Conflicts of interest and inducements

21 October 2016

Conflicts of interest

Position under MiFID

Article 18 of MiFID requires firms to take all reasonable steps to identify conflicts of interest both between themselves and their clients and among their clients.

Article 13 of MiFID requires firms to maintain and operate effective organisational and administrative arrangements with a view to taking steps in order to prevent conflicts of interest from having an adverse effect on client interests.

Where these arrangements cannot ensure with reasonable confidence that the risk of damage to client interests will be prevented, the firms must clearly disclose the conflicts to the clients.

The MiFID delegated directive 2006/73/EC sets out in article 21 relevant factors for assessing whether a conflict of interest is detrimental to the client. These are:

- whether the firm is likely to make a financial gain or avoid a financial loss, at the expense of the client;
- whether the firm has an interest in the outcome of a service which is distinct from the client's interest in that outcome;
- whether the firm has a financial or other incentive to favour the interest of another client or group of clients over the interests of the client;
- whether the firm carries on the same business as the client; and
- whether the firm or that person receives or will receive from a person other than the client an inducement in relation to a service provided.

Article 22 of the MiFID delegated directive states that firms' conflicts of interest policy must be set out in writing and be appropriate to the size and organisation of the firm and the nature, scale and complexity of its business.

The conflicts of interest policy must:

- identify the circumstances which constitute or may give rise to a conflict of interest entailing a material risk of damage to the interests of one or more clients; and
- specify procedures to be followed and measures to be adopted in order to manage such conflicts.

Changes under MiFID II

MiFID II imposes more onerous obligations on firms to manage conflicts of interest. The changes introduced by article 23 of MiFID II are:

- a new requirement to take all appropriate steps, which is more onerous than the current requirement to take reasonable steps in order to identify conflicts of interest;
- a new requirement to put systems and controls in place to prevent as well as manage conflicts of interest that cannot be prevented; and
- where organisational arrangements are not sufficient to prevent conflicts from adversely affecting client interests, a new requirement to make an enhanced disclosure of the conflict and the steps taken to mitigate the risks before undertaking any business on the client's behalf.

The disclosure must be in a durable medium and include sufficient detail to enable the client to make an informed decision with respect to the service in the context of which the conflict arises.

Disclosure may only be used as a way of managing conflicts of interest as a measure of last resort. Where a firm relies on disclosure, it is required to state expressly that the organisational and administrative arrangements established by the firm to prevent or manage conflicts are not sufficient to ensure, with reasonable confidence, that the risks of damage to the interests of the client will be prevented.

A firm is also required to assess and periodically review (at least annually) its conflicts of interest policy.

Inducements

Position under MiFID

A firm must act honestly, fairly and professionally in accordance with a client's best interests (article 19 of MiFID).

Article 26 of MiFID delegated directive 2006/73/EC expands this in relation to inducements. Firms are not regarded as acting honestly, fairly and professionally in accordance with clients' best interests if they pay or are paid a fee, commission or non-monetary benefit for providing investment or ancillary services to clients in exchange for investment or ancillary services, unless they can rely on an exemption.

The exemptions are:

- fees/commissions/non-monetary benefits paid or provided to or by the client;
- fees/commissions/non-monetary benefits paid or provided to or by a third party where:
  - prior to the provision of the service the nature and amount of the fee/benefit is disclosed to the client in an understandable manner (where the amount cannot be ascertained, the method of calculating that amount, must be clearly disclosed to the client);
  - the fee/benefit is designed to enhance the quality of the relevant service to the client and;
  - the fee/benefit does not impair the firm's compliance with its duty to act in the client's best interests;
- fees necessary for the provision of investment services eg. custody costs and legal fees.

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Changes under MiFID II

The inducements rules regime in articles 24(7) – 24(9) of MiFID II and the Commission delegated directive (C2016) 2031 provide that the current MiFID regime applies for all MiFID II firms but stricter rules apply to independent advisers and portfolio managers.

Firms that provide independent advice to clients and/or portfolio management may not accept fees, commissions, monetary benefits and non-monetary benefits by any third party in relation to the provision of services to clients.

Minor non-monetary benefits

Accepting minor non-monetary benefits is allowed, provided that:

• the benefits are capable of enhancing the quality of the service provided;

• the benefits are of a scale and nature such that they could not impair compliance with the firm’s duty to act honestly, fairly and professionally in accordance with the clients’ best interest;

• the nature and amount of any benefit is clearly disclosed to the client; and

• the client is informed about mechanisms for transferring the fee/commission/monetary benefit/non-monetary benefit received (where applicable).

