

## The MiFID II Inducements Regime

*MiFID II contains a number of inducements requirements, including rules relating to conflicts of interest, research, hospitality, corporate access, and payment for order flow. This Client Alert outlines these requirements and will help firms understand how they apply both to themselves and to their counterparties in common scenarios.*

The MiFID II inducements regime is complex and can cause confusion. Not only do different requirements apply to different scenarios, but the same requirements apply differently to the different parties involved in a single scenario. As a result, parties to a transaction may reach different conclusions when conducting their own assessment of whether a particular fee structure or benefit is permissible. This may be the case in common sell-side / buy-side and manufacturing / distribution interactions.

This *Client Alert* therefore outlines the MiFID II inducements regime and applies the rules to a number of common scenarios involving the payment of fees, or provision of other benefits such as research, corporate access, and hospitality. This will help firms that are subject to MiFID II understand how the inducement related obligations interact and apply both to themselves and to their counterparties.

The analysis set out in this *Client Alert* is general in nature and relies on a number of unstated simplifying assumptions. Given the complexity of the MiFID II inducements regime, firms should consult their own legal advisors for advice on applying these requirements to any specific scenario.

### Relevant MiFID II Requirements

The following MiFID II requirements are relevant to the provision and receipt of inducements.

- **Clients' best interests**

MiFID firms must act honestly, fairly, and professionally **in accordance with the best interests of their clients**. As a result, any firm should consider whether payment or receipt of a fee or other benefit is in accordance with their clients' best interests.

- **Conflicts of interest**

General MiFID II **conflicts of interest** provisions require firms to identify, prevent, and manage conflicts of interest, and implement effective organisational arrangements to prevent conflicts of interest adversely affecting their clients. This will include conflicts relating to fees and other benefits.

- **Inducement regime**

MiFID II contains: (i) a **general inducements rule**, under which firms must not pay or receive third-party benefits unless certain conditions are met, and (ii) a **specific prohibition on third-party benefits**, other than certain **minor non-monetary benefits**, which applies only to firms providing particular MiFID investment services and activities.

- **General inducements rule**

The **general inducements rule** prohibits firms from paying benefits to or receiving benefits from third parties, unless the benefits are designed to enhance the quality of the relevant service to the client, and do not impair compliance with the firm's duty to act honestly, fairly, and professionally in accordance with the best interests of its clients.

- **Prohibition on third-party benefits in relation to portfolio management and independent investment advice**

MiFID II contains a **specific prohibition** on a firm accepting and retaining benefits received from third parties in relation to the firm's provision of portfolio management or investment advice services to its underlying clients, other than certain specified **minor non-monetary benefits**. This prohibition applies only to firms providing portfolio management or independent investment advice, and only to the recipient firm (rather than the party providing the benefit).

- **Unbundling**

MiFID II contains **unbundling** requirements which require firms providing execution services to identify separate charges for execution (which only reflect the cost of executing the transaction), and to unbundle and apply separately identifiable charges to other benefits or services.

- **Payment for order flow**

MiFID II best execution provisions **prohibit payment for order flow**. The prohibition applies to the firm **receiving** the payment, and will apply to a firm routing underlying client orders to a venue or executing broker in return for receipt of fees or other benefits.

## Relationship Between the Rules

The various MiFID II requirements interact in **complex** and **technical** ways. Different requirements apply to different scenarios, and different requirements may apply to the various different parties interacting in a single scenario. Even if the same requirements apply to the various parties interacting in a single scenario, they may apply in different ways given the differing roles of the various parties. Therefore, firms must be aware not only of how the requirements will apply to them, but also how the requirements will apply to the parties they are interacting with.

