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Implementation of MIFID II

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Introduction

On 29 September 2018, **Royal Decree-law 14/2018** of 28 September, amending the Consolidated Text of the Securities Market Law (the "**Royal Decree-law**") was published in the Official State Gazette (*Boletín Oficial del Estado*), implementing into Spanish law the provisions of Directive 2014/65/EU of 15 May 2014, on the markets in financial instruments ("**MiFID II**") which were pending of been implemented following publication of Royal Decree-law 21/2017 of 29 December, which partially implemented MiFID II in the area of market infrastructures.

The Royal Decree-law entered into force on the day following its publication in the Official State Gazette, except for specific provisions that are still pending regulatory development (agents, the system of granting and withdrawal of authorisation to investment firms, branches and freedom to provide services, evaluation of the acquisition of qualifying holdings, the internal organisation and operating general requirements, algorithmic trading and direct electronic access and regulation of professional customers and eligible counterparties). The current regulatory framework under the Consolidated Text of the Securities Market Law (the "**Securities Market Law**") continues to apply to the abovementioned matters.

It should also be taken into consideration that many of the precepts under the Royal Decree-law have already been developed through Delegated Regulation (EU) 2017/565 of 25 April 2016 (the "**Delegated Regulation**"), which is directly applicable in Spain and must therefore be taken into account when applying the Royal Decree-law.

Notwithstanding the foregoing, it is notable that important matters have yet to be implemented, such as product-governance requirements, cases in which it is understood that an inducement is designed to enhance the quality of the service, minor non-monetary benefits acceptable in the fields of independent advice or discretionary portfolio management and inducements regarding research. These matters are regulated in the Delegated Directive (EU) 2017/593 of 7 April 2016 (the "**Delegated Directive**") and their implementation is expected to occur through the amendment of Royal Decree 217/2008 of 15 February, on the legal framework governing investment firms (the "**RD 217/2008**"), as established in the draft amendment to RD 217/2008 published in August 2017.

The following is a summary of the main novelties that the Royal Decree-law has incorporated into the Securities Market Law.

List of financial instruments

The Royal Decree-law amends Article 2 of the Securities Market Law to adapt it to the list of financial instruments provided for in Section C of Annex I of MiFID II in order for those instruments to be listed under the new Annex to the Securities Market Law, which also incorporates the definition of negotiable securities and depositary receipts pursuant to the same terms as MiFID II.

Limits on positions in commodity derivatives

New Articles 85 to 89 regulate the setting of position limits in commodity-derivatives matters by the Spanish Securities and Exchange Commission (the CNMV), their reporting, the breakdown of the information to be provided about them, along with their supervision, pursuant to the terms established in Articles 57 and 58 of MiFID II, as well as in accordance with European implementing regulations (Delegated Regulation, Delegated Regulation (EU) 2017/564 and Implementing Regulation (EU) 2017/1093).

Cases of non-application of the Securities Market Law and exceptions

The Royal Decree-law directly incorporates the wording of Articles 2 and 3 of MiFID II by regulating the cases of non-application of the Securities Market Law (and other exceptions) under the new wording of Articles 139 and 139 *bis* of the Securities Market Law, respectively.

NON-APPLICATION OF THE SECURITIES MARKET LAW

The following novelties regarding the non-application of the Securities Market Law are noteworthy:

- Intragroup services. This category involves the provision of services exclusively to their parent companies, subsidiaries or other subsidiaries of their parent companies.
- Dealing on own account on an exclusive basis with instruments other than commodity derivatives or emission allowances unless they:
  - are market makers;
  - Are members or participants of a regulated market or an MTF, or have direct electronic access to a trading venue, except for non-financial institutions that execute transactions that mitigate (in an objectively measurable manner) the risks directly linked to the commercial activity or treasury-financing activity of those non-financial institutions or their groups in a trading venue,
  - apply a high-frequency algorithmic trading technique, or
  - deal on their own account when executing client orders.
- Trading on own account (including cases when they are market makers and do not execute client orders) and the provision of services in commodity derivatives or emission allowances, provided that:
  - on an individual and aggregate basis, it consists of an ancillary activity with respect to the principal (in accordance with Delegated Regulation (EU) 2017/592), when considered in relation to the group, and that principal activity does not constitute the provision of investment services and activities within the scope of this law or an activity legally reserved for credit

institutions under Law 10/2014 of 26 June, or when they act as market makers in relation to commodity derivatives;

- do not apply a high-frequency algorithmic trading technique, and
- annually inform the corresponding authorities that they seek to benefit from this exception.

- Transmission-system operators and operators or administrators of an energy-balancing mechanism, a distribution system or a system designed to keep the supply and use of energy in relation to the commodity derivatives used to carry out such activities.

