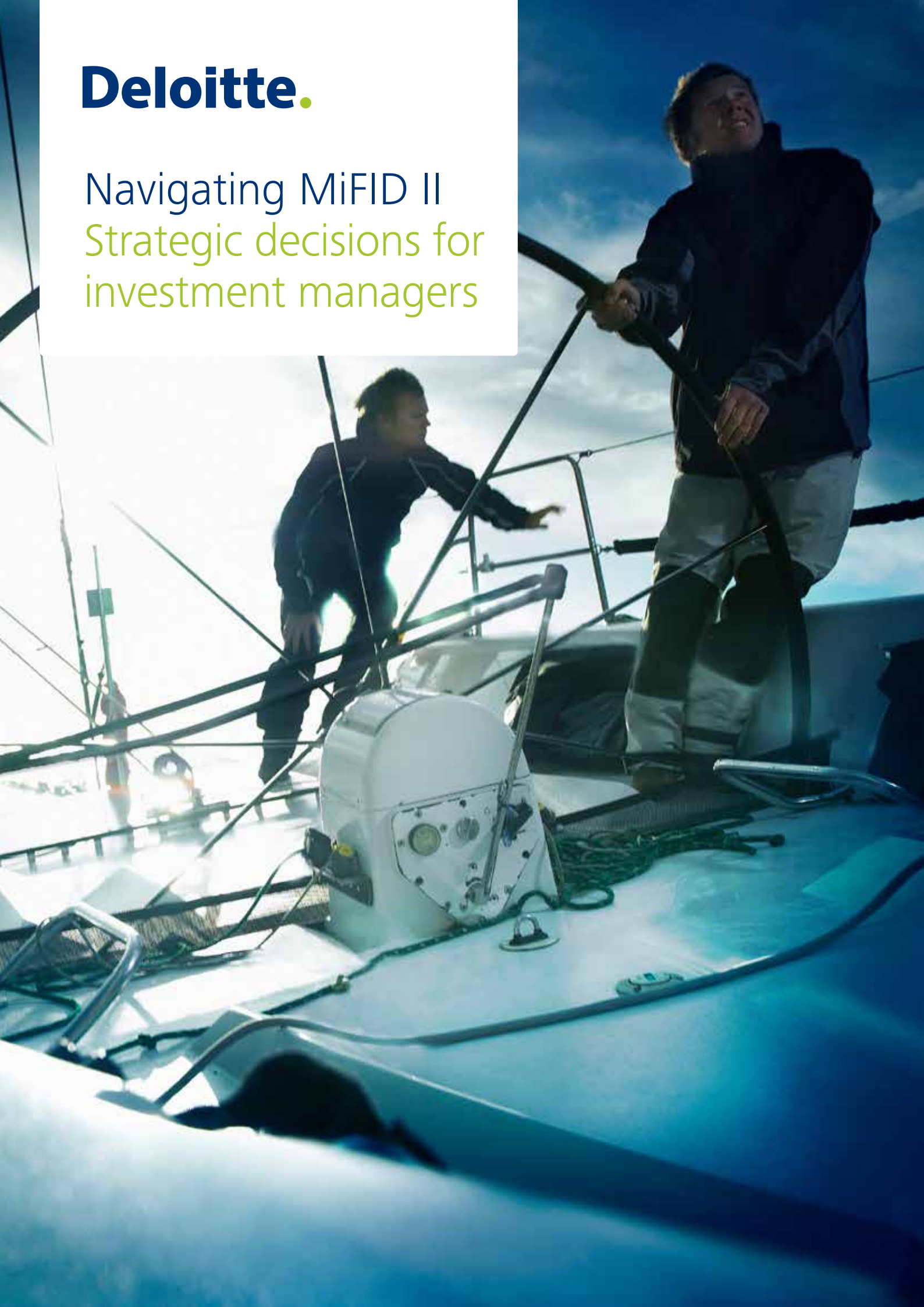


**Deloitte.**

Navigating MiFID II  
Strategic decisions for  
investment managers



# Contents

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Executive summary	1
Introduction	3
Significance of MiFID II for investment managers and key challenges	4
Implications of MiFID II – key messages from interviews and our insights	6
How can investment managers gain a competitive advantage?	15
Investment managers' implementation progress	17
Conclusion	19
Endnotes	20
Contacts	22


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# Executive summary

MiFID II<sup>1</sup> will have significant and wide-ranging implications for the operations, conduct and governance of a wide range of firms in Europe, even ahead of its implementation on 3 January 2017. As importantly, it raises many strategic questions for the investment management industry. What are the key challenges and implications of MiFID II? How can investment managers gain a competitive advantage? And how much progress have investment managers made in implementation? This paper seeks to answer these questions, drawing on discussions with 15 firms and two independent external experts, as well as views based on the work Deloitte has carried out with clients in this area.

Out of all the European regulations to affect investment management, all but one of our interviewees thought that MiFID II will have the greatest impact on their strategy over the next two years. In particular, the investment research rules were viewed as a key strategic challenge by 65% of our interviewees. These propose unbundling research from dealing commission and have been a contentious part of the implementing measures; the European Commission has delayed publication of the Delegated Acts, now expected in November, which will provide further clarity on these rules. In addition, the increased requirements in relation to transaction reporting were viewed as an operational challenge by all those to whom we<sup>2</sup> spoke.

We identify the following key implications of MiFID II for investment managers:

	<ul style="list-style-type: none"> <li>• <b>Clients and products:</b> We anticipate that some firms will launch more “non-complex” products relative to “complex”, mainly as a result of the re-definition of complex products under MiFID II and the stricter sales rules that apply to them. Some interviewees were considering restructuring their product offerings.</li> </ul>
	<ul style="list-style-type: none"> <li>• <b>Distribution:</b> In a bid to shift the “balance of power” away from distributors and towards investment managers, investment managers are likely to want multiple distribution channels which serve specific client segments, which in turn may drive an increase in direct to client (D2C) offerings and investment in digital services. This is already a trend in the UK and we expect it to become so in Continental Europe.</li> </ul>
	<ul style="list-style-type: none"> <li>• <b>Markets:</b> The way investment managers interact with the market will change. We expect that the number of Systematic Internalisers (SIs) will increase and that there will be a reduction in OTC trading. All-to-all trading venues can provide investment managers with an additional source of liquidity and so several interviewees thought that their use will increase. Following publication by the European Securities and Markets Authority (ESMA) of the Regulatory Technical Standards (RTS) in September, we now have a clearer picture of how the transparency regime will be calibrated, but it may be some time before the impact of the rules on fixed income liquidity becomes clearer.</li> </ul>
	<ul style="list-style-type: none"> <li>• <b>Investment research:</b> The MiFID II rules on investment research, if implemented in their current form, will make the price of research more transparent. We expect this to lead to investment managers increasing their scrutiny of the quality of research and decreasing their research budgets, resulting in more specialised offerings by research providers. Further clarity is needed on the rules and how the sell side will price research before investment managers decide how to purchase research in future, for example, by setting up a research payment account (RPA), or paying for research directly.</li> </ul>
	<ul style="list-style-type: none"> <li>• <b>Transaction reporting:</b> In implementing MiFID II, the investment managers we interviewed indicated that they will no longer choose to delegate their reporting to brokers, with most choosing to report in-house, and others undecided or preferring to outsource to a third party provider. We think there will be a large number of smaller investment managers for which bringing reporting in-house will not be a cost-effective option due to the technology implications. Therefore, we expect there will be demand for a third party reporting solution, but whether an effective solution will emerge is still to be seen.</li> </ul>
	<ul style="list-style-type: none"> <li>• <b>Costs and pricing:</b> MiFID II will increase costs and reduce margins, as the increased costs are unlikely to be passed on to investors due to competition between firms and the increased disclosure requirements under MiFID II making charges more transparent for investors.</li> </ul>
	<ul style="list-style-type: none"> <li>• <b>Operating model:</b> Many interviewees thought that MiFID II could make the EU less attractive as a location for investment management activities, particularly with regard to the market structure, transparency and investment research rules. We do not expect MiFID II to drive any significant increase in outsourcing, although some interviewees commented that there may be standalone activities that could be outsourced, such as Transaction Cost Analysis (TCA) or operating an RPA.</li> </ul>

