

# MiFID II

Governance and organisation





# MiFID II planning and implementation is a top priority for asset managers affected by European regulations and brings with it both challenges and opportunities.

## What are the new governance requirements under MiFID II?

Provisions which were previously imposed on the management bodies of banks under the Capital Requirements Directive (CRD IV) will be extended to investment firms under MiFID II.

Management bodies are required to be of sufficiently good repute, possess collectively sufficient knowledge, skill and experience and commit sufficient time to performing their functions. Management bodies should also be sufficiently diverse in terms of age, gender, origin, education and profession in order to avoid group thinking. They are responsible for oversight of a firm's strategic objectives, risk strategy and internal governance, including defining and overseeing human resources, policies and products, and remuneration, and are accountable for the implementation of governance arrangements with a view to preventing conflicts of interest and in a manner that promotes the integrity of the market. In taking decisions the management body must take into account:

- The firm's risk tolerance.
- Clients' needs and characteristics.

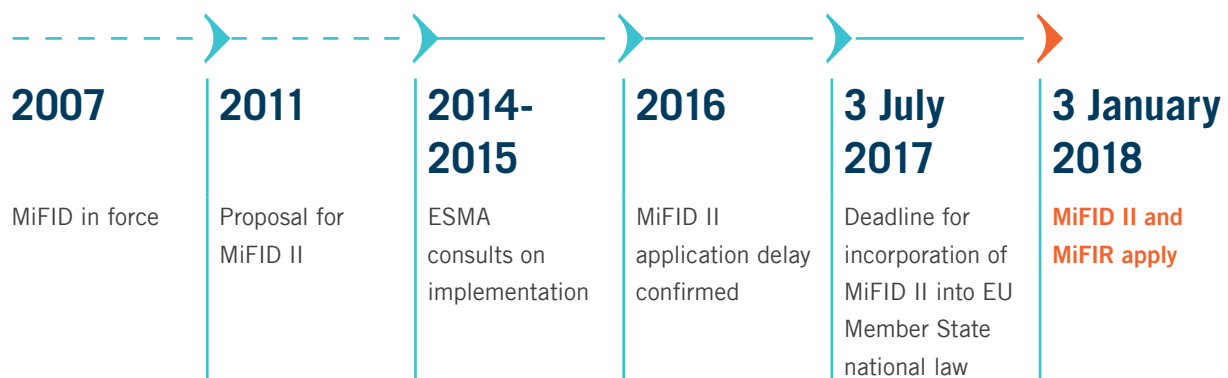
The management body must have adequate access to information and documents to fulfil this role properly.

In addition, the limitations on number of directorships under CRD IV will now also apply to MiFID regulated firms. Members of the management body of a "significant" investment firm will not be able to hold at the same time more than:

- One executive directorship and two non-executive directorships; or
- Four non-executive directorships.

For these purposes directorships held within the same group are a single directorship. As with CRD IV, competent authorities may permit members of management bodies to hold one additional non-executive directorship. In addition, firms may not combine the role of CEO and chairman without justification and specific regulatory approval.

Institutions which are significant in terms of their size, internal organisation and the nature, scope and complexity of their activities must also establish a nomination committee composed of non-executives to review and make recommendations in respect of the composition of the management committee. The management body must also monitor and review (at least annually) the adequacy and implementation of the firm's strategic objectives, the effectiveness of the firm's governance arrangements and the adequacy of the policies relating to the provision client services.



## What are the new organisational requirements under MiFID II?

The organisational requirements under MiFID II aim to ensure that regulated investment firms operate with a high level of integrity, competence and soundness. MiFID II includes a new product governance regime and increases the scope and detail of the compliance, risk and audit functions that a firm's internal policies and procedures need to cover. Certain new provisions are summarised below.

### Product governance

Explicit procedures for product governance are now required for investment firms that manufacture, distribute or recommend financial instruments to clients.

Manufacturers of financial instruments must maintain, operate and review a product approval process of each financial instrument before it is marketed or distributed to clients and ensure that staff manufacturing possess the necessary expertise to understand the characteristics and risks of the financial instruments. Manufacturers must take reasonable steps to ensure that each financial instrument is distributed to its identified target market.

Distributors must have in place adequate arrangements to obtain information on the product approval process, and to understand the characteristics and target market of each financial instrument (as well as any services marketed). The rules apply regardless of client type, although the Delegated Directive provides that the approach to compliance may be proportionate and appropriate, taking into account the target market for the product.

AIFM and UCITS management companies, otherwise outside the scope of these rules, will be affected by virtue of the requirements attaching to distributors.

Investment firms must regularly review the financial instruments offered or marketed to assess whether they remain consistent with the needs of that market and whether the distribution strategy remains appropriate. Distributors must provide manufacturers with information on sales to support manufacturers' product reviews.

### Data security

MiFID II has added requirements relating to sound mechanisms for the security of data which are new to the existing requirements for firms to have effective control and safeguard arrangements for information processing systems. These include mechanisms to:

- Guarantee the security and authentication of the means of transfer of information.
- Minimise the risk of data corruption and unauthorised access.
- Prevent information leakage and maintaining the confidentiality of the data at all times.

### Record-keeping

MiFID II includes new rules on recording telephone and electronic communications relating to transactions when dealing on own account and providing client services that relate to the reception, transmission and execution of client orders (whether or not those transactions actually conclude). Investment firms must notify new and existing clients of the telephone conversations or communications that may be recorded (and that copies of such recordings are available upon request) before accepting client orders by telephone.

