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26 May 2015

Tom Ward
Financial Conduct Authority
25 The North Colonnade
Canary Wharf
London E14 5HS
Email: dp15-03@fca.org.uk

AFME response to DP 15/3

Dear Tom

Please find attached the AFME response to DP 15/3.

Please do not hesitate to contact me if you would like to discuss the issues covered in this submission or would like us to provide further information about any of the matters which our members have raised. We would be happy to continue to engage with the FCA in ongoing dialogue on this and, in due course, may raise with you any further issues on the subject that AFME members bring to our attention.

Yours sincerely

Angela Teke

Managing Director, Compliance

Angela.teke@afme.eu

Tel: 0207 743 9369

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Consultation response

Discussion Paper 15/3 on Developing our approach to implementing MiFID II conduct of business and organisational requirements.

26 May 2015

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on **Discussion Paper 15/3 on "Developing our approach to implementing MiFID II conduct of business and organisational requirements".** AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia.

AFME is registered on the EU Transparency Register, registration number 65110063986-76.

We summarise below our high-level response to the consultation, which is followed by answers to the individual questions raised.

Executive Summary

We strongly welcome FCA's willingness to engage with the industry on its own thinking at an early stage of its implementation and planning process. This is particularly important given the very tight timelines firms will be facing in implementing MiFID II. However, we note that in a number of areas, the FCA's proposals go beyond the MiFID II requirements but that no clear cost-benefit assessment has been provided to justify this approach. We would therefore strongly encourage FCA to undertake such detailed assessments and stand ready to contribute.

Questions

<u>**Chapter 2: Applying MiFID II rules to insurance based investment products and pensions**</u>

Q1: Do you agree that, in principle, we should look to ensure a consistent regulatory regime between insurance based investment and pension products, and MiFID II investments? If not, please explain why.

<u>**AFME comments:**</u>

- We agree that a consistent regulatory regime is preferable and support consistency with other legislative measures such as PRIIPs and IDD.

Q2. Assuming IDD does not replicate MiFID II in terms of changes to suitability assessments and client reporting, we plan to apply minor changes where we currently read-across MiFID II rules to insurance-based investments and pensions. Do you agree with this approach? If not, please explain why not.

AFME comments:

- We agree, as AFME members support consistency with other regulatory measures such as PRIIPs and IDD. However, we would suggest any final policy decisions should be postponed until the outcome of IDD is clearer.

Q3: Assuming IDD does not replicate MiFID II in terms of the appropriateness test, should we look to apply MiFID II's appropriateness test to sales of insurance-based investments and pensions?

AFME comments:

- As outlined above our members would generally prefer consistency of requirements. However, we would suggest that any final policy decisions should be postponed until the final outcome of IDD is clearer. In general, consistent processes for products with a similar economic effect allow more streamlined administration for firms as well as provide greater clarity for consumers. We support the appropriateness test in relation to more complex insurance-based products. However, we are concerned that the current MiFID II appropriateness test will apply to non-advised sales of non-UCITS retail schemes, notwithstanding that these are broadly substitutable for UCITS schemes. This appears inconsistent, and could unnecessarily limit consumer choice and/or decision-making. We believe the FCA should avoid extending this anomaly to insurance-based investment products. Consequently, we believe any extension of the MiFID II appropriateness test should be subject to careful consideration, and targeted only at products which genuinely exhibit greater complexity.

- We would also suggest that FCA should proceed with particular caution regarding pensions given ongoing changes in the UK legislative framework for pensions.

Q4: If we were to apply MiFID II's appropriateness test to insurance-based investments, what factors or criteria do you consider make an insurance-based investment and pension product complex?

AFME comments:

- See our answer to Question 3. We would suggest that structured insurance products and other products which embed a derivative (but excluding products linked to investment funds which utilise derivatives solely for the purpose of efficient portfolio management) should be subject to the appropriateness test. We would also suggest that products which include a material element of leveraging and/or for which liquidity is restricted should be subject to the appropriateness test

Q5: Assuming IDD does not replicate MiFID II with regard to product governance and staff remuneration provisions, to what extent should we look to apply MiFID II's obligations to insurance-based investments and pensions? What would be the implications of doing this, or of not doing it?

AFME comments:

- We welcome FCA's intention not to extend the MiFID II costs and charges requirements to insurance based investments and pensions at this stage.

