

Luxembourg

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News on MiFID II and its implementation

On 3 July 2014 the Directive 2014/65/EU of the European Parliament and of the Council on Markets in Financial Instruments ("**MiFID II**") has entered into force, repealing the former Directive 2004/39/EC ("**MiFID**") and the Regulation on Markets in Financial Instruments ("**MiFIR**").

MiFID II will have to be implemented into Luxembourg law by June 2016 at the latest, whereas MiFIR will have a direct effect as a European regulation. Therefore all EU firms undertaking investment business or providing investment services to clients must be fully compliant with MiFID II by 3 January 2017. Final details on the "Level 2" texts are expected to be developed by ESMA and the European Commission by the end of 2015.

The core objective of MiFID II is to ensure a high degree of harmonised protection for investors in financial instruments. Moreover its purpose is to ensure and safeguard the efficiency and integrity of the financial system by an extension of scope in regard to the definition of investment services and financial instruments as well as the restriction of some of the MiFID exemptions and the establishment of common regulatory requirements by governing the functioning of the regulated markets.

This overview will summarise the main changes brought by MiFID II.

1. Scope of MiFID II

MiFID II has introduced an organised trading facility as a new type of trading platform (the "**OTF**"), defining it as a multilateral system which is not regulated market or multilateral trading facility (the "**MTF**"). The OTF is more informal, whereas the investment firm will be permitted operating an OTF to engage in matched principal trading in bonds, structured finance products, emission allowances and certain derivatives only where the client has consented to the process.

At this point the attention should be paid to the emission allowances that are a result of the extension of the definition of the financial instruments. Emission allowances consisting of any units recognised for compliance with the Emissions Trading Scheme Derivative (2003/87/EC) are an extension in order to combat a range of fraudulent practices that

have occurred in the spot secondary markets in emissions allowances. In addition commodity derivatives that can be settled and that are traded on an OTF have been added.

Furthermore several changes to MiFID exemptions have been made in regard to:

- dealing on own account;
- emission allowances trading by installation operators;
- ancillary business;
- commodities dealer and "locals" that have been deleted;
- commodity related systems; and
- central securities depositaries.

2. Investor protection

2.1. Changes regarding to third party payments and benefits

An important change of MiFID II is the strengthening of the antecedent MiFID protections around payments investment firms and credit institutions receive for their provision of investment services or performing investment activities (the "**Firms**") and therefore limit the receipt of commissions. Due to this MiFID II will introduce a complete ban on Firms receiving payments or other forms of non-monetary benefit from third parties for a service they carry out on the client's behalf. If these Firms receive any payment of a third party, they have to pass it on to the client; however minor non-monetary benefits that enhance the quality of the service provided to the client, are remaining admissible as long as they are clearly disclosed to it.

Thus, to maintain the client of more confidence that the service providers act in their best interest, the provision of any other investment services than portfolio management or independent advice are only being allowed as long as they (i) are disclosed to the client, (ii) do enhance the quality of the relevant service or (iii) do not impair the Firm's duty to act honestly, fairly and professionally towards the client.

2.2. Investment advice and product governance

Under MiFID II service provider will have to advise the client on a (i) broad and independent basis or (ii) more restricted analysis of a sufficiently diverse range of financial products available on the market.

A further matter to consider is that MiFID II will require Firms to have stricter internal or organisational requirements to ensure that Firms have explicit product governance arrangements around their product design and distribution. Firms are required to (i) identify the target market for each product and (ii) ensure all relevant risks. This will lead to a situation where poor quality products are less likely to be found in the market place or distributed to the client.

2.3. Safeguarding of client assets and product intervention

MiFID II obliges Firms to have proper controls to safeguard the client's ownership rights. Furthermore each Member State's financial regulator will be provided with important powers to ban certain products permanently and to limit their marketing to certain investor types only. MiFID II meets the need to strengthen the role of management bodies of Firms, regulated markets and data reporting service providers in ensuring sound and prudent management of the Firms, promotion of the integrity of the market and the interest of investors. These management bodies should be responsible and accountable for the overall strategy of the Firms.

2.4. Information types

There will be changes to information type's being supplied to client before the investment takes place, so that Firms must provide information to their clients:

- in regard to financial instruments, where an appropriate and clear guidance and warnings of risks associated with them is needed, as well as on whether the financial instrument is intended for the everyday retail market or for more sophisticated professional clients; and
- on whether the advice is based on a wide or narrow range of financial instruments.

2.5. Disclosure of information on costs and charges

To guarantee more comprehensive and detailed information on the costs that Firms charge while providing their investment services, MiFID II introduces additional disclosures about the costs and related charges of a Firm, mainly:

- Costs relating to both investment and other ancillary services (cost of advice, the financial instrument);
- Provision of total figure of all costs to the client; and
- Provision of itemised breakdown of costs by Firm on request of client.

2.6. Greater price transparency

The requirements to ensure prices are clear before and after trading on an exchange or other type of trading platform, will now apply to a wider set of financial instruments than just shares, meaning Firms must be clear about the prices they sell or buy bonds, depositary receipts, exchange traded funds, structured finance products and derivatives.