We identify three sources of potential competitive advantage for firms under MiFID II:

- Larger investment managers will be better able to absorb the increased costs of MiFID II and the impact of MiFID II on smaller investment managers that focus on niche areas may be relatively more contained, leaving a “squeezed middle”. Firms should consider where MiFID II disproportionately affects them compared to peers. Possible options are market consolidation, or changing product offerings and/or investment strategy.
- MiFID II will give rise to a significant amount of new data. Market-leading firms will seek to use the increased data to their competitive advantage and use MiFID II as a catalyst to ensure their data infrastructure is flexible and efficient.
- MiFID II will drive changes in the distribution landscape. Investment managers that have multiple distribution channels and robust links with distributors will be in a strong position. Investment managers should be continually looking to innovate, recognising that online, mobile and social media are becoming primary channels for consumers.

In terms of implementation, most firms we surveyed said they had completed – in whole or in part – their project initiation and governance, impact assessment, gap analysis and project mobilisation (resource analysis and project plan). Most also plan to be well into their implementation programmes by February 2016, before all the MiFID II rules are finalised, meaning they will need to retain flexibility in their programmes to adapt to last minute changes.

# Introduction

MiFID II will have significant and wide-ranging implications for the strategy, operations, conduct and governance of EU investment firms, banks, regulated markets and data reporting services providers. Its predecessor, MiFID, shook up capital markets in 2007, opening up competition in equity markets, and MiFID II is set to transform trading and transparency further, although this time the greatest effects will be on derivatives and fixed income markets. Other aspects of MiFID II are expected to be more evolutionary, building on, modernising and addressing deficiencies in the original Directive. The sheer scale of MiFID II is vast: over 5000 pages of text have been published by the EU institutions to date. With the 3 January 2017 compliance deadline rapidly approaching, firms have a challenging timeline ahead.

MiFID II will introduce the following key changes for investment managers:

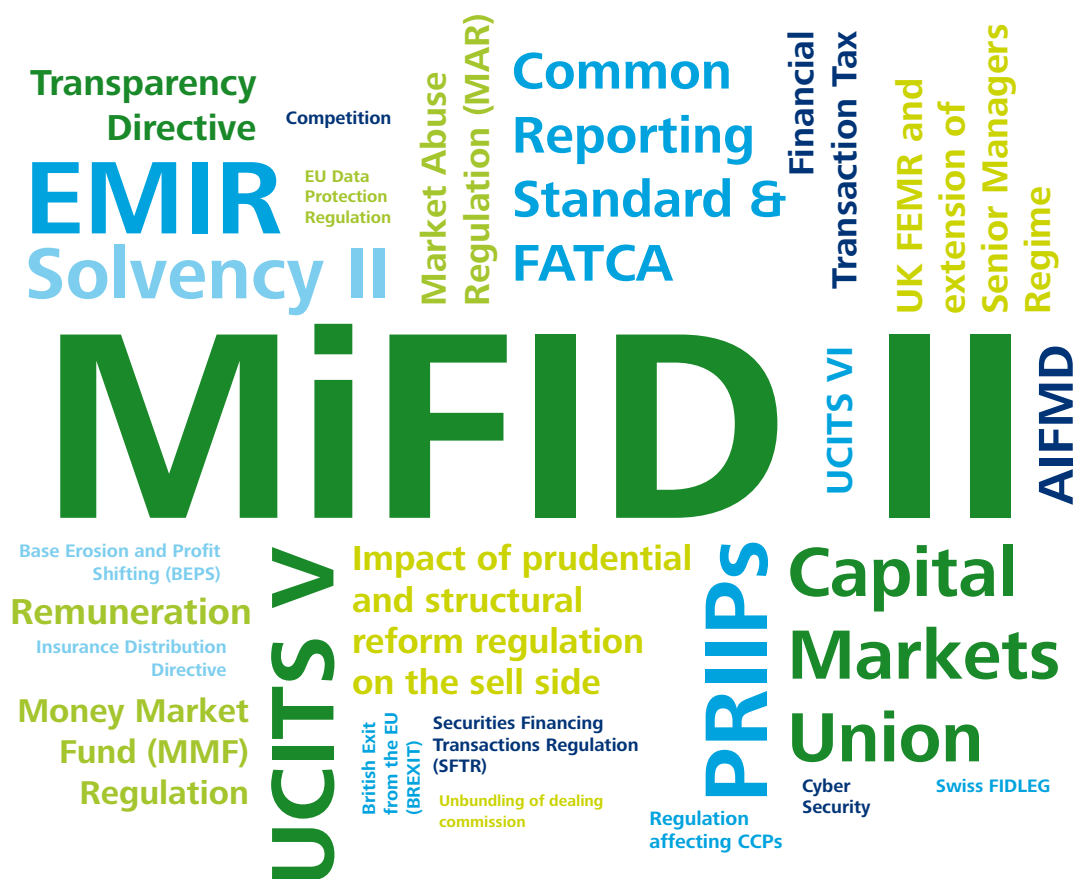
- Strengthen governance and organisational requirements, such as on Board diversity, the management of conflicts of interest and record-keeping.
- Strengthen investor protection rules with respect to advice, inducements, disclosure, investment research, the suitability and appropriateness regimes, best execution and client assets; and also introduce product governance and product intervention rules.
- Affect how investment managers interact with the market through extending the scope of the pre- and post-trade transparency regime to non-equities; introducing a new category of trading venue for non-equities – the organised trading facility (OTF) – and a trading obligation for certain equities and derivatives; and strengthening the SI regime.
- Increase transaction reporting requirements significantly.
- Introduce specific provisions with respect to commodity derivatives and for algorithmic and high frequency trading (HFT).
- Introduce a third country regime so that third country firms will be able to provide investment services to eligible counterparties and professional clients in the EU without a branch, once the third country is deemed equivalent and the firm has registered with ESMA.

This paper provides feedback on the significance investment managers attach to MiFID II and what they see as the key challenges; discusses the implications of MiFID II and the areas where investment managers can potentially gain a competitive advantage; and benchmarks how far investment managers are in terms of implementation. In order to inform the paper, we interviewed 13 investment managers, two asset service providers and two independent external experts.<sup>3</sup>

