MFSA

MALTA FINANCIAL SERVICES AUTHORITY

CONSULTATION DOCUMENT

CONDUCT OF BUSINESS RULEBOOK
PHASE 1

[MFSA REF: 04/2015]

6 May 2015

Closing Date: 13 June 2015

Note: The documents circulated by the MFSA for the purpose of consultation are in draft form and consist of proposals. Accordingly, these proposals are not binding and are subject to changes and revisions following representations received from Licence Holders and other involved parties. It is important that persons involved in the consultation bear these considerations in mind.

Contents

CONSULTATION

CONDUCT OF BUSINESS RULEBOOK

PHASE 1

Introduction

In 2013, the Malta Financial Services Authority ("MFSA") appointed two internal task forces – an Investment Services Task force and a task force to analyse Consumer Redress to review the existing Conduct of Business regulatory regime in investment services and the definition of appropriate policy changes for the enhanced protection of customers in investment services. These task forces focused on various aspects, such as the fair treatment of customers, alternative dispute resolution and redress mechanisms, consumer education and financial literacy, compensation schemes, promotion of competition, financial inclusion as well as broader market conduct addressing financial markets efficiency and integrity issues.

The Conduct of Business (Investment Services) Task Force presented the MFSA Board of Governors with initial recommendations for the review of the current Conduct of Business regulatory regime in investment services and the definition of appropriate policy changes for the enhanced protection of customers in investment services. The recommendations put forward included a proposal for the creation of a single, unified Code regulating Conduct of Business in financial services.

On the 27th January 2014 the MFSA issued a consultation document regarding the "*Proposed Conduct of Business Rules for the Enhanced Protection of Customers in Investment Services*" (MFSA Ref. 03/2014).

In the meantime, as of 1st January 2015, Dr. Michelle Mizzi Buontempo was appointed as director of the Conduct Supervisory Unit. The transfer of supervision duties of Company Service Providers and Trustees from the Securities and Markets Supervision Unit has already taken place, however the Conduct Supervisory Unit is still not operational with respect to the other areas of financial services as the relevant resources and structures are still being identified and set up. This newly setup Unit has been tasked with the setting up and the implementation of the regulatory framework, aiming to secure appropriate client protection in financial services through a supervisory regime seeking to address potential or emerging risks for financial services clients.

The Unit shall also endeavour to strengthen the responsibilities of regulated persons in treating customers fairly. To achieve this end, a Conduct of Business Rulebook is currently being drafted setting out the regulatory requirements of regulated persons insofar as their conduct vis-à-vis their clients is concerned.

Why are we consulting

The purpose of this Consultation Paper is to obtain the industry's views on:

1. The first three draft Chapters in the Conduct of Business Rulebook which address the following issues: (1) Client Disclosure Requirements, (2) Product Governance and Oversight and (3) Conflicts of Interest;
2. Regulatory approaches which the MFSA proposed to adopt in relation to specific areas such as the selling of complex products, the application of the Rulebook to structured deposits, documents to be provided to clients in Maltese and English, etc.

The MFSA is currently reviewing the Chapters which cover other areas relating to Conduct of Business by regulated persons. The MFSA will be issuing these other chapters for consultation in due course.

Who does this Consultation effect?

Initially, the Rulebook will be addressed to persons providing investment services (excluding custodians) and to persons carrying on insurance activities (insurance undertakings and insurance intermediaries). It is envisaged that the conduct of other regulated persons would also fall under the remit of the Conduct Supervisory Unit, at a later stage.

Therefore, this consultation is primarily of interest to persons licensed under the Investment Services Act (excluding custodians), persons regulated under the Insurance Business Act or the Insurance Intermediaries Act and individuals who work with or advise such entities, as well as persons licensed as credit institutions under the Banking Act, who sell or advise clients in relation to structured deposits as defined within the Rulebook.

It is envisaged that the conduct of other regulated persons will also fall under the remit of the Conduct Supervisory Unit, at a later stage.

Context and Sources of Proposals

It is the MFSA's intention to have one Conduct of Business Rulebook which will be applicable to investment firms, UCITS management companies and insurance companies and intermediaries. The entities shall be collectively referred to in the proposed Rulebook as "Regulated persons". Furthermore, certain parts of the Rulebook will also apply to credit institutions who sell or advise clients in relation to structured deposits.

In drafting a comprehensive Conduct of Business Rulebook, the MFSA is transposing the requirements found in the relative EU Directives. These are mainly MiFID II, the current Insurance Mediation Directive ("IMD I") and the proposed new IMD (IMD II)[1] and, to a lesser extent certain provisions relating to Solvency II and UCITS IV and V – together with any relevant Level 2 measures.

[1] Discussions are currently underway at European level to rename this directive as Insurance Distribution Directive ("IDD").

The MFSA has also incorporated in the draft Rules, the Technical Advice issued by ESMA and which was presented to the Commission for the latter to issue Level 2 Measures under MiFID II. It is not yet known whether the new Level 2 Measures will take the form of Directives (which will need to be transposed) or Regulations (which are directly applicable and hence do not require transposition). In this context therefore, it should also be noted that the relevant draft Rules may also need to be amended if the Commission does not adopt ESMA's technical advice or if it does not adopt them in toto or if the Level 2 measures are adopted by way of Regulation.

With respect to the IMD II, the MFSA has referred to the latest drafts – which will eventually replace the current IMD I. At the moment the text of IMD II is being discussed in trialogue between the EU Council, European Parliament and the Commission. It is envisaged that an agreed text will be available by the end of the Latvian Presidency (which ends on 30 June 2015) and that the final Directive will be published by the end of this year. However, in drafting the Rulebook which is the subject of this Consultation procedure, the MFSA has been closely following the developments in the draft texts of IMD II and has transposed the text of this Directive as it developed over various discussions at EU level. The Rulebook will be amended as necessary when IMD II is published.

In addition, the MFSA has also made reference to opinions and guidelines issued by the European Supervisory Authorities (ESMA, EIOPA and the EBA) and has included some of these as Rules. Examples of such instances include ESMA's "Opinion on Structured Retail Products: Good practices for Product Governance Arrangements" and the EIOPA "Guidelines on Product Oversight and Governance Requirements for Insurance Undertakings".

In drafting the Rulebook, the MFSA has adopted an approach whereby certain provisions which are found in the draft IMD II and certain other opinions and guidelines issued by EIOPA which the MFSA believes can be applied to persons licensed under the Investment Services Act, have been extended to apply to such persons, in areas which are not covered by MiFID II. Conversely, certain provisions which are found in MiFID II as well as opinions and Guidance issued by ESMA and which in the opinion of the MFSA could apply to persons regulated under the Insurance Business Act or the Insurance Intermediaries Act are also so applied to latter category of regulated persons in the Rule Book. In carrying out this exercise, the MFSA has kept in mind the principle of proportionality and recognises that certain provisions would apply only to a particular category of regulated persons. In such cases, this was reflected in the drafting of the relevant Rules. Accordingly, the applicability provisions in each section of each chapter of the Rulebook are of paramount importance.

The MFSA has also adopted this approach in the light of the emerging trend at EU level, whereby similar conduct of business requirements are being rendered applicable to investment firms, insurance undertakings and insurance intermediaries. Nevertheless the MFSA has also taken cognisance of certain requirements which are specific only to certain categories of regulated persons in view of the inherent nature of the activities carried out by such regulated persons, and therefore has not indiscriminately applied all requirements horizontally across the board.

Furthermore, in the original consultation regarding the "*Proposed Conduct of Business Rules for the Enhanced Protection of Customers in Investment Services*", the MFSA had also put forward a number of recommendations to the industry concerning the regulatory approach to be adopted. Therefore in the drawing up of this Rulebook the MFSA has included some of these recommendations whilst also taking on board and incorporating where deemed appropriate, the feedback received from the industry.

What are you required to do next?

The MFSA is seeking feedback on the proposals set out in this Consultation Paper. Responses should reach the MFSA by 13 June 2015.

Please send your responses by email to **csu@mfsa.com.mt** or alternatively by conventional post and addressed to: **The Director – Conduct Supervisory Unit, Malta Financial Services Authority, Notabile Road, Attard**.

