MiFID Coordination
Markets Policy and International Division
Financial Conduct Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

Sent by email: cp16-29@fca.org.uk

20 December 2016

Dear Sir or Madam,

AIMA/MFA response to FCA Consultation Paper CP16/29,
"Markets in Financial Instruments Directive II Implementation"

The Alternative Investment Management Association[1] ("AIMA") and Managed Funds Association ("MFA")[2] (collectively: "the Associations"; "we") welcome the opportunity to provide comments to the Financial Conduct Authority (the "FCA") on its third Consultation Paper[3] relating to UK implementation of MiFID II (the "Consultation Paper").

In general, the Associations agree with the "copy-out" approach that the FCA has taken in relation to incorporating the Level 1 and Level 2 text of MiFID II[4] into the FCA Handbook. We support in particular efforts by UK and other EU regulators to keep the drafting of national implementing measures as close to the text of MiFID II as possible, given that this should increase the probability of harmonisation across the European Union.

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[1] AIMA, the Alternative Investment Management Association, is the global representative of the alternative investment industry, with more than 1,700 corporate members in over 50 countries. AIMA works closely with its members to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programmes, and sound practice guides. Providing an extensive global network for its members, AIMA's primary membership is drawn from the alternative investment industry whose managers pursue a wide range of sophisticated asset management strategies. AIMA's manager members collectively manage more than $1.5 trillion in assets.

[2] The Managed Funds Association (MFA) represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent, and fair capital markets. MFA, based in Washington, DC, is an advocacy, education, and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry's contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk, and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, the Americas, Australia and many other regions where MFA members are market participants.

[3] *See* https://www.fca.org.uk/sites/default/files/cp16-29.pdf.

[4] Directive 2014/65/EU on markets in financial instruments.

In our detailed response in Annex 1 we address a number of the points discussed in the CP. In particular, we suggest that:

- the FCA reconsider the impact of MiFID II rules on payment for research on fixed income markets and explore alternative approaches to ensure that clients are not left paying more for research and execution than they do currently;

- investment managers should have the ability to pay a research provider according to the managers' assessment of the value of research received – rather than operating under strict *ex ante* pricing models for research;

- investment managers should be able to disregard unsolicited research material from unrelated third parties that they have not elected to receive. Furthermore, investment managers should be able ignore research from connected third parties which they have expressly stated that they do not want to receive;

- the FCA should work with its counterparts at ESMA level to deliver a consistent approach in respect of whether corporate access services are to be considered a minor non-monetary benefit;

- regulators in the EU need to work with counterparts in other jurisdictions to address the implications of MiFID II for non-EU brokers (including, importantly, US broker-dealers) who provide research to EU investment managers;

- the FCA should not gold plate MiFID II client categorisation provisions and should allow grandfathering of clients whose status changes under MiFID II;

- reporting under RTS 28 should come into effect from April 2019, rather than April 2018;

- the FCA should not extend MiFID II standards on best execution and reporting to AIFMs and UCITS managers in order to avoid inconsistencies between the UK approach and that of other Member States;

- FCA should provide further guidance to clarify the application of product governance requirements for firms that provide services to professional clients, with a focus on implementing the regime in a proportionate manner;

- ESMA should clarify that portfolio management is not covered by MiFID II provisions on product governance; and

- the FCA should not extend taping requirements to all discretionary investment managers ("DIMs") and should preserve the exemption for DIMs in situations where their sell-side counterparties record calls.

The Associations would be pleased to discuss the issues addressed in this letter with you. Please do not hesitate to contact Jennifer Han (jhan@managedfunds.org), Adam Jacobs-Dean (ajacobs-dean@aima.org) and Matthew Newell (mnewell@managedfunds.org) in relation to the issues raised in this letter.

Yours truly,

/s/	/s/
Stuart J. Kaswell Executive Vice President, Managing Director & General Counsel MFA	Jiří Król Deputy CEO Global Head of Government Affairs AIMA

ANNEX 1

Inducements and research

Q9: Do you agree with our approach to transpose the MiFID II proposals for the receipt of research linked to the new MiFID II inducement rules as a new COBS 2.3B? If not, please state why and provide any suggestions for an alternative approach.

We believe that it is sensible for the FCA to create a new COBS 2.3B as part of its transposition of the MiFID II requirements. However, we have a number of comments on the FCA's approach to specific aspects of the rules on payment for research, which we detail below.

Setting budgets for use of RPAs and client-specific research charges

At paragraph 3.21 of CP, the FCA expresses its view that "firms can set a research budget that applies to a number of client portfolios or funds where they share similar investment strategies and objectives" to the extent that those portfolios or funds share similar research needs. The Associations welcome this approach to implementation of the Research Payment Account ("RPA") structure, as we believe that it will make the regime operationally more straightforward to administer, thereby reducing on-going compliance costs for firms that receive research from third-party research providers.

The CP also states at paragraph 3.23 that firms must be able to estimate and disclose client-specific charges on an upfront basis. We believe that it should be left to firms to decide how they will express this client-specific charge, which could either be presented as an absolute figure or as a proportion of fund assets, based on what the firm believes will provide the most helpful view to clients. Firms should also have the discretion to define budget periods and the start date of a given budget period, so as to give them the greatest possible operational freedom in administering the budget.