# Significance of MiFID II for investment managers and key challenges

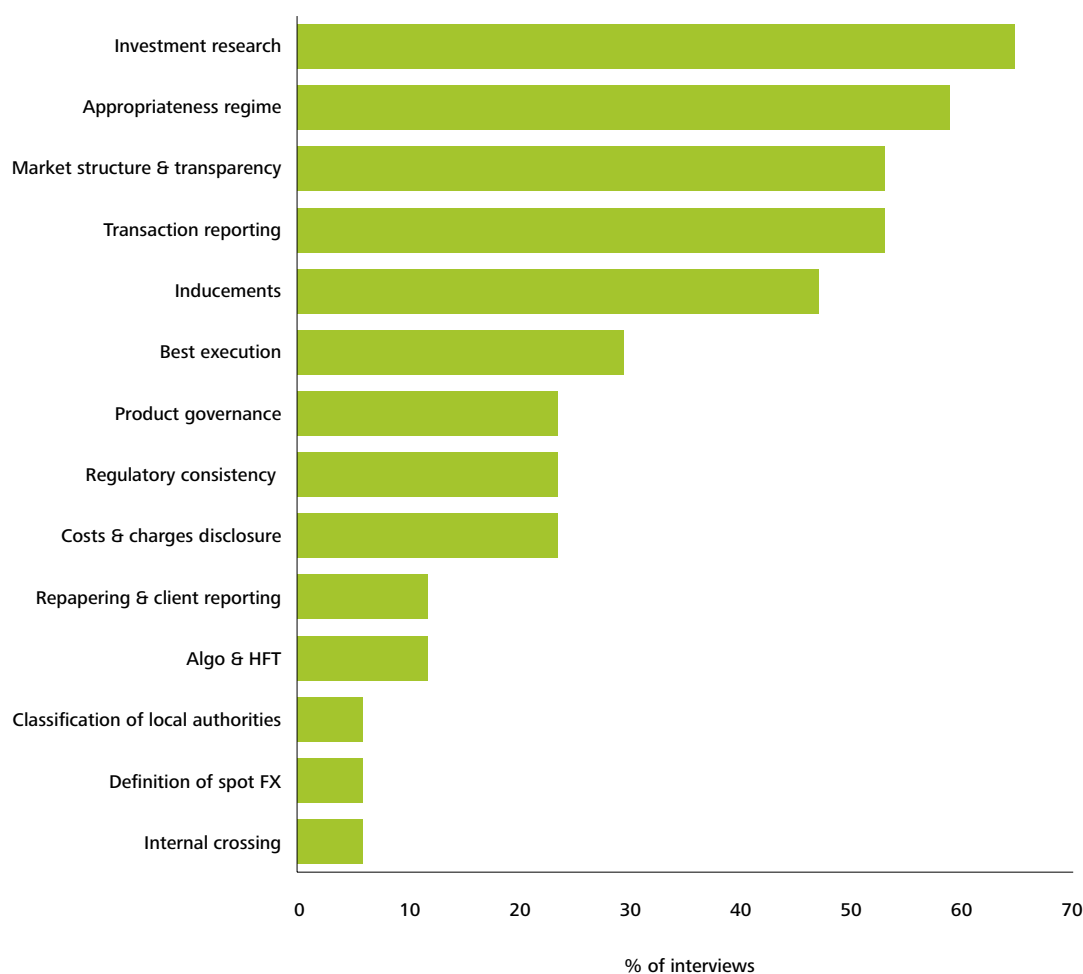
Out of all the upcoming European regulation affecting investment management, all but one of our interviewees thought that MiFID II will have the greatest impact on business strategy over the next two years. This was not due to any one element, but because, in aggregate, it would affect almost every aspect of their business either directly or indirectly. While MiFID II stood out, there was a wide range of views among firms on which other regulations or regulatory themes would also affect strategy over the next two years. In total, a further 25 initiatives were highlighted, with the European Market Infrastructure Regulation (EMIR),<sup>4</sup> the Undertakings for Collective Investment in Transferable Securities (UCITS) Directive V,<sup>5</sup> the Regulation on Packaged Retail and Insurance-based Investment Products (PRIIPs),<sup>6</sup> Solvency II,<sup>7</sup> and Capital Markets Union,<sup>8</sup> all mentioned by four interviewees or more. Firms' ability to leverage synergies between these initiatives, both in terms of determining strategy and in implementation, will be crucial to maximise efficiency. See Figure A.

Figure A. Depiction of regulatory initiatives investment managers view as having the greatest impact on European strategy over the next two years<sup>9</sup>



The interviewees cited a large number of key themes arising from MiFID II that they thought would affect their strategy and operating model. Figure B provides an overview of these. Four themes – the rules on (i) investment research; (ii) the appropriateness regime; (iii) market structure and transparency; and (iv) transaction reporting; – were cited by over half those interviewed. The concerns expressed by interviewees were broadly consistent, with a handful of outliers. Non-traditional managers typically had different concerns to traditional managers, for example, focusing on MiFID II implications for algorithmic trading and HFT.

**Figure B. Key strategic themes raised in interviews<sup>10</sup> (%)**



In addition to strategic challenges, firms also raised a number of operational challenges related to: (i) transaction reporting (raised by all interviewees); (ii) repapering and client disclosure, such as on best execution and costs and charges; and (iii) recording communications and record-keeping. These are summarised in Box A on page 14.

# Implications of MiFID II – key messages from interviews and our insights



## Clients and products

Under MiFID II, the range of products deemed complex and subject to the appropriateness regime will be broadened, so that fewer products will be able to be sold on a purely execution-only basis, without any assessment of the investor's knowledge and experience. Importantly, structured UCITS<sup>11</sup> will be considered complex and non-UCITS, such as UK Non-UCITS Retail Schemes (NURS), are likely to be so. Investors too will be made more aware when they are purchasing a complex product as, under PRIIPs, the product will be required to carry a "comprehension alert" on its Key Information Document (KID). The Delegated Acts will provide further clarity on the products that will be deemed "complex".

We expect platforms to improve their capabilities to facilitate the appropriateness test, but that some UK investment managers will nevertheless prefer to launch a greater proportion of new products as "non-complex" (i.e. UCITS, excluding those that are structured) to avoid the more stringent requirements that accompany the appropriateness test. A majority of interviewees agreed with this view. Several firms were also considering restructuring their existing products as UCITS.

The effect in Continental Europe is likely to vary by Member State, as some EU regulators have sought to increase investor protection in recent years by reducing product complexity and/or increasing expectations on the sales process. Some countries, such as Luxembourg and the Netherlands, expect a similar trend as in the UK. Other countries, such as France and Spain, sell relatively fewer products on an execution-only basis (i.e. without the appropriateness test), and in Belgium the local regulator has warned firms of the limitations of the execution-only regime as part of recent supervisory inspections. Therefore, broadening the type of products deemed "complex" under MiFID II is not expected to drive significant changes in these countries. In Italy, as a result of changes in local rules, many investment managers have already changed their product ranges to reduce complexity.<sup>12</sup>

Increased disclosure requirements on each product, including disclosure of costs and charges, and new product governance rules will also increase the costs to the firm per product, as well as the comparability of each product. It will be clearer to investors as well as firms, competitors, and independent advisers which products compare unfavourably. We expect this to continue the existing trend of investment managers rationalising their product ranges.<sup>13</sup> In addition, as passive products do not need to be supported by investment research, unlike actively managed products (discussed below), we also expect these rules to support growth in low cost, passive products.<sup>14</sup>

Those we spoke to did not expect MiFID II to drive any significant changes in investment managers' target markets. MiFID II will require increased segmentation of target markets and that firms take reasonable steps to ensure that products are distributed to the identified target market. As a result of the product governance rules, investment managers are more likely to have an increasingly detailed breakdown of the end-investor population from their distributors that will assist them in further tailoring products to these segments and in fulfilling their monitoring obligations. This will be particularly important as investment managers continue to take advantage of pension reform changes in the UK, which provide those aged 55 and over with more choice than previously about where to invest their pension savings.

We anticipate that some firms will launch more "non-complex" products relative to "complex", mainly as a result of the re-definition of complex products under MiFID II and the stricter sales rules that apply to them. Some interviewees were considering restructuring their product offerings.





The UK distribution landscape has already been shaken-up by the Retail Distribution Review (RDR). MiFID II follows aspects of the RDR regarding the banning of commission payments, albeit with some important differences in scope.<sup>15</sup> Therefore, some of the most significant changes in distribution will be felt in Continental Europe.