Any queries should be addressed to:

Dr. Michelle Mizzi Buontempo
Director
Conduct Supervisory Unit
Email: mmizzibuontempo@mfsa.com.mt

Dr. Sarah Pulis
Analyst
Conduct Supervisory Unit
Email: spulis@mfsa.com.mt

Dr. Petra Camilleri
Analyst
Conduct Supervisory Unit
Email: pcamilleri@mfsa.com.mt

What will we do?

The MFSA plans to publish the final Conduct of Business Rulebook, once all the parts of the proposed Rulebook have been issued for consultation to the industry. Regulated persons will be granted a transitional period to comply with requirements emanating from this new Rulebook. Further details will be announced by the MFSA at a later date.

MFSA Consultation Procedure – 27th January 2014 – MFSA's Feedback

The MFSA refers to the Consultation document issued on the 27th January, 2014 (**Ref.03/2014**) regarding the "*Proposed Conduct of Business Rules for the Enhanced Protection of Customers in Investment Services".*

The original Consultation referred to the protection of clients in investment services, although Recommendation 15 of the said document proposed that the Authority establishes a single, unified Conduct of Business Code which sets out the requirements which all financial services providers are required to satisfy when dealing with clients irrespective of the category of providers. Recommendation 15A proposed that such Code should be applicable to:

(a) all financial services providers, including persons exercising their right to passport into Malta via freedom of establishment or freedom to provide services;

(b) both retail and professional clients.

It was also highlighted however, that the objective is not a 'one-size-fits-all' Code. The Code should separately address (under specific headings or chapters) conduct of business requirements currently applicable to a specific sector, client or product.

Moreover, it was also proposed that the initial phase of constructing the Code should primarily focus on consolidating the existing legal instruments into a single document. The project should then seek to encompass new conduct of business practices driven by domestic experiences and EU legislation such as MiFID 2, IMD 2 and Solvency II.

In this context, the MFSA has decided that the Conduct of Business requirements should also be extended, for the time being, to insurance undertakings and insurance intermediaries as well as to credit institutions who sell or advise clients in relation to structured deposits, where applicable. It is the intention of the MFSA to eventually address also the protection of clients of Banking services.

Following the assessment of the feedback received by the MFSA from various interested parties, the MFSA has decided to take up the following recommendations with respect to the issues relating to the scope of the current Consultation Document, namely: Disclosures, Product Governance and Conflicts of Interest:

Recommendation (numbered as in the 27th January 2014 Consultation Document)	**Industry Feedback**	**MFSA Position:**
Recommendation 17: Following from the European Commission MiFID II proposal, there should be the banning of commission and inducements in the case of independent financial advice	One respondent argued that "firms holding themselves to be independent advisers" should invariably be	**This Recommendation will be implemented by the MFSA and most of the comments have been taken into consideration. Further details will be indicated in the Chapter relating to Sales Processes within the Rulebook, which will**

and discretionary portfolio management.	prohibited from receiving commissions or other benefits from product providers; that is, there should not be the possibility that they may receive such fees even if they disclose same to the customer prior to the transaction, as is being proposed in the Consultation Paper, and this with one exception namely in the case of primary issue of non-complex securities such as bonds or equities on a stock exchange. It was argued that disclosure is not an adequate safeguard against misselling in cases of sale of products paid on a commission basis. It was also suggested that an additional requirement be included to provide that a firm holding itself to be an Independent Financial Advisor is prohibited from remunerating its staff on the basis of the value of sales or of earnings generated by transactions. It was also argued that this recommendation should be subject to the qualification that the receipt of sales commission on an IPO is allowed, even in the case of an Independent Financial Advisor.	**be issued for Consultation, in due course. It should be noted in fact that the comment that disclosure is not an adequate safeguard against misselling was taken on board in the drafting of the relevant rules. Similarly the remuneration of staff by an independent financial advisor, on the basis of value of sales was also addressed in the Chapter dealing with Conflicts of Interest.** **On the other hand the MFSA disagrees with the proposal to provide an exception to allow the receipt of sales commission on an IPO, even in the case of an Independent Financial Advisor as it believes that requirement of independence should be applied across the board.** **The comment relating to the application of such proposals to fund managers was also taken into consideration.**

	Another industry participant pointed out that the proposals relating to this recommendation should not concern fund managers	
Recommendation 18: There should be the setting up of specific arrangements and internal procedures by investment firms devoted to MiFID inducement rules. The systems should enable the firms to identify, classify and evaluate all types of fees, commissions and non-monetary benefits prior to the provision of any investment or ancillary service to their clients. The investment firm's policies and procedures to be followed when assessing the legitimacy of the payments and non-monetary benefits should include the basis for the decision/evaluation process.	An industry participant stated that as long as Regulated Persons continue to fully disclose to the client the fees attributable to each transaction, the current structure should not be changed. It was however acknowledged that there is a need to eliminate conflicts of interest which may arise out of the payment of commissions.	**The MFSA considers that it is important for Regulated Persons to have clear arrangements and procedures to ensure compliance with the relevant regulatory requirements, as disclosure is not considered to be sufficient. Furthermore, these procedures would facilitate the regulated person to assess whether a payment is allowable or otherwise.** **This Recommendation has been implemented by the MFSA in the draft Chapter relating to Conflicts of Interest in the Rulebook.**
Recommendation 19: Any type of payment or non-monetary benefit falling under Article 26(b) of the Level 2 Directive (an inter-firm commission) should be assessed to ensure that it is designed to enhance the quality of the service while not impairing compliance with the firm's duty to act in the best interests of the client. In addition, the client should be given clear prior disclosure.	No feedback on this recommendation was received from the industry	**This Recommendation has been implemented by the MFSA in the draft Chapter relating to Conflicts of Interest in the Rulebook.**

Recommendation 20: An investment firm can only consider a given payment as a fee if the payment is necessary for the service and if it cannot give rise to conflicts of interest between the firm and its clients.	No feedback on this recommendation was received from the industry	**This Recommendation has been implemented by the MFSA in the draft Chapter relating to Conflicts of Interest in the Rulebook**
Recommendation 21: Senior management, or where appropriate the supervisory function, after taking advice from the compliance function, should approve the general policy to be applied by the investment firm to inducements and approve the design of remuneration policies and practices. Inducements and remuneration policy should be key areas in compliance function activities. These would then be implemented by appropriate functions to promote effective corporate governance. Responsibility for the implementation should rest with senior management.	No feedback on this recommendation was received from the industry	**This Recommendation will be considered further in the Chapter of the Rulebook dealing with Governance which will be issued for Consultation, in due course.**
Recommendation 23: The remuneration of sales staff and advisors should be structured in a manner that avoids creating an incentive to recommend investment products with the highest commission for the investment firm and/or the highest rewards for the sales staff.	No feedback on this recommendation was received from the industry	**This Recommendation has been implemented by the MFSA in the draft Chapter relating to Conflicts of Interest in the Rulebook**
Recommendation 25:		

Investment firms should provide clients with clear, prior disclosure about the existence, nature and amount or method of calculating that amount of the different inducements payable/receivable. Inducements should be classified by in-group and other investment firms, and by whether it is one-off or ongoing. Inducements should be split between monetary and non-monetary ones, and between the different categories of investment and ancillary services to which they relate. In addition, investment firms should provide their clients with an online inducements calculator. This information should be maintained by the investment firm internally and updated as necessary, with submission to the MFSA made once every year.	An industry participant pointed out that a distinction should be made between the concept of "remuneration" and "inducement". The latter is generally sued to refer to fees, commissions and non-monetary benefits paid or provided by the regulated person, while "remunerations" tends to refer to payments or benefits to the regulated persons' officers and employees. Detailed rules and guidance on the conditions under which inducements may be given or received, and disclosure to clients are already laid down by MiFID. It was also stated that it was not entirely clear how the proposed general obligation to provide an online inducements calculator can be applied in practice.	**This feedback in relation to the differentiation between the concept of "remuneration" and "inducement" was taken on board in the implementation of this recommendation both in the draft chapter relating to Disclosures as well as in the draft chapter relating to Conflict of Interest.** **Furthermore, the comments in relation to the online inducements calculator were also taken on board, and this requirement has not been included.**
Recommendation 26: Investment firms should have specific arrangements and procedures to ensure a prompt and appropriate treatment of client requests regarding inducements, with a specific person responsible. Procedures should embed arrangements for the keeping of records of information	No feedback on this recommendation was received from the industry	**This Recommendation will be considered further in the Chapter of the Rulebook dealing with Governance which will be issued for Consultation, in due course.**

