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C H A N C E

Sea of Change
Regulatory reforms – reaching new shores

Briefing note

October 2014

MiFID2 for Asset Managers and Private Banks

The landscape of European asset management is set to change, with the implementation of MiFID2 in January 2017.

Although it is too early to tell precisely what this landscape will look like, as in many cases the Level 1 framework is to be supplemented by detailed Level 2 implementing measures, a number of key issues are emerging. In particular, these concern product manufacturing and distribution, driven primarily by new rules on product governance, inducements, the introduction of the concept of 'independent advice' and the review of what constitutes complex and non-complex products.

In this briefing, we examine these issues and explore some of the more pressing questions for the asset management and private wealth industry.

Question 1: What are the new product governance requirements? Will they affect manufacturing and distribution?

Yes. The new rules on product governance are the key MiFID2 enhancement to product distribution and will have a significant impact, imposing specific requirements on both manufacturers and distributors.

Although the new rules are linked to the various stages of the product life cycle, from product generation ideas through to post-sale follow-up, they all have the same starting point: the requirement that manufacturers and distributors must always act in the best interest of the client. For example, requirements in the Level 1 text oblige manufacturers to ensure that products are designed to meet the needs of an identified target market of end clients, that the distribution strategy is appropriate to that target market and to take reasonable steps to ensure that the products are actually distributed to the target market.

For their part, distributors must understand the products they offer or recommend, assess the compatibility of the products with the needs of the target market and ensure that they only proceed to offer or recommend a particular product when it is in the client's best interest.

Further detailed requirements will be set out in the Level 2 measures and ESMA has recently consulted on these. ESMA's proposed product governance obligations for manufacturers and distributors are shown in the table below.

What are the respective responsibilities of manufacturers and distributors?

A number of questions arise in the context of product governance, particularly on the respective responsibilities of manufacturers and distributors. For example, it is no longer possible, when assessing product distribution, to only focus on the obligations of the distributor at the point of sale, as 'distributor-like' obligations are placed on product manufacturers higher up the chain.

Key to this is the concept of 'target markets'. Manufacturers must now identify potential target markets for each product and are obliged to ensure effective distribution to that target market and that the product performs as intended. A big challenge for manufacturers is how granular must the target market analysis be. Positive action must be taken if the required standards are not met. Additionally, there will be board level responsibility for product governance and an increased role for senior managers, as well as for the

MiFID2 - Key issues for asset managers and private banks

- Product governance
- Conflicts and inducements
- Independent advice
- Appropriateness of complex and non-complex products
- Information on costs and charges
- Best execution
- Transaction reporting
- Product intervention
- Timeline for implementation

"…There is a noticeable trend in MiFID2 towards 'retailisation' of the institutional environment…."

compliance function, so firms will need to consider what this oversight will look like.

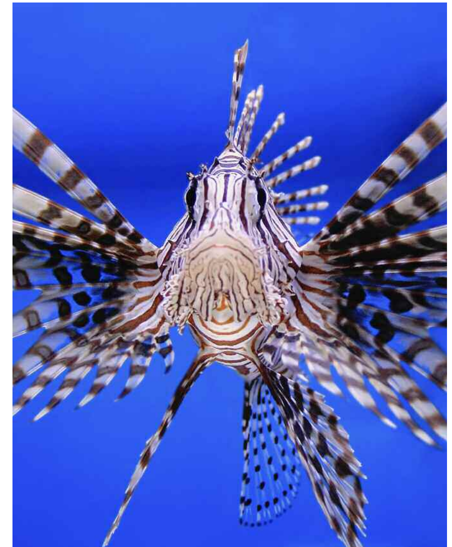
What are the obligations of a distributor when dealing with a third country/non-MiFID firm manufacturer?
From the perspective of a distributor, one of the most pressing questions concerns its obligations *vis-à-vis* third country or non-MiFID firms.

