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By email to cp16-29@fca.org.uk

AFME Response to Consultation Paper FCA CP16/29 (Markets in Financial Instruments Directive II Implementation Paper III)

Dear Sir, Madam

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on the FCA Consultation Paper entitled Markets in Financial Instruments Directive II Implementation - CP16/29.

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

Yours faithfully

Will Dennis

Managing Director, Compliance

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Consultation response

Markets in Financial Instruments Directive II Implementation - Consultation Paper III

3 January 2017

1.1 The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on **FCA CP16/29 Markets in Financial Instruments Directive II Implementation (CP)**.

1.2 We summarise below our high-level response to the CP, which is followed by comments on some of the proposed changes.

Executive Summary

1.3 AFME appreciates the work that the FCA has carried out in amending the Handbook considering the Markets in Financial Instruments Directive II (MiFID II). We value the opportunity to respond to the work that has been carried out so far and we see the amendment of the FCA Handbook as a chance to ensure that UK market participants continue to have the guidance they need which will assist with their roles.

1.4 We have set out our responses below which we would be grateful if the FCA would consider, as we believe that the suggested changes would assist the UK market in understanding and applying the MiFID II regime and support FCA objectives.

1.5 Overall, AFME supports the steps taken in the CP to align the Handbook with the measures due to come into effect with the application of MiFID II. AFME does not however support the gold-plating of EU Directives as this leads to differences of regulation across Europe and consequent confusion. There are also some comments we would like to seek more clarity on and/or provide you with some information as to the impacts of some of what is proposed in the CP.

General

2.1 AFME understands that some of the obligations in the FCA Handbook will apply to non-MiFID entities and recognise that in certain circumstances this is necessary in order to streamline rules and obligations on similar type entities.

2.2 AFME would therefore welcome clarity regarding the FCA's intent, specifically a tabulation of the proposed rule extension to the various non-MiFID entities. This would be particularly helpful as it would give a clear focal point to all types of entities in determining which specific provisions of the Handbook apply to them.

2.3 AFME notes that COBS 1.2.3R highlights how certain definitions are used in the "EU" Handbook provisions. However, AFME is concerned that these clarifications may be missed by readers who are less familiar with the organisation of the Handbook and would suggest that

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2.3.1 these definitions are signposted in the Glossary so as to avoid any interpretative issues and;

2.3.2 Glossary terms that are also mentioned in COBS 1.2.3R be flagged in the relevant Glossary entry.

Chapter 2 & 3 - Inducements

3.1 AFME welcomes the FCA's proposed rules implementing the Delegated Directive on inducements but considers certain aspects of the proposed UK rules impracticable, potentially detrimental to the operation of financial markets and constituting considerable divergence from European harmonisation. We have focused below only on the aspects of the proposals that would benefit from improvement and not on issues which are already settled in the Delegated Directive and therefore necessary in the new regime[1], even though we maintain the reservations we have previously expressed on several aspects of the new regime.

3.2 "Execution-related" goods and services

3.2.1 AFME is concerned by the statement in the CP that "execution-related goods and services" may no longer be supplied as a benefit linked to execution charges (p. 27, section 3.20, footnote 14). The concept of "execution-related goods and services" derives from the current UK rules on the use of dealing commission (COBS 11.6). Under these rules, investment managers are permitted to purchase such goods and services through dealing commissions where they are "directly related to the execution of trades on behalf of the investment manager's customers" (COBS 11.6.3R (3) (c)). In our view, the suggestion that such services may now be viewed as a separate "benefit" linked to execution charges under the MiFID II regime is flawed, because:

3.2.1.1 The concept of "execution-related goods and services" derives from UK regulation. It is not referred to or reflected in the MiFID II regime, which instead refers to "execution services". This term is not defined in MiFID II or the MiFID II delegated directive. As such, we think that it is inappropriate to effectively qualify the scope of the MiFID II "execution services" concept by reference to pre-existing UK rules.

