

# MiFID II and PRIIPs: The final countdown begins



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It is now less than two months until the 3 January 2018 compliance deadline for the revised Markets in Financial Instruments Directive (MiFID II) and the 1 January 2018 compliance deadline for the EU Packaged Retail Investment and Insurance-based Products (PRIIPs) Regulation. Given these impending deadlines, we set out some of the key considerations investment managers should be thinking about in the lead up to implementation.

## PRIIPs Regulation

The PRIIPs Regulation will apply to alternative investment funds (AIFs) which are made available for investment by EU retail clients (as defined in MiFID II, see below) after 31 December 2017. UCITS funds are also in scope but will benefit from a transitional exemption until 31 December 2019.

Where it applies, the PRIIPs Regulation will require that a three-page, standardised key information document (KID) is made available to EU retail investors pre-investment. The PRIIPs KID must include projections of future performance in four specified market scenarios, as well as information on costs, but it is prohibited from including any past performance information.

Accordingly, firms which currently make their alternative investment funds (AIFs) available for investment by EU retail investors – including indirectly through IFAs or other intermediaries – will need to decide whether to close their funds to EU retail investors after 31 December 2017 or prepare KIDs for use from 1 January 2018.

We would be happy to advise you on how to comply with the PRIIPs Regulation, including which funds will be in scope and what measures to take in relation to your websites, as well as assisting you with drafting and/or reviewing your draft KIDs.

Read Dechert OnPoint: [An Update on the Regulation on Key Information Documents for Packaged Retail and Insurance-Based Investment: Key Points for EU and Non-EU Asset Managers](#).

## MiFID II implementation

It is likely that you will have by now conducted your scoping exercise to assess which requirements are relevant to your firm and how any non-EU companies in your group may be indirectly impacted, for example, through EU trading venues and/or counterparties. Consequently, now will be the time to focus on putting that scoping plan into action. This may include updating relevant marketing documents/pitch books, offering and fund documentation, delegation and service provider arrangements, internal procedures and staff training, regulatory reporting and other areas impacted by MiFID II. As a reminder, we have listed some of the key areas that we are currently advising our clients on in respect of the final stages of their implementation projects.

**Please also see our [MiFID Hub](#) for further detail on key topics.**

## MiFID II scope and application to UCITS and private fund managers

Whilst neither UCITS management companies (ManCos) nor full-scope alternative investment fund managers (AIFMs) (including hedge fund and private equity/debt fund managers) are authorised under MiFID, where they conduct certain MiFID “top up” activities (e.g. managing a separately managed account), then certain MiFID II provisions apply. In addition, UCITS ManCos and AIFMs which distribute their products through MiFID firms will be indirectly impacted by MiFID II’s new product governance rules. In such instances, you will need to think about updating prospectus language to include information to help MiFID-regulated distributors comply with the

MiFID II product governance regime, including information on the target market and costs and charges. In many cases these will represent new disclosures for firms. In addition, UCITS ManCos and AIFMs may also wish to consider whether any additional updates are required with regard to their 'know your distributor' (KYD) diligence procedures and any potential impact on business plans. Finally, AIFMs may also wish to consider updating their investment management agreements to include provisions which are applicable as a result of national regulators gold-plating certain requirements.

Further consideration will need to be given with respect to how MiFID II should specifically apply to your business model. Primarily, this would include provisions relating to best execution, independent investment advice, inducements, product governance, client classification and telephone taping requirements. You will need to think about updating relevant documentation and internal processes with regards to these requirements, whilst taking into account that not all of your activities may necessarily fit squarely into the box of regulatory guidance provided, consequently requiring more specificity in your internal compliance material reflecting your business model.

### Considerations for non-EU firms

Whilst non-EU firms are not directly in scope of MiFID, non-EU entities need to consider the potential

impact of MiFID II on certain aspects of their business, including where they delegate to a MiFID entity or vice versa, or where they execute trades with or through a MiFID entity. In such instances, non-EU firms need to consider the potential cross-border impact of MiFID II, including their use of "softed" research and relevant inducement rules, best execution requirements or product governance rules.

As set out in our recent [asset management regulatory round-up](#), it is helpful that the SEC has now issued no action letters which permit payment to US broker-dealers for research using cash ("hard dollar"), instead of on a bundled "soft dollar" commission basis (see Inducements – the use of research below). If you are a member of the UK's Investment Association, you may also find it helpful to view their recent guidance with respect to the use of research and intra-group arrangements.