OTHER EXCEPTIONS

- Natural persons who provide investment services and activities exclusively in commodities, emission allowances or derivatives thereof for the sole purpose of hedging the commercial risks of their clients (where those clients are exclusively local electricity undertakings, natural gas undertakings, or operators as defined in Article 3(f) of Directive 2003/87/EC), and provided that these customers jointly hold 100 per cent of either the capital or the voting rights of those persons, exercise joint control and are exempt under Article 139(1)(j), if they themselves provide these investment services and activities.
- Case of partial application of the Securities Market Law, pending regulatory development, for natural persons who are not authorised to hold clients' funds or securities and the only investment service that they provide is the reception and transmission of orders (to investment firms, credit institutions, or branches of the same, and to collective investment institutions and fixed-capital investment companies) or advice.

Marketing and advice of structured deposits

Article 145 of the Securities Market Law extends the application of specific principles to structured-deposits marketing and advice.

A structured deposit is defined as a deposit that is fully refundable on the maturity date under conditions stating that any interest or premium will be paid (or jeopardised) according to a formula involving factors such as:

- an index or combination of indices, excluding variable-rate deposits whose return is directly linked to an interest-rate index such as Euribor or Libor;
- a financial instrument covered by the Markets in Financial Instruments Directive, or a combination of financial instruments;
- a commodity or combination of commodities or other physical or non-physical non-fungible assets; or
- a foreign exchange rate or combination of foreign exchange rates.

In particular, the following Securities Market Law provisions apply:

- Articles 182, 183.1 and 2, Article 193.2.a), b), c), d) and e) and Article 194 (corporate governance and internal organisation requirements);
- Articles 208 to 220 *sexies* (rules of conduct);
- Articles 146, 147 and 221 (tied agents and management and execution of orders); and
- Articles 197, 207, 276 *bis* to 276 *quinquies* and Title VIII (obligation to notify infringements within the entity and to the CNMV and sanctioning regime).

Management bodies

The Royal Decree-law introduces the following novelties in connection with management bodies.

APPOINTMENT OF NEW MANAGEMENT BODIES (ARTICLE 158)

- The communication of new members of the management body or of the senior management of the parent entities only applies to investment firms:
  - other than those provided for in Article 4(1)(2)(c) of Regulation (EU) 575/2013, and
  - which parent company is a financial holding company or a mixed-financial holding company.
- The CNMV's obligation of prior notification and non-opposition is extended to the following appointments (provided that they are not members of the management body):
  - the individual in charge of internal-control functions, financial directors and other posts that have been identified as key for an investment firm's risk approach;
  - the same posts in the parent companies that meet the requirements under the preceding point and that are:
    a) significant consolidated entities;
    b) significant entities forming part of a group, where the investment-services firm (on a consolidated basis) is not a significant entity; or
    c) significant entities that do not form part of a group.

  However, if such appointments, as well as those of members of the management or senior bodies, are subject to authorisation from other EU supervisory bodies, a mere communication to the CNMV will suffice.

RECRUITMENT AND ASSESSMENT OF POSITIONS

- In the procedures for recruiting members of the management body, the recruitment of women shall be pursued.
- The suitability requirements for the members of the management body of Article 184 *bis* of the Securities Market Law will also apply to those in charge of internal-control functions, financial

directors and other posts that have been considered key in view of the risk of the investment firm and, where appropriate, of the dominant entities indicated in the second bullet of the previous section “Appointment of New Management Bodies”.

Branches and freedom to provide services

The Royal Decree-law introduces important novelties into the field of the provision of investment services in Spain by companies from third countries:

- the provision of investment services or activities, with or without ancillary services, to retail clients or to professional elective clients by a company from a third country may only be carried out through the establishment of a branch in Spain;
- depending on the volume of the activity, the complexity of the products or services, or for reasons of general interest, the CNMV may require that a third-country company establish a branch if it provides or intends to provide investment services or activities in Spain, with or without ancillary services, to professional clients *per se* or to eligible counterparties.

This last point goes beyond the scope of MiFID II, which does not require, under any circumstances, that a branch be established when dealing with clients who are eligible counterparties or professionals *per se*.

Algorithmic trading and Direct Electronic Access

ALGORITHMIC TRADING

Articles 195 and 195 *bis* regulate the following aspects of entities engaged in algorithmic trading:

- systems of controls and risks to be established;
- pending regulatory development: notification of its activity and information on the same to the CNMV, record keeping and record keeping of orders in the event of using high-frequency algorithmic trading techniques; and
- algorithmic negotiation as a market-creation strategy.