3.2.1.2 Under the existing UK regime, the concept of "execution-related goods and services" is intended to recognise that certain activities carried on by a broker are inextricably linked with the actual execution of a transaction with or on behalf of the investment manager. Examples of such activities mentioned in previous FSA papers include booking and processing of orders, active order management, carrying out programme trades and other complex trading strategies, 'working' orders in tranches to minimise market impact costs, and certain sales and trading advice (CP 05/5). If such services cannot be paid for by portfolio managers via dealing commissions as "execution services", then it is not clear that portfolio managers can either accept or pay for such services at all, on the basis that they do not constitute either "research" or "acceptable minor non-monetary benefits",

[1] Under the MiFID II inducements regime set out in the Delegated Directive, buy-side firms will need to evaluate the services that they receive from brokers by reference to the following four categories:

a) **"Execution services"**: reflecting the costs of executing a transaction (as per Art. 13(9) of the MiFID II delegated directive), these charges must be separately identified but may be paid for via dealing commissions.

b) **"Research"**: materials constituting third party research (as described in Recital 28 of the MiFID II delegated directive) will not constitute an inducement when paid for out of the portfolio manager's own resources or via a research payment account.

c) **"Non-monetary benefits"**: cannot be accepted by portfolio managers and charged to their clients via dealing commissions (Art. 12(2) of the MiFID II delegated directive), but may be paid for out of the portfolio manager's own resources. Such non-monetary benefits must be subject to a separately identifiable charge.

d) **"Acceptable minor non-monetary benefits"**: as listed in Art. 12(3) of the MiFID II delegated directive (and the proposed COBS 2.3.A15 R), such benefits may be received by portfolio managers without charge.

other than out of their own resources. We do not think that this is either the intended or the desired outcome of the legislation.

3.2.1.3 The MiFID II inducements regime applies to non-monetary benefits provided "*in connection with* the provision of an investment service or an ancillary service". Certain activities, however, should properly be seen as an *integral part of* the investment service (or ancillary service) being offered to the portfolio manager (and, indirectly, its underlying customers) and so not subject to the inducements regime at all. The benefit of these services goes to the end client; therefore, the risk addressed by the MiFID II inducement rules of improper inducement is not inherent in these goods and services which are inextricably linked to the provision of execution to the end client.

3.2.1.4 We are concerned that such a restrictive approach may in effect prohibit portfolio managers from carrying out complex transactions. Transactions in complex derivatives, structured products, or the execution of bespoke trading strategies, for example, typically require significant investment of time and resources by a broker to structure transaction(s) to meet the client's needs in advance of executing any trades. Recital 30 of the MiFID II delegated directive, however, states that "any non-monetary benefit that involves a third party allocating valuable resources" to the portfolio manager will not constitute an acceptable minor non-monetary benefit. Given this, it is essential that such structuring activities fall within the remit of "execution services", as otherwise it is not clear that portfolio managers will be able to benefit from such activities at all and, by extension, will be restricted in their ability to enter into complex transactions. This could be a significantly negative result for the operation of financial markets.

3.2.2 We therefore ask the FCA to clarify in its Policy Statement that the scope of "execution services" includes all services and activities that are integral to the execution of a transaction.

3.3 Scope

Requirement to price research and execution services separately

3.3.1 AFME notes the helpful guidance in COBS 2.3C.4G which states that this section of rules is intended to enable firms subject to the more restrictive inducements provisions to meet their obligations. However, the requirement for sell-side firms to price research separately for all investment firms as set out in COBS 2.3C.1R would appear to go beyond this, as "investment firms" (whether based in the EU or not) captures a far broader set of firms than those subject to the restrictions under Article 24(7) or (8) of MiFID II, and would require executing firms to separately price research for firms who are neither prohibited from accepting research free of charge nor from paying for it as part of an execution cost. AFME recognises that the language of "investment firms" is included in the MiFID II delegated Directive Article 13(9); however AFME thinks that this text needs to be read in light of the provisions in the primary legislation and the intention of this part of the rules, which is limited to facilitating compliance for firms caught by Article 24(7) or (8). In particular, AFME notes that the delegated power on which Article 13(9) of the delegated Directive is predicated depends on Article 24(13) of MiFID II, which is about making rules for firms that receive inducements, not firms providing execution services.

