FCA COMMENTS ON THE EXTRATERRITORIAL EFFECT OF MIFID II

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Investment Management Alert

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For a broader discussion of the key components, requirements, and impact of MiFID II, including those discussed in this update, please refer to our "MiFID II Toolkit for Global Investment Managers."

In a letter to the Alternative Investment Management Association (AIMA) made available to AIMA members on Monday, August 7, the Financial Conduct Authority (FCA) responded to a request from AIMA seeking interpretation and guidance on MiFID II requirements related to the delegation of certain management functions to non-EU firms, including U.S. subadvisors. The provisions at issue (specifically, Article 31 (outsourcing) of the MiFID II delegated regulation and Article 24 (inducements) of the MiFID II Directive) are of particular importance because they represent one of the most likely avenues of MiFID's extraterritorial effect on firms that are not directly subject to MiFID. While the FCA's letter is clear that MiFID-licensed firms may not absolve themselves of their responsibilities under MiFID II through delegation, it does present the possibility that MiFID-licensed firms and their non-EU delegates may achieve compliance through alternative arrangements that ensure that the substantive requirements of MiFID II are met.

BACKGROUND

Article 31 of the delegated regulation provides that MiFID-licensed investment firms outsourcing operational functions deemed "critical or important" shall remain fully responsible for discharging all of their obligations under MiFID II and for ensuring that (i) outsourcing does not result in delegation of responsibility by senior management; and (ii) the relationship and obligations of the investment firm towards its clients under MiFID II are not altered. Article 24 of the Directive prevents MiFID-licensed firms from receiving material third-party payments or benefits in connection with the management of client accounts that could induce the firm to act against the best interests of the client. Famously, this provision, together with Article 13 in the MiFID II delegated directive, requires MiFID-licensed firms to unbundle research costs from execution costs, and to either pay the cost of research directly or pay for research through a research payment account (RPA) funded by separate research charges to the client.

THE FCA'S RESPONSE LETTER

In the letter, the FCA quickly disposes of the notion that the delegation of portfolio management responsibilities can entirely relieve the delegating party of its responsibilities to ensure that clients receive the level of protection afforded by MiFID II. Thus, a MiFID-licensed manager cannot avoid unbundling research from execution simply by delegating portfolio management responsibilities to a non-EU manager that is not subject to MiFID II, as this would expose clients to the very conflicts arising from inducements that Article 24 was intended to address. Although not expressly stated in the FCA's letter, the FCA's comments should be taken as referring to delegations to both affiliated and nonaffiliated delegates of the MiFID-licensed manager as both types of delegation are considered outsourcings under MiFID II.

However, the FCA does not express the position that a MiFID-licensed firm must ensure strict compliance by a delegated manager with all of the requirements of the MiFID II inducement regime. Instead, the FCA takes the position that a delegating firm must "take steps to secure for its clients substantively equivalent outcomes as they would expect to receive on the relevant investor protection provisions in MiFID II," and that this responsibility "may" be satisfied if the delegated manager conforms to the substantive requirements of MiFID II "through other operational arrangements that are consistent with, but without necessarily being precisely the same as, the MiFID II provisions."

The FCA specifically refers to the issue that arises where a U.S. manager cannot make separate payments to a U.S. broker for research, indicating that, in this case, the obligation could be met by MiFID-licensed firms securing "the most comparable standards possible" from the U.S. manager by requiring it to:

Set a budget for the maximum research costs it will incur on behalf of the delegated funds, and provide a policy for how that budget will be used;

Fully account for the research inputs it receives in relation to managing the delegated funds, the value of the research inputs used (using objective benchmarks or metrics to make this value-assessment), and control payments made to research providers in line with the valuation of services; and

Have systems and controls to ensure the receipt of research does not influence order routing and best execution decisions, or give rise to any other conflicts of interest that risks material detriment to the delegated clients' funds.

We note that "the most comparable standards possible" is a watering down of the substantially equivalent concept, which may be read to open the door for similar relaxations in relation to delegation to managers in other jurisdictions in analogous circumstances.

PRACTICAL IMPLICATIONS

The FCA was careful to qualify its comments by noting that formal, legal interpretations of the MiFID II outsourcing provisions must come from either or both of the European Commission and European Securities and Markets Authority. Absent this formal guidance, or similar guidance from other member state regulators, the FCA's views set forth in the letter are not authoritative for MiFID-licensed firms operating in other EU member states.

Nevertheless, the letter represents important insight for firms struggling with the implementation of MiFID II in the adviser/subadviser context, particularly where a U.S. or other global manager provides subadvisory services to a MiFID-licensed firm. Specifically, the FCA's position appears to open the door for U.S. managers to satisfy the demands of these clients through enhanced tracking and reporting of their soft dollar usage, without needing to establish formal RPAs that introduce numerous complications under U.S. law that have not, as yet, been addressed by the SEC or its staff. Ultimately, the specific manner and scope of these protections must be negotiated between manager and subadviser.

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