disclosed to clients regarding inducements.		
Recommendations 27 to 29	In relation to Recommendation 29, one respondent argued that this recommendation emanates from CRD IV that applies to large institutions cannot be extended to the local retail market. The respondent stated that such a stipulation could send counterproductive signals that quality compliance is an option to be rewarded by variable remuneration. It was also argued that quality compliance is not an option but a necessary ingredient that has to be built into the system, risked based or full check depending on the size of the institutions. Any failures should be disciplined by punitive measures rather than adherence rewarded as if over and above the call of duty.	**The MFSA considers that certain issues relating to remuneration of staff of a Regulated person fall within the remit of the prudential supervision of that Regulated person. In fact, further detailed requirements emanate from the Capital Requirements Directive and from the UCITS Directive. These will be implemented through amendments in the existing Rules.**
Recommendation 30: Adequate and appropriate controls should be set up and maintained by investment firms to ensure compliance with their remuneration policies and practices. The controls should be applied throughout the firm and be	No feedback on this recommendation was received from the industry	**This Recommendation has been implemented by the MFSA in the draft Chapter relating to Conflicts of Interest in the Rulebook**

subject to periodic review. Controls should include at the very least; monitoring calls for telephone sales, sampling of advice and client portfolios provided to check suitability, and going through client documentation on a regular basis.		
Recommendation 31: Appropriate and transparent reporting lines should be in place across the investment firm or group to assist in escalating issues involving risks of non-compliance with MiFID conflicts of interest and conduct of business requirements.	No feedback on this recommendation was received from the industry	**This Recommendation has been implemented by the MFSA in the draft Chapter relating to Conflicts of Interest in the Rulebook**
Recommendation 32: Persons engaged in control functions should be independent from the business units they oversee and have appropriate authority. They should be compensated in accordance with the achievement of the objectives linked to their functions, independent of the performance of the business area they control.	No feedback on this recommendation was received from the industry	**This Recommendation will be considered further in the Chapter of the Rulebook dealing with Governance which will be issued for Consultation, in due course.**
Recommendation 33: The receipt of inducements on a recurrent basis by intermediaries providing financial advice requires that the intermediary keep the situation of the clients and financial instruments under review to confirm the continued suitability of the investments.	No feedback on this recommendation was received from the industry	**This Recommendation will be implemented by the MFSA. Further details will be indicated in the Rulebook Chapter relating to Sales Processes which will be issued for Consultation, in due course.**

Recommendations 40 to 42:	In relation to Recommendation 41, one respondent argued that the term "particularly complicated" requires further definition and clarity. Similarly the fact that such investments "should only be permitted to be sold to professional clients" goes beyond the scope of MiFID unless the term "professional" is distinct from that provided in MiFID. In relation to Recommendation 42, one respondent proposed that the text "advised distribution channels" should read "on an advisory or discretionary basis" because evidently the purpose of the Recommendation is to outlaw an abusive sale on an execution-only basis and not to impede a transaction on a discretionary basis when the ISLH is assuming its responsibility for the suitability of the security transaction involved for the particular client.	**Reference is made to Section 2 of this Consultation Paper relating to the regulation of the sale of Complex Products. The MFSA is proposing that complex products are sold solely on an advisory basis.** **With respect to Recommendation 42, the phrase "advised distribution channels" has been amended to read "on an advisory basis".**

Section 1: The Proposed Conduct of Business Rulebook – Structure and Content

Applicability of Rulebook

The Conduct of Business Rulebook will be generally applicable to "Regulated persons" which means any of the following persons:

i. persons holding an investment services license within the meaning of the Investment Services Act, other than Alternative Investment Fund managers or person licensed to act as custodians in relation to a collective investment scheme, in terms of the said Act, including a European investment firm which has established a branch in Malta in exercise of a European right in terms of the 'European Passport rights for Investment Firms Regulations' and a European management company which has established a branch in Malta in terms of the 'Investment Services Act (UCITS Management Company Passport) Regulations, in so far as it provides MiFID services in terms of Article 6(3) of the UCITS IV Directive or if it markets its UCITS in Malta;

ii. persons registered under the Investment Services Act (Tied Agents) Regulations, 2007;

iii. persons authorised to carry on the business of insurance under the Insurance Business Act, including a European insurance undertaking which has established a branch in Malta in exercise of a European right in terms of the 'European Passport Rights for Insurance and Reinsurance Undertakings Regulations';

iv. persons enrolled under the Insurance Intermediaries Act to act as insurance brokers, insurance agents, insurance managers or tied insurance intermediaries, including a European insurance intermediary which has established a branch in Malta in exercise of a European right in terms of the 'European Passport Rights for Insurance Intermediaries Regulations'; and

v. persons licensed as credit institutions under the Banking Act who sell or advise clients in relation to structured deposits.

Retail vs Professional Clients

This Rulebook aims to regulate the conduct of Regulated Persons vis-à-vis their clients. In this context, the term "client" shall mean any natural or legal person to whom a regulated person provides a service.

In this context, the Rules distinguish between two types of clients: Retail clients and Professional Clients. Professional Clients are those clients which meet certain determined criteria laid down in Section 1 of Annex II of the MIFID II and Annex 1 the draft IMD II – which are practically identical. These clients would, because of their stature and/or activities, be deemed to have sufficient

knowledge and experience in the products and services they would like to purchase from the regulated person and therefore do not need a high level of investor protection. Conversely, clients which do not fall within this category shall be deemed to be retail clients who have little or no knowledge and/or experience of the products and services offered by the regulated person and would hence require a higher element of investor protection (e.g. by way of additional disclosures by the regulated persons). In the drafting of the Rulebook, the Rules which apply solely in the context of professional clients have been clearly indicated. Accordingly, where a Rule does not specify that it applies only to professional clients or only to retail clients, it should be taken to apply to both types of clients.

Q1:	**Do you agree with this approach taken by the Authority, whereby the distinction in treatment between Professional and Retail clients has been harmonised for Regulated Persons providing insurance – related services and for Regulated Persons providing investment services? Please provide your reasons if you do not agree**

Furthermore, although in the legislation regulating insurance – related services, such as IMD II, reference is made to "customers", the term "client" has been used in the Rulebook to ensure better consistency in view of the harmonised approach being adopted, as described in Section 1 of this paper.

Q2:	**Do you agree with the adoption of the term "client" to replace "customer" in the context of insurance – related services? Please provide your reasons if you do not agree.**

Prudential vs Conduct Supervisory Requirements

Currently, Regulated persons are subject to a number of Rules contained either in the Investment Services Rulebook for Investment Services Providers or in the various Rules issued under the Insurance Business Act or the Insurance Intermediaries Act. These Rules cover both the prudential requirements as well as the conduct of business requirements and compliance therewith by Regulated Persons is currently supervised by the Securities and Markets and Supervision Unit in the case of investment services providers, and by the Insurance and Pensions Supervision Unit in the case of insurance undertakings and insurance intermediaries.

With the setting up of the Conduct Supervisory Unit and the drawing up of the Conduct of Business Rulebook, the supervision of conduct of business of investment services providers and insurance undertakings and intermediaries will fall within the remit of this Unit. Moreover, the relevant Rules will no longer form part of the Investment Services Rules for Investment Services Providers and relative Rules published in terms of the Insurance Business Act or the Insurance Intermediaries Act, which shall be repealed. The prudential supervision of the abovementioned entities will remain

within the remit of the Securities and Markets Supervision Unit and the Insurance and Pensions Supervision Unit, respectively. The existing Investment Services Rules for Investment Services Providers as well as the relative Rules published in terms of the Insurance Business Act or the Insurance Intermediaries Act, from which the conduct of business rules are being carved out will be amended and shall remain in force with respect to requirements of a prudential nature.

Structure and Layout of the Conduct of Business Rule Book

The MFSA proposes to divide the Conduct of Business Rulebook into a number of Chapters as follows:

1. Client Disclosures and Reporting
2. Product Governance
3. Conflicts of Interest
4. Selling Process and Practices
5. Contractual Agreement with Retail Clients
6. Execution of clients' orders
7. Governance of Regulated persons

Each of the Chapters will comprise a General Part which will apply across the board to all the types of Regulated persons as defined in the Glossary to the Rules. The Chapters shall contain other Parts which would contain Rules which are particular to a specific type of Regulated person and would as such apply only limitedly to the types of Regulated person indicated in the applicability clause contained in the relevant Part.