3.3.2 AFME considers that the omission of the reference to firms established in the Union and the resulting extension of scope wrongly gold-plates the MiFID II requirements on firms when dealing with investment firms that are not subject to the prohibitions in Articles

24(7) or (8) of MiFID II, either because they are not European investment firms or because they are European investment firms that are not subject to the narrower inducements rules. We would suggest amending COBS 2.3.C1 R (1) to clarify that it captures "an investment firm subject to Art 24(7) and (8) of Directive 2014/65/EU".

Extraterritoriality Issues

3.3.3 AFME is currently working with its US affiliate association, the Securities Industry and Financial Markets Association (SIFMA) and its members, in identifying the specific issues members have with the potential conflict between the US and European regulatory regimes for investment research post-MiFID II application, in particular:

3.3.3.1 **The Investment Advisors Act 1940.** In order for providers to accept hard dollar payment for research content and services authored by US broker-dealers, they will need to have Investment Advisor status, which imposes a fiduciary duty to those clients who receive research and prevents principal trading with those clients to whom the duty is owed. Whether the Investment Advisors Act would be implicated for payments from European-domiciled clients for access to US authored research and US domiciled research analysts and/or payments from global clients to European broker dealers if the global client shares US authored research content with its US affiliates, are difficult open questions.

3.3.3.2 **Section 28(e) of the Securities Exchange Act 1934.** This provision creates a safe harbour that allows investment advisers, under certain circumstances, to use client commission payments (soft dollars) to purchase eligible brokerage and research services. The safe harbour protects a manager from a claim that it breached its "best execution" fiduciary duty to its investors solely by not selecting, in conjunction with a purchase of eligible brokerage and research services, the lowest commission rate available, if the adviser determines in good faith that the amount of the commissions paid is reasonable in relation to the value of the brokerage and research services provided by the relevant broker-dealer. The safe harbour is available only on agency transactions and certain riskless principal transactions. For buyside firms to fall within the Section 28(e) safe harbour, research basis points may only be added to execution commission on agency transactions and certain 'riskless' activity. If seeking to use an operational arrangement that collects a research charge alongside a transaction fee, an EU regulated investment manager which is also registered with the SEC will need to collect research charges when carrying on risk principal-based trading activity to be on a level playing field with other EU investment firms and to mitigate any cross-subsidisation/conflicts of interest.

3.3.4 According to data provided by one AFME member, its EMEA domiciled clients consumed more US-authored research (approximately 50% of their total consumption) than EMEA-authored research. These statistics highlight the strong incentive to find agreed solutions as soon as possible as a failure to do so may result in a substantial disadvantage to EMEA domiciled clients, in particular, if legal conflict results in a reduction in their overall ability to access US research.

3.3.5 AFME requests that the FCA continue to engage, directly and with other European policymakers, with the SEC regarding potential conflict between the US and European regimes and assist in developing a workable solution to the benefit of investment research consumers in both regions. An outcome that involves European asset managers no longer

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being able to access US-authored investment research or engage with US-based analysts is a particularly negative outcome that would hurt their investment process and therefore European investors.

3.3.6 Additionally, and although we have highlighted the issue in the US (being the most important market), AFME understands that this problem is not confined to the US and that similar problems exist to a greater or lesser degree in each of Canada, Japan, South Korea and possibly many other jurisdictions. The solution needs to come from Europe, as it does not seem likely that all the other jurisdictions will change their rules to suit the new European rules.

3.4 Daily sweep to a Research Payment Account

3.4.1 In COBS 2.3B.6-19G of the draft Handbook rules, the FCA proposes guidance relating to the collection of research charges alongside transaction fees or costs providing an important and increasingly more useful option to portfolio managers and their end clients, in particular global portfolio managers who must accommodate for an array of international clients with various regulatory requirements. In the accompanying CP text, the FCA proposes that a broker deducting research charges from transaction fees or costs should sweep the funds collected to an RPA *"immediately following the associated transaction (e.g. daily or within the settlement period for the transaction"*, although acknowledging that *"detailed reconciliations may take place less frequently, e.g. weekly or monthly*".

