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FINANCIAL MARKETS LAW COMMITTEE

Markets in Financial Instruments Directive and the Markets in Financial Instruments Regulation

Response to the European Securities and Markets Authority consultation paper on the revised markets in financial instruments directive

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1. INTRODUCTION

1.1. The role of the Financial Markets Law Committee (the "**FMLC**" or the "**Committee**") is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks and to consider how such issues should be addressed.

1.2. The FMLC welcomes the opportunity to respond to a consultation published by the European Securities and Markets Authority ("**ESMA**") on 22 May 2014 ("**the CP**") which sets out in draft, ESMA's technical advice to the European Commission on the contents of delegated acts required by several provisions of Directive 2014/65/EU on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (recast) ("MiFID II") and Regulation (EU) No 600/2014 on markets in financial instruments and amending Regulation (EU) No 648/2012 ("MiFIR").

1.3. ESMA's draft technical advice if adopted by the European Commission, would constitute the MiFID II implementing measures with regards to organisational requirements and operating conditions for investment firms. The topics covered in the CP are: investor protection, transparency, data publication, micro-structural issues, requirements applying on and to trading venues, commodity derivatives, and portfolio compression.

1.4. This paper highlights requirements under "investor protection" which could give rise to misunderstanding, unless clarified. The requirements are in relation to:

- The recording of telephone conversations and electronic communications
- Product governance
- Safeguarding client assets
- Information to clients on costs and charges
- Legitimacy of inducements to be paid to/by a third person

- Best execution

2. INVESTOR PROTECTION

Recording of telephone conversations and electronic communications (*Section 2.6*)

2.1. Article 16(7) of MiFID II requires the recording of telephone conversation and electronic communications "relating to" own account transactions and the reception, transmission and execution of client orders. It is clear from the second paragraph of Article 16(7) that these go beyond communications that actually result in the execution of transactions if they are "intended to result in transactions".

2.2. The CP confirms that "some" internal as well as client-facing communications are subject to the recording requirement where the call in question "relates to or is intended to result in transactions" (paragraph 6 of Section 2.6 of the CP). The FMLC considers that the reference in MiFID II to communications that are "intended to result in transactions", especially when extended to apply to internal communications, is potentially so broad as to catch virtually any communication made within the front office of an investment firm, and therefore that some limitation in its scope is likely to have been intended. It would be helpful for ESMA to provide further guidance as to any intended limitation of the types of communication that are within the scope of the recording requirement. For example, it seems unlikely that preliminary or exploratory communications, especially in the context of the development or structuring of a product or a proposed transaction, are intended to be caught, although they could be said to be within the letter of the recording requirement.

2.3. The CP poses the further question (Q11) whether clients should be required to sign minutes of face-to-face conversations which result, or may result, in transactions. The answer to this question is a policy matter and falls, therefore, outside the remit of the FMLC. The Committee notes, however, that to the extent that it may not prove feasible to obtain client signatures of such minutes, breach of the requirement would be inevitable and compliance would, as a result, be uneven across the market for investment services. This may lead to regulatory uncertainty in practice.

Product governance (*Section 2.7*)

2.4. Article 16(3) of MiFID II requires an investment firm which manufactures financial instruments for sale to clients to maintain, operate and review a process for the approval of each financial instrument and significant adaptations of existing financial instruments before it is marketed or distributed to clients. The term "manufacturer" is not defined in MiFID II but in the CP ESMA refers to manufacturers variously as "investment firms that create, develop and design products" and "investment firms that develop products and offer these products to clients through other investment firms" (paragraph 7 of Section 2.7).

It is important for firms to be clear as to when the MiFID II product governance provisions apply. Although the concept of a "manufacturer" appears to refer to the designer of an investment product incorporating a number of features to create a single product, such as a structured product, the breadth of the suggested definition means that it could also refer to any instrument issued by an investment firm such as a simple OTC derivative. The FMLC suggests that a clear definition of the term is provided, indicating clearly the activities of a "manufacturer" that are intended to be covered by the product governance provisions.

