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# *Flash News*

## ESMA releases its Final Technical Advice on MiFID II/MiFIR

*20 January 2015*

On 19 December 2014, ESMA delivered its final Technical Advice (TA) regarding the implementation of MiFID II and MiFIR to the European Commission (EC) who will use it to prepare its delegated legislation. ESMA also launched a consultation on draft regulatory technical and implementing standards (RTS/ITS) covering mainly MiFIR topics.

### Background

The **Markets in Financial Instruments Directive II (MiFID II)** and **Regulation (MiFIR)** voted on 15 April 2014 entered into force on 2 July 2014.

These new texts intend to address a number of shortcomings of the initial MiFID framework as well as some sources of systemic risk which became apparent during the financial crisis.

**ESMA's TA and draft RTS/ITS** seek **to translate Level 1 (MiFID II and MiFIR)** requirements on **investor protection and markets topics into implementing rules**. The guidelines and technical standards to be published to achieve the objectives and goals proclaimed by the EU are in fact substantial. There will be more than 60 additional guidelines and technical standards expected on Level 2 and Level 3 of the implementation until June 2016.

### ESMA Final Technical Advice on investor protection topics

The highlights of the TA include the following:

***Third party inducements***

**Firms providing independent advice and portfolio management** are not allowed to *receive* third party inducements except minor non-monetary benefits under certain conditions.

ESMA (1) provides a **definition of minor non-monetary benefits** (2) proposes to introduce an **exhaustive list** of these benefits and (3) specifies the treatment of **financial research**. The provision of research is not to be considered as an inducement if it is received in return for direct payments by the firm out of its own resources or payments from a separate research payment account controlled by the firm under certain conditions.

**In all other cases, firms providing investment or ancillary services** are allowed to *pay and receive* third party inducements under certain conditions, among which **enhancement of the quality criteria** of the inducements:

ESMA advises to introduce a **non-exhaustive list** of situations where this quality enhancement test is not passed. The list that ESMA had initially drawn up had raised great concern, some viewing it as introducing a de facto ban of inducements.

ESMA has amended the list and has removed the situation where the inducement is "*used to pay or provide goods or services that are essential for the recipient firm in its ordinary course of business*".

An inducement is now considered as **not** enhancing the quality of the service if:

- it is not justified by the provision of an additional or higher level service to the client, proportional to the level of inducements received (e.g. the provision of non-independent advice combined with a periodic assessment of suitability of the products the client has invested in),
- it directly benefits the recipient [...] without tangible benefits to the client,
- in relation to an on-going inducement, it is not justified by the provision of on-going benefit to the relevant client.

The final report gives examples of higher quality service situations that aim at encouraging the provision of high quality non-independent advice, the assessment of a wide range of financial instruments (in favour of open architecture) or the provision of post-sale services by firms to clients.

***Disclosure of costs and charges to clients***

ESMA advises to **extend the scope** of the obligation to inform clients on costs and charges to **professional clients and eligible counterparties**. It provides for the possibility for firms to agree on a limited application of such obligation for these clients, except when the financial instruments embed a derivative or when services of investment advice or portfolio management are provided to professional clients.

ESMA gives further specifications regarding the firms subject to the disclosure obligation and the **costs and charges to aggregate and disclose**.

As regards UCITS, ESMA recommends to the European Commission to consider UCITS KIID to be sufficient, with the possibility of requiring the disclosure of costs and charges that are not included in the UCITS KIID. Transaction costs should be calculated and disclosed by the firm if not provided by the UCITS management company.

## *Independent investment advice*

ESMA clarifies the **selection process** that independent advisers have to set-up to assess and **compare** a sufficient range of sufficiently diverse financial instruments. The process must include elements such as a diversified selection of products by type, issuer, or product provider or criteria of comparison such as costs, complexity and the characteristics of the clients.

ESMA also specifies (1) the conditions under which a firm providing independent advice is allowed to focus on certain categories or a specified range of financial instruments and (2) those under which a firm **can provide both independent and non-independent advice.** In that case, the firm must not hold themselves out as "independent" for their business as a whole and ensure a **clear separation between both type of advice services and advisers (physical persons).**

## *Product governance*

ESMA clarifies the product governance obligations of manufacturers and distributors.

**Manufacturers** have to identify the **target market at a *"sufficient granular level"*** to avoid the inclusion of investors for whom the product is not compatible, conduct a **scenario analysis** of the product, analyse the charging structure and perform a **regular review of existing products** to identify crucial events that affect the potential risk or return expectations.

**Distributors** have to ensure that the products and the intended distribution strategy are consistent with the identified target market, identify the investors for whom the product is not compatible and perform regular review of the products distributed to ensure the **continued consistency of the product and distribution strategy**.

ESMA specifies that product governance requirements **apply to MIFID firms**. As regards **UCITS management companies and AIFM "with extended scope"**, product governance **only apply for the MiFID service**.