- Whilst we support harmonisation of regulatory requirements and welcome remuneration provisions that incentivise all sales advisors to act in clients' best interests, we have previously raised a number of significant concerns with regard to the MiFID product governance requirements and would caution against extending them to insurance based investment products and pensions without further consultation and proportionate application to these specific products.

Chapter 3: Treatment of structured deposits

Q6: What should our approach be to incorporating the new requirements for structured deposits into our conduct of business rules?

AFME comments:

- AFME members do not support Option 3 which would result in a significant increase in regulatory obligations without a specific regulatory mandate and in the absence of a clear cost benefit analysis indicating demonstrable benefits to clients. Given that FCA does not favour Option 1, Option 2 would appear the option that achieves the most pragmatic outcome for firms and consumers.

Chapter 4: Receipt of commissions and other benefits for discretionary investment managers

Q7: Should we develop rules to ban rebating of third party payments altogether by DIM firms to clients?

AFME comments:

- No, in the absence of any evidence that the FCA's proposals are proportionate and necessary, we see no need for the FCA to take any such action, which goes beyond MiFID II and would create an unlevel playing field across the EU.

Q8: Should we develop rules to ban cash rebating of third party payments by DIM firms to clients, but allow other types of rebating?

AFME comments:

- See our answer to Question 7.

Chapter 5: Professional client business – client categorization and treatment of local public authorities and municipalities

Q9: Do you agree with our approach to re-categorise local authorities undertaking non-MiFID business as retail clients, with the option to opt up to elective professional client status? Do you agree that that the opt-up criteria for local authorities should follow our existing approach with respect to non-MiFID business?

AFME comments:

- Whilst we recognise the FCA's rationale as expressed in paragraphs 5.11-5.12 of the consultation, namely the anticipated move towards greater levels of investment in MiFID instruments by local authorities, AFME members are concerned by the proposal to introduce MiFID client categorisation for non MiFID business in the absence of any EU mandate to do so or a cost-benefit analysis clearly showing the case for such an extension of requirements. Members have requested confirmation that the proposal does not extend to non-investment products and therefore will not capture such services as e.g. payment services and rolling credit facilities, as any such extension would be unnecessary and disproportionate given the nature and risk profile of those non-investment products/services. However, even if the proposal is confined to investment products, the proposal would be problematic for those firms which do not service retail clients and has the potential to create confusion as an extra layer of classification is planned to be introduced solely for local authorities. Local authorities may be denied access to products going forward if classifications are introduced where they did not exist before and this

may be particularly true depending upon the outcome of outstanding ESMA consultations on complex products.

Q10: Do you agree with the approach set out in option A and the possibility of providing guidance on the qualitative test? If so, please explain what sort of guidance you think would be useful. Please provide any evidence to support your views.

AFME comments:

- AFME believes that this is a very complex issue and that there are inherent significant challenges with each of the options outlined. In order to establish the most appropriate option, we would strongly encourage the FCA to undertake appropriate cost benefit and impact analysis and closely work with the industry. We also note that there a number of remaining areas of uncertainty that need to be clarified. For example we would ask FCA to confirm the treatment of local authority pension schemes, i.e. will they be treated as per se professionals in line with Annex II, I1f of MiFID II ?

- Overall our Members do not support Option B. For example, if the FCA should seek to extend the quantitative test to include all 3 rather than just 2 criteria, even larger authorities may not be meeting the criterion of conducting ten trades per quarter and thus could not be opted up from retail status. Similar issues are likely to arise from a significant increase in the portfolio size requirement. The consequence could be limitations in local authorities' access to finance both with regard to the products they could access as well as the counterparties they could transact with (given that not all firms offer services to retail clients).

- Our members believe that there are both advantages and disadvantages to both Option A and C. Given the complexity inherent in both choices and the limited time available to the industry for assessing the DP, we believe that the FCA should undertake a more detailed impact assessment with AFME members and other industry participants including local authorities e.g. through Industry Roundtables before making any final policy choices.

- Option A is likely to present the least disruption to a system of classification that to date has worked well. AFME members believe that the client categorisation scheme has worked well overall and this has been confirmed by CESR. Furthermore, the revised MiFID rules will introduce a number of enhanced investor protection measures in areas such as suitability and appropriateness assessments and product governance: these provide additional comfort that clients such as local authorities will obtain the appropriate protections.