Safeguarding client assets (*Section 2.8*)

2.5. Article 16(10) of MiFID II provides that an investment firm

> "*shall not conclude title transfer financial collateral arrangements with retail clients for the purpose of securing or covering present or future, actual or prospective obligations of clients*".

Despite the lack of any apparent basis in MiFID II, ESMA was asked by the Commission to provide technical advice on measures to ensure an appropriate use of title transfer financial collateral arrangements (***TTCA***) when dealing with non-retail clients. In its draft technical advice, ESMA recommends that TTCA in relation to non-retail clients should be considered not to be appropriate where "there is only a very weak connection between the client's liability or consideration to the firm and the use of TTCA" and "where the amount of client funds or financial instruments subject to TTCA far exceeds the client's liability" (paragraph 3 of ESMA's draft technical advice).

2.6. The manner and extent of collateral required by a firm from a professional client are matters that go to the heart of the commercial relationship between the firm and the client and that are typically the subject of negotiation. To the extent that regulatory intervention is justified (on which it is not for the FMLC to comment) the FMLC considers it paramount that any limitations be clear and easily ascertainable. Expressions such as "very weak connection" and "far exceeds" are, however, inherently uncertain. They raise a number of issues of interpretation, for example:

i. A pool of collateral may be provided to cover a varying obligation under a running account facility. Unless it is permissible to consider the maximum amount of the permitted liability it will be onerous continually to monitor the level of collateral against the actual liability outstanding at any time.

ii. A pool of collateral may be provided to cross-collateralise obligations owed under different facilities or arrangements between a firm (or other companies in the firm's group) and the client. Where some of those obligations are in turn collateralised by other items of collateral it will be difficult to determine whether the collateral pool in question "far exceeds" the amount of the secured obligations.

iii. If one counterparty is able to negotiate a lower ratio of collateral to obligations owed than another (or agrees to permit a greater ratio of collateral in return for paying a lower fee), it is unclear whether collateral provided by the counterparty providing a greater ratio of collateral will be regarded as having "only a very weak connections" with that counterparty's liabilities.

2.7. The existing MiFID Implementing Directive provides for investment firms to give retail clients information with respect to the use of financial instruments held by the firm for the client.[1] ESMA suggests in the CP providing additional protection to clients by introducing an explicit restriction on allowing liens over client assets. It proposes that

> *"liens over client assets that would enable a third party to dispose of these assets in order to recover debts, that do not relate to the clients or*

[1] Commission Directive 2006/73/EC, Article 32(7)

provision of services to the clients, should not be permitted except in cases where this is required in a jurisdiction when holding assets there" (paragraph 13 of the draft technical advice).

2.8. Where a firm appoints a sub-custodian to hold client assets in a country where the firm itself is not a member of local clearing and settlement systems, the firm will need to be clear as to the extent of any lien that it may grant to the sub-custodian over those assets. The FMLC considers that reference to liens "that do not relate to the clients or provision of services to the clients" is uncertain in the context of the usual situation where the firm opens an omnibus client account with a sub-custodian in which all of its clients' assets are held. First, it is not clear what type of obligation may be secured by such a lien. The firm will owe fees to the sub-custodian and may incur a temporary overdraft in order to settle a purchase transaction. Both those obligations relate to the provision of services by the sub-custodian to the firm, but not to the firm's underlying clients whose assets are being held, although the services are provided to the firm on behalf of the underlying clients. Alternatively, the firm may provide an indemnity to a sub-custodian in relation to liabilities that the sub-custodian incurs in providing services under the sub-custody agreement. Such a liability is not the direct cost or consequence of a service provided to the firm's underlying clients, but nevertheless relates indirectly to such a service.

2.9. Secondly, the reference to "clients" (plural) is unclear. A consequence of the pooling of client assets referred to above is that, although a lien over the firm's account with the sub-custodian may secure a liability such as a fee or an overdraft that is attributable to the firm's client's generally, the lien may not relate only to assets held on behalf of the client on whose behalf the relevant liability was incurred. It would be helpful to understand whether this type of security over an omnibus account is permissible.