Rules and Guidance

The Rules which are binding on Regulated persons are indicated with the letter 'R' before the number assigned to each Rule in the relative Part of the Rulebook. Accordingly, on the coming into force of the Rulebook, failure to observe any of the requirements of the Rules would amount to a breach of an applicable regulatory requirement.

The MFSA is also, in some instances, providing guidance with respect to the Rules. Such guidance may relate to further clarifications of a Rule or to steps which the Regulated person may take in order to comply with a specific Rule. Any Guidance is indicated in the Rulebook with the letter 'G' before its number and is indicated immediately below the Rule to which such guidance relates. It is important to note that compliance with Guidance is not compulsory as long as the requirements of the Rules are observed at all times.

Glossary of Terms

A Glossary of Terms used throughout the Rulebook is included as an annex to the draft chapters being issued for consultation, which should be referred to facilitate the reading and interpretation of the Rules. It should be noted that this Glossary will continue being updated as the drafting of the other chapters of this Rulebook is finalised.

Q3:	**Are there any additional topics which you consider should be included in the RuleBook? In this regard, please remember that the Supervision of Regulated person will now be split between the Conduct Supervisory Unit – for conduct of business matters and the Securities and Markets Supervision Unit or the Insurance and Pensions Supervision Unit, as applicable, for prudential matters.**
Q4:	**Do have any comments with respect to the layout of the Rulebook? Specifically, do you agree that the guidance should be included immediately after the Rule to which it relates?**

Section 2: Complex Products

Complexity

Complexity, in the context of investment products, is a relative term, and depends on the risk/reward profile and other characteristics of the product.

MiFID I introduced a distinction between products deemed either "non-complex" or complex for the purposes of sales which are not made through a personal recommendation or provided via a portfolio management service. This categorisation is not typically aimed at clients, but is used by Regulated persons to determine whether then need to conduct an appropriateness test when distributing a particular product without advice. An appropriateness test is a test which is to be carried out by the Regulated person to understand the knowledge and experience of the client, in order to enable it to assess whether a particular product is appropriate for the client in question. In terms of MiFID 1, the appropriateness test applies to all complex products, so products which are deemed to be complex cannot be sold on an execution only basis (without an appropriateness test).

In terms of MiFID, complex products are those which do not meet the criteria of "non-complex" as set out under Article 24(4)(a) of MIFID II and Article 38 of the MIFID Implementing Directive.

Further to the above, examples of complex products include: contracts for differences (CFDs); binary options; turbos; exchangeable bonds; callable bonds; puttable bonds; convertible bonds; warrants; certificates; derivative relating to underlying securities, currencies, interest rates, yields or commodities; credit linked notes and asset backed securities.

In the aftermath of the financial crises in 2008, due to low returns from more traditional forms of investments or ordinary deposits and due to volatility in the markets, investors were seeking other investment opportunities which would increase their returns. Investment firms have responded to such demands by devising alternative and more sophisticated investment strategies, often through complex products (including structured products). These products were offered to retail investors thus exposing them to asset classes, market segments and investment strategies which were previously only available to professional investors.

From an investor protection perspective, this trend poses certain risks for retail clients who may not be able to understand the risks, costs and expected returns of some complex products and/or the drivers of risks and returns. This hampers the ability of retail clients to make informed decisions and increases the likelihood of client detriment (for example, unexpected losses).

Locally, notwithstanding the implementation of the MiFID requirements referred to above, we have had negative experiences where complex products have been sold to retail clients who did not fully understand the risks of such investments and/or who could not afford to invest considerable portions of their money in such products. When certain products of this type defaulted, clients suffered huge losses or an outright loss of their capital. Our experience has shown that MiFID I has not satisfactorily addressed the dangers of misselling complex products to retail clients.

In a deliberate attempt to increase investor protection, MIFID II has restricted the types of products that are classified as "non-complex". This directive introduces new complexity criteria for debt securities, which will be considered complex if they have a "*structure which makes it difficult for clients to understand the risks involved.*" It also introduces criteria for structured deposits, so that products with a structure that makes it difficult for a client to understand the risk of return, or understand the cost of exiting before maturity, will automatically be considered complex.

Furthermore, in the light of the above, the MFSA's expectation is that the types of products which will be considered "non-complex" will be significantly limited.

Regulatory approach towards the sale of complex products to retail clients

It is the MFSA's intention to introduce new Rules to regulate and supervise the sale of complex products to retail clients in a more efficient and effective manner. In this regard, the MFSA considered two specific options which are set out below.

Although MiFID allows the sale of such products both on an advisory basis (and hence subject to a suitability test) as well as on a non-advisory basis (subject to an appropriateness test), under the first option being proposed by the MFSA, it will not be possible to sell complex products to retail clients solely on the basis of an appropriateness test. Hence, as a matter of policy, the MFSA is proposing to require all sales of complex products to retail clients to be effected on an advisory basis and hence after a suitability test is carried out by the Regulated person vis-à-vis the retail client in question.

Option 1: Allow Regulated persons to sell Complex Products to retail clients only on an Advisory Basis

Under this option, the MFSA would allow Regulated persons to sell complex products to retail clients only if accompanied by investment advice in relation to such products. This approach would mean that the Regulated person would invariably be required to carry out a full suitability test with respect to the client and must be satisfied that a complex product is suitable for the client before recommending it. Therefore, a client would no longer be able to purchase a complex product without obtaining the relevant investment advice or merely on the strength of an appropriateness test carried out by the Regulated person (which would only assess the client's knowledge and experience in relation to a given product).

The main advantage of this approach is that the possibility of misselling complex products is reduced given that the Regulated person has to assess the product's suitability vis-à-vis the client's circumstances before the sale of such a product can be effected. This may however mean additional costs for both the Regulated person – which would need to invest more in the education of its investment advisors to ensure that they are sufficiently competent to provide advice in relation to complex products – as well as for the client, who would presumably be charged a fee for the provision of investment advice by the Regulated person.

However, it must be pointed out that under this approach, given that the Regulated person would be providing a fully-fledged advisory service in relation to a complex product, thereby carrying out a full suitability test vis-à-vis a client, the risk of the misselling of the product and the attendant exposure to liability will be decreased for the Regulated person. On the other hand, clients may be willing to pay an additional fee if they are assured that they will be purchasing products which are deemed by the Regulated person to be suitable for them.

The MFSA is currently in favour of adopting this option.

Option 2: Diversified Treatment of Complex Products according to their "complexity level".

This option considers that not all complex products have the same degree of complexity. Accordingly, some complex products have more complicated and non-transparent structures which render them more difficult for retail clients to understand than other products, which, although falling within the definition of "complex products" in terms of the MiFID Implementing Directive, may not be too complicated for some retail clients to understand.

Therefore, under this option, the sale of "particularly or highly complex" products to retail clients would be prohibited. On the other hand, the sale of other complex products (which are not particularly or highly complex) will only be permissible if sold on an advisory basis, and therefore only affected after a suitability test is carried out vis-à-vis the client to whom such complex products are offered.

In this context, the MFSA will indicate very general criteria as to what would constitute "particularly complex" or "highly complex" instruments for Regulated persons to be able to assess the nature of the products they make available to clients. The MFSA shall not issue any determinations as to whether any particular product or type of product may be deemed to be "particularly or highly complex".

The MFSA is also encouraging Regulated persons to categorise the products which they offer by complexity and by risk and to include proper disclosures in all marketing information.

Q5:	**Do you agree with MFSA's approach to require complex products to be sold to retail clients only on an advisory basis, and hence subject to a suitability test? Please indicate your reasons if your answer is no.**
Q6:	**Which option from the above two would you prefer? Please supply reasons for your choice.**

Section 3: Structured Deposits

What are Structured Deposits?