Several firms thought that the rules would lead to an increase in strategic partnerships between investment managers and non-independent advisers and increased white-labelling of products. As product governance rules will require agreements on exchange of information between manufacturers and distributors, distributors are likely to become more selective about the investment managers they deal with due to the logistics of setting up these agreements and providing the necessary information, which may disadvantage smaller and less established investment managers. Investment managers are likely to want multiple distribution channels which serve specific client segments, which in turn may drive an increase in D2C offerings and investment in digital services. The increased use of platforms has already been a trend in the UK and we expect it to become so in Continental Europe.<sup>16</sup>

As distribution and advice become more expensive, there will be a continued increase in non-advised distribution via platforms (see Figure C). Platforms will continue to develop their capabilities so that they are better able to perform the appropriateness test, enabling the sale of products defined as complex under MiFID II, or provide advice or portfolio management in a cost-effective way – for example through “robo advice”.<sup>17</sup> Innovation in digital distribution may also be supported in the UK through HM Treasury and the Financial Conduct Authority’s (FCA) forthcoming Financial Advice Market Review,<sup>18</sup> which will examine whether firms face any barriers to providing advice to those with less complex financial needs and is expected to make proposals ahead of the 2016 UK Budget.

Some firms thought there would be a reduction in independent advice in Continental Europe, with some exiting the market and others reclassifying themselves as non-independent. However, as independent advice is not currently defined or makes up a small proportion of the distribution market in a number of EU countries, we expect the impact of MiFID II on the number of independent advisers to be mixed across the EU.

There is likely to be a move towards clean share classes<sup>19</sup> and the phasing-out of legacy commission across the EU, a view held by a number of our interviewees. This will hit investment managers which rely on high commission payments to distribute products and, depending on the “grandfathering” provisions in the rules, affect firms’ profits. In the UK, the FCA has said that it has no plans to change its current rules regarding pre-RDR trail commission.<sup>20</sup>

A common concern among interviewees was the extent to which Member States, including the UK, will “gold-plate” the Directive, which would lead to inconsistencies in regimes across the EU. While figure C shows that, out of the survey countries, only the UK and the Netherlands are expected to “gold-plate” the rules, we still expect differences in local supervisory approaches.

Figure C. Expected changes in distribution market and implementation across EU Member States<sup>21</sup>

Expected changes in market and implementation	Belgium	France	Germany	Italy	Netherlands	Spain	UK	Ireland <sup>21</sup>	Luxembourg <sup>21</sup>
Increase in distribution via digital platforms?	↑	↑	↑	↑	↑	↑	↑	↑	↑
Increase in D2C offerings?	↑	↑	↑	↑	↑	↑	↑	↔	↑
Impact on number of independent investment advisers?	↔	↔	↓	↑	↔	↑	↔	↓	↓
Move towards “clean” share classes?	✓	✓	✓	✓	✓	✓	✓	✗	✓
Expect local regulator to “gold-plate” MiFID II rules?	✗	✗	✗	✗	✓	✗	✓	✗	✗

In a bid to shift the “balance of power” away from distributors and towards investment managers, investment managers are likely to want multiple distribution channels which serve specific client segments, which in turn may drive an increase in D2C offerings and investment in digital services. This is already a trend in the UK and we expect it to become so in Continental Europe.



## Markets

The introduction of Multilateral Trading Facilities (MTFs) and a transparency regime for equities under MiFID opened up competition between trading venues and led to lower transaction costs, reduced bid-ask spreads and faster trading times in equity markets.<sup>22</sup> However, the increase in trading venues also led to fragmentation in equity markets and a growth in so-called dark trading.<sup>23</sup> MiFID II seeks to address market fragmentation and increase transparency across financial instruments. It will introduce a new trading venue for non-equities – the OTF<sup>24</sup> – and a more robust regime for SIs.<sup>25</sup> It also introduces a trading obligation for certain equities and derivatives and extends the transparency regime to non-equities (e.g. derivatives and bonds).

So what do these changes mean for where trading will take place in future? The short answer is that investment managers will “follow liquidity”, although there was no consistent view amongst interviewees on where this would take them. In fixed income, most firms expected to trade more via SIs and on trading venues, with many firms expressing a preference to trade on electronic platforms where possible. Some investment managers thought that they would execute smaller fixed income trades, or those sufficiently large to qualify for the post-trade publication deferral, on MTFs. Due to the introduction of quantitative thresholds above which a firm must register as an SI, we expect that the number of SIs will increase: most investment banks will set themselves up as SIs in at least one asset class and larger investment banks will become SIs in multiple asset classes. This suggests that more trading, particularly in fixed income, will be through SIs. A few investment managers also thought that there would be an increase in HFT trading in fixed income markets, starting with government bonds.

In derivative markets, due to the introduction of the trading obligation, we anticipate a reduction in OTC trading, with more trading taking place on venues. It is not yet clear how much non-equity trading will flow to OTFs: all interviewees thought that it was too soon to say how far they would execute on OTFs. Regarding equity markets, despite some concern about the equity pre-trade transparency waiver volume cap, most interviewees did not state that MiFID II would drive significant changes in equity markets.

All-to-all trading venues<sup>26</sup> can provide investment managers with an additional source of liquidity, particularly as prudential requirements continue to restrict the sell side in fixed income markets. Several interviewees thought that their use might increase.

The majority of interviewees thought that MiFID II would reduce fixed income liquidity, adding to what they saw as the negative effect of existing regulatory constraints for the sell side, such as capital and liquidity requirements. Some thought this would potentially lead to worse prices for end investors, less trading - reducing the rate at which investment managers seek to take advantage of market inefficiencies – and portfolio managers being required to hold higher cash balances, reducing overall returns. One firm thought it would be important for more investment managers to have trading desks that understood risk-taking and the depth and source of liquidity.

Following publication by ESMA of the RTS in September, we now have a clearer picture of how the transparency regime will be calibrated. The liquidity test will rely on a bond-by-bond assessment that will be performed at the end of every quarter based on a set of quantitative criteria. The liquidity of newly issued bonds will be determined by their issue size and the time passed since the issuance. This approach will help to address issues around potential misclassification of bonds, particularly reflecting concerns that bonds tend to be most liquid straight after issuance, but become less so with time. However, it may be some time before the impact of the rules on fixed income liquidity becomes clearer.

With increased market transparency, analysing the data to ensure best execution will be paramount. We expect enhanced TCA services from vendors and other third party providers to emerge ahead of 2017.

The way investment managers interact with the market will change. We expect that the number of SIs will increase and that there will be a reduction in OTC trading. All-to-all trading venues can provide investment managers with an additional source of liquidity and so several interviewees thought that their use will increase. Following publication by ESMA of the RTS in September, we now have a clearer picture of how the transparency regime will be calibrated, but it may be some time before the impact of the rules on fixed income liquidity becomes clearer.



## Investment research

ESMA’s technical advice to the Commission on the Delegated Acts proposed that portfolio managers will only be able to accept broker research where they pay for it directly (e.g. through their own resources or through an increase in portfolio management or advice fees) or from a ring-fenced RPA that is funded by a specific charge to their clients, agreed upfront and subject to appropriate controls, oversight and disclosure. These rules will be clarified when the European Commission adopts the Delegated Acts, expected in November.

Based on the proposed rules, we expect the rules on investment research to lead to investment managers increasing their scrutiny of the quality of research, with an accompanying flight to quality, and reducing their research budgets as the cost becomes more explicit. This is consistent with the interviewees’ views. None of the interviewees could quantify how much they currently paid for fixed income research as the cost is typically embedded in the spread. However, several investment managers questioned its value and expected to reduce their consumption of it should its price become more visible, as proposed under the rules.