Funding an RPA by collecting charges alongside transaction costs

Operating RPAs

We believe that an important aspect of the MiFID II framework is the flexibility that it affords firms to collect client charges alongside transaction commissions, leveraging the strengths of the existing Commission Sharing Agreement ("CSA") architecture. As the FCA rightly notes, it is likely that firms will have to make operational changes to existing CSAs to properly integrate them into the RPA structure.

At paragraph 3.24 of the CP, the FCA states that in practice it expects that "using a single RPA to manage each separate research budget set by the firm would be the most effective way to meet the requirements". There is some ambiguity in this statement and it is unclear to us whether it implies that a firm should have a single firm-level RPA aggregating multiple research budgets, or whether the FCA envisages that a firm would have a series of separate RPAs, each associated with a separate research budget for a group of clients or funds operating under the same strategy.

Draft COBS 2.3B.14G suggests more clearly that the FCA envisages that a firm will operate one RPA for each group of clients under the same strategy, meaning that there are likely to be multiple RPAs at firm level where a firm offers multiple investment strategies.

We would welcome clarification of this point, but would also note that it would be preferable if the FCA were to leave it to firms' discretion to determine how many RPAs they will operate in light of their operating structure, research relationships and clients' needs.

The CP also addresses the frequency with which research charges that are deducted from a transaction fee should be "swept" into an RPA, suggesting that this should occur daily or within the settlement period for the transaction (paragraph 3.24, first sub-bullet). We believe that setting such tight timeframes for sweeping will lead to unnecessary operational costs, particularly given that budgeting periods are likely to be expressed in months, rather than days. We would suggest that the FCA remove the reference to specific sweeping timescales and permit firms to determine the timeframe during which research charges will be ceded to the RPA based on ensuring that research payment accounts are appropriately funded to be able to pay for research in accordance with the agreement between a firm and its clients. Draft COBS 2.3B.19G is less explicit than the accompanying commentary of the CP, referring only to the need to collect client research charges "without undue delay". We view this as a reasonable approach.

Client money considerations

The establishment of RPAs also gives rise to client money considerations. While we understand that RPA funds are not client money as per draft COBS 2.3B.15G, it is not explicitly clear how excess money in the RPA over and above what is required for the purchase of investment research should be treated. Industry understanding of this point is that excess funds in an RPA only become client money at the point at which a firm rebates this money to the fund or client and not in advance of a firm making a decision to make such a rebate. It would be helpful if the FCA could confirm our understanding of this point.

Valuation of research

In its discussion of RPA mechanics, the FCA also sets out its view that "[a]ny payment for research should be justified based on a firm's quality criteria and valuation approach, and **corresponding prices offered by providers for agreed levels of goods and services**" [emphasis added].

While we recognise that more explicit pricing of their research by providers might improve competition and create new opportunities for independent research providers, we would strongly caution the FCA against adopting any framework that could serve to undermine the ability of buy-side firms to reward research at a level that represents best value for their fund or account clients. We believe that the current drafting set out in the CP is weighted too heavily in favour of research providers and could disadvantage investment managers who purchase research.

In practice, managers will use a variety of approaches to valuing research and rewarding the research providers from whom they receive research. In some cases, the amount that an investment manager is willing to pay to a research provider is determined after the research has been received, reflecting the manager's assessment of the quality of the research material and its value to on the manager's trading decisions and performance (a value which is entirely subjective and as determined by each investment manager based on their particular circumstances). This logic is inherent in the broker vote process as it exists today as part of running a CSA. It would be harmful to fund and account clients if an investment manager were constrained in its ability to pay less (or not at all) for research material that is deemed to be of little value after it has been received (or, equally, to pay more where deemed appropriate). Research is not a uniform commodity and it is important that an investment manager retain the ability to put a value on research that is in its clients' best interests.

For example, a manager could conclude that the research provided by broker A is not as valuable nor as timely as research provided by a different broker B at lower cost. It would be in the interests of the investment manager's clients for the investment manager to pay broker A less rather than to pay broker B more.

Alternatively, there might be situations in which a manager takes the view that the level at which a broker prices its research undervalues the research based on the cost of comparable services provided by other brokers. In this scenario, it would not be in investors' interests to pay over and above the quoted price for the service.

Similarly, independent research, like broker research, can vary in quality and value even among similar providers. The manager can best evaluate the value to investors, in some cases doing so prior to subscription and in other cases after receipt of research by considering the relative value of one research provider compared to other providers.

Research and minor non-monetary benefits

<u>Blocking unwanted research</u>

At paragraph 3.28 of the CP, the FCA refers to the need for firms to not accept research where to do so would constitute a breach of the research provisions. We believe that this statement must be qualified in order for it to be workable for firms.

Firstly, there are situations in which it is appropriate that a firm receive research for free, for example in a situation where it is trialling the goods and services of a research provider in order to make an assessment about whether to establish a relationship with that provider. This will be particularly important for independent research providers, who are not able to market their services as an adjunct to execution services.