We note that the MiFID II Product Governance guidance is a key impact area for business conducted on a cross-border basis. For example, EU distributors distributing non-EU funds will now need information on the positive and negative target markets of non-EU funds they distribute. This may mean updating prospectus language, distribution agreements and also updating internal systems and controls to ensure that the relevant information is being shared appropriately with any contracting EU MiFID entity

## Implementation across Europe

### Implementation in the UK

National regulators (such as the UK Financial Conduct Authority (FCA)) may gold-plate certain areas of MiFID II. For example, the FCA has stated that certain MiFID II requirements will also apply to UCITS ManCos and AIFMs when managing UCITS or AIFs.

We would be happy to advise you further on how MiFID II has been implemented in the UK, including on the gold-plated areas that will apply to AIFMs and UCITS ManCos when managing AIFs and UCITS, such as telephone taping.

### Implementation in Germany

The German regulator BaFin issued a draft of the updated key MiFID compliance guidance (MaComp) in which it implemented the new code of conduct rules for investment firms and branches of EU firms but also added further sections on suitability requirements, commissions, inducements and complaints handling.

Also German distributors started pushing on receiving key target definition data from asset managers. Although the European MiFID template (EMT) endorsed by the European Fund and Asset Management Association is the standard document for the transfer of the data, German distributors expect to be able to download the relevant data from specific German data providers which requires fund managers to transfer the data to these providers and to deal with mapping requirements between the EMT and the specific data fields of the data provider.

### Implementation in France

Whilst the legislative implementation of MiFID II is complete, the L'Autorité des marchés financiers (AMF) General Regulations have been partly modified and certain sections are subject to an ongoing public consultation. The AMF has published several guides with respect to MiFID II (Guide for Asset Management Companies, Guide for Financial Advisors (which is a regulated French national regime) and Guide on the funding of research).

We do not anticipate that the French distribution market will change drastically pursuant to MiFID II and we anticipate that few distributors will declare themselves independent. As a result, one of the key issues with respect to MiFID II for French distributors is the possibility to continue receiving commissions or 'retrocession fees' when distributing a private equity closed-end fund on a non-independent basis (i.e., what additional or higher-level service can be provided to the client on an on-going basis).

### Implementation in Ireland

MiFID II has been transposed into Irish law and will be effective in Ireland from 3 January 2018. The Central Bank of Ireland has indicated that it is not seeking to impose any gold-plating requirements or provide guidance or interpretation in relation to MiFID II.

In Ireland, the primary impact of MiFID II is expected to be in relation to UCITS ManCos and AIFMs that have contracted with MiFID-authorized entities to provide services in respect of Irish UCITS and AIFs as part of a delegation model framework. This includes (a) MiFID authorised asset managers appointed as investment manager to UCITS/AIFs and/or (b) MiFID authorised distributors to whom the UCITS/AIF product distribution function has been delegated. UCITS ManCos/AIFMs will be impacted because the relevant service provider will need information and other support in order to meet its obligations under MiFID II. UCITS Mancos and AIFMs which are authorised to carry out MiFID investment services will be directly impacted.

We would be happy to advise you further on how MiFID II has been implemented in Ireland and in particular on how it may impact your UCITS/AIF.

## Implementation in Luxembourg

The Luxembourg government deposited a bill of law with Parliament on 3 July 2017 (the MiFID Bill) which will transpose MiFID II and implement MiFIR in Luxembourg. The MiFID Bill does not currently provide for any gold-plating. The main part of the implementation will be achieved by amending the Luxembourg law of 5 April 1993 on the financial sector, as amended. Other implementing acts will be introduced through amendments to various laws and a re-setting of the law of 13 July 2007 on markets in financial instruments, as amended, as well as lower-level legislation and regulation. As of the date of this publication, neither the Commission nor the State Council (Conseil d'Etat) has yet provided an opinion on the MiFID Bill. The timeline for the implementation – with a deadline of 3 January 2018 – seems extremely tight, bearing in mind that: (a) the implementation for MiFID I took more than eight months in Luxembourg; (b) MiFID II is even more complex; and (c) implementation includes delegated national acts that will depend on the final law. Consequently, it may very well be that the process of implementation continues after 3 January 2018.

## MiFID II – A reminder of key areas

Key areas of MiFID II are summarised out below.