2.7. Structured deposits

Additionally MiFID II will cover structured deposits belonging to a category of financial products which was previously unregulated at EU level, but which satisfies similar clients, needs and raises comparable investor protection challenges to the types of financial instrument already within scope of MiFID. In conclusion this means that in future the sale of structured deposits will have to comply with several MiFID requirements as conduct of business and conflicts of interest rules. These, among others, complex products cannot be sold to clients on an execution-only basis, before it has received all the relevant information on this type of instrument.

2.8. Third country firms

There is no "EU passport" available for non-EU firms providing investment services or performing investment activities having established a branch in a Member State (the "**Third Country Firms**"). MiFID II contains a harmonised regime in regard to the cross-border provision of their services.

In regard to retail clients the relevant Member State may require that a Third Country Firm wishing to provide investment services to those clients on its territory established a branch in that Member State.

3. Corporate Governance

MiFID II provides new requirements regarding the management body members of the Firms which have to comply with the corporate governance provisions of CRD IV (Directive 2013/36/EU). As set out in Article 88 of CRD IV, the management body must:

- have overall responsibility for the firm and approve the implementation of its strategic objectives, risk strategy and internal governance;
- ensure the integrity of the accounting and financial reporting systems;
- oversee the process of disclosure and communications;
- oversee senior management.

Furthermore management body members must comply with the limitation of directorships they may hold at the same time.

4. Whistleblowing

Authorities must have effective mechanisms to enable external reporting by employees of financial institutions of potential or actual breaches of the provisions of MiFIR and of national provisions implementing MiFID II.

5. Recording (telephone and electronic communications)

Firms are obliged to record all calls and electronic communications, whereby new clients have to be notified in advance about the recording.

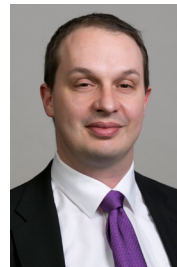
6. Miscellaneous

All these changes will apply across all the European Member States. The use of trading technology as algorithmic trading has let arisen risks. Those potential risks from increased use of technology are best mitigated by a combination of

measures and specific risk controls directed at firms that engage in algorithmic trading techniques, building up on technical guidelines by ESMA (ESMA/2012/122).

The short guide for retail investors to MiFID II and MiFIR is available on the ESMA'S website.

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Regulation on key information documents for investment products

1. Background

In the wake of the financial crisis, a proposal for a regulation on key information documents ("**KIDs**") for retail investment products was introduced by the EU Commission in July 2012 as a way to tackle market inefficiencies and enhance investor protection. On 15 April 2014, the EU Parliament issued its final position on this new regulation relating to packaged retail and insurance-based investment products¹ (respectively "**PRIIPs**" and the "**Regulation**") which shall be approved by the EU Council shortly.

The Regulation aims at creating a level playing field in the retail investment market by providing a harmonised set of information allowing investors to understand and compare financial products which are often viewed as complex and opaque.

2. Scope

The Regulation defines PRIIPs as encompassing:

- "packaged retail investment products", meaning investments where, regardless of their legal form, the amount repayable to the investor is subject to fluctuations because of exposure to reference values, or to the performance of one or more assets which are not directly purchased by the investor; and
- "insurance-based investment products", meaning insurance products which offer a maturity or surrender value and where that maturity or surrender value is wholly or partially exposed, directly or indirectly, to market fluctuations.

Further to this definition, PRIIPs can be broadly categorised into four groups:

- All types of investment funds;
- Insurance-based investment products;
- Retail structured securities; and
- Structured term deposits.

3. Requirements

The requirements imposed by the Regulation shall apply only to PRIIPs sold to retail customers. More specifically, it should be noted that:

- The product manufacturer (e.g. a fund manager) is responsible for drawing up and publishing a compliant KID on its website before making a PRIIP available to retail investors ;
- The product intermediary (i.e. the seller or advisor) is responsible for providing investors with the KID as pre-contractual information.

In terms of format and content, KIDs shall comply with the specific standards set out in the Regulation. A document with similar though not identical features already exists for UCITS funds (i.e. the key investor information document or "**KIID**").

4. Implementation

After final approval by the Council, the Regulation shall be published in the Official Journal of the European Union and enter into force twenty days thereafter. All impacted products have two years to comply with the Regulation which shall be reviewed four years after its entry into force.

However, UCITS funds benefit from a transitional period of five years during which they can continue using the KIID. After such period of time, possible refinements to the KIID regime shall be considered with a view to ensuring maximum comparability among all retail investment products at EU level.

¹ See details in [Note 8486/14](#) available on the Council's public registry website.

Final adoption of the UCITS V directive by the EU parliament²

On 15 April 2014, the EU Parliament approved the proposal for a directive amending Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to UCITS as regards depositary functions, remuneration policies and sanctions (the “**UCITS V Directive**”), following the agreement reached with the EU Council last February.



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² On 23 July 2014, the Council formally adopted the UCITS V Directive. As at time of print, the final text is still expected to be published in the Official Journal of the European Union and shall enter into force twenty days after such publication. For further information, please read our recent Newsflash on this topic.

Imprint

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