For example, in the context of sell-side / buy-side interactions, a sell-side firm may be permitted to provide benefits to its buy-side client under the **general inducements rule** (because its client does not count as a third party for the purposes of this rule). However, its buy-side client may be prohibited from receiving the benefits under the inducements regime (either under the **general inducements rule** or the **prohibition on third-party benefits** — depending on whether the buy-side firm is providing portfolio management or independent investment advice to its underlying clients). To add to the complexity, the buy-side firm may need to consider whether the receipt of the benefits breaches the prohibition on **payment for order flow**, and the sell-side firm will need to separately consider whether the benefits amount to a service that should be subject to a separately identifiable charge under the **unbundling** requirements. Similar considerations apply in a distribution context — while a manufacturer may be permitted to make payments to a distributor, a distributor would need to assess whether it can receive payments under the **general inducements rule** and the requirements on **payment for order flow**. In all cases, firms will also need to ensure they comply with their obligations to act in accordance with their **clients' best interests**, and to prevent and manage **conflicts of interest** which may arise, particularly when interacting with multiple parties.

In order to assist firms in their assessment of which requirements apply, a number of worked examples showing how the different requirements apply to situations involving the payment of fees or the provision of other benefits are set out below.

## Worked Examples

### Corporate securities issuance

- **Scenario:** An investment bank is providing underwriting and/or placing services to a corporate client issuing securities to investors.
- **Analysis:** The investment bank will be subject to the **general inducements rule**. As a result, the investment bank will need to consider whether sales and trading commission received from investors is designed to enhance the quality of the service provided to its corporate client, does not impair compliance with the firm's duty to act in accordance with the best interests of its corporate client, and should be disclosed. If the investment bank is acting only for the corporate client this should be straightforward. The analysis may be complicated if the investment bank regards the investors as its clients in relation to the transaction (*i.e.*, if the investment bank does not rely on the UK corporate finance contact exemption). If so, the investment bank will have two clients with opposing interests in the same transaction, and will also need to ensure that it complies with (i) **conflicts of interest** requirements, and (ii) the **general inducements rule**, this time also considered in respect of the investor clients (*i.e.*, that any fees paid by the corporate client are designed to enhance the quality of the service provided to the investor clients, do not impair compliance with the firm's duty to act in accordance with the best interests of its investor clients, and are disclosed). In practice, the disclosure requirements have received detailed attention, and trade associations have considered the possibility of analysing this scenario as one in which two separate and unconnected transactions occur (one with the corporate client, the other with the investors) such that disclosure is not required.
- **Comment:** Even in this relatively straightforward scenario, multiple MiFID inducements requirements may apply depending on the facts.

### Manufacturing and distribution

- **Scenario:** A manufacturer is structuring and issuing products (such as structured notes) to a distributor for onward distribution to underlying investors.

- **Analysis:** From the perspective of the manufacturer, it is simply interacting with a single distributor client. As a result, there are no third parties to this relationship and **conflicts of interest / the general inducements rule** will not apply to any distribution fee it pays to the distributor. However, the analysis is more complicated from the perspective of the distributor. The distributor is passing products on to underlying investor clients. As a result, any distribution fee the distributor receives from the manufacturer is received from a third party in the context of the distributor's client relationships with the underlying investors. Under the **general inducements rule**, the distributor will therefore need to ensure that any distribution fee it receives is designed to enhance the quality of the service / does not impair its duty to act in the best interests of the underlying investors. And if the distributor is providing independent investment advice or portfolio management services to the underlying investors, the **prohibition on third-party benefits** may prevent the distributor retaining any distribution fee at all. The distributor may also wish to consider whether it could be viewed as routing orders from underlying investors to the manufacturer — in which case, a distribution fee could constitute **payment for order flow**, if the manufacturer is a market maker and the distributor is seen as a broker.
- **Comment:** This scenario provides a clear example of how the MiFID inducements analysis may differ from the perspective of different parties within a single transaction. In this case, various requirements fall on the distributor as recipient of the potential inducement, and so the distributor will need to undertake its own assessment of whether receipt of a distribution fee is permissible.