Acceptable minor non-monetary benefits are reasonable, proportionate and of such a scale that they are unlikely to influence the firm’s behaviour in a way that is detrimental to the interests of the relevant client. According to article 12 of the Commission delegated directive the benefits which qualify as acceptable minor non-monetary benefits are:

• information relating to a financial instrument or an investment service which is generic in nature or personalised to reflect the circumstances of an individual client;

• written material from a third party that is commissioned and paid for eg. by a corporate issuer to promote a new issuance, provided that the relationship is clearly disclosed in the material and that the material is made available to anyone wishing to receive it;

• participation in conferences, seminars etc on the benefits and features of a specific financial instrument or an investment service;

• hospitality of a reasonable de minimis value, such as food and drink during a business meeting, conference etc; and

• other minor non-monetary benefits which a member states deems capable of enhancing the quality of service provided to a client and, having regard to the factors set out in the Commission delegated directive.

Enhancing the quality of the service

Whether a monetary/non-monetary benefit enhances the quality of the relevant service to the client is an assessment that is made on a case by case basis. Article 24(9) of MiFID II states that any payment or benefit which is necessary for or enables the provision of investment services cannot give rise to conflicts with the firm’s duty to act honestly, fairly and professionally in accordance with the client’s best interest. Such payments or benefits include custody costs, settlement and exchange fees, regulatory levies or legal fees.

Article 11 of the MiFID II Commission delegated directive (C2016) 2031 gives further guidance on situations where the quality of the relevant service is enhanced. These include situations where a monetary/non monetary benefit:

• is justified by the provision of higher level service to the relevant client which is proportional to the level of inducements received eg. access to a wide range of instruments;

• does not directly benefit the recipient firm, its shareholders or employees without a tangible benefit to the relevant client;

• is justified by the provision of an on-going benefit to the relevant client in relation to an on-going inducement.

Record keeping and reporting in relation to inducements

Firms are required to keep records to show that any fees, commissions or non-monetary benefits paid or received by the firm are designed to enhance the quality of the relevant service to the client.

The record keeping obligations in Article 11 of the MiFID II Commission delegated directive (C2016) 2031 are:

• keeping an internal list of all fees, commissions and non-monetary benefits received by the firm from a third party in relation to the provision of investment or ancillary services; and

• recording how the fees, commissions and non-monetary benefits paid or received by the firm enhance the quality of the services provided and the steps taken in order not to impair the firm’s duty to act honestly, fairly and professionally in accordance with the best interests of the client.

In addition, firms that provide independent advice to clients and/or portfolio management must set up and implement a policy to ensure that any fees, commissions or any monetary benefits paid or provided by any third party are allocated and transferred to each individual client.

The reporting obligations on firms are to disclose to the client the following:

• information on the payment or benefit concerned (minor non-monetary benefits may be described in a generic way but other non-monetary benefits received or paid shall be priced and disclosed separately);

• where a firm is unable to ascertain in advance the amount of any payment or benefit to be received or paid and instead disclosed to the client the method of calculating that amount, the firm shall provide its clients after the event with information of the exact amount; and

• at least once a year, as long as (on-going) inducements are received by the firm in relation to the investment services provided to the relevant clients, the firm shall inform its clients on an individual basis about the actual amount of payments or benefits received or paid.

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Inducements and research

Investment firms may receive research without this constituting an inducement. Article 13 states that the provision of research by third parties to investment firms providing portfolio management or other ancillary services shall not be regarded as an inducement provided that it is paid for by:

- direct payments by the firm out of its own resources; or
- payments from a separate research payment account (RPA) controlled by the firm where a number of conditions need to be fulfilled, such as:
  - the RPA is funded by a pre-agreed charge to the client;
  - the investment firm is responsible for the account;
  - the charge is not linked to the volume and/or value of transactions;
  - the investment firm regularly assesses the quality of the research according to robust quality criteria and its ability to contribute to investment decisions.

The total amount of research charges received may not exceed the research budget set by the investment firm for the purpose of establishing the need of third party research.

Similarly to the general inducement regime, the research specific inducements rules include reporting and record keeping obligations. Where a firm makes use of the RPA, it shall provide the following information to clients:

- before the provision of an investment service to clients, information about the budgeted amount for research and the amount of the estimated research charge for each of them; and
- annual information on the total costs that each of them has incurred for third party research.

Articles 13(5) – 13(8) of the Commission delegated directive impose governance and oversight requirements to ensure that the RPA is operated in clients’ best interests.

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