Larger investment managers and those whose strategy does not rely on a significant proportion of external investment research (e.g. passive or quantitative strategies) will be in a relatively stronger position with respect to the investment research rules. The majority of interviewees felt that smaller firms would be disadvantaged by the rules, as the costs implied by the change would be proportionally greater for them.

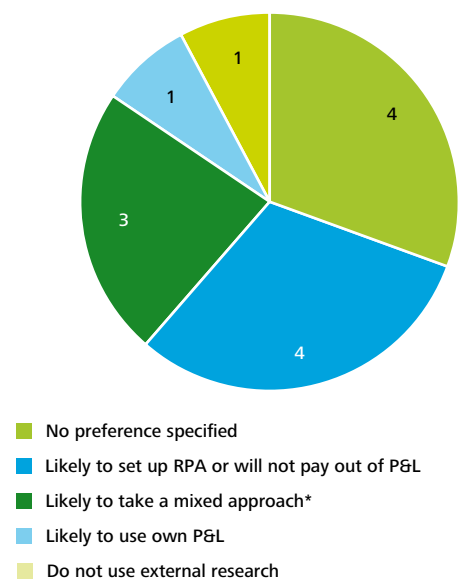
If implemented in their current form, we expect the rules to lead to a reduction in the number of analysts at sell side firms and some independent research providers exiting the market. We also expect increased specialisation in the type of research provided by firms. There may be some reduction in coverage of smaller corporates, but concerns could be overstated, as investment managers, in their search for higher quality research, are likely to source research from a more diverse range of suppliers and so boutique research providers focusing on niche areas will be able to differentiate themselves in the market.

While all investment managers said they could not determine their exact response to the rules until they saw the final provisions, the early responses were mixed. See figure D.

Several factors were cited as influencing their decision:

- (i) the extent to which they use external research;
- (ii) the operational complexity of setting up an RPA and alignment to Commission Sharing Arrangements (CSA);
- (iii) the difficulty of implementing a different regime in the EU versus other jurisdictions; (iv) the uncertainty about the definition of research and sharing research between entities and jurisdictions; and (v) the VAT and client asset implications. Depending on the final rules, third party providers could emerge to offer RPA outsourcing services.

**Figure D. Potential actions interviewees expected to take in response to investment research rules<sup>27</sup>**



\* Several investment managers said they might use a combination of RPA or paying for research out of P&L depending on asset class or entity, or increasing their in-house research team.

The MiFID II rules on investment research, if implemented in their current form, will make the price of research more transparent. We expect this to lead to investment managers increasing their scrutiny of the quality of research and decreasing their research budgets, resulting in more specialised offerings by research providers. Further clarity is needed on the rules and how the sell side will price research before investment managers decide how to purchase research in future, for example, by setting up an RPA, or paying for research directly.

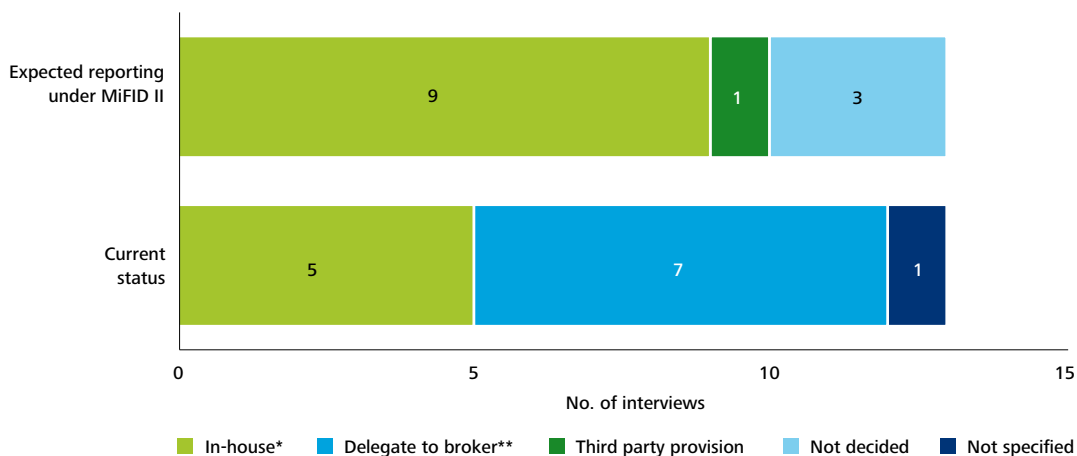
## Transaction reporting

In order to facilitate regulatory oversight of financial markets, MiFID already requires investment firms executing transactions in financial instruments to report details of these to competent authorities on a T+1 basis. MiFID II will increase the scope of products, transactions and data fields (from 23 to an expected 65) that must be reported, as well as change the format of existing data fields.

All interviewees shared the view that transaction reporting would be a key challenge and costly to implement,<sup>28</sup> with most specifying that larger investment managers would be better placed to absorb the costs. There was scepticism from the firms about the usefulness of some of the data, both to regulators and firms.

Figure E sets out how the investment managers we interviewed currently report under MiFID and how they plan to report under MiFID II. In implementing MiFID II, the firms interviewed indicated that they will no longer choose to delegate their reporting to brokers, with most choosing to report in-house, and others undecided or preferring to outsource to a third party provider.

**Figure E. Current and planned reporting under MiFID II<sup>29</sup>**



\*Includes using third party systems/utility or outsourcing to a third party with close connections to the firm;

\*\*Some transactions (e.g. non-EEA) may not be delegated.

Interviewees had varying motivations for bringing reporting in-house. A key one was that brokers and other third parties would not have all the data directly available to them in order to report. Many interviewees did not think that there would be sufficient value in sending out data to a third party to compile reports for whose completeness and accuracy they retain ultimate responsibility, while at the same time losing the expertise needed to oversee the process. Delegation to a broker was not considered an attractive option, due to concerns regarding data protection and trading strategy visibility.

However, we think there is a large portion of the industry which has not considered the transaction reporting implications in detail. We expect there will be a large number of smaller investment managers, underrepresented among the firms we spoke to, for which bringing reporting in-house will not be a cost-effective option. Therefore, we expect there will be demand for a third party reporting solution. This could be provided, for example, by (i) asset service providers, either alone or in conjunction with a third party provider; or (ii) investment banks/brokers, working in conjunction with a third party provider. The solution will likely either need to be high-volume and low cost, or offer a comprehensive data and reporting solution. It will also need to address issues such as confidentiality and the ability to ensure effective oversight.

The majority of interviewees expected to report via an Approved Reporting Mechanism (ARM). Five investment managers stated that they would ideally like to do all of their regulatory reporting<sup>30</sup> through a single ARM/trade repository, while others had not decided or did not express an opinion. We expect that ARMs will seek to make reporting more straightforward and provide additional services.

**In implementing MiFID II, the investment managers we interviewed indicated that they will no longer choose to delegate their reporting to brokers, with most choosing to report in-house, and others undecided or preferring to outsource to a third party provider. We think there will be a large number of smaller investment managers for which bringing reporting in-house will not be a cost-effective option due to the technology implications. Therefore, we expect there will be demand for a third party reporting solution, but whether an effective solution will emerge is still to be seen.**



## Costs and pricing

We expect that MiFID II will increase investment managers' costs. This was also a view shared by the interviewees, who cited transaction reporting, investment research rules, and disclosure of best execution as generating both one-off and ongoing costs, and repapering and disclosure of costs and charges as generating mainly one-off costs. Interviewees had mixed views on the impact the market structure and transparency rules will have on trading costs and fund performance.