MiFID II goes beyond the existing FCA regime, including requiring:

- "Relevant" internal telephone and electronic communications to be recorded.
- Face-to-face conversations with clients to be recorded (including by written notes).
- Records to be kept for five years (or, where requested by the regulator, up to seven years) in contrast to the current six months under the FCA's current regime.

Records must be stored in a durable format that does not permit alteration or deletion and must be capable of replay or duplication.

A firm's telephone recording and electronic communications policy should be proportionate and should cover in scope communications and recording procedures (including specific information in respect of in person meetings). The policies should be technology neutral and should prevent the use of private devices except in exceptional circumstances.

Effective oversight and control over these policies and procedures must be evidenced by the management body and firms must periodically monitor their records on a risk based and proportionate basis to ensure compliance.

In the UK, the FCA has indicated that it will remove the existing discretionary investment management exemption, bringing discretionary investment managers fully within the scope of the rules as well as extending the MiFID

II regime to AIFMs, UCITS management companies, financial advisors, corporate finance firms and firms engaging in oil and energy market activities.

### **Complaints handling**

The complaints handling requirements have been extended to apply to complaints received from all clients (rather than just retail clients) under MiFID II. The rules are more prescriptive, with a new requirement for firms to establish a complaints management function, which may be carried out by the compliance function.

An investment firm must provide details of the complaints process (including information regarding the firm's complaints policy and the contact details of the complaints management function) to clients or potential clients, either on request or when acknowledging a complaint. Firms must reply to complaints without delay using plain language and communicate to the client the firm's position in respect of the complaint and the client's options (which might include referring the complaint to alternative dispute resolution or taking civil action). Information on complaints and complaints handling is now also required to be provided to the firm's competent authority, though this is already the case for FCA firms in respect of retail clients.

### **Compliance function**

The compliance function is required to meet new requirements to report at least annually to the management body on the implementation and effectiveness of the overall control environment for investment services and activities, on the risks that have been identified and on complaints handling reporting as well as any remedies undertaken or to be undertaken. The compliance function must also report directly to the management body where it detects a significant risk of failure by the firm to comply with its obligations under MiFID II.

The compliance function is also required to exercise greater oversight over the complaints handling process and use it as a source of relevant information in the context of its general monitoring responsibilities, specifically analysing complaints and complaints handling data in order to ensure that any risks or issues are identified and addressed.

MiFID II specifies that the monitoring of the adequacy and effectiveness of the compliance measures, policies and procedures put in place should be undertaken on a "permanent" basis (MiFID I was silent on the frequency).

### **Outsourcing**

The MiFID II requirements in respect of outsourcing remain substantially the same. However, MiFID II clarifies that the outsourcing firm needs to retain the necessary resources and expertise in order to effectively supervise the third party service provider and must be able to ensure continuity in the event of termination by either taking on the functions itself or appointing another third party. It also includes content requirements for the written agreement which must be put into place between the firm and the service provider, including: provisions relating to instructions; termination; right to information, inspection and access to records; and consent to further outsourcing. The firm must be able to terminate the outsourcing arrangement immediately where this is in the interest of its clients.

In addition, where the outsourcing is of portfolio management services to a third country service provider: (i) such service provider must be subject to supervision by its local regulator; and (ii) there must be a cooperation agreement meeting specified requirements between the competent authority of the firm and the local authority of the service provider. This requirement is no longer limited to services in respect of retail clients and the ability of the firm's competent authority to consent to the outsourcing arrangement in the absence of the requirements at (i) and (ii) is no longer available.

### **Responsibility of senior management**

Responsibility for oversight of the firm's organisational requirements must be clearly allocated as a significant function to one or more senior managers and records of the allocation of significant functions should be kept up-to-date.

### **Next steps for investment firms**

Certain firms for the first time will become subject to the corporate governance requirements of CRD IV and work may need to be undertaken to demonstrate compliance with these rules by January 2018 (which may include making changes to a firm's board and ensuring a nominations committee is established).

Investment firms should be reviewing products they currently manufacture/distribute/recommend, including assessing their respective target markets and client types. Where third party distributors are engaged, distribution agreements and any sub-distribution agreements should include obligations on distributors to provide sales information in order to allow product

manufacturers to review their products and on product manufacturers to provide product information to distributors. Firms that collaborate in product manufacturing should consider what agreements they will need to implement.

Firms should take a broad approach in determining which communications should be recorded given the scope of the directive (which may require investment in new technology or retention of a third party provider). Firms must ensure systems are in place to advise clients of the firm's recording and record keeping policy prior to the provision of reception, transmission or execution services. To the extent that they do not already do so, investment management agreements will need to be amended to permit recording of telephone conversations and electronic communications. Updates to data security systems and privacy policies should also be considered.

Firms should be reviewing their complaints handling policies and procedures to ensure that they are compliant with the new MiFID II rules and appoint appropriate individuals to perform the complaints handling function. Compliance policies should also be reviewed in light of the new reporting requirements and the interaction between compliance and the complaints handling process. Responsibility for organisational requirements should be allocated to an appropriate member of senior management and the record of allocation functions should be maintained.

Firms which outsource critical or important functions should ensure that they have in place a written agreement compliant with the content requirements under MiFID II and that any outsourcing of portfolio management functions to a third country service provider fulfils the requirements relating to supervision and cooperation agreements in MiFID II.



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