Secondly, it is difficult to envisage how a manager can stop accepting research if a research provider with whom it has a relationship ignores an instruction to discontinue the supply of research or where the research provider simply "spams" its distribution list with research material. In our view, as long as the investment manager has taken reasonable steps to communicate its desire not to receive research from the research provider, which might entail writing to the relationship manager or relevant sales contact (and following up where required), then the firm should not be penalised if research continues to be sent to its employees. Similarly, investment managers should be able to disregard unsolicited research material from unrelated third parties that they have not elected to receive.

Corporate access services

Draft COBS 2.3B.23G identifies corporate access services as services that could not be paid for from research payment accounts. We believe that corporate access services could still fall with the concept of minor non-monetary benefit and highlight our support for the AMF's approach to this issue.[5]

In particular, the AMF deem "straightforward introduction without provision of a service of an intellectual nature", such as merely providing a "concierge" service, as a minor non-monetary benefit that does not need to be paid for using the research budget.[6]

We consider that such services could clearly be deemed to fall within the definition of a minor non-monetary benefit under Article 12(3)(e) of the Delegated Act, in that the service itself is not of significant value, but it is still capable of enhancing the quality of service to a client and is unlikely to impair compliance with an investment firm's duty to act in the client's best interests. We note that most issuers actively want to meet and talk with investors. Accordingly, a concierge service is generally merely administrative to facilitate meetings that the issuer wishes to have, rather than providing any added value by occasioning the issuer to meet with investors where it would not otherwise do so. It would be inefficient and unnecessary to attempt to put an explicit price on such concierge services, simply resulting in the underlying clients of investment firms paying additional fees to brokers and banks. We therefore suggest that concierge services should be treated as a minor non-monetary benefit.

The AMF has further stated that "if corporate access is combined with a higher added value service such as, for example, the preparation by an analyst of a detailed briefing note drawing lessons from a meeting attended by that analyst, recommending a given strategy in relation to the securities of the issuer in question or its industry sector and enabling the investment firm to form an opinion, enhanced corporate access service could be considered research within the meaning of Article 13 of the Delegated Directive." Again, we would endorse this position.

As noted elsewhere in this submission, we believe that it is important that the UK implement MiFID II in a manner that is consistent with European legislation, whilst also considering the approach taken by other Member States; this is particularly important in light of the UK's withdrawal from the EU and the need to consider future equivalence determinations and the competitiveness of the UK's financial services industry after Brexit.

Accordingly, it would be useful for the industry if the FCA were to engage with its counterparts at ESMA level to promote a harmonized EU-wide approach on this issue

[5] See Page 17 of the Public consultation by the AMF on the new rules for the funding of research by investment firms under MiFID II. Available at: http://www.amf-france.org/en_US/Publications/Consultations-publiques/Archives.html?docId=workspace%3A%2F%2FSpacesStore%2F15f91213-d77a-48d4-b2dc-e63806b708e4.
[6] Ibid.

Implications for firms

Fixed income research

At paragraph 3.38 of the CP, the FCA notes that investment managers will have to put in place new arrangements for fixed income research, particularly given that this is outside of the scope of the existing COBS 11.6 that covers only research relating to equities and equities derivatives. This is further addressed in the cost benefit analysis included in the CP, that suggests:

> "For fixed income and other asset classes, costs versus benefits may be broadly cost-neutral in the short term. This is because separate payments for research on fixed income may offset out any potential reduction in transaction costs passed to clients, or with any net difference likely to be very small." (p.149)

We respectfully disagree with the FCA's assessment of the likely impact of the new rules in the fixed income space and remain of the view that the new rules will lead to additional cost for clients without concomitant benefits in terms of lower execution costs. Indeed, we are not aware of any reliable means of disaggregating the cost of research from bond spreads and note that where firms employ "soft dollar" arrangements to generate funds to pay for fixed income research, the softing amounts might in fact be generated alongside non-execution expenses, such as clearing fees. Our concern is that in moving to explicit pricing of fixed income research, investment managers, and ultimately their clients, will end up carrying additional research costs, and there will not be any tightening of spreads for trading those instruments.

While we appreciate that the FCA's starting point for implementation of MiFID II requirements is determined by the European legislation, we would nevertheless encourage the FCA to take a more critical approach to the application of MiFID II rules on payment for research in the fixed income space.

For example, there are potentially good reasons to treat certain categories of fixed income research – including macro research - as an acceptable minor non-monetary benefit, particularly where the research is broadly disseminated to a large number of the research provider's trading counterparties, and we would strongly encourage the FCA to consider this possibility seriously to ensure that investment managers, and ultimately their investors, are not left worse off as a result of MiFID II rules on payment for research.

We would also encourage the FCA to engage further with research providers and those that actively trade fixed income products to explore further how MiFID II could best be implemented in a way that accommodates spread-based markets. The FCA might also need to consider more direct supervisory intervention to ensure that where brokers provide both execution and research services on a bundled basis at the present point in time, they do in future adjust their spreads to account for explicit remuneration of their research services.