MiFID II captures structured deposits within its remit. This product may be seen to be a hybrid between a banking product and an investment product. Essentially, structured deposits are deposits which are fully repayable on maturity on terms under which interest or a premium is paid or is at risk according to a prescribed formula (typically involving the performance of an index, stock or commodity). MiFID II in fact extends its application to investment firms and credit institutions which sell or advise clients in relation to structured deposits, therefore when such persons are acting as intermediaries for those products issued by credit institutions that can take deposits.

How does MiFID II Regulate Structured Deposits?

Structured Deposits were regarded as having a similar "economic effect" to other financial instruments which are subject to MiFID II and accordingly, the latter's investor protection measures requirements have been extended to these products. Many of MiFID II's conduct of business and organisational requirements will now apply to structured deposits, imposing a variety of new obligations on their manufacture and sale. These new obligations include:

- suitability and appropriateness testing;
- rules on inducements and conflicts of interests;
- product governance and staff remuneration requirements;
- disclosure (including provision of certain information and disclosures relating to costs and charges); and
- post-sale reporting obligations.[2]

MFSA's proposed regulatory approach to Structured Deposits

In view of MiFID II's treatment of structured deposits, which were brought within the scope of its investor protection and conduct of business rules, the MFSA has also decided to take a similar approach in extending the application of various rules which would be applicable to financial instruments, to structured deposits as well. In fact, the MFSA has included 'structured deposits' in the definition given to 'Product' within the Rulebook.

In this respect, the MFSA needs to decide how to incorporate these products within its regulatory regime. The MFSA is in fact contemplating the following two options:

[2] Article 1(4) of MIFID II specifies the Articles in this Directive which would apply to structured deposits.

Option 1:

In terms of this option, certain conduct of business rules applicable to financial instruments and which specifically emanate from MiFID II, would also be made applicable to structured deposits. In this manner, structured deposits would be treated on par with other financial instruments vis-à-vis those requirements derived from MiFID II.

The MFSA considers structured deposits to be a form of an investment product. This view is also endorsed by the European Commission, as apparent from the fact that MiFID II extended several of the organisational and conduct of business obligations applicable to the provision of services in relation to financial instruments, to structured deposits. This confirms the European Commission's objective to achieve a uniform regulatory treatment of similar investment products.

Article 1(4) of MiFID II itself applies the following Articles to Structured Deposits:

TABLE 1

MIFID II Article	Subject Matter
Article 9(3)	Requirements relating to the Management Body's obligations with respect to governance arrangements ensuring effective and prudent management
Article 14	Membership of authorised Investor Compensation Scheme
Articles 16(2), (3) and (6)	Establishment of policies and procedures relating to compliance with obligations under MiFID as well as personal transactions, prevention of conflicts of interests, product approval process, identified target market, and retention of records
Article 23	Measures relating to identification, prevention or management of conflicts of interest, including requirements relating to disclosure of any conflicts of interest which possibly may not be avoided.
Article 24	General Principles such as: acting in the best interest of clients; identification of target market; information to clients (including marketing communications) to be fair, clear and not misleading; information on the Regulated Person and the services offered; requirements and disclosures relating to investment advice; requirements relating to commissions and inducements of Information to Clients
Article 25	Assessment of Suitability and Appropriateness and requirements relating to reporting to clients
Article 26	Provision of services through the medium of another Investment Firm
Article 28	Client Order Handling Rules
Article 29	Obligations of Investment Firms Appointing Tied Agents
Article 30	Requirements applicable to transactions executed with Eligible Counterparties
Articles 67-75	These Articles relate to the powers conferred to national competent authorities of EU Member States (the MFSA in the case of Malta) which have now also been extended to include within the remit of the Authority, persons providing services in relation to structured deposits.

Therefore, under this first option being put forward by the MFSA, it is only those rules in the Rulebook which emanate from MiFID II and which the same Directive clearly indicates as being

applicable to both structured deposits as well as to financial instruments (Table 1) which would be expressly indicated as being applicable to both financial instruments and structured deposits, within the Rulebook.

Option 2:

From a review of the above-cited MiFID II provisions applicable to financial instruments, which have also been extended to structured deposits, the MFSA considers that practically all conduct of business requirements for financial instruments have been applied to structured deposits. In this regard, the MFSA believes that there might be merit in considering extending to structured deposits even those additional requirements set out in the Rulebook which are not sourced directly from MiFID II.

Therefore, in terms of this option the conduct of business requirements which will apply, under the Rulebook, to financial instruments would be extended to Regulated persons selling or providing advice in relation to structured deposits. It should be highlighted that any Rules which do not apply to financial instruments would consequently not be applicable to structured deposits either.

The MFSA tends to favour the second option of the above two, because it considers that standardising its requirements for structured deposits and financial instruments may bring simplicity and consistency for Regulated persons, reduce client confusion and remove the possibility of regulatory arbitrage (particularly in the light of evidence that these products perform the same economic functions as financial instruments within the meaning of MiFID II).

Therefore, apart from the requirements emanating directly from MiFID II and which the Directive expressly extends to structured deposits (as indicated in Table 1 above), the MFSA proposes to apply certain additional requirements which have been extended horizontally to financial instruments, also to structured deposits. Such requirements relate namely to the following:

TABLE 2

PRODUCT GOVERNANCE
Proportionality in implementing product governance and oversight arrangements, vis-à-vis the nature, scale and complexity of the risks of the business
Documentation requirements relating to arrangements adopted and actions taken in relation to product oversight and governance
Requirements relating to the review of product governance and oversight arrangements, including product monitoring and identification of target market
Role of the management body of a manufacturer of products vis-à-vis the establishment, implementation and review of product governance and oversight arrangements
Specific requirements in relation to distribution channels
DISCLOSURES
Advertisements
Additional requirements relating to advertising, including approval of advertisements relating to structured deposits, choice of medium for advertising and warning statements to be included.
Disclosure of Information on Regulated Person
Regulated Person to ensure that the designation given to employees reflect the service being

provided by such employee. The employee shall clearly disclose whether he/she is authorised to provide advice and whether the service is being provided is of an advisory nature or otherwise.
Disclosures on Services and Products Provided by the Regulated Person
The Regulated Person is to provide to each client the terms and conditions attaching to the structured deposit in a durable medium before the client purchases the structured deposit in question.
Manner in which disclosures relating to costs and associated charges must be made before the structured deposit is purchased by the Client.
Requirement to provide a Key Information Document as mandated by the PRIIPs Regulation
Disclosures Relating to Conflicts of Interest
Where the Regulated Person charges a fee and receives a commission in respect of a structured deposit, it must disclose to the client, in good time prior to the purchase of the Structured Deposit, whether or not the commission will be offset against the fee wither in full or in part.

Section 4: Disclosures

Obligation to disclose information to clients

The MFSA maintains that a Regulated person should disclose information to clients in a comprehensible form and in such a manner that Clients are reasonably able to understand the nature and risks of the Service to be provided by the Regulated person and of the type of Product that is being offered, and consequently to take decisions on an informed basis.

Any Advertisements issued by the Regulated persons should be fair, clear and not misleading. Furthermore, certain disclosures are to be made in good time prior to the provision of the Service or conclusion of the contract leading to the purchase of the financial product, such that the Client has adequate time to process the information resulting from the disclosures made before deciding whether to purchase such Service or Product.

Durable Medium

The draft Rules require a Regulated person to effect certain disclosures "in a durable medium". In terms of the Rulebook, information will be deemed to be disclosed "in a durable medium" if the following criteria are followed:

(a) the information is provided on paper ;

(b) in a clear and accurate manner, comprehensible to the Client;

(c) in English, or in any other language agreed by the parties; provided that, in the case of Clients resident in Malta, the documents indicated in the Section below shall be provided both in English and Maltese unless the person to whom the information is to be disclosed specifically chooses to receive such information in either English or Maltese only; and

(d) free of charge .

However, where information is required to be disclosed in a durable medium, a Regulated person may disclose such information, in a durable medium other than on paper, only if:

(a) the provision of that information in that medium is appropriate to the context in which the business between the Regulated person and the Client is, or is to be, carried on; and

(b) the person to whom the information is to be disclosed, when offered the choice between information on paper or in that other durable medium, specifically chooses the provision of the information in that other medium.