3.4.2 This proposal is a concern to AFME because:

3.4.2.1 The suggestion that funds should be swept daily into an RPA is unduly burdensome on both the brokers and their clients. It requires reconciliation processes which are not coterminous with any settlement process and certainly go much further than any reconciliation process available to the industry at present. The operational challenges inherent in performing daily sweeps would introduce additional operational risk for both clients and brokers.

One of our members examined data from a sample of their CSA clients in July 2016 and found that more than 50% of CSA accruals on a daily basis were under or equal to USD$100 per day. Daily sweeps of such small amounts would be operationally burdensome and disproportionally raise the operational costs incurred by the client. AFME believe that a sweep frequency that is proportionate and appropriate to the trading process and size of the client (e.g. monthly or longer) and robust contractual provisions specifying the control of the portfolio manager of such funds would achieve a similar beneficial outcome without the accompanying cost.

3.4.2.2 Such daily sweeps are not mentioned or required by the terms of the MiFID II delegated directive, which is not prescriptive as to how any "operational arrangement for the collection of the client research charge" should work. It appears far from certain that other European jurisdictions will impose such onerous requirements on brokers active in their jurisdictions (we note, for example, that the AMF's public consultation on the funding of research by investment firms under MiFID II does not mention such requirements). UK brokers, therefore, may be placed at a competitive disadvantage to their European counterparts.

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3.4.3 AFME therefore asks that the FCA provides more flexibility regarding the frequency of sweep from the RPA and instead introduces best practice guidance that brokers should transfer balances on a regular basis in line with the expectations of their portfolio manager clients. AFME expects that an industry standard will develop in the run-up to the implementation of the rules.

3.4.4 AFME notes the requirements in COBS 2.3B.19G(1) and believes these could be problematic in the context of an enhanced CSA style model where a broker collects research payments alongside execution commission which are transferred to an RPA. AFME would like to discuss how members should be thinking about these requirements with FCA staff.

3.5 Operational practicalities – RPA collecting the research charge alongside an execution charge

3.5.1 AFME believes that the three research payment models (P&L Method, RPA Accounting Method and RPA Transaction Method) are all viable options for investment managers providing flexibility for international investment managers that have operations spanning multiple jurisdictions. Such managers need to be able to adopt a payment model that can be applied globally. AFME has outlined two scenarios below and would therefore request the FCA provide guidance to confirm the rebate process as outlined satisfies the requirements of COBS2.3B.7R to ensure the total amount of research charges collected does not exceed the research budget.

3.5.1.1 For those asset managers that are considering collection of the research charge alongside an execution charge (CSA-like model) and set budgets at strategy level - consider the implications if the firm executes a block order which is allocated to multiple funds across different strategies - the research rate charge alongside the execution charge may need to be different at the allocation level in order to accrue the relevant amount for each strategy RPA. This would require industry wide operational infrastructure upgrades across both the sell-side and buy-side to support globally.

AFME has concerns on the limited implementation timeframe, and therefore there is a need for tactical solutions that meet the key principles, whilst allowing more time for the industry to adapt post-trade processes to cope with variable commission/research charge rates at allocation level.

AFME proposes that it should be permitted to set the research rate charge the same (weighted average for example) for each allocation (at block level) and use a rebate/re-capture like mechanism to correct for any over-charging/cross-subsidisation as long as the investment manager discloses upfront to its clients the accounting practice it will adopt and that the total research charge to the underlying client is in line with what was notified to them upfront.

3.5.1.2 For those asset managers that are considering to collect the research charge alongside a transaction charge (CSA-like model) - consider the implications if the firm under-generate research charges to meet the research budget (i.e. low turnover) - would the asset manager have to:

(i) make a top up payment into an RPA from its own P&L to meet the set budget level; or
(ii) could the investment manager adjust the research charge/bps up to meet budget as long as the total charge to underlying client remained in line with what was agreed/notified to

them upfront (likewise where firm may over-collect, will they be able to adjust research bps down/ switch off)?