### Best execution and reporting to clients

The requirement to seek best execution under MiFID I will be built upon under the new directive. Key changes include a requirement to take all sufficient steps to obtain best execution and publishing data on the quality of execution. Consequently a gap analysis of your firm's existing order execution policy against the new requirements, in combination with an assessment of how to disclose and monitor the new disclosure requirements, should be undertaken.

[Download our fact sheet on best execution.](#)

### Product governance

The new product governance requirements apply to MiFID firms which create, develop, issue and/or design financial instruments (referred to as “manufacturers”) and to MiFID firms which distribute financial instruments, structured products and investment services, including separately managed account services, to clients. A MiFID firm involved in both the manufacture and distribution of such products will need to apply both sets of requirements. AIFMs and UCITS ManCos, which are otherwise outside the scope of these rules, may be indirectly affected by virtue of the requirements attaching to distributors. This is also true for investment firms that collaborate (including entities not subject to MiFID II) in manufacturing such products, who are now required to outline their product governance responsibilities in a written agreement, as are third country investment firms marketing financial instruments through an EEA MiFID investment firm. In addition, the FCA's PROD sourcebook applies these rules as non-binding guidance to UK AIFMs and UCITS ManCos.

Investment firms should be reviewing products they currently manufacture/distribute/recommend, including assessing their respective negative and positive target markets and client types.

[Download our fact sheet on product governance.](#)

## Transaction reporting

Under MiFID I, transaction reporting applied only for transactions executed in financial instruments admitted to trading on a regulated market, plus any OTC contract which derives its value from any such instrument. Under the new directive and implementing regulations, instruments fall in scope if executed on a “trading venue” (i.e. regulated market, multi-lateral trading facility or organised trading facility) and “execute” and “transaction” are now defined. Further, the amount of data that must be reported is greatly increased, from 23 to 65 reporting fields. As a result a much broader range of transaction reporting data will need to be captured. It will remain possible for asset management firms to delegate certain reporting requirements to brokers. However, in the UK, full-scope AIFMs and UCITS ManCos are out of scope of these transaction reporting requirements, even where they engage in MiFID “top up” activities.

[Download our fact sheet on transaction reporting.](#)

## Trade reporting

The MiFID II / MiFIR transparency regime is composed of two core obligations, namely: (a) pre-trade transparency, designed to provide market participants with near real-time broadcast of basic trade data around firm quotes, applicable to market operators (e.g. an EU regulated market) and firms operating a “trading venue” (e.g. an EU regulated market, MTF or the new organised trading facility market category); and (b) post-trade transparency, designed to provide market participants with near real-time broadcast of basic trade data around executed trades, applicable to market operators, firms operating a trading venue, and firms that trade financial instruments OTC.

Under MiFID I, pre-and post-trade transparency obligations were limited to trading in shares admitted to trading on a regulated market. MiFIR broadens the scope of pre- and post-trade transparency obligations to the following financial instruments: shares, depositary receipts, exchange-traded funds, certificates, bonds, structured finance products, emission allowances, derivatives, if the financial instrument is admitted to trading on any EU trading venue. Firms should consider the following: (a) whether the increased list of in-scope financial instruments puts their trading in scope; (b) if this is the case, whether there are any transactions which are excluded, for example, give-up/give in transactions and transfers of financial instruments as bilateral or CCP collateral are carved out; (c) if trading OTC, is their counterparty, or will it become, a “systematic internaliser” (SI). If it is, in some circumstances the SI may trade report on behalf of its counterparty; (d) for intragroup execution and trading arrangements, which entity will be market facing and subject to the trade reporting obligation; and (e) how their existing agreements with counterparties have allocated responsibility for trade reporting and whether these now need revision.

## Inducements – the use of research

MiFID II introduces a new model under which research provided by a third party to an investment firm must be paid for out of either the firm’s own resources or a research payment account (RPA) funded by specific charges to clients and controlled by the investment firm. Managers will therefore need to decide whether to bear these research costs or to pass them on to their funds and other clients. In our experience, many (but by no means all) managers are choosing to absorb at least some of these research costs. As mentioned above, additional complications can arise where there are cross-border delegation arrangements in place, which may require reviewing and amending any intra-group or other delegation agreements in place to take into account the guidance provided by EU regulators and non-EU regulators such as the SEC. Finally, if you do decide to use an RPA, you will need to consider budget and allocation policies as well as the required disclosures to investors.