Where, in terms of the Rule Book a Regulated person is permitted to disclose information to a Client by means of a website, and where that information is not addressed personally to the Client, the following conditions must be satisfied:

(a) the provision of that information in that medium is appropriate to the context in which the business between the Regulated person and the Client is, or is to be, carried on;

(b) the Client shall specifically consent to the provision of that information in that form;

(c) the Client shall be notified electronically of the address of the website, and the place on the website where the information may be accessed;

(d) the information shall be up to date; and

(e) the information shall be accessible continuously by means of that website for such period of time as the Client may reasonably need to inspect it.

Where a Regulated person communicates with a Client by means of a website, it must ensure that it has in place appropriate arrangements in order to record all the specific information disclosed to the Client by means of its website, including dated screen shots of such disclosures, in order to demonstrate that it has complied with all its regulatory requirements

Provided that tied insurance intermediaries shall not carry on tied insurance intermediaries activities through the internet, except with the consent of the Regulated person to which it is tied.

Documents to be provided in both Maltese and English

The MFSA considers that some documents contain very important information for the client either to enable that client to make an informed decision as to whether to purchase a product or service or otherwise, or because the documents contain essential information about the rights and obligations of the client when the product or service is purchased. In this respect, the MFSA considers it of utmost importance that clients understand the contents of such documents

Accordingly, the MFSA is proposing that the following documents be provided in both Maltese and English by the Regulated person:

(a) The Key Information Document (KID) required under the PRIPS Regulation

Documents relating to Services Provided by persons holding an investment services license, other than Alternative Investment Fund managers or persons licensed to act as custodians in relation to a collective investment scheme, and tied agents:

(b) Client Agreement

(c) Application Form to purchase any investment Product or the Order Form through which an order is placed for a financial instrument to be bought/sold on behalf of the Client by the Regulated person.

(d) Client Fact Find, Account Opening Form, Account Opening Application Form or any document which is used by the Regulated person to gather the information required in order for it to assess the suitability or appropriateness of the Client with respect to the Services or Products being sold.

(e) Suitability Statements including, the periodic assessment of suitability required in the case of portfolio management services.

(f) Reports to be provided to the Client on the Service provided. These reports should include, in*ter alia*, the costs associated with the transactions and Services undertaken on behalf of the Client.

Documents relating Services provided in relation to UCITS Schemes .

(g) The Key Investor Information Document (KIID) required under the UCITS IV Directive when selling UCITS.

Documents relating to Services Provided by persons authorised to carry on the business of insurance or persons enrolled to act as insurance brokers, insurance agents, insurance managers or tied insurance intermediaries:

(h) In the case of Life Insurance Policies, the quotation and the Schedule containing the summary of the policy;

(i) Insurance Policy;

(j) Proposal Form;

(k) Renewal Notice;

(l) Claim Form;

(m) Suitability statement[3];

(n) The Statutory Notice to be provided to Clients in terms of the Insurance Business (Long Term Business Contract Statutory Notice) Regulations; and

(o) The Statutory Notice Required in terms of Insurance Intermediaries Rule 4 – Code of conduct for Insurance Intermediaries. (Bancassurance statutory notice).

Q8: Do you agree with the above list as to the documents which are to be provided in both Maltese and English? Please provide reasons if you disagree.

Please indicate any other documents which you feel should also be included in the list.

[3] This consists in a periodic assessment of the suitability of the product recommended to a client.

Costs and Charges Disclosures

MiFID II and the draft IMD II introduce a new costs and charges disclosure requirement. This entails that Regulated persons must disclose, prior to the provision of a product or service, and on an annual basis as appropriate, all costs and charges related to a product or service and its distributor, which are not caused by the occurrence of an underlying market risk, and which must include the cost of advice, where relevant, the cost of the product recommended or marketed to the client also encompassing any third party payments.

MFSA appreciates and understands that there are a number or technical challenges in presenting information relating to aggregated costs and charges to clients. This is particularly true in the light of the fact that, in addition to the MiFID II and draft IMD II requirements which relate to costs and charges associated with both products and services, a separate pre-contractual disclosure is being developed as part of the PRIIPs Regulation. Moreover, under the UCITS Directive, a Key Investor Document (KID) is also required, although this would ultimately be replaced by the PRIIPs Key Information Document.

As highlighted in ESMA's technical advice to the Commission, it is important that there is consistency between the MiFID II costs and charges requirement, the PRIIPs Regulation and the UCITS Directive. This consistency is essential to avoid client confusion and ensure that the burden placed on Regulated persons to provide this information, is proportionate.

By way of example, the UCITS KID does not currently require firms to provide information about transaction costs. However, if the Commission adopts ESMA's technical advice, Regulated persons will be required to include information about transaction costs in the MIFID II costs and charges disclosure.

While some of these technical challenges may be addressed by the Commission in the final implementing measures, the MFSA is aware that Regulated persons may still face some technical challenges to prepare the MiFID II and draft IMD II costs and charges disclosure**.**

Q9: Are there any technical challenges which Regulated persons are likely to face in meeting these disclosure requirements that you feel we might be able to help address? If so, what solutions do you suggest to overcome these challenges.

Marketing Rules

Selection of Media for Advertisements

Chapter 1 of the Conduct of Business Rulebook also contains the Rules relating to marketing communications, which would include advertisements, which may be issued by Regulated persons.

These Rules specifically require Regulated persons to ensure the medium they select to market their product or service is correspondent to the nature of the product or service in question. For instance, complex products should not be advertised in the mass media, for example, through billboards or newspaper advertisements. This is because these products are not easily understandable by retail

investors and such an exposure of these products, would possibly lure unsophisticated retail investors into buying products which would not be suitable or appropriate for them. In this context, the MFSA notes that experience has shown that cases of mis-selling of investment products and services have occurred following mass marketing of certain products which were not suitable for all types of retail clients, notwithstanding the MIFID provisions requiring suitability or appropriateness testing by Regulated persons before effecting sales of investment products and services.

Standardised Disclaimers.

In requiring certain disclosures to be made in Advertisements issued by Regulated persons, the MFSA is issuing, as Guidelines, a sample of the text which Regulated persons may use in order to abide by the relative Rule requesting a particular disclosure. **However, it is important to note that the wording included in the Guidance is being so included as a suggestion, and that there may be instances where this would need to be amended or supplemented to ensure that the relative warnings cover all the risks of the product/service being advertised.**

Q10: Do you agree that the proposed Guidance with respect to Advertisements should include sample standard wording? Please provide reasons if you do not agree.

Section 5: Financial Product Governance

Requirements for Manufacturers and Distributors

MiFID II introduced extensive product governance requirements on both manufacturers and distributors of investment products. Generally speaking, manufacturers will need to identify, and take reasonable steps to distribute to, a target market of end clients. They will need a product approval process and to review periodically the target market and performance of the investment products they offer. Distributors will need sufficient understanding of manufacturers' products and product approval process so as to identify and sell to their own identified target market. The concept of Financial Product Governance is also to be addressed in IMD II, the final text of which is currently under discussion between the European Commission, the EU Parliament and the EU Council.

In drafting this Chapter of the Rulebook the MFSA has also referred to the Guidelines issued by EIOPA on Product Oversight and Governance Requirements for Insurance Undertakings, some of which have also been applied horizontally to Regulated persons which are licensed under the Investment Services Act. However, bearing in mind the principle of proportionality, it was also noted that there were certain requirements which of their very nature can only be applied to insurance undertakings and insurance intermediaries, and consequently, in such cases the MFSA restricted the application of such requirements only to the latter category of Regulated persons.

This draft chapter contains Rules which are applicable to Manufacturers of financial products or services, to Distributors of such products and to persons who are both Manufacturers and Distributors (i.e. entities which distribute the products which they manufacture themselves). In this context, a Manufacturer has been defined as any of the following persons who is responsible for the development and issuance of a product or makes changes to, or combines existing products:

i. Any person authorised under the Insurance Business Act, or an investment services licence holder within the meaning of the Investment Services Act; or

ii. A European insurance undertaking, or a European investment firm, provided that the clients to whom such products are to be offered by such firms, include clients resident in Malta;

iii. Any person licensed as a credit institution under the Banking Act which manufactures structured deposits.