Competitive pressures and increased transparency over charges will, for the most part, prevent investment managers from passing this incremental change on to end investors, although charging for investment research could be an exception to this. While the majority of interviewees agreed with this, and two also thought that increased competition would reduce charges further following MiFID II implementation, several also thought that competition could be blunted without additional standardisation in costs and charges calculations. Over time, charges in Continental Europe may reduce further due to changes in the inducement rules, as was seen in the UK after the introduction of the RDR.<sup>31</sup> Therefore, we anticipate that MiFID II will not only increase investment managers' costs, but also reduce margins, at least in some countries.

Due to the increased focus on transparency of costs and charges in MiFID II and the upcoming FCA asset management competition market study, investment managers will need to understand where they bundle prices for products and services and in particular where they cross-subsidise from one part of the business to another. Bundling and cross-subsidisation have featured prominently in other FCA competition market studies. They will need to introduce more explicit pricing based on disaggregating the key activity components (distribution, platform/administration and investment management) and distinguishing between upfront/one-off charges and ongoing charges.

MiFID II will increase costs and reduce margins, as the increased costs are unlikely to be passed on to investors due to competition between firms and the increased disclosure requirements under MiFID II making charges more transparent for investors.



## Operating model

Many interviewees thought that MiFID II could make the EU less attractive as a location for investment management activities, particularly with regard to the market structure, transparency and investment research rules. At the extreme, some investment managers thought that MiFID II would disrupt market liquidity to such an extent that it would drive investment out of the EU and that corporates would choose to issue outside the EU, particularly as they thought that investment research coverage of corporates would be reduced. Investment managers are often global businesses; their clients and dealing desks are often not in the same location as the portfolio manager and they typically have flexibility regarding where they locate certain activities. However, none of the firms interviewed is planning relocation strategies outside the EU as a result of MiFID II, though several firms commented that they would keep it under review. If they are a third country firm in a jurisdiction that receives equivalence, they will be permitted, once registered with ESMA, to provide investment services to eligible counterparties and professional clients in the EU directly without establishing a branch or subsidiary.

None of the interviewees thought that MiFID II would lead them to increase their outsourcing and it seems the reverse is more likely, as many investment managers indicated that they plan to bring transaction reporting in-house. However, some interviewees commented that there may be standalone activities that could be outsourced, such as TCA or operating a RPA.

The volume of repapering that would be required under MiFID II was a concern for many interviewees, in terms of the necessity of negotiating agreements and the logistics of making changes.<sup>32</sup> This is expected to increase one-off legal costs. Firms will also need to assess the composition of their board, due to requirements in relation to diversity, and to consider whether they need additional resource or expertise in their compliance function to fulfil its increased responsibilities. Staffing and resource requirements should be given due consideration by firms, not just as part of the implementation process, but on an ongoing basis.

Many interviewees thought that MiFID II could make the EU less attractive as a location for investment management activities, particularly with regard to the market structure, transparency and investment research rules. We do not expect MiFID II to drive any significant increase in outsourcing, although some interviewees commented that there may be standalone activities that could be outsourced, such as TCA or operating an RPA.

## Box A: Common operational challenges indicated in the interviews

### **Transaction reporting**

This was consistently identified as the main operational challenge with concerns in relation to (i) sourcing the necessary data and the necessary systems upgrades/recalibrations; (ii) reporting from non-EEA branches; (iii) data warehousing requirements; (iv) preventing over-reporting; and (v) keeping up to date with which instruments have been admitted to trading or are traded on a trading venue, particularly due to the expected proliferation in trading venues.

### **Disclosure and repapering**

MiFID II will increase disclosure to investors and will require a significant amount of repapering. The following key areas were highlighted:

- Regarding disclosure of costs and charges, some investment managers said that they do not currently have access to the necessary data, and that there is insufficient clarity on what needs to be factored into costs. There was also concern regarding ensuring consistency with other regulatory disclosure requirements in PRIIPs and the UCITS Directive.
- Firms felt strongly that the requirements on disclosure to investors on best execution policies and the annual disclosure of firms' top five execution venues per asset class by volume would be very costly to implement, require the collection and aggregation of a large volume of data, and not necessarily provide commensurate benefit to investors.
- The product governance and inducement rules, and rules affecting how investment managers interact with the sell side, would require a significant amount of potentially complex and controversial repapering with respect to service level agreements with distributors and brokers respectively. All parties will need to revise their respective roles, indemnities and liabilities under MiFID II.

### **Recording communications and record-keeping**

MiFID II will increase requirements in relation to recording communications and retention of records. Depending on the final rules, many firms thought that these would be costly to implement.



# How can investment managers gain a competitive advantage?

## The squeezed middle

There is already a trend for larger investment managers to get larger.<sup>33</sup> We expect that MiFID II will accelerate this trend, with larger investment managers better able to leverage economies of scale and absorb the increased costs resulting from MiFID II. Larger investment managers will also have more options available with respect to the investment research rules. For example, a larger investment manager may have the option of paying for research out of P&L, but not passing this cost on to investors, which could be relatively difficult for smaller investment managers to do.

Smaller investment managers that focus on niche products may also be in a strong position, as the impact of MiFID II on their business is likely to be relatively more contained. Investment managers that employ passive and/or quantitative strategies, which do not rely on research, will also be in a relatively stronger position. This will leave a “squeezed middle”. Whether or not a firm is in the “squeezed middle” will depend not only on its AUM but also on its product range and client base. Firms with diverse and complex product offerings, for example that include derivatives and HFT, and/or firms that distribute to retail investors, will be relatively more affected by MiFID II.

Firms should consider where MiFID II disproportionately affects them compared to peers. Possible responses are market consolidation (either merging with another investment manager or acquiring a distributor), or changing product offerings and/or investment strategy. There was some evidence of market consolidation in the UK as a result of the RDR.<sup>34</sup> Due to changes to the inducements rules, we may see this occur across Continental Europe as a result of MiFID II.

## The importance of data

All of the interviewees thought that the new reporting, disclosure and product governance requirements would generate a significant amount of new data, but most thought that this data would be costly to generate and there was scepticism about its usefulness to either firms or regulators. Only a few interviewees had views about how they might use the increased data to their advantage and even fewer were thinking about the analytics technology necessary to analyse it. This is hardly surprising given other, more pressing issues, but in future we expect market-leading firms to seek to use the increased data to their competitive advantage (see Box B) and use MiFID II as a catalyst to ensure their data infrastructure is flexible and cost-effective so that their systems can collect and store the necessary data, with a data warehouse with sufficient capabilities but also flexibility.

## Digital distribution

MiFID II inducements rules and the necessity of setting up agreements with distributors under the product governance rules may lead distributors to rationalise the manufacturers they deal with. Under product governance rules and the appropriateness regime, firms will need to ensure that their target market is aligned to their distribution strategy and that the distribution method for complex products accommodates the appropriateness test.

Investment managers that have multiple distribution channels and robust links with distributors will be in a strong position. They should be continually looking to innovate, recognising that online, mobile and social media are becoming primary channels for consumers. Winners will take advantage of digital technologies.