ESMA's draft technical advice requires distributors to take all 'reasonable steps' to ensure that the level of information obtained from the manufacturer is of a reliable and adequate standard to ensure products are distributed according to the needs of the target market. Where the required information is not publicly available, 'reasonable steps' will require an agreement that the manufacturer or its agent will provide all relevant information. Taking this a step further, ESMA explores the idea of requiring a written agreement, where the manufacturer would be obliged to provide all relevant product information to the distributor. In practice this might prove problematic, as it is not at all certain whether third country or non-MiFID firms would be prepared to enter into a written agreement. Although ESMA recognises proportionality depending on what information is otherwise available, distributors still need to assess the target market appropriately and, if they cannot fulfil this obligation adequately, they may encounter compliance problems.

Clearly, detailed guidance on these issues would be constructive, as there are many unanswered questions and the position is not entirely clear. At this stage what is clear however, is that the new requirements will have a significant impact, not least of which will be on documentation, as new distribution agreements, including platform agreements, will need to be put in place.

Question 2: What are the new rules on conflicts and inducements? Will research be affected? Would the same rules apply to UCITS and AIFs?

MiFID2 strengthens the requirements on conflicts and inducements, obliging firms to take all appropriate steps to identify and prevent or manage conflicts of interest. Over-reliance on disclosure, particularly generic disclosure, is not permitted and specific rules on inducements have been introduced. Together, the new rules in this area represent a significant change for the asset management and private wealth industry and have provoked much debate.



What are the new requirements on inducements?
If independent investment advice or portfolio management is provided, investment firms are not allowed to accept and retain fees, commissions or any monetary and non-monetary benefits from a third party. While this is consistent with the UK Retail Distribution Regime, it is a major change for continental firms. A softening of the blow is that firms can act as a 'flow through' and pass on third party payments to their underlying clients. Also, minor non-monetary benefits are permitted, as long as they are in the best

Product Governance – Obligations on manufacturers and distributors

Manufacturer

- To manage conflicts of interest as part of product processes
- To have in place governance processes for effective oversight and control
- To assess potential target market
- To assess poor investor outcomes
- To consider the charging structure and the impact on outcomes for target market
- To regularly review investment products

Distributor

- Products and services must be compatible with needs of target market
- To provide information to manufacturers to assist with post-sale governance
- Compliance function must review product governance arrangements
- Management/governance body must endorse investment products and services and target markets
- Where third country firms or non-MiFID manufacturers are involved, must ensure reliable and adequate information from manufacturer to ensure distribution in accordance with needs of target market

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interests of the client and have been clearly disclosed to the client beforehand.

For other investment services, the existing rules have been largely retained. This means that firms cannot pay or receive monetary or non-monetary benefits unless they enhance the quality of service to the client, do not impair the firm's duty to act in the best interest of the client and have been clearly disclosed beforehand.

There are specific provisions prohibiting firms from receiving any monetary or non-monetary benefits for routing client orders to a particular trading or execution venue where it would infringe the conflicts of interest or inducement rules.

We do not yet have full details of the rules on inducements, as this is one of the areas where ESMA is to provide technical advice to the European Commission. However, the ESMA consultation paper issued in May 2014 provides an indication of ESMA's thinking in this area including, importantly, on what constitutes 'minor non-monetary benefits'.

What are 'minor non-monetary benefits'?

In ESMA's view, 'minor non-monetary benefits' must be of such a scale and nature that they cannot be judged to impair compliance with the firm's duty to act in the best interests of its clients. This exemption will be interpreted strictly so, for example, it is unlikely to cover corporate hospitality and sponsorship.

ESMA advises the European Commission to introduce an exhaustive list of minor non-monetary benefits which would be permitted. These would include participation in conferences, seminars and other training events and hospitality of a reasonable *de minimis* value.

How will access to research be affected?

It is frequently asked whether research is a 'minor non-monetary benefit'. The answer is most probably not, unless it is widely distributed to a large number of persons or the public or is generic in nature. ESMA is likely to consider any research that involves a broker allocating valuable resources to a portfolio manager as not qualifying as a 'minor non-monetary benefit'. Likewise, privileged access to research analysts, including face-to-face meetings and conference calls, bespoke reports, investor field trips and corporate access would not be considered 'minor non-monetary benefits'. In the UK context, this is beyond what is currently allowed under the FCA's new rules on the use of dealing commission.

What is the position with regards to UCITS and AIFs?