On the other hand, the term Distributor would, for the purposes of the Rulebook refer to:

1. Any of the following persons:

i. Any person authorised under the Insurance Business Act, the Insurance Intermediaries Act, or an investment services license holder within the meaning of the Investment Services Act;

ii. A European insurance undertaking, a European insurance intermediary, or a European investment firm exercising a European right within the meaning of the 'European Passport Rights for Insurance and Reinsurance Undertakings Regulations', the 'European Passport Rights for Insurance Intermediaries Regulations' and the 'European Passport rights for Investment Firms Regulations', respectively ;

who:

a) takes up or pursues the activities of advising on, proposing or carrying out other work preparatory to the conclusion of contracts of insurance, concluding such contracts, or assisting in the administration and performance of such contracts, in particular in the event of a claim. This shall include an 'ancillary insurance intermediary'; or
b) is involved in the following investment services as defined in the First Schedule to the Investment Services Act, with respect to a product: reception and transmission of orders in relation to one or more instruments, execution of orders on behalf of other persons, management of investments, investment advice and placing of instruments without a firm commitment basis; and

2. Any person licensed as a credit institution under the Banking Act who sells or advises clients in relation to structured deposits;

Any reference in the Rulebook to a distributor shall be construed to refer to any of the above persons who intends to distribute a product or a structured deposit to clients resident in Malta.

The concept of "identified target market"

The Rulebook introduces the concept of *"identified target market".* This term refers to a group of clients or potential clients to whom a particular product or service is being offered by a Regulated person, or for whom a manufacturer is developing a product.

The MFSA understands that this is a new concept for the local industry and feels that it is very important for the Regulated person to ensure that appropriate products are made available to clients, depending on the latter's characteristics. In this regard, the Rules set out a set of criteria to be followed by Regulated persons in their determination of the *"identified target market*" or of the groups of Clients for which a product is considered likely to meet interests, objectives and characteristics. These criteria include:

a) level of risks of the product to be designed;

b) level of risks that the client is willing to bear;

c) liquidity accessibility that the client is expected to get;

d) understanding of the complexity of the product; or

e) potential creditworthiness or financial capability of the client;

f) the level of information available to the identified target market and the degree of financial capability, of the identified target market or group of Clients whose interests, objectives and characteristics, the product is unlikely to meet.

Manufacturers designing products that are distributed through other investment firms or other insurance intermediaries as applicable, should identify the target market on a "theoretical basis". Distributors should use the manufacturers' target market assessment (unless it is unavailable i.e. in the event the manufacturer is not subject to MiFID) together with existing information on their clients to identify their own target market for a product. If the Regulated person acts as both manufacturer and distributor there is no need to duplicate the target market assessment and distribution strategy exercise, although the Regulated person should ensure it undertakes these activities in sufficient detail to meet both the manufacturer and distributor obligations.

Q11: Do you think that there should be additional guidance for Regulated persons in order to help determine their "identified target market"? Please provide comments to support your views.

Distribution of Products Manufactured or Issued by Third Country Manufacturers

When products are manufactured or issued by a third-country manufacturer based in a non-EEA Member State, the Distributor shall take all reasonable steps to ensure that the level of product information obtained from the third country manufacturer is of a reliable and adequate standard to ensure that products will be distributed in accordance with the characteristics, objectives and needs of the identified target market.

Where all relevant and material information is not publicly or otherwise available, the reasonable steps required shall include an agreement with the manufacturer or its agent that the manufacturer or its agent will provide all relevant information. Publicly available information may only be accepted if it is clear, reliable and produced to meet the requirements of any relevant EU Directive.

Q12: What do you think would be the major challenges for Regulated persons to comply with these proposed Rules?

Q13: Do you agree with the horizontal approach being proposed by the MFSA in so far as Product Governance and Oversight is concerned? Please provide comments to support your views.

Q14: Do you agree with the proposed definitions of 'Manufacturer' and 'Distributor'? In particular, do you think we should extend the definition of 'Manufacturer' to include non-regulated entities such as Listed Companies? Please provide comments to support your views.

Q15: Do you agree with the approach being recommended in relation to third-country manufacturers? Please provide comments to support your views.

Section 6: Conflicts of Interest

Duty to avoid conflicts of interest

MiFID II sets out a very high-level premise that a Regulated person is required to act honestly, fairly, professionally and in accordance with the best interests of its clients. This implies an inverse requirement of seeking to avoid conflicts of interest to the extent possible. Nevertheless, it is acknowledged that the nature of financial services activities could give rise to potential situations of conflicts of interest. In such cases a Regulated person is expected to identify and manage conflicts of interest and have in place measures which cater specifically for such situations. Should these measures not be sufficient to effectively manage conflicts of interest, these should be disclosed to clients.

The Conduct of Business Rulebook transposes the relative requirements emanating from MiFID II and UCITS IV directives, as well as the corresponding implementing directives, relating to the establishment of appropriate organisational and administrative arrangements to prevent any conflicts of interest from adversely affecting the interests of its clients. Some of these obligations are already in place under the existing Investment Services Rules for Investment Service Providers. However, these will be reflected in the Conduct of Business Rulebook.

Regulated persons are required to establish, implement and maintain an effective conflicts of interest policy, taking into account the size and organisation of the Regulated person as well as the nature, scale and complexity of its business. These requirements are also being extended to insurance undertakings and insurance intermediaries which carry out distribution of insurance-based investment products, in terms of the amendments made to the existing IMD by MiFID II (IMD 1.5). The proposed Rules in fact provide a non-exhaustive list of events and circumstances which could result in situations of conflicts of interest. This list of circumstances has been updated to include factors mentioned in the Technical Advice being put forward by ESMA and EIOPA to the Commission.

Operational Independence

Rules relating to operational independence are based on provisions deriving from MiFID II, UCITS IV and the proposed IMD II draft, and are therefore also being applied horizontally to all Regulated persons, save for a few specific Rules applicable solely to investment services providers, excluding UCITS management companies.

Remuneration

MiFID II introduces a number of rules aimed at regulating staff incentives and the remuneration of sales staff and advisers which rules are aimed at pre-empting failures in the sales process, namely by

seeking to avoid remuneration structures which may incentivise staff to sell products inappropriately. In particular, MiFID II requires that staff are not remunerated, or have their performance assessed by Regulated persons in such a way that conflicts with the latters' duty to act in the best interest of the client, or which provides an incentive for recommending or selling a particular product when another product may be better suited for the client's needs.

Rules which have been included based on ESMA's and EIOPA's technical advice to the Commission include specific measures that deal with issues such as:

- ensuring that Regulated persons do not create remuneration policies that provide incentives that may lead relevant persons to favour their own interests or the Regulated person's interests to the potential detriment of any client;
- ensuring management approval of a Regulated person's remuneration policy, and rendering senior management responsible for the continuous monitoring and where necessary the relevant revision of such policies; and
- remuneration or other similar incentives should not be solely or predominantly based on quantitative commercial criteria, but should instead be based on appropriate qualitative criteria encouraging relevant persons to act in the best interest of the clients.

ESMA's Technical Advice largely reflects the principles set out in ESMA's guidelines on remuneration policies and practices for MiFID firms published in 2013, which investment services licence holders were already required to take into account in complying with the Investment Services Rules for Investment Services Licence Holders. These guidelines, which are currently applicable to Regulated persons involved in any MiFID business, are aimed at setting a number of standards and expectations on the design and governance of remuneration practices, whilst at the same time keeping under control any risks that such remuneration policies and practices may create. If the Commission takes up ESMA's Technical Advice in this field, such guidelines will become Level 2 Measures and hence become binding on investment firms. Accordingly, the MFSA has elected to also draft these guidelines as rules. The MFSA is aware that several European initiatives aimed at matters relating to remuneration for particular markets, financial products and types of firms, either through EU directives or through implementing measures or guidelines, are in the pipeline. These are likely to affect the local legislative and regulatory framework. Apart from MiFID II, other directives such as Solvency II, IMD II and CRD IV, already cover, or are expected to cover remuneration to varying extents. Whilst it is acknowledged that the legislative approach at a European level may vary from one sector to another, the MFSA is proposing that these rules relating to remuneration should be made applicable to all Regulated persons in order to ensure that remuneration practices and policies do no give rise to conflicts of interests. This approach would provide all the relevant sectors with clear requirements to ensure that any remuneration policies drawn up do not promote inappropriate incentives to staff and that responsibility is placed on the management body to define and approve such policies in order to ensure that all Regulated persons clearly identify, prevent or manage conflicts of interest arising as a result of remuneration structures.

