ESMA recommends that firms review their

conflicts policies at least annually. ESMA conflates this requirement with its Final Report's advice that firms' compliance functions report annually (see below), and this works alongside other, enhanced areas of responsibility for that function (see *Product Governance* below).

Conflicts of interest: analysts

While the Final Report concludes that the distinction drawn between true investment research and marketing communications in the Implementing Directive is sufficiently clear, and does not require any amendment, it does make two, potentially far reaching recommendations.

Firstly, ESMA suggests that marketing communications and those who produce them should be subject to Art 25(1) of the Implementing Directive. This would result in firms effecting measures designed to ensure an appropriate level of independence for those producing marketing communications that come within the definition of recommendations in Directive 2003/125/EC.

The Final Report also recommends amendment of the Implementing Directive to insert a new provision requiring the physical separation of analysts from those whose interests may conflict with the interests of the recipients of the research. Firms may, on proportionality grounds, establish "appropriate alternative information barriers".

It is important that ESMA's starting point for organisational requirements is physical separation as well as a wider application of concepts of independence as this puts the onus on the firms to demonstrate it would be more proportionate to deploy less onerous "alternative information barriers". Firms should review and potentially revise their approach in these areas.

The compliance function

Again, at first blush, the provisions of MiFID II differ little from those of MiFID I (at Art 6). Article 16(2) of the MiFID II Directive requires the establishment of adequate compliance policies and procedures, and ESMA's Final Report recommends the integration and modification of existing Art 6 of the MiFID Implementing Directive. Article 6 mandates policies and procedures as well as the establishment of an independent compliance function, and ESMA recommends including an obligation to report to management at least annually on the overall control environment and identified risks, as well as to monitor and report on complaints handling (though note that the Implementing Directive at Art 9 already includes requirements that senior management must receive annual compliance reports showing remediated matters). ESMA also proposes that the monitoring obligation be "on a permanent basis", which is at least a more emphatic statement of the function's obligations.

For MiFID firms, regulators will expect that the operational approach and effectiveness of the compliance function, in addition to overall firm governance, be reviewed against the subtle adjustments required by MiFID II.

Product governance

MiFID II's direct intervention in both the manufacturing and distribution of financial instruments and responsibility for product governance marks a significant departure from MiFID I. Product governance obligations operate as distinct obligations that apply without prejudice to any assessment of appropriateness or suitability that is required during the sales process.

Looking at those obligations, in Recital 71, Art 16 and Art 24, the MiFID II Directive requires firms to identify and understand the clients to whom products and services are to be provided, and, when manufacturing financial instruments, ensure that the needs of that target market are identified, understood and reflected within the product's design. In particular, Art 16 requires firms that manufacture financial instruments to maintain, operate and review a process for the approval of both new financial instruments and "significant adaptations" of existing financial instruments before the product is either marketed or distributed. The product approval process must identify the target market and ensure that both the distribution strategy for and risks that attach to that market segment are assessed.

Article 16 places product design requirements within the context of a firm's obligations to organise and operate itself with a view to preventing conflicts of interest, and ESMA's Final Report suggests that management must have effective control over the product governance process. Further structural requirements include that the compliance function oversees the development and periodic review of product governance arrangements, specifically in order to detect any compliance failures by manufacturers. In the UK, when considering what may be a reasonable strategy, firms can look to guidance given by the Financial Conduct Authority (FCA) in its paper TR15/2: Structured Products: Thematic Review of Product Development and Governance.

Remuneration

While MiFID I does not specifically address remuneration, in June 2013, ESMA published "*Guidelines on remuneration policies and practices (MiFID)*" (ESMA/2013/606). MiFID II essentially codifies these Guidelines by introducing a new obligation at Art 9(3)(c) requiring management to "define, approve and oversee" a remuneration policy that encourages responsible conduct and the fair treatment of clients, while also avoiding conflicts of interest.

Within the conflicts of interest provisions at Art 23(1), MiFID II requires firms to identify, prevent and manage conflicts engendered by remuneration and other incentive structures. Article 24(10) adds another layer as remuneration or assessment of the performance of staff should not be done in a way that conflicts with clients' best interests. In particular, this means that targets or other measures that inappropriately incentivise sales of

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particular financial instruments should be reviewed. In the UK, the FCA released GC 15/1 on performance management, which may help firms navigate this point, when finalised.

ESMA's Final Report suggests management should approve the remuneration policy after taking advice from the compliance function. Expanding on this, ESMA makes senior management responsible for "day-to-day implementation … and the monitoring of compliance risks related to the policy". Of course, many firms will already be well rehearsed on remuneration issues and the FCA has recently proposed generally applicable requirements that cut across non-MiFID firms based on MiFID II's remuneration standards (FCA Discussion Paper 15/3).

CONCLUSION

These non-exhaustive examples demonstrate how MiFID II adds detail, prescription and responsibility to existing organisational requirements and looks to expand into new and significant areas. Responsibilities fall heavily on management and compliance, indicating an era when regulators look to both compliance with rules and how that compliance is achieved. Given the degree and rapidity of recent regulatory change, MiFID I implementation in practice arguably did not require extensive modifications to business models and practices. In some quarters, the results are considered disappointing; the legislature is looking for an altogether different scale of shift by 3 January 2017. ■

Further Reading:

- MiFID II and the AIFMD: Is an onshore model for third country asset managers inevitable? [2014] 8 JIBFL 497.
- MiFID II: the hoops and hurdles which will restrict access to the EU market [2014] 4 JIBFL 252.
- LexisPSL: Financial Services: MiFID II and MiFIR essentials.