### Box B: Data that will be available in the new world and how it can be used

- **Pre- and post-trade transparency data** – This data can be analysed to better understand pricing and liquidity to improve execution quality.
- **Transaction reporting** – The FCA has increased its expectations of firms with respect to surveillance. This was also an area of focus in the UK's Fair and Effective Markets Review (FEMR). If the regulator uncovers an issue which could have been detected from data available to the firm, but which had not been analysed, the firm will be on the back foot. As one investment manager put it, the increased data provides "a noose to hang yourself with". However, there is an upside to the transaction reports. Firms should be using them as part of their own market abuse surveillance under MAR.
- **Product governance** – Investment managers should ensure they use the information they receive from distributors to understand more about their target market and their target market's behaviour so as to more closely align product design with investor requirements. They will also be able to monitor more closely that their distributors are aiming products at the appropriate target market.
- **Best execution** – Investment managers should be focusing on best execution and TCA across all instruments in scope of MiFID II. Trading desks should be using this information to improve their execution quality. The requirement for the public disclosure of the top five trading venues across asset classes will also provide firms with increased information about where their competitors trade.
- **Costs and charges disclosure** – The rule changes are likely to be costly to implement, but provide the opportunity for investment managers to better understand the direct and indirect costs that they charge to clients. As the FCA looks at competition in its market study later in the year, it will be important that firms understand where they are cross-subsidising from one part of their business to another, as that is an expected area of focus. Investment managers with a simple and clear charging structure will be in a relatively stronger position. The PRIIPs KID will also allow investment managers to see the costs and charges of competitors more clearly.
- **Management information** – Investment managers should be thinking about how they can use this data to improve their management information (MI). For example, the product governance information will be useful for conduct risk MI. MI will be particularly important for senior managers to get comfort once the Senior Managers Regime is extended to "firms active in fixed income, currency and commodity (FICC) markets", expected to include investment managers, under FEMR.

# Investment managers' implementation progress

As of August 2015, most firms we surveyed said they had either completed or partially completed their project initiation and governance, impact assessment, gap analysis and implementation stage (IS) 1, which we defined as project mobilisation (resource analysis and project plan). By February 2016, most firms expect to have completed IS1 and to have completed or partially completed IS2 (analysis and design) and IS3 (IT build, process implementation, policy draft and training). There was more variation in firms' current programme status (up to IS3), compared to where they expect to be in February, meaning that firms that are relatively far behind plan to catch up over the next months. See figures F and G.

As firms plan to be well into their implementation programmes before MiFID II rules are finalised, they will need to retain flexibility in their programmes to adapt to last minute changes. Firms with larger AUM were not noticeably further ahead than firms with smaller AUM, based on the survey results. Examples of good practice were where firms had engaged the business early on in the process, so that their input had fed into consultation responses, or where firms had a specific workstream or individual dedicating to looking at the strategic implications of MiFID II.

**Figure F. Surveyed investment managers' MiFID II implementation progress (as of August 2015)<sup>35</sup>**

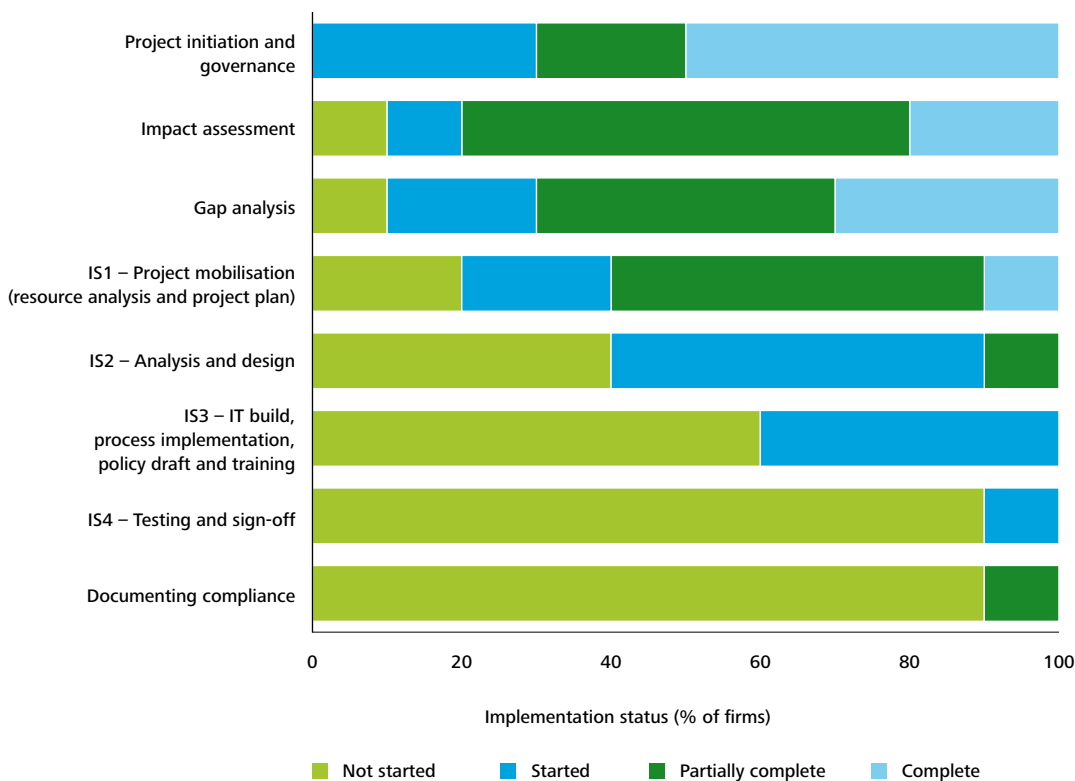
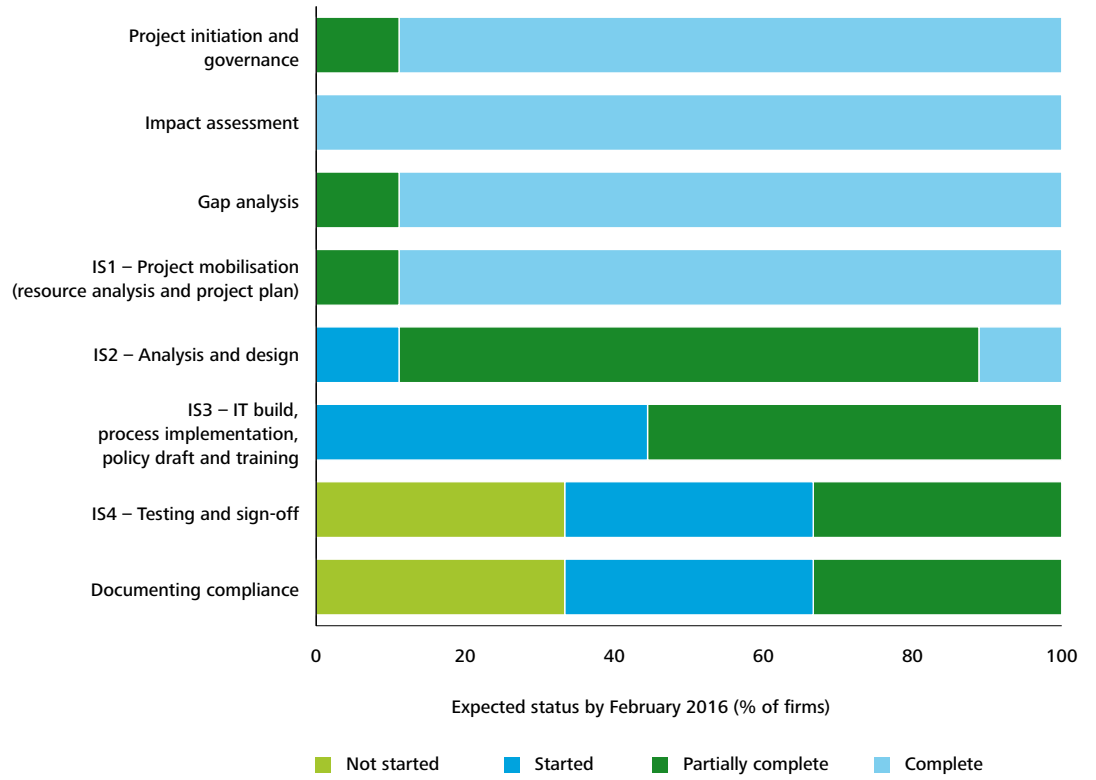


Figure G. Expected status by February 2016 of surveyed investment managers' MiFID II implementation progress<sup>36</sup>



# Conclusion

MiFID II will be a significant challenge for investment managers to implement and will affect almost every aspect of their business, either directly or indirectly. It will increase the costs of doing business and will reduce margins, as we expect competition and increased transparency of costs and charges to prevent investment managers from passing on the costs to investors. Larger investment managers with greater economies of scale will be better able to absorb the costs of MiFID II, and small niche firms may be less affected by certain rules. Firms in the “squeezed middle” should consider how they should respond, with possible options being market consolidation, or changing product offerings and/or investment strategy.