Research payments to non-EU brokers

We would like to take this opportunity to highlight some of the cross-border implications of MiFID II requirements, particularly when it comes to investment managers' relationships with US broker-dealers.

It is long-standing practice in the US for broker-dealers who provide investment research to investment managers to be remunerated through "soft dollar" arrangements structured in a way that complies with Section 28(e) of the Securities Exchange Act of 1934 ("Exchange Act"). This provides a safe harbour that protects an investment manager from liability, as long as the manager determined in good faith that the amount of the commission was reasonable in relation to the value of the brokerage and research services received.

In turn, a US broker-dealer who provides investment research and is compensated through a soft dollar arrangement would typically be excluded from the definition of investment adviser in the Investment Advisers Act of 1940 ("Advisers Act"), which specifically excludes from the definition of investment adviser a broker-dealer whose provision of investment advice is "solely incidental" to the conduct of its business as a broker-dealer and who receives no "special compensation" for providing such services.[7]

A question arises, therefore, as to whether a US broker-dealer could accept a payment from an RPA for research that it has provided to an execution client and still be exempt from registration under the Advisers Act.

We understand that the SEC would view payments out of an RPA as hard dollar payments, which would mean that a broker-dealer which advises on the value of securities, on buying or selling securities or which "issues or promulgates analyses or reports concerning securities" would need to seek registration under the Advisers Act in order to receive such payments. The requirements associated with operating under the Advisers Act for broker-dealers are likely to prove disruptive to client relationships.

For example, one of the consequences of a broker-dealer being required to register as an investment adviser is that Section 206(3) of the Advisers Act generally prevents an investment adviser from trading as principal with an advisory client without disclosing its capacity in writing and receiving client consent to the transaction. The application of this provision and others in the Advisers Act would increase regulatory burdens for broker-dealers which would likely be passed on to clients.

We believe that the FCA, ESMA and European Commission should jointly work with the SEC to identify potential solutions to this problem, similar to approaches with other cross-border issues. In particular, we believe EU regulators should seek to mitigate potential harmful effects on EU investors that would occur if US research providers are not able to service them in a way that

[7] Section 202(a)(11)(C) of the Advisers Act.

complies with MiFID II standards. This will ultimately support the smooth implementation of the EU rules.

To the extent that this is not addressed quickly by regulators, firms will need to consider the establishment of operational structures that can achieve compliance with disparate sets of rules. In our recent discussions, the FCA indicated that it would, for example, accept structures whereby an EU investment manager makes an intra-group payment to a non-EU parent in exchange for access to research obtained by its parent through softing arrangements with local brokers. It would be helpful to have explicit confirmations that firms can establish such structures in order to deal with the reality of significant differences between the EU's rules on payment for research and those of other jurisdictions.

Q10: Do you agree with our approach to extending the research and inducements requirements to firms carrying out collective portfolio management activity? If not, please give reasons why.

At paragraph 3.30 of the CP, the FCA explains that it is consulting on the basis of applying the research and inducements requirements in MiFID II to MiFID-exempt UK authorised firms carrying out investment management of collective investment schemes.

As with other MiFID II standards, we question whether it is appropriate to extend them to the full population of investment managers, including those authorised under other sectoral legislation. We note that other jurisdictions are unlikely to implement MiFID II in this manner, such that gold-plating by the FCA could lead to inconsistency and competitive distortion within the EU. In addition, given the UK's withdrawal from the EU, it is appropriate to consider at this stage how the read-across of MiFID II requirements to non-MiFID firms could impact any eventual equivalence discussions between the UK and EU regarding their respective rules and also how this could impact the competitive standing of the UK asset management industry.

Q11: Do you agree with proposals to retain some guidance provisions from the existing COBS 11.6 in the new COBS 2.3B section, where they continue to be relevant under the new proposals? If not, please give reasons why.

We generally find guidance material to be helpful and welcome its incorporation under COBS 2.3B.

Q12: Do you have any views on areas where we have proposed new guidance provisions to clarify our interpretation of steps firms could take to ensure compliance with the new inducements and research proposals and the detail of the proposals? If not, please give reasons why and any alternative suggestions.

Please see our response to Q9, which identifies those areas where we believe that the FCA should consider an alternative approach.

Q13: Do you have any views on whether further guidance provisions are needed to clarify other aspects of the new inducements and research proposals and how firms should interpret and implement changes to comply with these provisions? If so, please detail specific aspects on which you think FCA guidance is desirable.

At paragraph 3.28 of the CP, the FCA states that it is for firms receiving research to make their own assessment of whether material or services are indeed research for the purposes of the inducements provisions. While we appreciate the point that firms should not be able to exploit the labelling of research material as a means to disregard the inducements provisions, we note that it would be an undesirable outcome if firms adopted different approaches to what constitutes research and would suggest that this is a point that could helpfully be addressed by ESMA in a Question and Answer or preferably Guidance where this can be delivered quickly. In this regard, we note that the AMF has clarified that "macroeconomic research distributed widely to a large client base for marketing or sales purposes" would constitute a minor non-monetary benefit, a position that could helpfully be endorsed at ESMA level in order to foster consistent implementation of MiFID II standards across the EU.[8]

It would similarly be helpful for ESMA to consider the status of other services such as capital introduction with a view to adopting a common EU-wide position on how they should be treated in the context of the inducements provisions. The present CP does not itself offer any additional commentary on this point, which could lead to uncertainty.