DIRECT ELECTRONIC ACCESS

Article 196 regulates the following aspects of entities providing direct electronic access:

- systems and controls to be established;
- entities must ensure that their customers respect the laws and regulations of the trading venue to which they have electronic access;
- obligation to establish a written agreement between the institution and the customer; and
- pending regulatory development: notification of its activity and information on the same to the CNMV and record keeping.

It is noteworthy that algorithmic trading and direct electronic access are also regulated under the Delegated Regulation and Delegated Regulations 2017/584 and 2017/589.

Data-reporting services

The Royal-Decree law introduces a new Title V *bis* that for the first time regulates the data-reporting services.

In particular, it regulates the following aspects of the data-reporting services provider:

- The types of data-supply providers and the reservation of activity:
  - approved publication arrangements (APA).
  - consolidate tape providers (CTP).
  - approved reported mechanism (ARM).
- The authorisation of CNMV and the procedure for granting the authorisation, including the necessary requirements to obtain it.
- The registry of data providers.
- Dissemination and information-processing requirements applicable to APA, CTP and ARM.
- Requirements for the management bodies of data-reporting services providers.
- Organisational requirements:
  - for the management of conflicts of interest;
  - for ensuring systems capacity, business continuity and information quality; and
  - for the management of the outsourcing of functions.

Manufacture and marketing of financial products

The new Article 208 *ter* of the Securities Market Law establishes the basic requirements that should govern the manufacture and marketing of financial products. Those requirements are further developed in Articles 9 and 10 of the Delegated Regulation (which implementation is expected to take place through the modification of Royal Decree 217/2008) as well as in the ESMA Guidelines on MiFID II product-governance requirements (ESMA35-43-620 ES), which the CNMV declared on 12 September 2017 that it intendeds to comply with them.

ENTITIES THAT MANUFACTURE FINANCIAL PRODUCTS

- Defined target market: the design must meet the needs of a defined target market of end clients.
- Distribution strategy: ensure that it is compatible with the defined target market and take reasonable steps to ensure that it is distributed within that market.

ENTITIES THAT MARKET FINANCIAL PRODUCTS

- Product knowledge: they must understand the characteristics of the product.
- Defined target market: assess their compatibility with the defined target market.
- Customer interest: it must be guaranteed that they are marketed or offered only when in the clients' interest.

Conduct rules

Notwithstanding the regulatory development under the Securities Market Law, the following novelties stand out with regard to the rules of conduct:

CATEGORISATION AS ELIGIBLE COUNTERPARTIES

The new second paragraph of Article 203 expressly regulates the existing criteria of the European Commission and the CNMV according to which the category of eligible counterparty is only applicable in relation to the service of reception and transmission of orders, execution of orders on behalf of third parties or dealing on own account and the ancillary services directly related thereto, but not in the case of advice and discretionary-portfolio management services.

PERIODIC SUITABILITY ASSESMENT

In the case of discretionary-portfolio management or when the investment firm has informed the client that it will carry out a periodic assessment of the appropriateness of the recommendations, the periodic report must contain an updated statement on the manner in which the investment meets the retail client's preferences, objectives and other characteristics.

EXEMPTION FROM CONVENIENCE ASSESSMENT

This exemption may not be applied when the auxiliary service provided consists of granting credits or loans (Article 141.b) that do not involve existing credit limits of loans, current accounts and overdraft facilities of clients.

NON-COMPLEX FINANCIAL INSTRUMENTS *PER SE*

The same list of non-complex financial instruments provided for in existing Article 217 of the Securities Market Law is maintained, including, as a novelty, that the following cannot be considered non-complex financial instruments:

- money-market instruments or securitised bonds or debt that incorporate a structure that makes it difficult for the client to understand the risks incurred;
- structured deposits; and
- structured UCITS, although they were already considered to be a complex financial instrument.

Remuneration and conflicts of interest

The Royal Decree-law incorporates the following novelties to various Securities Market Law principles on remuneration and conflicts of interest (although they were already included in the ESMA Guidelines on MiFID remuneration policies and practices):

- Article 189: investment firms' remuneration policies should address the entity's risk management and the management of conflicts of interest.
- Article 189 *ter*: remuneration policies and practices should be defined and implemented in accordance with Article 27 of Delegated Regulation 2017/565 in such a way that:
  - equal treatment of customers and no prejudice to their interests is guaranteed;
  - the own interests of employees or the entity are not favoured to the client's detriment; and
  - they must not be based exclusively or primarily on commercial criteria and must instead take qualitative criteria into account.

  The CNMV may specify the criteria to be taken into account for such policies and remunerative practices of persons having a direct or indirect impact on the provision of investment services.
- Article 220 *bis*: investment firms must not make any arrangement by way of remuneration, sales target or any other that could provide an incentive to its staff to recommend a particular financial instrument to a retail client when the investment firm is in a position to offer a different financial instrument that would meet the client's needs.