The rules described above relate to research received in the context of discretionary portfolio management, which is an investment service under MiFID2. They would not apply to research received in the context of collective portfolio management, which, because of the exemption in Article 2(1)(i) of MiFID, is not an investment service. To create a level playing field, particularly as both services are often provided by different parts of the same firm, ESMA is advising the European Commission to consider the possibility

Use of dealing commission - Focus on the UK

"… unbundling research from dealing commissions would be the most effective option to address the continued impact of the conflicts of interest created for investment managers by the use of a transaction cost to fund external research…" the FCA

The UK regulator has recently issued new rules on the use of dealing commissions which came into force in June 2014. Further reforms are planned, specifically focusing on the use of dealing commissions to pay for investment research, which are described in its July 2014 discussion paper. Acknowledging the progress on MiFID2 at EU level, and in particular agreeing with the stance taken by ESMA in its draft technical advice on whether research could be considered a 'minor non-monetary benefit', the FCA has stated that its preferred option is to introduce any fundamental reforms at EU level through MiFID2, as 'unbundling' research from execution arrangements across the EU would address many of the concerns about the UK regime. However, it has not ruled out going further than MiFID2 if, from the perspective of the FCA, its ultimate implementation does not go far enough.

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of aligning the relevant provisions of the UCITS and AIFMD directives with the MiFID2 provisions in this area.

Question 3: Are there new requirements for intermediaries giving independent advice?

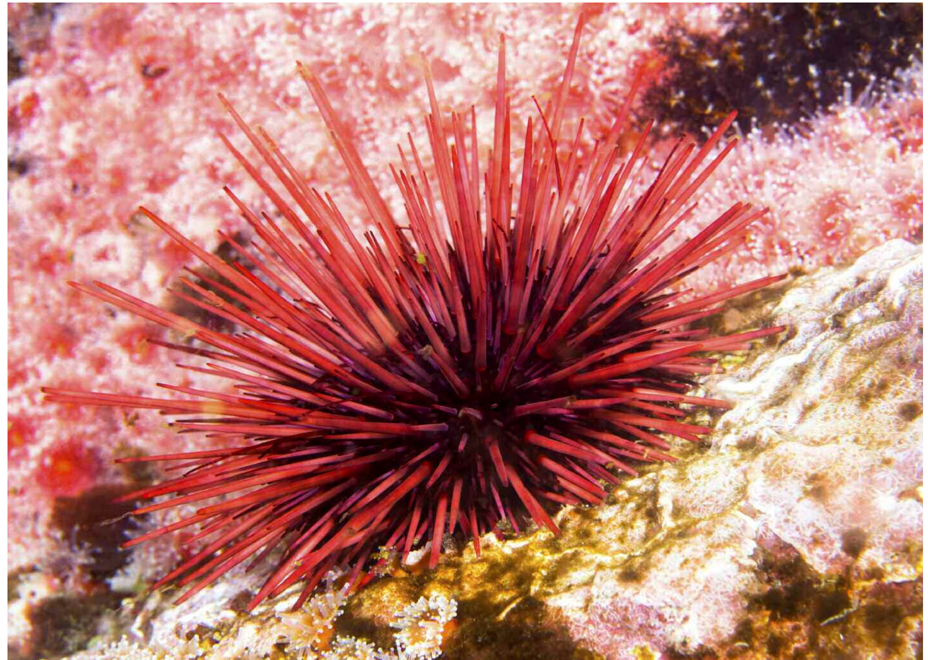
Yes. MiFID2 introduces new requirements for intermediaries providing investment advice on an independent basis, prohibiting them from limiting their advice to their own products or products coming from entities with which they have close links. In addition, the retention of any inducements from third parties is forbidden.

These requirements will require firms to reassess their product selection processes, ensuring a fair and appropriate comparison of different financial instruments. Detailed requirements will be contained in the Level 2 measures, when it will be clearer how this requirement maps on to the UK regime.

Question 4: Does MiFID2 change the rules on complex and non-complex products? Does that affect what products can be sold on an 'execution only' basis?

Yes. MiFID2 will introduce changes on what products can be classed as 'non-complex', and hence can be sold on an 'execution only' basis, and those that are 'complex' and will require firms to conduct an appropriateness assessment. Firms will therefore need to reassess their products to determine whether they are complex or non-complex and, consequently, how they can be sold.