- However, Option A would require additional checks on local authorities (in line with the new guidance) which could prove onerous for them. We note that under the Local Government Act 1972, Section 151, every local authority has to make arrangements for the proper administration of their financial affairs including the appointment of a suitable and sufficiently competent financial officer, thus placing certain requirements on the authorities themselves with regard to the administration of their financial affairs to ensure that tax payers' money is spent wisely. This should be the basis upon which any additional guidance is formulated as well as taking into account the wealth of existing material on good governance of local authorities. Such guidance should be pragmatic rather than result in an overly restrictive and bureaucratic tick box approach.

It would also be important that any guidance should be fully and transparently be consulted upon and that it does not deny local authorities access to or continuity of services by imposing overly restrictive conditions and tests which firms must carry out or verify. Furthermore, we note that even with additional guidance provided, an element of discretion and subjectivity will remain in the assessment.

- With regard to Option C, classification on the basis of accounts is relatively straightforward and less subjective and, as such, some AFME members have expressed support for this streamlined approach. Local authorities currently classified as per se professionals will be able to opt up to elective professional status under MiFID II. However, on the negative side, many local authorities that are currently opted up to elective professional status will not be meeting the large undertakings test going forward. This means they will face restrictions with regard to the products they can access as well as the counterparties they can transact with (given that not all firms offer services to retail clients). These factors could lead to the consequence of local authorities being shut out of the market and leave several authorities which currently opt up with nowhere to go and with products they cannot continue to have serviced. This would therefore have unintended consequences on consumer choice and growth.

Q11: Do you agree with the approach set out in option B? Please provide your comments and any evidence to support your views.

AFME comments:
- See our answer to Question 10. AFME members do not support Option B.

Q12: Do you agree with the approach set out in option C? Please provide your comments and any evidence to support your views.

AFME comments:
- See our answer to Question 10.

Chapter 6: Advisor Independence

Q13: Do you consider that MiFID II's standard of independent advice is different, in practice, to the UK's RDR standard? If so, please explain why.

AFME comments:
- In intent the MiFID II and RDR standards are probably not very different. However, we would prefer a consistent approach and definition in line with the MiFID provisions as this would provide greater clarity for consumers and avoid creating in practice a potentially unlevel playing field across the EU.

Q14: How should we implement MiFID II's requirement to develop an independence standard for advice on shares, bonds and derivatives?

AFME comments:
- We welcome FCA's acknowledgement that a comprehensive and fair assessment would not require the adviser 'having to consider every possible product as this would be disproportionate'.

- We also welcome that FCA does not propose to extend the current retail investment product definition (RIP) and is conscious that such action would lead to increased firm costs without corresponding consumer benefit.

Q15: Should we continue to include insurance-based investments and pensions within our definition of 'retail investment product'?

AFME comments:

- See our answers to Chapter 2.

Q16: Should we include structured deposits within our definition of 'retail investment product'?

AFME comments:

- Before making any policy decisions, we would suggest that the FCA should undertake a full cost benefit analysis of this issue.

Chapter 7: Appling MiFID II remuneration requirements for sales staff and advisers to non-MiFID firms

Q17: Do you think we should explore applying MiFID II's remuneration standards for sales staff and advisers across to non-MiFID business?

AFME comments:

- AFME welcomes the FCA's recognition of the various Directives and associated implementing measures being developed at European level that address (or will address) remuneration practices across various sectors and products.

- One key ongoing initiative that is of particular concern is the EBA's revision of its Remuneration Guidelines. The EBA is currently seeking views on proposals to apply the CRD's remuneration requirements to all subsidiaries within a banking group, regardless of whether these are subject to the CRD on a standalone basis or not. We are concerned that this proposal will create an unlevel playing field for businesses operating in markets where there are out-of-scope firms, such as investment management businesses, both within the EU as well as in relation to third countries. The possible extension of the scope of the CRD's requirements also implies that some businesses may have to deal simultaneously with different requirements (e.g. complying with EBA and ESMA guidelines) and it is currently not yet clear whether these requirements are consistent and compatible. This example of the potentially wide reaching consequences of changes to remuneration requirements in one area leads us to conclude that, at this stage, and at least until EU legislative requirements have bedded down, the FCA should not consider expanding MiFID II remuneration requirements further as there is the very real risk that they may conflict with future requirements resulting from other remuneration regimes.