AFME believes that both options should be permitted as long as the investment manager discloses upfront to its clients the accounting practice it will adopt and that the total research charge to the underlying client is in line with what was notified to them upfront.

3.6 Ex-ante research budgeting vs. Ex-post evaluation

3.6.1 In section 3.26 of the CP, the FCA notes that *"Any payment for research should be justified based on a firm's quality criteria and valuation approach,* ***and*** *(emphasis added) corresponding prices offered by providers for agreed levels of goods and services."*

3.6.2 This comment is of concern to AFME because:

3.6.2.1 There is a temporal disconnect between the setting of the research budget and payment out of that budget based on the quality and value assessment for the research provided. Although the research budget and prices for the goods and services will be set ex-ante under MiFID II, AFME members believe allocation of the research budget, and the actual payments made under that budget, to research providers could still be based on an ex-post evaluation of the quality of the research received and its value to the client, the timing of which must be done ex-post.

3.6.2.2 Consider the situation if the top analysts at a well-known research provider were to leave mid-year after a large amount for the provider's services had been previously budgeted. The firm's assessment of quality and valuation of the product may be affected by the events.

3.6.2.3 The situation described above also illustrates the necessity of reasonable buy-side trial periods, for example three months, in situations where providers are marketing a new product and/or analyst. These trial periods would allow a firm the flexibility to seek out the best research product for its clients and/or itself while promoting effective competition among research providers (see also section 3.9).

3.6.3 AFME therefore asks the FCA to confirm that the assessment of quality and valuation can be made either on an ex-ante or an ex-post basis using a sufficiently granular and robust broker evaluation process, in line with FCA DP 14/3 best practices, as a suitable method to assess the quality and value of research provided (independent always from any execution services that may have been provided during the period).

3.7 FICC research

3.7.1 In section 3.38 of the CP, the FCA notes that investment firms will have to *"extend or establish new arrangements to ensure they can make payments to receive research when managing and transacting in non-equity or equity related derivative instruments."* AFME are aware that different pricing models may end up being commonplace depending on among other things, whether the research charge is for research on an equity or on a non-equity financial instrument.

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3.8 Controls for unsolicited research

3.8.1 AFME notes the comments in section 3.39 of the CP regarding the prevention of unsolicited and unpaid research. AFME understands the intention is to prevent a loophole to provide research without payment by classifying it "unsolicited". However, the proposals on investment firms to have controls to prevent the receipt of unsolicited and unpaid research are impossible to implement fully.

3.8.2 AFME therefore requests that the proposal be tailored to require investment firms to prevent receipt of unsolicited and unpaid research on a reasonable endeavours basis, with appropriate controls and reviews to ensure that their procedures mitigate the possibility of receiving such research in a systematic fashion.

3.9 Trial periods

3.9.1 Similar to "unsolicited research", AFME understands the intention behind the FCA view on allowing trial periods for receipt of research. However, as for any commercial services offer, trial periods are an important tool for research providers to attract consumers. They increase competition and innovation and can lead to cheaper and better research for end-users, while avoiding restrictions on competition. AFME agrees with the FCA intention to prevent a possible loophole, but believe a flexible approach must be given for trial periods so that overall, consumers conduct their investment decisions based on the best research available. Naturally trial periods need to be designed and controlled such that they are not in effect a way to circumvent the regulatory requirement.

3.9.2 AFME requests that the FCA state that use of trial periods are still possible without indirectly onerous requirements (e.g. sign-up applications) that similarly make it harder for research providers from attracting new consumers.

3.10 Subscriptions for publications

3.10.1 AFME is concerned that the reference to "subscriptions for publications" as an example of goods or services that the FCA does not regard as *research* (COBS 2.3B.23 G (6)) may be viewed as covering access (via a firm's portal or third party aggregator site) to content properly falling within the meaning of research as set out in the Delegated Directive.