Of particular interest to asset managers will be the treatment of non-UCITS collective investment undertakings and structured UCITS. The Level 1 framework lists the



products that are considered 'non-complex' and which can therefore be sold on an execution only basis and clearly excludes from this list structured UCITS. The treatment of non-UCITS collective investment schemes is more ambiguous. Are they, like structured UCITS, *automatically* complex (and hence ineligible to be sold on an execution only basis)? It appears that a difference of opinion is emerging here between ESMA and some in the asset management community.

According to ESMA, MiFID2 signals that shares in non-UCITS collective investment undertakings should not be considered non-complex; in other words, that they are automatically complex. This view is not shared by many in the asset management industry who think that this is a misinterpretation of the Level 1 text. Deciding which side of the line these products fall has significant implications, particularly for the retail market. In the UK, for example, non-UCITS retail schemes (NURS) would be faced with a significant increase in costs if they remodelled their operation to accommodate suitability assessments. As a result, retail investors may ultimately have less investment choice if this segment of the market declined.

Question 5: Does MiFID2 give regulators product intervention powers?

Yes, although as these powers are new it is not certain at the moment how they might be used. MiFID2 gives national regulators and the European supervisory authorities (ESMA or the EBA) broad powers to intervene to prohibit or restrict the marketing, distribution or sale of financial instruments or structured deposits, or the exercise of certain practices or activities, in certain circumstances, namely if there is a significant investor protection concern or a threat to the orderly functioning and integrity of financial markets or the stability of the financial system.

This is an extremely broad power and, as the product intervention powers are new, there are many questions on how these might operate in practice. Acknowledging the difficulties, the draft technical advice lists a set of non-

exhaustive criteria that could be taken into account by ESMA or a national competent authority when considering the possibility of exercising their product intervention powers. However, the criteria are still broad in nature, so are not overly helpful in delimiting the circumstances of intervention. ESMA intends to do further work in this area, including acting as a co-ordinator between national authorities to develop a common understanding of how these new powers should be used.

Question 6: Will MiFID2 require more information on costs and charges to be disclosed to clients?

Yes. Generally speaking, fair, clear information that is not misleading must be provided to clients and all costs and associated charges on services and products must be disclosed. However, we are still some way off finalising the precise details on what this will entail, as much of the detailed reporting requirements will be contained in the Level 2 measures.

The ESMA consultation paper goes into extensive detail on costs and charges, covering such matters as who should receive reports, what pre- and post-sale costs should be disclosed, how costs and charges should be aggregated and the timing and format of reporting. The draft technical advice contains an annex providing a detailed list of the costs and charges that must be disclosed; these include management fees, performance fees and advisory fees.

A number of issues arise from the proposals. For example, illustrating the trend in MiFID2 towards 'retailisation' of the institutional environment, the European Commission has asked ESMA to consider the possibility of how the requirements might apply to eligible counterparties. The draft technical advice is for cost disclosure requirements to apply to professional clients and eligible counterparties, although in some circumstances eligible counterparties may opt out of this classification, for instance when investment advice or portfolio management is provided, or where the financial instrument embeds a derivative.

Reaction from the industry to the draft advice has been mixed. Although supporting the notion that there should be 'full and meaningful' disclosure, providing information to professional clients as a matter of course is resisted in some quarters in favour of making it available on request.

In the retail space, another grey area is the boundary with UCITS and PRIIPS. Here, there is a concern that the requirements of MiFID2 may overlap or conflict with UCITS and PRIIPS in some cases. This is an open issue, as not only are we in the early days of MiFID2 Level 2, but the PRIIPS Level 2 measures are also not known at present and have yet to be fully tested. Consequently, precisely how the rules will interact is unclear at the moment. This is, therefore, an area which must be addressed in the final technical advice.

Question 7: Will MiFID2 change the rules on best execution?

Yes. Although MiFID2 does not make major changes to best execution requirements, it does impose some additional requirements, while amending and clarifying others.

So, for example, under MiFID2 the requirements are amended so that firms must take all 'sufficient steps' to achieve the best possible results, rather than all 'reasonable steps' as at present. In addition, firms executing orders for professional clients must assess the firm's own commissions and costs on each venue when comparing the merits of different venues; currently this only applies to retail business.