Chapter 8: Recording of telephone conversations and electronic communications

8a) Taping requirements for Article 3 firms

Q18: Do you agree that Article 3 firms should be subject to a regime that is identical to the regime for non-Article 3 firms? What impact would this have for these firms?

AFME comments:

- No, we do not agree. AFME members have previously highlighted a range of concerns with the MiFID Level 1 and 2 provisions including the minimum 5 year retention period, the need to record internal conversations and the requirement to make recordings available to clients on request, all of which will lead to considerable cost increases for firms with little clearly demonstrable benefit for clients and regulators.

- Given that the FCA recognizes that extending the requirements for smaller firms (both retail and corporate) would present a significant change including potential costs, we would urge the FCA to undertake a more detailed cost benefit analysis before coming to any conclusions and aim for a proportionate rather than identical implementation approach reflecting the nature, size and complexity of the Article 3 firms.

Q19: What other approaches do you suggest we could take that would meet the objectives of the MiFID II requirement?

AFME comments:

- Based on firms' experiences with the implementation of the UK mobile phone recording requirements, we would urge FCA to ensure that technology providers systems' are sufficiently robust and advanced to allow firms to meet the new standards before imposing new requirements on firms.

8b: The current recording rules for discretionary investment managers

Q20: Do you agree that the two recording exemptions for discretionary investment managers should be removed?

AFME comments:

- See our answers to Question 18 and 19.

Q21: Do you agree that discretionary investment managers should be required to comply with Article 16(7) of MiFID II?

AFME comments:

- See our answers to Question 18 and 19.

Q22: Are there any technical challenges firms are likely to face in meeting these disclosure requirements that you feel we might be able to help address? If so, what solutions do you suggest to overcome these challenges?

AFME comments:

We agree that there are technical challenges in presenting aggregated costs and charges information to consumers, especially with these being defined very broadly (any deduction not caused by the occurrence of underlying market risk) and where the expectation would be for firms to disclose these as exact monetary values (as opposed to indicative percentage-based bands) prior to the transaction.

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Based on our member feedback, AFME would like to highlight the following practical examples of challenges and potential solutions:

Ongoing charges for mutual funds and portfolio management/advisory services

Challenges:

- Ongoing mutual fund charges are indicative (based on previous year costs of running the fund or, for new funds, based on expected costs) – so they change over time and will not be the exact charge the client will actually pay in future;
- Every fund has different charges associated with it and these get updated over time. Requiring firms to translate these percentage-based charges into monetary amounts (based on client transaction values) would mean that firms have to maintain and continuously update (or source externally) extensive databases which contain details on charges for funds they distribute – this means additional administrative effort and cost;
- Using such indicative percentage-based figures to calculate the monetary value of the future cost of fund ownership could be misleading given that the fee values available to firms are historical or estimated and also because the value of client fund portfolios fluctuates over time and so ongoing charges also fluctuate.
- Also, portfolio management or investment advice fees levied by investment advisers may also be charged on an ongoing basis. However, these fees are normally charged on a periodic basis, based on the average market value of a client's portfolio over that period. As such, disclosure of the monetary values for management fees or other ongoing charges for a particular investment on a pre-trade basis could be unhelpful or misleading to clients as the actual fee charged (often charged in arrears on a periodic basis) could fluctuate from the point of sale disclosure as a result of market value movements between transaction date and date the ongoing fee is charged.

Potential solution:

- Firms should be able to provide clients with fund KIIDs which contain the historical/estimated level of ongoing charges and firms should provide general examples which explain how to translate such a percentage based fee into monetary value.
- Similarly, in respect of ongoing management or advisory fees and charges, firms should be able to provide the percentage based fee as part of any initial disclosures of service costs and charges and provide examples of how those fees could be translated into monetary values for a particular investment.

Bid/ask spread for securities and unit trusts (This is not related to market risk)

Challenges:

- Spreads vary by security and depend on market conditions so their disclosure to clients in advance of the transaction and in monetary terms would be technically difficult.

Potential solution:

- If the bid/ask spread is in the scope of disclosures required by MiFID II, then firms should be expected to bring to the client's attention that certain types of products operate a bid/ask spread and explain what this means. If the bid/ask spread is not in scope, then the scope should be clarified.

