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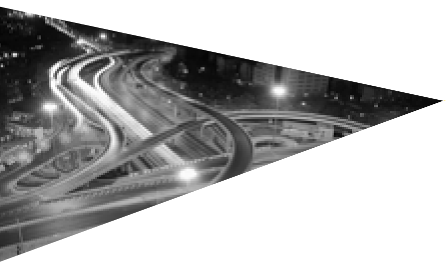
FSO Alert



European Parliament endorses MiFID II package

European Parliament endorses the upgrade of the Markets in Financial Instruments Directive (MiFID II) and ESMA issues opinions on complex and structured products

On 15 April 2014, the European Parliament voted to endorse the upgrade of the Markets in Financial Instruments Directive (MiFID II). Under MiFID II, financial services firms, including banks and investment firms, need to rethink their product governance, distribution and financial markets activities.

How EY can help

EY helps financial services firms to:

- Understand the impact of the MiFID II package on business and operational models
- Analyze the impact of revised inducement regime on the distribution models of investment funds
- Plan for, and implement, the new requirements

Background

The objectives of the revision of the MiFID Directive are to strengthen the protection of investors and to make financial markets more efficient, resilient and transparent. The MiFID II package will apply to banks, investment firms, market operators, and entities providing post-trade transparency in the European Union.

In October 2011, the European Commission issued its proposed *Review of the Markets in Financial Instruments Directive (MiFID).*

After more than two years of intensive work to define their positions, an agreement between the European Commission, the European Parliament and the Council of the European Union on the MiFID II package was reached in January 2014. The agreed text has now been endorsed by the European Parliament.

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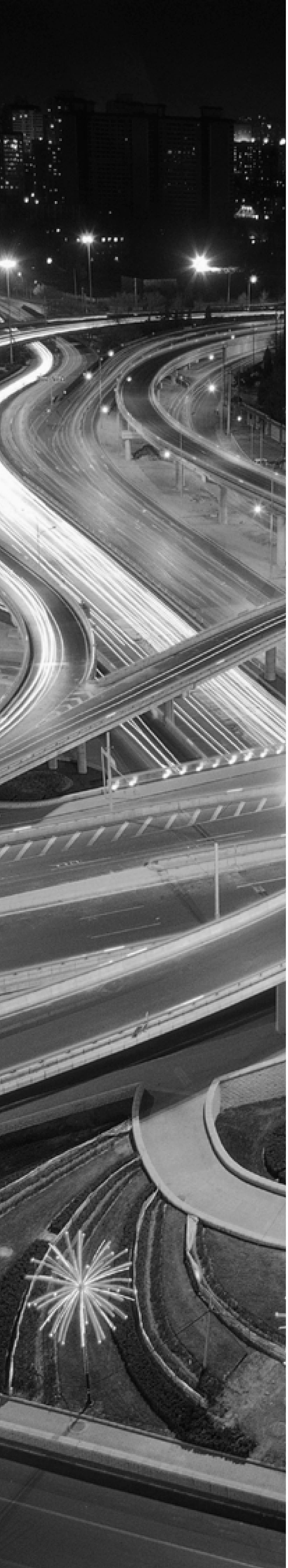

The interpretation and practical implementation of key elements of MiFID II will depend on the clarifications developed by the European Securities and Markets Authority (ESMA). These so-called "Level 2" measures will be drafted by ESMA for public consultation, finalized by ESMA and then adopted by the European Commission.

The adoption of MiFID II follows the publication by ESMA of opinions on marketing and selling of complex products and on structured retail product governance practices.

In February 2014, ESMA issued its Opinion on *MiFID practices for firms selling complex products* and an Investor Warning on *Risks of investing in complex products*. In March 2014, ESMA issued an Opinion on *Structured Retail Products – Good practices for product governance arrangements*. Both of ESMA's opinions are significant in the context of the interpretation of MiFID II provisions.