3.10.2 **We therefore ask the FCA to clarify that "publications" in this context would not include content within the meaning of research as set out in the Delegated Directive.**

3.11 Hospitality

3.11.1 AFME notes that, as stated in paragraph 2.12, the FCA published in April 2016 its key findings and expectations on non-monetary benefits. In relation to hospitality, these findings and expectations went beyond what the industry believed represented current guidance. Subsequent publications and speeches by the FCA, while generally helpful, have not completely clarified the position. For the avoidance of doubt, therefore, we would appreciate it if the FCA would confirm that both now, and after the coming into force of MiFID II, the following statements are correct:

3.11.1.1 The provision of reasonable hospitality by firms to clients, including by wholesale firms to asset managers, can be acceptable.

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3.11.1.2 All such hospitality should be in accordance with the firm's documented entertainment policy, which policy should be approved and monitored by the firm's compliance department with reference to, among others, anti-bribery and corruption law and regulation.

3.11.1.3 Enhancement of the quality of service to the client can include building a better personal relationship between the client and those in the firm who deal with that client.

Chapter 4 - Client Categorisation

4.1 AFME is concerned with the FCA proposals for introducing criteria in classifying local authorities as professional clients. COBS 3.5.3 R sets out qualitative and quantitative criteria for investment firms in determining whether to classify local authorities as professional clients. AFME questions whether the COBS 3.5.3AR (2) (b) threshold of GBP 15 million is a suitable level for local authorities.

4.2 More generally, AFME is concerned that the criteria in each of COBS 3.5.3A R (2)(a) and COBS 3.5.3A R(2)(c) could also limit the ability of a local authority to be opted up to professional status given the practical difficulty in applying these requirements. In respect of COBS 3.5.3A R (2)(a), in practice, it may be difficult for a local authority to satisfy this element of the quantitative criterion, particularly in the context of a local authority pension fund, given such funds often do not trade frequently or consistently throughout the year. Similarly, with regard to 3.5.3A R(2)(c), practically applying this criterion to employees of a local authority may be difficult given it is not anticipated that local authority employees would generally satisfy these requirements. However, we understand that external consultants are often contracted to local authorities (and sit on the local authority pension fund investment committees) in order to help direct the decision making and investments of the pension fund itself. AFME would therefore suggest that the FCA provide guidance to the effect that the experience and activities of external consultants and/or the pension fund investment committee experience as a whole could be taken into account when determining whether the local authority satisfies this aspect of the criteria. We note that in the context of other aspects of MiFID II (i.e. appropriateness/suitability) it is possible to review knowledge and experience of a third-party representative of a client so we believe analogies can be drawn to this context.

4.3 AFME members operate their businesses as far as possible on an internationally consistent basis and therefore would prefer local authorities to be treated consistently across Europe, so we would in the first instance suggest that FCA refrains from exercising the power MIFID grants it to make UK-specific rules. If, however, FCA considers that the specific characteristics of UK local authorities mean that they should be afforded increased default level of protection, as proposed in the current draft rules, then we would submit that the characteristics of the local authorities and the need for protection remain the same regardless of the location of the entity conducting business with the local authority. Therefore, the classification rules should be written in a way that is focused on the nationality of the local authority, an approach that is consistent with the policy intention behind the power granted by the EU legislator. It will be important for EU Member States to develop a consistent approach to this, and AFME would therefore suggest that the point of classification of local authorities in accordance with the guidance of the NCA competent for the authority be discussed at ESMA level.

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4.4 The FCA requires that local authorities are categorised separately depending on the capacity in which they are acting (i.e. either as treasury manager or a pension fund administrator), and apply the opt-up criteria separately to each business line. In the case in which the local authority does not keep its assets separate between the two functions (treasury manager and pension fund administrator) AFME requests further FCA guidance as to what evidence can be used for calculating the GBP 15 million threshold of the client's financial instrument portfolio.

Chapter 8 - Appropriateness

5.1 AFME notes the new COBS 10A which sets out appropriateness rules for non-advised MiFID or equivalent third country business. In light of the forthcoming Insurance Distribution Directive (IDD) which will apply to insurance and reinsurance distributors from 23 February 2018, AFME would appreciate clarity from the FCA on whether it will review the scope of COBS 10A, particularly in light of the proposals contained in Article 30 of the IDD.