There is a new obligation on firms to inform clients, post execution, where the order was executed and the obligation on firms to provide information on order execution policies has been clarified.

The Level 2 measures are likely to make additional changes, particularly the detail to be included in order execution policies and the content, format and timing of execution quality data. The draft technical advice raises a number of issues for the asset management industry, particularly concerning the rules that will apply in different scenarios – when firms are executing orders, or transmitting and placing orders with

"…the financial crisis has shown limits in the ability of non-retail clients to appreciate the risk of their investments…To that extent, it is appropriate to extend some information and reporting requirements to the relationship with eligible counterparties…"

European Commission

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brokers for execution. Not only are the precise requirements ambiguous at times, there may also be practical and unforeseen difficulties in implementation. For example the level of detail required to be disclosed by firms transmitting or placing orders that might be executed outside a RM, MTF or OTF may impose such a hefty administrative burden as to be impracticable for large portfolio management firms with a large number of approved counterparties.

Question 8: Will transaction reporting requirements be more onerous under MiFID2?

Yes. Investment firms which execute transactions in financial instruments which are traded on a trading venue must report complete and accurate details of the transactions to the competent authority as quickly as possible, and no later than the close of the following working day.

When looked at in detail, the reporting requirements are more onerous than at present because MiFID2 significantly expands transaction reporting obligations, both in terms of the types of instruments that are subject to the reporting obligation and the details to be reported.

The Level 1 framework will be supplemented by detailed Level 2 measures, covering such issues as who can report to a competent authority and who has responsibility for the accuracy and completeness of the reports. ESMA will consult on draft technical standards on transaction reporting, probably at the end of the year.

What are the main issues raised by the transaction reporting requirements?

The transaction reporting requirements raise a number of significant issues, such as precisely what is meant by a 'transaction' and 'execution of a transaction', issues around identification of clients and traders, as well as the technical requirements for file formatting and timing.

Can reporting be delegated?

For asset managers, one of the most pressing concerns is whether reporting can be delegated and, if so, the rules that would apply.

MiFID2 permits the transmission of orders to another firm, typically a broker, for execution. The question then arises as to who is responsible for reporting. In order for firms to be clear whether the obligation falls on the transmitting firm (such as an asset manager) or a receiving firm (such as a broker), ESMA proposes specific conditions be met: that relevant information be provided; that a written agreement be in place between the order

"… MiFID2 requires an execution policy to be clear, precise and sufficiently detailed so that it is easily understood by clients… experience of sub-standard quality of execution policies provided by investment forms clearly points to the need to develop new requirements in this field…" ESMA

Best Execution – Focus on the UK

"*Retail and professional clients are being failed by firms that don't properly apply the rules on best execution when trading on their behalf*" *the FCA*

Although changes to best execution practices are in the pipeline through the implementation of MiFID2, the UK securities regulator, the FCA, has already conducted a thematic review into best execution and payment for order flow. In its report, published in July 2014, it cited a number of problems, including:

- The rules were often poorly understood or incorrectly applied, with frequent attempts by firms to limit their obligations to clients
- Some firms attempted to evade FCA rules by changing the description of services so that they could continue to receive payment for order flow
- Most firms lacked the capability to effectively monitor order execution or identify poor client outcomes
- Firms were often unable to demonstrate how they managed conflicts of interest when using connected parties or internal systems to deliver best execution for their clients

In light of the findings, FCA-regulated firms are expected to review their best execution arrangements and take immediate action to ensure that they comply with regulatory requirements. The FCA notes that MiFID2 is intended to address some of the observed weaknesses and expect firms to 'position themselves for the implementation of future policy changes'.

Although this review did not cover investment managers, many of its conclusions will be relevant, given their need to act in the best interests of their underlying clients and to obtain best execution on their behalf.

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transmitter and receiver; that the details are transmitted as agreed and that the transmitter has adequate systems and controls to ensure that the information submitted is complete and accurate. If all these requirements are met, an asset manager would be relieved of the duty to report a transaction.