MiFID II

The legislative measures adopted consist of:
- A recast of the MiFID Directive (Directive 2004/39/EC), which also amends the Insurance Mediation Directive (IMD – Directive 2002/92/EC) and the Alternative Investment Fund Managers Directive (AIFMD – Directive 2011/61/EU)
- A Regulation directly applicable in all Member States (MiFIR)

The key upgrades to the MiFID regime include:
- Stronger investor protection:
  - Strengthened governance and organizational requirements, including product governance and client asset protection
  - Strengthened rules of conduct, irrespective of client categorization
  - Clarification of the scope of execution-only services
  - Requirement to disclose to the client whether or not advice is provided on an independent basis
  - A framework for cross-selling practices
- Confirmed ban of inducements:
  - Ban on commissions (inducements) paid or provided by any third party or a person acting on behalf of a third party and in case of discretionary portfolio management and independent financial advice
  - General limitations on the receipt of commissions (inducements)
- Migrating derivatives trading to regulated platforms
- Strengthened and coordinated sanctions
- New market: the Organized Trading Facility (OTF)
- Limits on algorithmic trading and direct market access
- Position limits on commodity derivatives
- Broader scope of market transparency regime

ESMA MiFID practices for firms selling complex products

In February 2014, ESMA issued:

- An Opinion on *MiFID practices for firms selling complex products* for investment firms selling complex products on both an advised and non-advised basis
- An Investor Warning on *Risks of investing in complex products* for all types of investors

In these papers, ESMA is focusing on investor protection in the marketing and sale of complex products, in particular to retail investors.

In both papers, ESMA clarifies the MiFID definition of complex products or financial instruments. ESMA is of the opinion that products should generally be considered as "complex" when, for example, they:

- Are derivatives, or embed a derivative
- Are made up of one or more underlying financial instrument(s) that are difficult to value
- They use indices set up by the product manufacturer
- Have a fixed investment term of a number of years with barriers to early exit
- Have returns/pay-off structures involving multiple variables or complex mathematical formulas
- Include capital protection that may be conditional or partial

Examples of complex products include:

- Contracts for difference (CFDs)
- Binary options, turbos and warrants
- Exchangeable, callable, puttable, convertible, perpetual, subordinated bonds
- Certificates and credit linked notes
- Derivatives relating to underlying securities, currencies, interest rates, yields, or commodities
- Asset-backed securities

ESMA's *MiFID practices for firms selling complex products* outlines measures which should be implemented by firms selling complex products, including, *inter alia*:

- Organization and internal controls
- Suitability
- Appropriateness
- Disclosure
- Compliance

ESMA opinion on structured retail product governance

In March 2014, ESMA issued an Opinion on *Structured Retail Products – Good practices for product governance arrangements*.

ESMA's opinion includes a broad set of examples of good practices that firms, taking into account the nature, scale and complexity of their business, could put in place to improve their ability to deliver on investor protection.

"Structured retail products" (SRPs) are compound financial instruments that have the characteristic of combining a base instrument (such as a note, fund or deposit) with an embedded derivative(s) that provides economic exposure to reference assets, indices or portfolios. They provide investors, at predetermined times, with pay-offs that are linked to the performance of reference assets, indices or other economic values.

According to ESMA's opinion, depending on their role (manufacturing and/or distributing), firms' product governance arrangements should cover the following areas:

- General organization of product governance arrangements
- Product design
- Product testing
- Target market
- Distribution strategy
- Value at the date of issuance and transparency of costs
- Secondary market and redemption
- Review process

Implementation

In order to enter into force, the MiFID II package must be approved by the Council of the European Union and then published in the Official Journal of the European Union.

The MiFID II package applies as follows:

- The recast of the Markets in Financial Instruments Directive (MiFID II) applies 24 months after the entry into force. If the Council approves the Directive within a short period of time, the new MiFID could become mandatory at the beginning of the third quarter of 2016
- The Markets in Financial Instruments Regulation (MiFIR) applies 30 months after the entry into force. If the Council approves the Regulation within a short period of time, the new MiFIR could become mandatory at the beginning of the first quarter of 2017

ESMA's opinions on complex and structured products are not binding; however, national competent authorities should monitor the practices outlined in ESMA's opinion on complex products and promote the practices outlined in ESMA's opinion on structured products.

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