[Download our fact sheet on soft commission and payment for research.](#)

## **Recording of telephone calls and emails relating to trades**

The requirement to record information about transactions and equity and non-equity orders is of great practical importance. It is now also necessary to record telephone conversations and electronic communications that relate to client orders and proprietary trading.

Note this is one area which has been gold-plated in the UK which means it will apply to AIFMs and UCITS ManCos even when they are involved in management of UCITS and AIFs (i.e. not just “MIFID top up business”). In our experience, firms lag behind in the implementation of this requirement, which may require an assessment of existing trading practices, as well as investment in new equipment to ensure compliance.

## **Suitability and appropriateness**

MiFID II introduces a number of changes to the suitability and appropriateness regimes; for example, further products will be classified as “complex”. As a result, it will no longer be possible to sell these products to retail investors on an execution only (non-advised) basis - for example through execution-only brokers or platforms – unless an appropriateness assessment is carried out, which may not be feasible in many circumstances. Significantly, listed investment companies (investment trusts) will be deemed complex by default, subject to potential assessment and re-categorisation as non-complex on a case-by-case basis.

## **Conflicts of interest**

The requirements under MiFID II relating to conflicts of interest imposed on investment firms remain substantially the same as those imposed under MiFID I. However, while MiFID I emphasised the requirement to identify and manage conflicts of interest, MiFID II also provides for more extensive disclosure and oversight requirements.

Under MiFID II an investment firm needs to consider whether its approach to conflicts is overly reliant on disclosure as a method of managing its conflicts and whether it has taken adequate steps to prevent such conflicts. At the same time UK investment firms will need to retain sufficient disclosure to comply with potential fiduciary conflicts arising as a matter of common law.

[Download our fact sheet on conflicts of interest.](#)

## **Independent investment advice**

MiFID II includes a range of new requirements for firms holding themselves out as providing investment advice on an independent basis. This may impact the way in which certain managers distribute their products going forward.

Under the new framework, for a firm to provide independent advice it must define and implement a selection procedure. This procedure will assess and compare a sufficient range of financial instruments that are available on the market. Firms that provide independent advice but which focus on certain categories or a specified range of financial instruments will have to comply with additional restrictions.

[Download our fact sheet on investment advice.](#)

## **Client categorisation**

Investment firms need to categorise their clients in order to determine the correct level of investor protection and transparency. New and existing clients and prospective clients must be notified of their categorisation, and of their right to request a different categorisation, before services are provided. Note that local public authorities

and their pension schemes will be automatically classified as retail clients, but it is still possible to “opt up” these clients to elective professional client status. The opt-up procedures are slightly different from those previously in force.

[Download our fact sheet on client categorisation.](#)

### **Governance and internal organisation**

Provisions in the Capital Requirements Directive (CRD IV) on governance will be extended to investment firms under MiFID II. With this extension, management bodies will be required to be of sufficiently good repute, possess collectively sufficient knowledge, experience and skill and commit sufficient time to performing their functions. Institutions which are significant in terms of their internal organisation, size and complexity of their activities must also establish a nomination committee composed of non-executives. This will be to review and make recommendations in respect of the composition of the management committee under the new rules.

These organisational requirements aim to ensure that investment firms operate with a high level of competence, soundness and integrity. MiFID II's new product governance regime is reflected in requirements to increase the scope and detail of the compliance, risk and audit functions that a firm's internal policies and procedures need to cover.

[Download our fact sheet on governance and internal organisation.](#)

### **Remuneration requirements**

MiFID II introduces new remuneration rules which aim to reduce the risk that a firm's remuneration and incentive practices may give rise to conflicts of interest with its clients, and from having remuneration, sales targets or other arrangements that could provide an incentive to its staff to recommend a particular financial instrument when that firm could otherwise offer another financial instrument more appropriate to a client's needs. The MiFID II requirements are broadly similar to ESMA's existing remuneration guidelines under MiFID I, but are now given legislative status.

However, in the UK, full-scope AIFMs and UCITS ManCos are out of scope of these MiFID remuneration requirements.