Transaction charges incurred by OEICs/ICVCs (not related to market risk either)

Challenges:

- Fund transaction costs vary over time due to various factors such as value of net inflows or outflows and fund manager's trading patterns. Also, funds operate arrangements where, depending on circumstances, transaction costs may be charged to the fund (i.e.

  all investors) or only to investors who carry out transactions in fund shares. As such it is very difficult to estimate the amount of transaction costs a particular investor will incur when investing in a fund.

Potential solution:

- If fund transaction costs are in the scope of disclosures required by MiFID II, firms could provide clients with a summary of how these costs arise and how they are charged. If any indicative cost values need to be provided to clients, there should be a requirement to include them in fund KIIDs. If fund transaction costs are not in scope of disclosures, the scope should be clarified.

Q23: Should we investigate developing a standardised format for disclosing costs and charges for both point-of-sale and post-sale disclosures?

AFME comments:

- AFME believes that based on the very limited information provided by the FCA at this stage it would be difficult to answer this question conclusively. Whilst some members recognise the potential benefits in streamlining information and thus reducing the costs associated with its provision, others do not support the standardisation of costs and charges disclosures. The range of products and features which are available from multiple firms means it is difficult to see how this can be sensibly achieved to provide for all scenarios. We also note that there is a already a high degree of prescription applying to cost and charges disclosure, including UCITS and PRIIPS rules which any new standardised format would need to be compatible with. AFME members would be happy to engage further with the FCA on this topic which will require significant input and industry consultation before any policy conclusions can be made.

Chapter 10: MiFID II's revised inducement standards

Q24: Do you agree that we should maintain domestic consistency and look to apply MiFID II's inducement standards for independent advice also to restricted advice?

AFME comments:

- AFME's views on the inappropriateness of the use of the inducements regime to cover investment research are well-known to the FCA. Whatever regime is eventually introduced, however, must apply equally across the EU. It will be an unnecessary constraint on the UK asset management industry, which will have damage the UK industry with no material benefit to the consumer, if the FCA interprets MiFID II more widely than other EU national competent authorities

Q25: Do you agree that we should continue to have a consistent inducements regime for sales of MiFID II products and insurance-based investments and pensions? If not, please explain why.

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AFME comments:

- See our answer to Question 24.

Chapter 11: Complex and non-complex products and the application of the appropriateness test

AFME comments:

- We note that FCA do not ask any specific questions in this chapter but AFME members would like to take the opportunity to reiterate concerns with ESMA's technical advice on this issue.

- MiFID Level 1 defined structured UCITS as complex which allowed non-structured UCITS to be sold on an execution only basis. However, we are concerned that ESMA has significantly extended the scope of the provisions to include other criteria which will lead to the inclusion of other products in the "complex category" and their becoming subject to the appropriateness test. No clear rationale was provided for this extension beyond general investor protection concerns and the additional criteria such as references to "fundamentally alter the nature or risk of the investment" or having "the effect of making the instrument illiquid" are also unclear. We strongly agree with the FCA that not all complex products come with the same risks and therefore do not require the same level of knowledge and experience.

- In addition, with regard to the additional criteria proposed by ESMA, we would like to suggest that the boundary between complex and non-complex products for the purpose of the execution only service should be driven by their risk/reward profile, not an inappropriate focus on the detailed manner in which they are legally structured. Artificially excluding products simply because of the way in which they work rather than the return the investor will receive, risks unnecessarily excluding products that could be beneficial to investors.

- We would also suggest that FCA suggest to ESMA that the guidance on the appropriateness assessment of complex and non-complex instruments needs to be updated and re-issued for MiFID II as it was useful in the determination, particularly around products embedding a derivative.

- We note that ESMA has not specifically confirmed that Article 36 of the MiFID 1 Implementing Directive (which allows the necessary experience and knowledge to be assumed for professional clients) will be maintained under MiFID II. We understand from previous discussions with the FCA that this is the regulatory intention but as we consider this an intrinsic element of the appropriateness regime, it is important that this is formally confirmed in due course in the UK implementation programme.

Please do not hesitate to contact me if you would like to discuss the issues covered in this submission or would like us to provide further information about any of the matters which our members have raised. We would be happy to continue to engage with the FCA in ongoing dialogue on this and, in due course, may raise with you any further issues on the subject that AFME members bring to our attention.

AFME contacts

Angela Teke

angela.teke@afme.eu +44 (0)20 7743 9369