[8] *See* http://www.amf-france.org/en_US/Publications/Consultations-publiques/Archives.html?docId=workspace%3A%2F%2FSpacesStore%2F15f91213-d77a-48d4-b2dc-e63806b708e4.

Client categorisation

Q16: Do you agree with our approach to revise the quantitative thresholds as part of the opt-up criteria for local authorities by introducing a mandatory portfolio size requirement of £15m? If not, what do you believe is the appropriate minimum portfolio size requirement, and why?

At paragraph 4.13 of the CP, the FCA signals its intention to recalibrate the quantitative test that applies to a retail local authority client that seeks to opt up to professional status, by amending the quantitative threshold for portfolio size from EUR 500,000 as set by Annex II of MiFID II upwards to £15,000,000.

The Associations do not support this proposal and believe that it represents a significant and unnecessary departure from the agreed European legislation.

At present, many Local Government Pension Schemes ("LGPS") make asset allocations to alternative investment managers in order to help deliver their long-term obligations to their pension beneficiaries. We do not see that it is in the interests of LGPS to make it harder for them to achieve professional client status and believe that it would be highly undesirable if the FCA's approach to MiFID II implementation were to limit LGPS' ability to invest their assets freely in line with their risk tolerance and investment objectives.

The FCA also goes on to address the matter of grandfathering, clarifying at paragraph 4.22 of the CP that "firms with local authority clients who do not meet the re-calibrated quantitative criteria to become professional clients and which are not authorised to provide services to retail clients need to consider what permissions they need in order to continue servicing those clients".

Again, we do not believe that this approach would best respect the interests of local authority clients and could ultimately lead to situations in which a local authority client has to exit investments because of a change in its classification, negatively impacting its investment strategy and creating additional costs to exit and replace the position. We therefore believe that it would be preferable to apply MiFID II client categorisation on a forward-looking basis, such that existing client relationships are not reclassified as a result of the new regime.

As to the matter of how the UK's approach would interact with the approach taken by other jurisdictions within the EU, paragraph 4.16 of the CP notes that where firms provide MiFID or equivalent third-country business to local authorities and municipalities located in another EU Member State, firms should defer to the status of the local authority or municipality as determined by the law of the state in which that undertaking is established. While we do not object to this approach, we do believe that it is appropriate that there should be consistency in the approach taken across the EU to ensure that firms are able to implement the rules in an effective manner. The FCA's approach to the opt-up criteria in itself undermines the potential for consistency, which is another reason why we would prefer the FCA not to depart from the framework of Annex II of MiFID II.

Dealing and managing

Q33: Do you agree with our proposed approach to implementing the MiFID II requirements on best execution? If not, how could we amend our proposed approach?

The Associations have previously highlighted[9] our concern that subjecting investment managers to the disclosure provisions of RTS 28 could provide a commercial advantage to their brokers, whilst adversely impacting managers' ability to obtain best execution by impairing their ability to negotiate with brokers on pricing. While we appreciate that this aspect of the MiFID II framework has now been codified through Level 2 measures, we nevertheless believe that authorities should approach the implementation of the relevant provisions in a cautious manner to ensure that their impact is fully considered.

With this is in mind, we are particularly concerned with the approach being taken by the FCA and EU regulators regarding the implementation of the best execution provisions. For example, in late October, the FCA indicated at an industry roundtable that the first RTS 28 report will need to be published by MiFID investment firms in April 2018. This has caused considerable concern among our members who understood the first report to be due in 2019, which appears to us to be a reasonable interpretation of the wording in the primary legislation. The April 2018 timeframe is particularly concerning given that ESMA Level 3 interpretative material on RTS 28 reporting and RTS 27 reporting has yet to be published, which is expected to provide key information firms will need to ensure they are capturing the correct information come 1 January 2017 to ensure they can easily produce the RTS 28 reports. For example, at the time of the FCA confirming the April 2018 timeframe, key ESMA Level 3 Q&A remains outstanding, including guidance on identifying passive and active orders, and whether firms should capture the LEI at the entity or group level.

We believe that the FCA and other ESMA members should reconsider the date of application of RTS 28 reporting and would suggest that it would make greater sense for the regime to come into application from April 2019 at which point firms will be in a position to provide meaningful information. To the extent that the FCA continues to push for reporting from April 2018, we encourage the FCA to take into account the challenges that this will present to firms in its supervision of firms' compliance for the first reporting cycle.

Q34: Do you agree with our proposal to add new guidance to the Handbook chapter on best execution? If not, please explain why.

We generally find guidance material to be helpful and welcome its incorporation under COBS 11.2A.

Q35: Do you agree with our proposals for non-MiFID business? If not, what alternative approach could we consider?