Information to clients on costs and charges (*Section 2.14*)

2.10. Article 24(4) of MiFID II requires appropriate information on costs and related charges to be provided to clients. In its advice, ESMA indicates that investments firms should be able to agree a limited application of this and other information requirements when providing services to professional clients and eligible counterparties, except:

i. when the services of investment advice or portfolio management are provided, or

ii. when, irrespective of the investment service provided, the financial instruments covered embed a derivative (paragraph 2 of ESMA's draft technical advice).

2.11. The FMLC considers that these exceptions create uncertainty in a number of respects. In relation to (i), it is not clear whether, if a firm provides investment advisory or portfolio management services, information in relation to related services such as executing transactions in financial instruments must also be provided and cannot be waived, even where such costs are charged by a third party and passed on. In relation to (ii) above, it is not clear whether this applies where the transaction in question is itself a derivative, rather than embedding one. Furthermore, the concept of a transaction embedding a derivative is uncertain in marginal cases. It is unclear whether this would include a transaction such as a convertible bond that is itself convertible to another type of financial instrument (a transferable security) such that it could be regarded as embedding an option to purchase a share.

The legitimacy of inducements to be paid to/by a third person (*Section 2.15*)

2.12. Article 24(7)(b) and 27(8) of MiFID II provide that where an investment firm provides investment advice on an independent basis or portfolio management, it shall not accept and retain fees, commissions or any monetary or non-monetary benefits paid or provided by any third party or a person acting on behalf of a third party in relation to the provision of the service to clients other than minor non-monetary benefits that are capable of enhancing the quality of service provided and are of a scale and nature such that they could not be judged to impair compliance with the firm's duty to act in the best interests of the client.

2.13. In paragraph 14 of Section 2.15, ESMA considers the scope of the "minor non-monetary benefits" exemption and whether investment research provided by a broker to a portfolio manager could fall within the scope of the exemption. It indicates that

> *"any research that is tailored or bespoke in its content or rationed in how it is distributed or accessed would be of a scale or nature such that*

its provision is likely to influence the recipient's behaviour and cannot be a minor non-monetary benefit."

However, in its draft advice ESMA states that the exhaustive list of minor non-monetary benefits that it recommends the Commission introduce should include

"information or documentation relating to a financial instrument (including financial research) or an investment service. This information could be generic in nature or personalised to reflect the circumstances of an individual client" (paragraph 5 of ESMA's draft technical advice).

2.14. The two statements appear to be directly contradictory and the FMLC seeks clarity as to whether or not bespoke and tailored investment research should be capable of meeting the criteria. The FMLC suggests that it should be, because bespoke and tailored research is more likely to be geared to the needs of a portfolio manager's clients and therefore would more clearly enhance the nature of the service provided by the portfolio manager to its clients and would be less likely to create a conflict of interest between the portfolio manager's own interests and those of its clients.

Best execution (*Section 2.21*)

2.15. The CP suggests certain enhancements to the information required to be provided by firms in their execution policies. In relation to bespoke OTC products, ESMA recommends that: "the investment firm should be able to check the fairness of the price proposed to the client" (paragraph 4 of ESMA's draft technical advice).

2.16. The FMLC takes the view that the introduction of the reference to "fairness" in relation to best execution creates uncertainty, since this is not a concept that is used in MiFID II, which refers in Article 27 to the obligation to obtain the best possible result for clients, rather than to obtain a "fair" result. The introduction of an obligation to obtain a "fair" price appears to introduce a novel obligation to assess the fairness of the price of a financial instrument, in relation to dealings with professional as well as retail clients. In the context in which this obligation is introduced, where MiFID II does not refer to the concept at all, it is difficult to know how such a potentially wide-ranging concept as that of

fairness should be interpreted and what it might require in the case of assessing the fairness of a price.

3. CONCLUSION

3.1. The FMLC commends ESMA for its detailed technical advice to the European Commission. The Committee would however, welcome clarification or further guidance in respect of the issues discussed in this paper. The issues touch on provisions under "Investor protection" and concern in particular: the recording of telephone conversations and electronic communications, product governance, safeguarding client assets, information to clients on costs and charges, legitimacy of inducements to be paid to/by a third person, and best execution.

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