Chapter 11 - Investment research

6.1 AFME notes that COBS 12.2.14G includes wording from Articles 36 and 37 of the delegated regulation on research. However, COBS 12.2.14G states that COBS 12.2 will apply to both independent and non-independent research. With regards to non-independent research, AFME understands that it is not the FCA intention to require investment firms to impose a physical separation of those preparing non-independent research (i.e. sales people) from the trading desk, nor does AFME believe this is practical or proportionate given non-independent research falls to be treated as a "marketing communication" under MiFID II. The FCA's intention (and the drafting and purpose of Article 37(2) of the Delegated Regulation on research) appears to be reflected in COBS 12.2.21EU, which only refers to investment research, not non-independent research. This approach also seems consistent with other national competent authorities who seem to be giving a pragmatic interpretation to this provision by not applying the segregation and independence requirements to non-independent research. AFME would therefore request that the FCA redraft relevant provisions of COBS 12.2 to make clearer where provisions apply to both independent research and non-independent research, and when they do not.

Chapter 13 - Product Governance

7.1 AFME notes the FCA proposals here to extend the product governance provisions as rules for firms undertaking MiFID business, for firms that manufacture structured deposits and for branches of third-country investment firms. The proposals also state that these provisions would apply as guidance to non-MiFID firms involved that manufacture or distribute MiFID products.

7.2 While AFME appreciates that there may be some legal constraints in applying these provisions as rules to those non-MiFID firms, however AFME would still prefer that the application of the product governance provisions is as consistent as possible. AFME is unsure that applying these provisions as guidance rather than rules to those non-MiFID firms may reduce the requirement on those firms to apply such provisions. AFME would therefore propose that these provisions be applied as rules for all firms mentioned.

7.3 AFME has been unable to identify a disapplication provision in the Product Intervention and Product Governance Sourcebook (PROD) for eligible counterparties (ECPs). This would therefore

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extend the scope of the requirements beyond the MiFID II applicability requirements in the Level 1 Directive.

7.4 AFME members would welcome the opportunity to discuss the geographical scope of the product governance obligations and the practical implications of PROD 1.3.3R to PROD 1.3.12G.

7.5 AFME has had the benefit of seeing in draft the British Bankers' Association response to Chapter 13 – product governance – and is in broad agreement therewith.

Chapter 14 - Knowledge and competence requirements

8.1 AFME understands from the FCA that it considers its current approach to knowledge and competence already to be a significant step towards MiFID II compliance. AFME further understands that the FCA expects firm to have regard to the relevant ESMA Guidelines but will not be making any other specifications from the Guidelines within the body of the Handbook in this regard.

8.2 However, it would still be useful for firms to have sight of the guidance which the FCA intends to publish on its website as soon as possible in order that firms can prepare themselves in a timely fashion.

Chapter 15 - Recording of telephone conversations and electronic communications (taping)

9.1 AFME wishes to comment on the FCA's proposal to extend the taping regime to corporate finance business (see section 15.11).

9.2 We note that, as set out in section 15.21 of CP 16/29, Article 16(7) of MiFID II does not require NCAs to impose an obligation on investment firms to record conversations relating to corporate finance business such as the provision of advice and underwriting to issuers. This is because the recording obligations under MiFID II are intended principally to capture secondary market client orders rather than corporate finance business.

9.3 We also note that the proposal was not included in the discussion on taping in chapter 8 of DP 15/3 and is therefore a proposal which has not previously been highlighted as being a possible step which could be undertaken as part of the transposition of MiFID II into UK law.

9.4 Further, we understand that no other NCA is proposing to extend the obligation to record in this way as part of their transposition of MiFID II into national law.

9.5 AFME believes that the FCA should not extend the regime beyond the requirement set out in MiFID II because: (a) the introduction of taping would put firms operating in the UK at a competitive disadvantage; and (b) there would be practical difficulties in putting in place a regime to cover corporate finance business.

9.6 In short, AFME believes that the proposed extension will in fact have negative consequences for the operation of primary capital markets and the provision of M&A advice and be of little benefit to the aim of identifying market abuse. We would urge the FCA to reconsider its proposal.