The Associations do not support the FCA's proposals to extend: (i) RTS 28 reporting requirements to UCITS management companies, full-scope UK AIFMs (and incoming EEA AIFM branches) and

[9] *See* http://www.managedfunds.org/wp-content/uploads/2015/03/ESMA_CP.pdf.

those small authorised UK AIFMs and residual CIS operators which have not 'switched off' best execution obligations in their fund documents; and (ii) also the general MiFID II best execution standards to UCITS management companies and those small authorised UK AIFMs and residual CIS operators which have not 'switched off' best execution obligations in their fund documents. (We note that the FCA intends to consider separately whether to supplement the best execution obligations which currently apply to full-scope UK AIFMs with the other enhancements to the best execution provisions made under MiFID II.)

The Associations continue to be concerned that the RTS 28 reporting requirements will place investment managers and their fund clients at a competitive disadvantage and impair their ability to negotiate with brokers on pricing. Such disclosure requirement would be particularly harmful for investment managers with only one or two fund clients as it would disclose their clients' execution strategy.

Moreover, the Associations are concerned that the FCA's proposals go substantially beyond what is required by MiFID II. The EU legislators did not take the opportunity presented by MiFID II to extend any or all of the MiFID II best execution requirements to alternative investment fund managers (they did not, for instance, include in the MiFID II legislative package any amendments relating to best execution to the Level 1 AIFM Directive or Level 2 AIFM Regulation). Whilst the EU legislators might consider the extension of such requirements to AIFMs as part of "AIFMD II", we do not think that it is appropriate for the UK to gold-plate current standards in advance of such changes potentially being made.

Whilst it may be helpful for groups which have both MiFID investment firms and AIFMs/residual CIS operators in their group structure to have the option to apply MiFID II best execution standards on a group-wide basis in order to ensure consistency across business lines and achieve operational efficiencies, this should not be a mandatory requirement; it should be open to firms to make a decision based on their specific circumstances. For those hedge fund groups which are regulated solely under the AIFMD and do not have a MiFID firm, there is no advantage to them in applying the RTS 28 reporting requirements to their full-scope AIFM(s) and/or the more general MiFID II best execution requirements to their sub-threshold AIFM(s) (if they have not been able to 'switch off' best execution obligations in the relevant fund documents). Indeed, applying these standards would put such groups at a competitive disadvantage when compared with hedge fund groups operating in other EU jurisdictions given the additional compliance burden and costs such levelling up will necessarily impose.

Separately, in the event that the FCA confirms the extension of the RTS 28 reporting requirement to AIFMs and UCITS companies, we encourage the FCA to provide clarity on the timeframe for the first reporting at an early stage. In this regard, we suggest that the FCA give impacted firms until April 2019 to publish the first report.

Product Governance

Q51: Do you agree with our proposal to apply the MiFID II product governance provisions as rules for firms engaged in MiFID business? If not, please give reasons why.

Proportionality for professional clients

The Associations support the general approach taken to apply the MiFID II provisions as rules for MiFID business. And in light of the MiFID II provisions being driven by FCA guidance, including the RPPD, we support such guidance supplementing the rules where appropriate. There is, however, a considerable gap in the rules and guidance from our perspective with respect to addressing the proportionate application of the rules when firms are dealing with professional clients. The overall focus of the FCA's approach to implementing the product governance requirements remains on the retail market, making it difficult to understand the FCA's expectations in the institutional space. While we propose to raise this issue with ESMA as well, in relation to their Consultation Paper providing draft guidelines on MiFID II product governance requirements, to achieve an overall consistent approach, we believe it would also be appropriate for the FCA to consider establishing proportionality rules for certain categories of the target market assessment, allowing the requirements to be disapplied in appropriate circumstances or in relation to specific client types. We consider the AIFM Remuneration Code provides a useful example of how proportionality rules have been developed to acknowledge where certain considerations may be unnecessary, for example, for larger, sophisticated clients, who need less protection.

By way of example, to the extent that a firm has professional investor funds (e.g. AIFs), their number and their complexity should be taken into account in determining whether or not proportionality can be taken into account. To the extent a firm manages a large number of AIFs which implement a wide range of strategies, this is likely to indicate increasing complexity. A firm may consider its activities as non-complex where regulation limits the AIF strategies implemented or scope of investment in such a way that investor risk is mitigated. Where its activities are non-complex, or the products are non-complex as a result of the strategy (e.g. long-short equity), the target market assessment requirements should be disapplied.

In addition, we do not believe it is necessary or appropriate to apply the MiFID II product governance provisions to products offered by MiFID firms solely to overseas investors where local regulations apply. For example, it is often the case that a MiFID firm will register as in investment adviser with the U.S. Securities and Exchange Commission, and form a fund, pursuant to the U.S. Investment Company Act of 1940, targeted at, and solely for sale to, US retail investors. In such instance, the sole nexus to the EU is that the investment manager firm is domiciled in the EU, and may be a MiFID firm due to other EU activities or products. We question the justification for applying EU investor protection rules in these circumstances, where local investor protection rules will apply for those investors and may be more stringent, such as the U.S. Employee Retirement Income Security Act of 1974 ("ERISA").

