

Non-retail inducements rules under MiFID II – time to push back on gold-plating?

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The FCA's third consultation paper on MiFID II implementation, released in September 2016, proposes a number of changes to the current UK inducements rules, including the criteria for assessing whether inducements are 'designed to enhance the quality of service to the client'. These draft rules are stricter than the European law requires. Firms have until 4 January 2017 (the consultation deadline) to push-back on this 'gold plating'. Once the new rules have been finalised, they will become applicable from 3 January 2018, in line with the broader MiFID II package.

Currently, UK firms can only pay or accept inducements in certain circumstances. Fees paid on behalf of the client are allowed, and fees for custody and settlement services are also fine. Beyond this, a payment or non-monetary benefit can only be made to (or accepted from) a third party where that fee or benefit:

- does **not impair compliance with the firm's duty to act in the client's best interests**;
- is **clearly disclosed to the client in advance**, in a manner that is comprehensive, accurate and understandable; and
- is **designed to enhance the quality of the service to the client**.

Of these three requirements, the third (the 'quality enhancement requirement') is arguably the hardest to demonstrate. Existing guidance from CESR (the predecessor to ESMA) took a fairly flexible and pragmatic approach to how that requirement should be applied. MiFID II will supersede that guidance. The same three tests will still apply, but the rules on what amounts to 'quality enhancement' may be about to get a lot stricter.

The MiFID II implementing directive lists conditions that will *conclusively* demonstrate that the quality enhancement requirement is met (provided the inducement does not cause the service to the client to become distorted or biased). Specifically, it says the 'quality enhancement' requirement *is* met where an inducement meets all of the following conditions:

- it is justified by the provision of an additional or higher level service to the client that is proportionate to the inducement received (for example, certain kinds of investment advice or access to a wide range of products under certain circumstances);

- it does not directly benefit the recipient without tangible benefit to the client; and
- if the inducement is on-going, it is justified by the provision of an on-going benefit to the client.

The Delegated Directive makes it clear that the list of conditions is "non-exhaustive". That is, an inducement that meets all of these conditions *will* satisfy the quality enhancement test, but this is not the *only* way to meet that test. Ticking those boxes provides a 'safe harbour', but firms could still satisfy the 'quality enhancement' requirement in other ways.

The draft FCA rules, however, state that the quality enhancement test is *only* met if those requirements are met (plus the overall non-distortion requirement). This is a far less flexible approach, and goes beyond what the European law requires. This may be deliberate gold-plating by the FCA, or it could simply be an oversight that can still be corrected.

The distinction is subtle, but potentially important. Generally, less prescriptive regulation is preferable for firms. A flexible approach allows firms to innovate - provided their payment mechanisms are designed to enhance the quality of service to the client, it should not matter if they are not a neat 'fit' with the list above. The requirement for an on-going benefit could present a particular problem for asset managers, many of whom may share a portion of their on-going fees with intermediaries in exchange for a one-off introduction to new wholesale clients. It is hard to see why a fully-informed professional client should not be able to agree to the payment for a one-off service being spread over time rather than paid up-front.

Firms that want to challenge the gold-plated approach should make their views known to the FCA by the 4 January 2017 deadline. The FCA aims to be an efficient and proportionate regulator, so it ought to be particularly persuaded by firms who can show that their payment mechanisms meet the 'quality enhancement objective' by other means and would be unduly burdened by a more restrictive approach.

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