Independent advice

The new Article 220 *ter* of the Securities Market Law regulates independent advice as follows:

- A sufficient range of financial instruments available on the market must be assessed and must be sufficiently diverse with regard to their type and issuers or product providers.
- Prohibition of acceptance or retention of inducements.
- Possibility of accepting or retaining benefits that will be considered as minor non-monetary benefits, provided that it:
  - is communicated to the client;
  - enhances the quality of the service; and
  - does not affect the duty to act in the clients' best interests.

Regarding independent advice, Articles 52 and 53 of the Delegated Regulation should also be taken into account.

Inducements

The Royal Decree-law introduces the following amendments regarding inducements:

- Independent advice: prohibition of accepting or retaining inducements, except for minor non-monetary benefits.
- Discretionary management portfolio: prohibition of accepting or retaining inducements, except for minor non-monetary benefits.
- All other investment services: inducements are permitted insofar as they comply with the requirements established in Article 59 of Royal Decree 217/2008, with the novelty that the client must also be informed, where appropriate, of the mechanisms for transferring the inducements received by the investment firm to them.

  Nevertheless, the definition of the cases in which it is considered that the inducements are designed to enhance the quality and that they comply with the obligation to act in the best interests of the client, as set out in Article 11.2 of the Delegated Directive, has yet to be defined for these services. Such cases should be defined in the amendment to Royal Decree 217/2008, although the Royal Decree-law also establishes that the CNMV can create a closed list subject to the Government's authorisation.

Knowledge and competence

The Royal Decree-law introduces a new Article 220 *bis* regulating the obligation of natural persons who provide investment advice or information on financial instruments to have the necessary knowledge and competence to fulfil their obligations under the Securities Market Law.

To meet this obligation, the entities must take into consideration the content of:

- The ESMA's guidelines for the assessment of knowledge and competence (ESMA/2015/1886/EN).
- Technical Guide 4/2017 of the CNMV for the assessment of the knowledge and competence of staff who provide information and advice.

Management and execution of orders

The Royal Decree-law has incorporated the following amendments into the framework on the management and execution of orders:

- The steps to be adopted by the entities in order to obtain optimal results must be SUFFICIENT; this is in contrast to the current legal framework, under which the steps must be REASONABLE.
- Limited orders: measures to facilitate their earliest possible execution must be taken if they were not immediately executed under prevailing market conditions or trading venue.
- Prohibition against investment firms receiving any remuneration, discount or non-monetary benefit for directing orders to a specific trading venue or execution venue.
- Obligation of trading venues and systematic internalisers to make available to the public, free of charge and at least once a year, data relating to the quality of the execution.
- Obligation to publish annually the top five order-execution venues through which they executed client orders with information on the quality of execution obtained.
- Obligation of entities to inform the client, after the execution of the transaction, of the venue through which the order was executed.

Communication of infringements to the CNMV

Although the CNMV's webpage already provides a whistleblowing channel for the communication of infringements of securities market legislation, the Royal Decree-law introduces a new Chapter IV *bis* within Title X. Chapter IV develops the framework on communicating infringements to the CNMV:

- The communication of the infringement should be related to: the Securities Market Law and the Law 35/2003, of 4 November, on the Collective Investment Schemes.
- Channels: in writing (electronically or paper based), verbally (by telephone), or in person by meeting with officers from the CNMV.
- The communications' minimum content is regulated.
- Confidential nature of the communication.
- Protection of the whistle-blower in terms of employment and contractual concerns.

Sanctioning framework

The following are the most important amendments to the sanctioning framework:

INFRINGEMENTS

New sanctions were introduced under Articles 278, 281, 282, 283, 284, 291, 294, 295 and 296, which result from the infringements of the new obligations under the Securities Market Law.

SANCTIONS

- VERY SERIOUS
  - The quintuple of the sanction may also be calculated on the basis of the loss avoided.
  - The sanction may be also calculated, apart from the existing parameters set out in Article 302 of the Securities Market Law, as 10% of the legal person's total annual turnover pursuant to the most recently available accounts approved by the management body. If the legal person is a parent undertaking or a subsidiary of the parent undertaking that is obliged to prepare consolidated financial accounts, the total annual turnover to be taken into account will be the total annual turnover pursuant to the most recent consolidated annual financial statements.
  - The former sanction of EUR 600,000 is now increased to EUR 5,000,000.
  - New sanctions were introduced in sections 9 to 16 of Article 302 of the Securities Market Law.
- SERIOUS
  - The former sanction equivalent to twice the gross profits is increased to triple the gross profit.
  - New sanctions were introduced in sections 4 to 11 of Article 303 of the Securities Market Law.

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