To gain a competitive advantage, investment managers should be thinking strategically about how they can optimise their business under the new rules. This may include changes to their product range, distribution strategies, costs and charges, how they source and pay for research, how they report, where and how they trade, and the advantages of market consolidation. In particular, firms should be thinking about how they can use the increased data available under MiFID II to benefit their business and use MiFID II as a catalyst to ensure their data infrastructure is flexible and efficient. It will also be important for firms to have multiple distribution channels and robust links with distributors, including innovative distribution models such as online, mobile and social media.

With the 3 January 2017 deadline rapidly approaching and implementation programmes well under way, there is no time to delay in taking the necessary strategic decisions. In order to be market-leading, investment managers cannot focus purely on implementation, but must focus now on wider market and regulatory considerations.

# Endnotes

1. References to MiFID II include the revision to the Markets in Financial Instruments Directive (MiFID II) and the accompanying Regulation (MiFIR).
2. Deloitte LLP.
3. The investment managers represented traditional and non-traditional investment managers, with a range of distribution models. They had mean global assets under management (AUM) of £475bn and median global AUM of £270bn. They operated, on average, in 16 countries globally, including 9 European countries. The interviews were conducted in July and early August 2015.
4. [European Market Infrastructure Regulation](#), Official Journal, July 2012
5. [Undertakings for Collective Investment in Transferable Securities V](#), Official Journal, July 2014
6. [Packaged Retail and Insurance-based Investment Products](#), Official Journal, December 2014
7. [Solvency II](#), Official Journal, November 2009
8. [Action Plan on Building a Capital Markets Union](#), European Commission, September 2015
9. This Word Cloud gives greater prominence to regulation or regulatory themes that were mentioned by more interviewees and is based on the views of all 17 interviewees. Some interviewees listed global or UK regulation that they thought significant for their European business. It should be noted that many of the regulations and regulatory themes overlap.
10. "Key strategic themes" include the themes raised in response to the question "out of all the requirements in MiFID II, which do you think will have the greatest impact on your business strategy and operating model?". Some interviewees raised more themes than others and we have included all. Reference to inducements excludes investment research, which is taken as a separate point.
11. In Article 36(1) [UCITS IV Directive](#), structured UCITS are defined as UCITS which provide investors, at certain predetermined dates, with algorithm-based payoffs that are linked to the performance, or to the realisation of price changes or other conditions, of financial assets, indices or reference portfolios of UCITS with similar features.
12. Paragraph based on a survey of the Deloitte Pan-European Member Firm MiFID II Panel, collated September 2015.
13. Data from [Lipper](#) shows that the number of funds merged or liquidated by European fund managers has exceeded the number of funds they launched every year since 2011.
14. According to the Investment Association's [Asset Management Survey 2014-2015](#), there has been a growth in the use of passive investment strategies due to an intensification of the debate about the relative cost and delivery of active and passive management, and the announcement in March 2014 of the introduction in March 2015 of a charge cap of 0.75% on default funds being used for the purposes of automatic enrolment.
15. For example, the RDR applies adviser charging rules to all retail investment advice, whereas MiFID II bans only independent investment advisers and portfolio managers from accepting and retaining third party commissions, fees and benefits (except certain minor non-monetary benefits). The products and instruments in scope and the customers to which the rules apply also differ between the two regimes. The definitions of independent advice are also not the same.
16. According to the Investment Association's [Asset Management Survey 2014-2015](#), UK fund platforms accounted for more than 55% of industry gross retail sales in 2014, rising from 49% in 2013.
17. "Robo advice" is an online service that provides automated, algorithm-based portfolio management with minimal human intervention.
18. [Financial Advice Market Review, Call for Input](#), HM Treasury and FCA, October 2015
19. Clean share classes are share classes which do not pay trail commissions to financial advisers, platforms or brokers.
20. The FCA's rules in [COBS 6.1A](#) allow firms, in general, to continue to accept commission after 30 December 2012 if there is a clear link between the payment and an investment in a retail investment product which was made by the retail client following a personal recommendation made, or a transaction executed, on or before 30 December 2012. In its [MiFID II roundtable](#) 8 June 2015, the FCA clarified that it had no plans to change these rules.
21. Based on a survey of the Deloitte Pan-European Member Firm MiFID II Panel, collated September 2015. Most investment managers based in Ireland and Luxembourg focus on international clients and have relatively few domestic clients. Therefore, the views in relation to Ireland and Luxembourg are based on their understanding of the EU market as a whole.
22. [Consultation on the review of MiFID](#), European Commission, December 2010
23. [Impact of MiFID on equity secondary markets functioning](#), Committee of European Securities Regulators (CESR), June 2009
24. [MiFID II](#) defines an OTF as a multilateral system which is not a regulated market or an MTF and in which multiple third party buying and selling interests in bonds, structured finance products, emission allowances or derivatives are able to interact in the system in a way that results in a contract in accordance with Title II of the Directive.

25. [MiFID II](#) defines an SI as an investment firm which, on an organised, frequent, systematic and substantial basis, deals on own account when executing client orders outside a regulated market, an MTF or an OTF without operating a multilateral system.
26. All-to-all trading venues are trading venues which allow buy side participants to trade directly with other buy side or sell side participants.
27. Based on responses from 13 investment managers. No investment manager had decided on its response: the options indicated represent early preferences only. We exercised judgement in allocating the firms to the category that we thought best fit their responses.
28. We set out some of the operational challenges of transaction reporting in Box A.
29. Based on responses from 13 investment managers. We exercised judgement in allocating the firms to the category that we thought best fit their responses.
30. Such as reporting required under EMIR or that will be required under the forthcoming Regulation on Reporting and Transparency of Securities Financing Transactions (SFTR).
31. According to the FCA's [Post-implementation review of the RDR – phase 1](#), December 2014, product prices in the UK have fallen by at least the amounts paid in commission pre-RDR, and there is evidence that some product prices may have fallen even further, due in part to the introduction of simpler products and funds which have a lower charge and advisers and platforms exerting more competitive pressure on providers. The FCA also noted that there has been a decline in the sale of products which paid higher commissions pre-RDR.
32. Box A provides further detail on this.
33. The Investment Association [2014-2015 Asset Management Survey](#) shows that the combined market share of the top 20 investment managers increased from 60% in 1995 to 72% in 2014.
34. The FCA's commissioned research conducted by Europe Economics ([Retail Distribution Review Post Implementation Review](#), 16 December 2014), found that there was some vertical integration post-RDR, although notes that it was limited.
35. Based on survey responses of 10 investment managers, August 2015
36. Based on survey responses of 9 investment managers, August 2015

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Designed and produced by The Creative Studio at Deloitte, London. J1557