MiFID II: Inducements and marketing commissions

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The recast EU **Markets in Financial Instruments Directive** (MiFID II) came into effect in the UK and other EU member states on January 3, 2018.

Its requirements apply to all firms authorised as "MiFID investment firms" that conduct "MiFID business". Broadly, this means any firm that is carrying out investment activities in respect of financial instruments, both as set out in more detail at Annex C of MiFID II.

MiFID II is implemented partly by directly applicable regulations and partly by local legislation that was required to give effect to certain MiFID II provisions.

Background to the inducements regime

There are many aspects to MiFID II, but one that has been the subject of much debate has been those requirements related to "inducements", namely payments made to or received from third parties. MiFID II's requirements in respect of inducements are squarely aimed at conflicts of interest by targeting payments that may "induce" firms to make decisions or take actions that are not in their clients' best interests.

As such, the MiFID II inducement rules are linked to arts 23 (conflicts of interest) and 24 (general principles) supported by art 11 of the MiFID II delegated implementing directive.

It is worth setting out the core requirement at art 24(9) of MiFID II in full, which states that:

"Member states shall ensure that investment firms [essentially all MiFIDauthorised firms] are regarded as not fulfilling their obligations under Article 23 [conflicts] or under paragraph 1 of this Article [best interests rule] where they pay or are paid any fee or commission, or provide or are provided with any non-monetary benefit in connection with the provision of an investment service or an ancillary service, to or by any party except the client or a person on behalf of the client, other than where the payment or benefit:

- (a) is designed to enhance the quality of the relevant service to the client; and
- (b) does not impair compliance with the investment firm's duty to act honestly, fairly and professionally in accordance with the best interest of its clients.

…The payment or benefit which enables or is necessary for the provision of investment services, such as custody costs, settlement and exchange fees, regulatory levies or legal fees, and which by its nature cannot give rise to conflicts with the investment firm's duties to act honestly, fairly and professionally in accordance with the best interests of its clients, is not subject to the requirements set out in the first subparagraph."

FCA implementation of the inducement regime

In the UK, the MiFID II inducements rules are applied to Financial Conduct Authority (FCA)-authorised firms via a new COBS 2.3A of the FCA's handbook of rules and guidance (the FCA rules).

This was introduced following Discussion Paper 15/3 (DP15/3) published by the FCA in March 2015, the publication of draft text proposed for COBS 2.3A in an Consultation Paper 16/29 (CP16/29) in September 2016 and the publication of the FCA's Policy Statement 17/4 (PS17/14) in July 2017, which set out final rules.

The new MiFID II inducements regime was finally introduced via the Conduct, Perimeter Guidance and Miscellaneous

Provisions (MiFID II) Instrument 2017 (FCA 2017/39).

COBS 2.3A effectively contains two separate sets of inducements rules for payments within scope of the inducements regime:

- **Rules applying to firms providing independent advice and portfolio management services to retail or professional clients and to firms providing restricted advice to retail clients.**

The FCA bans firms providing independent advice, restricted advice or portfolio management services to certain clients from accepting third-party inducements. It also bans firms providing independent advice or portfolio management services to professional clients and non-UK retail clients from accepting and retaining third-party inducements. In the case of a marketing commission (often referred to as a "trail commission"), no relevant payments are being accepted in connection with these services; they are being paid only.

- **Rules applying to firms providing other investment services.**

These firms are subject to the general rule on inducements, which means that they cannot pay or accept any inducement unless they fall within one of three safe harbours. Broadly speaking, payments and receipts paid or provided to the client and proper fees necessary for an investment services are permitted. However, for a third-party payment or receipt to be permitted, as mentioned above a number of conditions must be satisfied and details of the payment or receipt must be disclosed to the client.

In addition, the FCA's rules on inducements and research in COBS 2.3B enable investment firms to receive research without subjecting it to an assessment under COBS 2.3A. Research acquired in accordance with COBS 2.3B will not constitute an inducement.

Are payments subject to the inducements regime?

In many cases, it will be clear when a payment falls within the above (or the safe harbour included at art 29(4) of MiFID II for payments made or received that fulfil certain requirements).

There appears to be some confusion, however, as to the applicability of the MiFID II inducement rules to payments of trail commission for marketing and distribution services.

The main determinants of whether a payment falls within the MiFID II rules are:

- Has a payment (or other benefit) been made or received?
- Is this in connection with the provision of an investment service?
- Is the payment made by or to a party other than the client?

In other words, these are questions connected to considering who is the client and what is the service being provided. Payments made or received by a client itself are outside the scope of the inducement rules. In many cases the manager is the client for marketing purposes.

In most distribution arrangements, the client is the fund and the fund is making payments to a distributor on its own behalf. In other arrangements, the manager is appointed both as manager and distributor. In these cases the manager typically makes distribution payments out of its own fees.

In respect of whether there is a relevant investment service that triggers the application of the MiFID II inducement rules, if the fund or investment manager has appointed the distributor, that manager is not providing a relevant service in respect of the distribution payment — the manager is simply the client and has appointed another to provide a service to it.

From the distributor's perspective, its client is likely to be the fund or investment manager. This would also be outside the scope of the inducement rules (despite the presence of a relevant service if it is a MiFID-authorised firm). Even if the client was the fund itself, the safe harbour provisions should still apply, but this can vary on a case-by-case basis.

UCITS funds and UCITS management companies are not subject to MiFID II as they are subject to their own requirements under the EU's UCITS framework. However, where a UCITS management company also carries out (or more specifically has an authorisation to carry out) MiFID activities (for example, managing investments) it will become subject to the MiFID II requirements. (There is also a separate discussion in the EU about introducing a MiFID II type of regime to UCITS funds, but this has yet to happen.)

In summary, COBS 2.3A5R: (i) will not apply to an FCA-regulated distributor as the distributor is paid by its client; and (ii) will not apply to an FCA-regulated fund manager.

This is because such payments flow from the fund to the distributor and are not payments made by the fund manager to the distributor in connection with the provision of an investment service to the fund manager by the distributor. As such, payments made to third-party marketers/distributors do not fall within COBS 2.3.A5R and these payments may continue to be paid after January 3, 2018 as before.

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