Overall, our members are of the view that it would be helpful for the regulators to provide clarity on how the rules would apply, on a sliding scale, depending on the nature of the product and the target market. While this is clearly intended from the text of the Delegated Directive, the

Associations believe that while the draft guidance can be applied easily to a fairly simple product sold to a retail client, it has limited flexibility in practical application to the huge variety of products and client types in the market. Clarity of expectations in this regard will ensure that resources are directed appropriately according to the complexity of the product and level of sophistication of the client. This will enable firms to streamline processes at the more sophisticated end of the market, where little benefit will be seen from extensive investor protection measures. Sophisticated investors have better financial fluency, know their own requirements, are able to understand more complex products and are able to perform their own due diligence on the fund and the fund manager.

On a related point, we believe it would be beneficial for industry if there were standardised client types within the MiFID II categorisations. The ESMA Consultation Paper on draft guidelines on MiFID II product governance requirements suggests that firms may develop their own descriptions within the MiFID II categories, for example 'private wealth clients' or 'sophisticated clients'. We believe that it would be worthwhile for the regulators to standardise the approach to common client types (noting this should not be exhaustive to allow for some flexibility) to ensure a level of consistency, and to identify where it may be appropriate to take a proportionate approach to the target market assessment, as discussed above.

In our view, there are a number of types of *per se* professional clients in relation to whom firms should be able to assume a detailed understanding of their own investment requirements and objectives, and that they will have performed their own due diligence on the fund and the fund manager. Unless it becomes apparent there are reasons that the investor is not properly advised, we believe client types of this nature should be subject to a proportionate approach under the regime. This will be relevant for a number of institutional investors, including for example, pension funds (and their management companies), sovereign wealth funds and national government bodies. Similarly, where a fund manager is selling interests in a fund to a regulated professional adviser or a regulated financial institution, such as a private bank acting as principal, conducting a target market assessment is likely to be duplicative and of little, if any, benefit.

There may also be other client types in the retail space where it may be appropriate for firms to also take a proportionate approach to conducting a target market assessment, for example, in relation to self-certified sophisticated investors and high net worth individuals. In this regard, the FCA currently exempts (at COBS 4.12 of the FCA Handbook) such persons from a restriction on the financial promotion of non-mainstream pooled investments; however, such persons will remain sufficiently protected by a suitability assessment.

Discretionary portfolio management services

AIMA and MFA members have noted the various references to portfolio management activity within the ESMA draft guidelines on MiFID II product governance requirements; and are concerned to the extent that ESMA's guidance is meant to cover the provision of discretionary portfolio management. The Associations intend to request that ESMA clarify that discretionary portfolio management is not included under its guidelines on MiFID II product governance requirements.

Portfolio management activity is defined in the MiFID II text as "managing portfolios in accordance with mandates given by clients on a discretionary client-by-client basis where such portfolios include one or more financial instruments." We think this definition clearly puts portfolio management outside the scope of the provisions of the MiFID II texts relating to "products" and "product governance" for the following reasons:

(i) Portfolio management envisages a mandate "given" by a client – meaning that it is the client who decides how their portfolio should be constructed rather than the creation of a "product" for sale across a potential spectrum of investors. This certainly reflects the reality of portfolio management activity within the institutional space where clients have very clear ideas about what type of portfolio they want and for which reasons (this could be for hedging purposes, liability matching purposes, pure investment purposes or a variety of other reasons all of which reflect the requirements on a case by case basis);

(ii) Portfolio management envisages "discretionary activity". This means that the manager will be choosing underlying investments using its discretion according to the mandate given. It is the manager and not the underlying client who will be making decisions on underlying investments. In this situation it is the discretionary portfolio manager which is the target market, not the portfolio manager's underlying client. This reflects the practice under AIFMD, for example, where a sale of an AIF to a discretionary manager is deemed to be a sale to a professional client regardless of whether the portfolio manager is managing a portfolio for a professional or retail client;

(iii) Portfolio management envisages activity on a "case-by-case basis". We think the concept of "product" is designed to cover financial instruments or products which may be sold on a mass or at least on a duplicated basis and not within a service which is clearly understood to relate to a single identifiable client on a "client-by-client basis"; and

(iv) Portfolio management relates to discretionary management in respect of portfolios which include one or more financial instruments. ESMA's guidance states that the "objective of the product governance requirements is to ensure that firms, which manufacture and distribute financial instruments and structured deposits, act in the clients' best interests during all the stages of the life-cycle of products or services." A discretionary portfolio may include financial instruments but those instruments will on the whole be manufactured or distributed by third parties. To the extent that a portfolio includes financial instruments which are manufactured or distributed by the portfolio manager itself then clearly those instruments will be caught by product governance requirements but not in other circumstances (and for the purposes of assessing target market this would include discretionary portfolio managers and not underlying clients of discretionary managers).

Given the possibility for a misunderstanding or divergence of interpretation by national regulators, advisers and the industry as a whole, we think that it is important that ESMA should explicitly confirm that the product governance requirements do not apply to discretionary portfolio management. We note that the absence of product governance in relation to discretionary portfolio management does not mean that there is a gap in the protection given to clients. This will be well covered under the suitability and appropriateness provisions.