ESMA advises to **clarify the scope of application** of these obligations. The obligations for distributors shall apply even if the products are issued by entities out of MiFID scope. When the **manufacturers are non-MiFID firms and third-country firms**, including UCITS management companies and AIFMs, distributors shall take all reasonable steps to ensure that the product information they obtain from them is of reliable and adequate standard to ensure the consistency of the distribution strategy with the target market. If no information is publicly or otherwise available, distributors shall conclude an **agreement with the manufacturer** to ensure that it will provide the information.

## ESMA Final Technical advice and Consultation papers on markets aspects

The highlights of the TA include the following:

### *Market integrity*

The criteria for the **product intervention** are not made more specific in the final technical advice. The investor protection concern and the potential threats to the orderly functioning and integrity of the markets are still the primary concerns of ESMA. However, ESMA considers that the list of criteria is not exhaustive for NCAs when they assess the need for an intervention.

The assessment of the **liquidity of a market** is extensively discussed. ESMA notes that there are still reasons for allowing Member States to specify additional financial instruments (equity and equity-like) as being liquid, even if they do not fulfil the criteria laid down in MiFIR. Based on the responses to the consultation paper, ESMA has also amended the definition for **money market instruments** to provide a sharper delineation between bonds, structured finance products and money market instruments.

### *Systematic internaliser regime*

Amendments have been also done on the **systematic internaliser** definition. ESMA still thinks that investment firms should assess their systematic internaliser activity on a quarterly basis. To make the calculation less sensitive to episodic internalisation, ESMA proposes to calculate the thresholds based on data from a longer rolling period, i.e. 6 months. The assessments by investment firms should be performed at pre-defined dates.

In addition, ESMA has doubled the timeframe for firms to comply with all the systematic internaliser regime obligations: ESMA now believes that 2 months should provide sufficient time in this respect instead of the former 1 month in the consultation paper.

### *Transparency regime*

Regarding the best execution policy, ESMA has amended its advice in order to provide more clarification on the term “fairness” in relation to OTCs. **The execution policy for investment firms** requires providing the list of execution venues and entities used for each class of financial instrument (**Transparency of execution venue selection**).

MiFIR requires a systematic internaliser **to execute its orders at the quoted prices at the time of the reception of the order** (equity-like instruments). However, orders received from their professional clients at prices different to the quoted ones can also be executed in case of some preconditions met. Based on questions received by the respondents from the consultation paper, ESMA has confirmed that transactions where a transfer of ownership between two counterparties occurs in the context of a repo transaction or the borrowing/lending of a financial instrument shall not be considered as transactions providing information as to level of trading interest. Accordingly, they will not fall into the **transparency regime**.

Besides that, ESMA also clarifies the **portfolio trades**: ESMA is of the view that ten financial instruments should remain the minimum number to qualify for a portfolio trade, which are exempted from **pre-trade transparency.**

For the **newly introduced pre-trade rules for systematic internalisers** in non-equity instruments, ESMA advices the European Commission that the size specific thresholds established for liquidity providers trading on request for quote and voice trading systems shall also apply to systematic internalisers.

### *Financial instruments*

ESMA clarifies the commodity derivative definition. **Wholesale energy products** within the scope of REMIT that are traded on an OTF and that must be physically settled do not fall into financial instrument definition. As this has an implication on the obligations arising from EMIR and CRD IV, the energy derivative contracts and the term "**must be physically settled**" are clarified in the technical advice.

Unfortunately, no clear delineation for the spot definition is made. Some respondents have requested an additional survey from ESMA in respect of the open discussion between the **delineation of FX spots and forwards and the term "commercial purpose"**, which has as well an impact on the EMIR reporting obligation. ESMA proposes maintaining the current definition while keeping the option open of looking at this topic again via future Guidelines, once MiFID II reaches the implementation stage.

## Next steps

Many texts are yet to be adopted. The key next steps for the complete adoption of MiFID II/MiFIR regime are the following:

- **Q1-Q2 2015:** Delivery of ESMA RTS to the EC for endorsement,
- **Q2 2015:** Drafting of Delegated acts by the EC,
- **Q1 2016:** Delivery of ESMA ITS to the EC for endorsement,
- **Q2 2016:** Transposition in national laws,
- **Q4 2016:** Application of new rules for firms in scope.

Our PwC Regulatory Watch services will keep you updated on any upcoming MiFID II/MiFIR-related developments. Impact assessment notes and technical papers can be regularly delivered to you by our in-house regulatory experts.

***For more information, please contact us:***


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|---|---|---|---|
| Olivier Carré | MiFID II Leader | +352 49 48 48 4174 | olivier.carre@lu.pwc.com |
| Emmanuelle Caruel-Henniaux | Regulatory Banking Leader | +352 49 48 48 2111 | emmanuelle.henniaux@lu.pwc.com |
| Cécile Liégeois | Regulatory & Compliance Advisory Partner | +352 49 48 48 2245 | cecile.liegeois@lu.pwc.com |
| Jorg Ackermann | Financial Services Consulting Partner | +352 49 48 48 4131 | jorg.ackermann@lu.pwc.com |
| Lionel Nicolas | Financial Services Consulting Partner | +352 49 48 48 4172 | lionel.nicolas@lu.pwc.com |


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