## Research

- **Scenario:** A sell-side firm is providing research services to buy-side clients.
- **Analysis:** The sell-side firm will be subject to **unbundling requirements**, and must ensure that the research services are subject to a separately identifiable charge. The obligations on the buy-side firm will depend on whether or not the firm is providing independent investment advice or portfolio management services to its underlying investors. If so, the **prohibition on third-party benefits** will apply. However, MiFID contains an express carve out from this prohibition for research paid for from the recipient's own resources or a separate research payment account, and so provision of the research will be permissible provided the buy-side firm pays for it in one or other of these ways. If the buy-side firm is not providing independent investment advice or portfolio management services, the firm will instead be subject to the **general inducements rule**, and must ensure receipt of research complies with this rule (or, alternatively, again pay for the research from its own resources or a separate research payment account, thereby bringing it outside the inducements regime).
- **Comment:** Again, inducements requirements generally fall on the recipient of the potential inducement (in this case, the research). However, this scenario differs from others in that MiFID II contains a specific carve out for research paid for in particular ways.

## Hospitality

- **Scenario:** A sell-side firm is providing hospitality to buy-side firms.
- **Analysis:** No specific inducements requirements apply to a sell-side firm providing hospitality — unless the hospitality is being provided in the context of providing services to another client (e.g., a corporate client). If they are being provided in such a context, the **general inducements rule** would apply, and **conflicts of interest requirements** would also apply if the recipient buy-side firms are themselves additional clients of the sell-side firm. From the buy-side firm's perspective, MiFID II inducement rules will apply; however, reasonable *de minimus* value hospitality is expressly provided for as an **acceptable minor non-monetary benefit**.

- **Comment:** Again, inducement requirements relating to hospitality generally fall on the recipient, which will need to make its own assessment of whether the hospitality is of sufficiently *de minimus* value to be permissible.

### Corporate Access

- **Scenario:** A sell-side firm is providing corporate access to buy-side firms.
- **Analysis:** The sell-side firm will generally be providing access in the context of a particular relationship to a corporate client, and so will need to consider the **general inducements rule** in relation to its corporate client. In addition, the sell-side firm may wish to ensure the firm is not treating the buy-side firms as clients in relation to the provision of corporate access, as this would trigger general **conflicts of interest** requirements (and potentially the need to consider **unbundling** requirements if the corporate access constitutes a service provided to the buy-side clients). From the perspective of the buy-side firm, no express provision allowing for corporate access as a minor non-monetary benefit exists, and so the buy-side firm would need to make its own assessment of whether the access is permissible. In practice, large events to which multiple buy-side clients are invited are more likely to be assessed as minor than one-on-one meetings. Events that are clearly being organised on behalf of a corporate client are also likely to be seen as a minor non-monetary benefit by investors who agree to attend.
- **Comment:** This scenario illustrates the fact-specific nature of the MiFID II inducements regime. The case is structurally similar to the hospitality scenario — a sell-side firm is providing a potential inducement to buy-side firms. However, despite this structural similarity, the analysis may differ given that the buy-side firm will be providing this in the context of a client relationship, and corporate access could potentially constitute a service subject to unbundling requirements.

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If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

**David Berman**

david.berman@lw.com  
+44.20.7710.3080  
London

**Brett Carr**

brett.carr@lw.com  
+44.020.7710.4695  
London

**Charlotte Collins**

charlotte.collins@lw.com  
+44.20.7710.1804  
London

**Stuart Davis**

stuart.davis@lw.com  
+44.20.7710.1821  
London

**Nicola Higgs**

nicola.higgs@lw.com  
+44.20.7710.1154  
London

**Gabriel Lakeman**

gabriel.lakeman@lw.com  
+44.020.7710.4645  
London

**Ella McGinn**

ella.mcginn@lw.com  
+44.20.7710.4649  
London

**Frida Montenius**

frida.montenius@lw.com  
+44.20.7710.1161  
London

**Rob Moulton**

rob.moulton@lw.com  
+44.20.7710.4523  
London

**Jonathan Ritson-Candler**

jonathan.ritson-candler@lw.com  
+44.20.7710.1815  
London

**Katy Sanders**

katy.sanders@lw.com  
+44.020.7710.4548  
London

**Emily Torrens**

emily.torrens@lw.com  
+44.20.7710.1883  
London

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