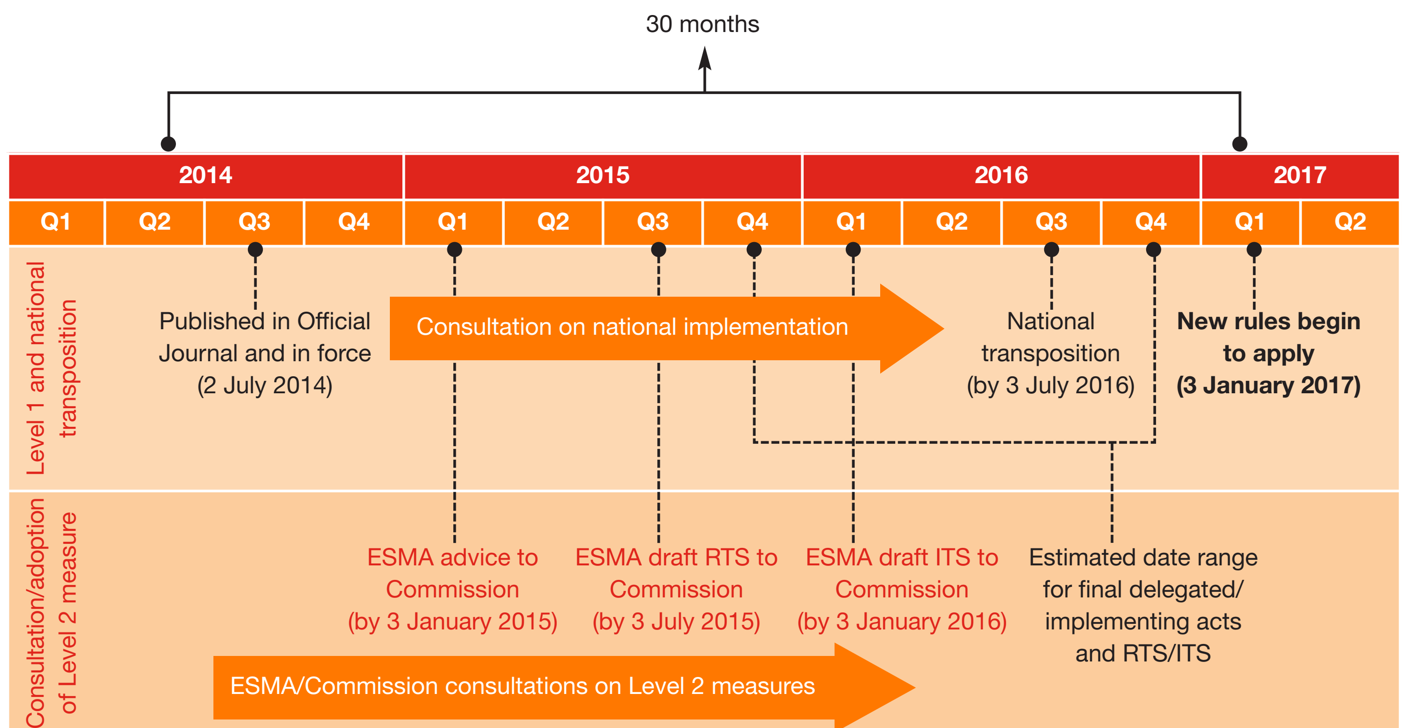
Questions have been raised around the content of the written agreement. What is the required level of detail? Would the information vary across asset classes? Could the information on each reportable instrument be set out in a central information source?

These remain unanswered questions at present, as the precise details of the reporting requirements is not yet clear. What is clear, however, is that the implementation challenges of transactional reporting are significant and should not be underestimated. Depending on the outcome, it may be that asset managers need to self-report due to systems build and dynamic data issues. This would be a change for many UK asset managers who are permitted under current FCA rules to allow brokers to report.

Question 9: What is the implementation timeline for MiFID2?

MiFID2 will apply from 3 January 2017, subject to limited transitional provisions. Many of the questions raised in this briefing can only be answered in full once the final Level 2 measures are published. There is no set date for publication of the final rules, as the estimated date ranges from Q4 2015 to Q4 2016. We are, therefore, still some way off providing definitive answers to many of the detailed implementation questions posed by MiFID2.

MiFID2 – expected timeline



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