9.7 We have set out below in more detail our concerns about the impact of the proposal on UK corporate finance business as well as the limits to the practical benefits of its introduction:

9.7.1 Issuers and corporate finance clients are very likely to prefer not to conduct business on a recorded line. As it will not be required in other jurisdictions, in our view this will lead

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to a decline in the demand for corporate finance services in the UK. In addition, we believe that some clients and other parties will not consent to the recording of telephone conversations, which would compound this adverse effect further. Accordingly, the proposals risk considerably hindering the proper functioning of UK financial markets in respect of corporate finance business.

9.7.2 Discussions between banks and clients in relation to corporate finance business routinely involve deliberations about potentially difficult and nuanced interpretations of specific issues. AFME believes that the act of recording such discussions would have a negative effect on the deliberations. As there would be a risk that recordings may be discoverable by third parties in litigation or other proceedings, participants may be concerned that statements made during such discussions may be misinterpreted when taken out of context or reviewed in hindsight. As a result, and out of caution, participants may decide to ask legal counsel to lead business discussions and be less willing to have an open dialogue about negative issues on a transaction which would, if not otherwise properly discussed and dealt with, increase the risks for the end investor and the transaction parties. It may also have the effect of parties being less willing to have an open discussion about new ideas.

9.7.3 As the proposed recording requirement would apply from the initial contact made until the conclusion or otherwise of the transaction, there will a long period during which staff may make calls relevant to the transaction. Corporate finance transactions (unlike the execution or receipt and transmission of orders) may last for a year or more and locating relevant conversations will require a long process of review. Furthermore, calls relating to corporate finance business are typically much longer than calls relating to trading activity.

9.7.4 As corporate finance staff travel frequently, relevant conversations take place on mobile phones. These conversations are not recorded as there are considerable challenges for banks in establishing an appropriately secure infrastructure in relation to calls on mobile phones. Even if an appropriate secure infrastructure to record these calls could be identified and applied consistency across the industry, it is also the case that network coverage varies and can be poor both in the UK and overseas. This means that corporate finance staff who are travelling will in many cases need to use unrecorded lines, for example in a hotel, and/or may be joining conference calls which are not recorded, particularly if hosted outside the UK.

9.7.5 Given the cross-border nature of corporate finance activity, calls to staff or clients in other jurisdictions (including conference calls involving internal colleagues from other jurisdictions) represent a significant portion of corporate finance discussions with clients, it is likely that data privacy considerations will restrict the ability of firms to record telephone calls which involve staff or clients based in jurisdictions outside the UK.

9.7.6 It should also be noted that, in the context of corporate finance transactions, the decisions taken on the transactional terms are already recorded in writing between the banks and the client. Article 76 of the Delegated Regulation, that is referred to in CP 16/29 for guidance, indicates that the information that is required to be recorded relates to the details of the order (information such as price, volume, type, and timing of the order), and that such records must be available to the client. In the case of corporate finance business,

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all such transactional details would be documented and available to the client (for example, in the context of new issuance transaction, in an underwriting agreement between the banks and the issuer). Such agreements are self-contained and do not require further contemporaneous records to be created. There is therefore no risk, in AFME's view, that a corporate finance transaction is executed without the agreement between the firm and the client.

9.7.7 Targeted key aspects of regulated corporate finance activities, namely market soundings are currently already recorded. The taping of these interactions, where the release of inside information has been identified, is a manageable process given the notice required for such calls and the specific, discrete nature of the interaction. All other corporate finance business discussions are unpredictable, do not necessarily involve discussions relating to inside information, which is the main concern from a market conduct perspective and in our view the use of the market sounding regime to reduce the risk of misconduct is a proportionate and targeted way for the FCA to reduce the risk of market abuse. The imposition of a broader obligation will not achieve the aim of enhancing market integrity.

10 AFME may have further comments and questions as the implementation of MiFID II proceeds and as ESMA and EU national competent authorities develop their writing. AFME is always ready and willing to assist the FCA in the implementation process.

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