Q52: Do you agree with our proposal to apply the MiFID II product governance provisions as guidance for non-MiFID firms involved in the manufacture or distribution of MiFID products? If not, please give reasons why.

The Associations are of the view that it is preferable that the provisions do not apply as guidance to non-MiFID firms. Non-MiFID firms will be subject to the product governance requirements to the extent that they provide MiFID investment services, and will also need to be in a position to meet information sharing requirements under the product governance regime. Beyond this, we believe application of the rules, even as guidance (historically akin to rules, where firms will likely need to justify departures from the guidance), would create an unreasonable regulatory burden on firms not providing MiFID services with entities across the UK and Europe. While many firms may choose to apply a consistent approach, where the group includes MiFID and non-MiFID entities, we believe it should be left to firms to make this decision based on what makes sense within their group.

Recording of telephone conversations and electronic communications (taping)

Q54: Do you agree with our proposed unified approach to implementing the MiFID II requirements on taping of telephone conversations and electronic communications? If not, please give reasons why.

Taping exemptions

At paragraph 15.2 of the CP, the FCA sets out its planned approach of applying a taping regime to Discretionary Investment Managers (DIMs), while also removing the current exemption for situations where a call is recorded by a sell-side broker.

This aspect of MiFID II will have a significant impact on our members, many of whom do not currently tape calls on account of the existing taping exemptions, which we strongly believe should be maintained following implementation of MiFID II. Even for those firms that do currently tape calls, the extended retention period under MiFID II will mean a significant increase in data storage costs, which is likely to be disproportionate relative to the supervisory and enforcement value of the additional time over which information must be held. We believe that regulation should only be imposed where necessary and appropriate to address a particular regulatory need. In the context of telephone and electronic communication recording, we do not believe that such a regulatory need exists and that in practice the majority of relevant conversations and communications necessary to enable effective supervision by national competent authorities are recorded by investment managers' sell-side counterparties, providing the requisite information for supervisory inquiries and investigations.

When sell-side recordings are not available, the Associations note that an obligation still falls on the DIM to record calls unless it is able to utilise the exemption for calls with non-EU brokers. Therefore, we do not agree that a sufficient regulatory gap for telephone and electronic communications recording exists to necessitate the removal of the DIM exemptions and believe that the limited supervisory benefits of removing the exemptions would be far outweighed by the increased and duplicative costs of double recording and monitoring by both buy- and sell-side. Placing such additional costs on those DIMs would simply make DIM investments more expensive for investors as those costs will likely be passed on in the form of higher management charges.

Scope of calls to be recorded

Draft SYSC 10A.1.6R states that "[a] firm must take all reasonable steps to record telephone conversations, and keep a copy of electronic communications, that relate to the activities referred to in SYSC 10A.1.1R…". Some of the activities detailed under SYSC 10A.1.1R are so broad that they could ultimately encompass most of the day-to-day operations of particular types of entity (e.g. the activity of managing an AIF is potentially extremely broad in terms of the operations that it covers). Accordingly, we do not believe that this drafting correctly transposes Article 16(7) of MiFID II, as it would suggest that some firms would essentially have to record all calls relating to their ongoing operations.

While we acknowledge the statement in the CP that "the overarching requirement to record certain activities already exists", it overlooks the very important limitation of this requirement to "relevant conversations and communications" (COBS 11.8.8R). Implementation of the Handbook text as drafted would have major cost, operational and technological implications for many firms because of the material widening of the scope of the recording obligation that the FCA proposes. We also note that it would certainly be the case that many more mobile telephone lines would have to be recorded (and specifically for staff who have no involvement in any of the activities detailed under Article 16(7) of MiFID II), which would present particularly significant challenges.

For example, the practical implications of SYSC 10A.1.6R could require a firm to record nearly all of its employees' daily telephone, videoconference and email, among other electronic, communications and retain those records for six years. In this day and age, for many employees a majority of their daily communications may be electronic. The volume of data, including thousands of hours or recordings would be extremely burdensome and expensive to retain for six years, and would likely require firms to hire new compliance staff just to review and monitor those records. Conversely, we see no benefit for the FCA's market surveillance activities arising from such an extension of the regime.

We strongly believe that the FCA should maintain the current more limited scope of the regime and that it should not "gold plate" the directive in this regard. We therefore suggest that the FCA redraft the Handbook language so that the extent of the obligation to record telephone calls or electronic communications is brought in line with MiFID II (i.e. to record telephone calls or electronic communications that relate to client order services and own account dealing) while leaving it to the commercial judgement of firms to decide whether or not to record additional conversations or communications. We suggest that:

- the FCA retain the formulation of COBS 11.8.1R rather than adopt draft SYSC 10A.1.1R, so as to more accurately track the scope of Article 16(7) of MiFID II;
- the FCA amend draft SYSC 10A.1.6R so that it requires a firm to "take all reasonable steps to record **relevant** telephone conversations";
- the FCA maintain the exemptions under COBS 11.8.6R; and
- the FCA maintain the language under COBS 11.8.8R to define a relevant conversation for the purposes of (draft) SYSC 10A.1.6R.