Q16: Do you agree with the MFSA's approach to apply obligations horizontally in relation to remuneration practices and policies to all Regulated persons? Please provide comments to support your views.

Inducements

The measures introduced by MiFID II in relation to the types of third party inducements which Regulated persons may receive have been significantly strengthened when compared to the existing standards under MiFID I. Regulated persons shall not be regarded as acting honestly, fairly and professionally in accordance with the best interests of a client if they receive or pay any fee or commission, or other non-monetary benefit, to or by a third party other than the client, unless such fee, commission, payment or benefit is designed to enhance the quality of the relevant service to the client and it does not impair compliance with the Regulated person's duty to act in the best interest of the client. This is subject to the exceptions related to proper fees and subject to certain disclosure requirements.

The Rules also provide that a Regulated person providing its Clients with advice on an independent basis is precluded from accepting and retaining fees, commissions or any monetary or non-monetary benefits from a third party (other than the client) or person acting on behalf of such third party, with the exception of minor non-monetary benefits which are deemed to enhance the quality of the service provided, and provided that it can be shown that such non-monetary benefits do not impair compliance the Regulated person's duty to act honestly, fairly and professionally in accordance with the client's best interests. Moreover such inducement would have to be disclosed to the client. It should be noted that these requirements already existed under the MiFID I regime.

Rules relating to inducements are also being extended almost in their entirety to all Regulated persons, including insurance undertakings and insurance intermediaries involved in the distribution of insurance-based investment products in order to ensure clarity and consistency in the standards expected, even though it remains unclear to what extent the IMD II will include inducement rules which reflect MiFID II's standards. With respect to UCITS Management companies, the MFSA is proposing to retain the qualification that such Regulated persons would only be subject to rules on inducements in so far as they offer MiFID business – where the UCITS Management company is managing individual portfolios or where it is offering certain non-core services.

Q17: Do you agree with the MFSA's approach to apply rules relating to inducements to all Regulated Persons, whilst restricting their applicability to UCITS Managements companies only when such UCITS Management company is offering MiFID business? Please provide comments to support your views.

Q18: In its Technical Advice ESMA is also advising the Commission to introduce an exhaustive list of non-monetary benefits that can be considered to be minor and which would therefore be acceptable. Do you think the Authority should consider including a similar list, exhaustive or non-exhaustive? Please provide comments to support your views.

Personal Transactions

It is being recommended that the draft Rules relating to personal transactions will be applicable only to persons licensed under the Investment Services Act, including UCITS Management companies, The proposed Rules reflect the already existing rules under the Investment Services Rules for

Investment Services Providers, which in turn are a result of transposition of MiFID I Implementing Directive and UCITS IV Implementing Directive.

Rules relating to the production and dissemination of investment research

These draft Rules are sourced from the provisions of MiFID Implementing Directive, most of which were in fact already covered by the existing Investment Services Rules for Investment Services Providers. In its Technical Advice on Conflicts of Interest in direct and intermediated sales of insurance-based investment product, EIOPA decided to abstain from advising the Commission to implement similar rules relating to conflicts of interest arising from assessments of investment opportunities in the context of IMD, in view of the fact that investment research does not belong to the typical business activities which an insurance undertaking or an insurance intermediary would carry out. Nevertheless it did not exclude that organisational requirements would apply in cases where an insurance undertaking/intermediary exceptionally produces and disseminates investment research – in which case general organisation requirements relating to management of conflicts of interest would apply. For this reason the MFSA has decided to apply these rules solely to persons licensed under the Investment Services Act, but also excluding UCITS Management companies.

Q19: Do you agree with the MFSA's approach to restrict the application of rules relating to the production and dissemination of investment research only to Regulated persons licensed under the Investment Services Act, excluding UCITS Management companies?

Specific Rules applicable to Investment Services Licence Holders which are licensed to provide the services of Underwriting of Financial Instruments and/or Placing of Financial Instruments with or without a firm commitment basis

This Chapter includes a section which sets out specific rules applicable to investment firms who provide the services of underwriting of financial instruments and/or placing of financial instruments with or without a firm commitment basis. These rules reflect the Technical Advice which is to be provided to the Commission in relation to MiFID II and MiFIR. These rules deal with specific matters such as advising to undertake an offering, pricing, placing, retail advice/distribution, lending/provision of credit, record-keeping and oversight.

Q20: Do you think that the Rules and Guidance set out in this Chapter adequately cover all situations relating to conflicts of interest and cater for all the necessary organisational requirements associated with the identification and management of such conflicts of interest?

Annex 1

List of Questions

Q1: Do you agree with this approach taken by the Authority, whereby the distinction in treatment between Professional and Retail clients has been harmonised for Regulated Persons providing insurance – related services and for Regulated Persons providing investment services? Please provide your reasons if you do not agree

Q2: Do you agree with the adoption of the term "client" to replace "customer" in the context of insurance – related services? Please provide your reasons if you do not agree.

Q3: Are there any additional topics which you consider should be included in the RuleBook? In this regard, please remember that the Supervision of Regulated person will now be split between the Conduct Supervisory Unit – for conduct of business matters and the Securities and Markets Supervision Unit or the Insurance and Pensions Supervision Unit, as applicable, for prudential matters.

Q4: Do have any comments with respect to the layout of the Rulebook? Specifically, do you agree that the guidance should be included immediately after the Rule to which it relates?

Q5: Do you agree with MFSA's approach to require complex products to be sold to retail clients only on an advisory basis, and hence only subject to a suitability test? Please indicate your reasons if your answer is no.

Q6: Which option from the above two (*options provided in Section 2)* would you prefer? Please supply reasons for your choice.

Q7: Should MFSA apply Option 1 or Option 2 (*options provided in Section 3*) in incorporating the new requirements for structured deposits into the Conduct of Business Rulebook?

Q8: Do you agree with the above list (*List of documents provided in Section 4)* as to the documents which are to be provided in both Maltese and English? Please provide reasons if you disagree.

Please indicate any other documents which you feel should also be included in the list.

Q9: **Are there any technical challenges which Regulated persons are likely to face in meeting these disclosure requirements (*disclosure requirements under 'Costs and Charges Disclosures' in Section 4*) that you feel we might be able to help address? If so, what solutions do you suggest to overcome these challenges.**

Q10: **Do you agree that the proposed Guidance with respect to Advertisements should include sample standard wording? Please provide reasons if you do not agree.**

Q11: **Do you think that there should be additional guidance for Regulated persons in order to help determine their "identified target market"? Please provide comments to support your views.**

Q12: **What do you think would be the major challenges for Regulated persons to comply with these proposed Rules (*Rules under Section 5 related to Product Governance and Oversight*)?**

Q13: **Do you agree with the horizontal approach being proposed by the MFSA in so far as Product Governance and Oversight is concerned? Please provide comments to support your views.**

Q14: **Do you agree with the proposed definitions of 'Manufacturer' and 'Distributor'? In particular, do you think we should extend the definition of 'Manufacturer' to include non-regulated entities such as Listed Companies? Please provide comments to support your views.**

Q15: **Do you agree with the approach being recommended in relation to third-country manufacturers? Please provide comments to support your views.**

Q16: **Do you agree with the MFSA's approach to apply obligations horizontally in relation to remuneration practices and policies to all Regulated persons? Please provide comments to support your views.**

Q17: **Do you agree with the MFSA's approach to apply rules relating to inducements to all Regulated Persons, whilst restricting their applicability to UCITS Managements companies**

only when such UCITS Management company is offering MiFID business? Please provide comments to support your views.

Q18: In its Technical Advice ESMA is also advising the Commission to introduce an exhaustive list of non-monetary benefits that can be considered to be minor and which would therefore be acceptable. Do you think the Authority should consider including a similar list, exhaustive or non-exhaustive? Please provide comments to support your views.

Q19: Do you agree with the MFSA's approach to restrict the application of rules relating to the production and dissemination of investment research only to Regulated persons licensed under the Investment Services Act, excluding UCITS Management companies?

Q20: Do you think that the Rules and Guidance set out in this Chapter adequately cover all situations relating to conflicts of interest and cater for all the necessary organisational requirements associated with the identification and management of such conflicts of interest?

Communications Unit
Malta Financial Services Authority
MFSA Ref: 04-2015
6th May 2015