[Download our fact sheet on remuneration requirements.](#)

### **OTC derivatives and commodities**

Commodity contracts traded on trading venues and economically equivalent contracts will be subject to position limits set by national regulators using a methodology specified in yet-to-be finalized regulatory technical standards. The reason for position limits being introduced is to support orderly pricing and settlement conditions, in order to prevent both market distorting positions and market abuse. MiFID II will therefore require Member States to establish and then impose a maximum quantitative threshold on a firm's net position. The definition of trading venues will be extended to include not only regulated markets and multilateral trading facilities, but also organised trading facilities.

### **Algorithmic trading**

Firms carrying out algorithmic trading will be subject to a range of obligations deriving from MiFID II, ranging from establishing new systems and controls to regulatory reporting. Firms that use a market making strategy will have to take into account the liquidity, scale and nature of the specific market and the characteristics of the instruments



being traded. In addition to the introduction of new algorithmic trading obligations, firms engaging in high frequency trading must store in approved form accurate and time sequenced records of all placed orders. This will include cancellation of orders, executed orders and quotations on trading venues. All of this information must be made available to the firm's regulator upon request.

## MiFID checklist

Highlighted below are some of the key steps and documents that you may need to update to ensure that you are fully compliant by 3 January 2018...

Relevant Document	Update Considerations
<b>Prospectus / Offering Documents</b>	<ul style="list-style-type: none"> <li>- Product Governance - Target Market language (consider also adding language in pre-sale disclosure documentation / application forms or monthly newsletters)</li> <li>- Inducements - disclosure of the use of a research payment account (RPA)</li> <li>- Additional Disclosures - updated risk warnings</li> </ul>
<b>Distribution Agreements / Placement Agent Agreements</b>	<ul style="list-style-type: none"> <li>- Draft Distribution Agreement Letter, including items such as: <ul style="list-style-type: none"> <li>o Target Market notifications</li> <li>o On-going dialogue / inter-action between distributor and manufacturer</li> <li>o Periodic reviews</li> <li>o Requirement for management information from distributor</li> <li>o Use of EMT</li> </ul> </li> </ul>
<b>Investment Management Agreements</b>	<ul style="list-style-type: none"> <li>- Draft IMA MiFID II letter, including updates on: <ul style="list-style-type: none"> <li>o Complaints policy disclosures</li> <li>o Conflicts procedures</li> <li>o Information on target markets</li> <li>o Client categorisation</li> <li>o Costs and disclosures</li> <li>o Information relating to use of research and payment method, including consents to any applicable RPA budgets</li> <li>o Suitability warning of failure to supply information</li> <li>o Best execution disclosures</li> <li>o Information on how quarterly statements may be provided</li> <li>o Position limits</li> <li>o Requirement for legal entity identifiers (LEIs)</li> </ul> </li> </ul>
<b>Subscription Documentation</b>	<ul style="list-style-type: none"> <li>- Review and update</li> </ul>
<b>Product Approval Processes</b>	<ul style="list-style-type: none"> <li>- Target Market assessment</li> <li>- Reference MiFID II product governance requirements</li> <li>- Documentation of regular review of product and risk spectrums</li> </ul>
<b>Compliance Manuals/ Operating Procedures</b>	<ul style="list-style-type: none"> <li>- Reflect policy decisions made in respect of MiFID II within relevant documents</li> </ul>
<b>Research Charge Agreements</b>	<ul style="list-style-type: none"> <li>- Seek to enter into the following agreements where relevant: <ul style="list-style-type: none"> <li>o Research charge collection agreement (RCCA), between the broker and the investment manager for the broker to collect research payment</li> <li>o RPA administration agreement – appointing an administrator to collect research charge from the broker</li> </ul> </li> <li>- Take into account trade association model agreements</li> </ul>
<b>Delegation Agreements/ Intra-group Arrangements</b>	<ul style="list-style-type: none"> <li>- Bolster language with respect to sharing of research where applicable (UK managers, see IA guidance)</li> <li>- Amend in relation to decisions regarding identification of executing entity for purposes of Transaction Reporting/ Trade Reporting requirements</li> </ul>

## Useful references

- [MiFID II Best Execution Guide](#). Published by the *Alternative Investment Management Association* (AIMA).
- [Terms for research under MiFID II](#). Published by *The Investment Association* with *Dechert LLP*. Dechert is an active member of the Investment Association's working group on MiFID II.

If you have any queries relating to MiFID II or PRIIPs please get in touch with your usual Dechert partner or contact.

This briefing was prepared by Dechert's MiFID II task force which sits within our 200-lawyer global funds and financial services practice group.

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