Don’t delay the MiFID II implementation phase

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On 10 February 2016, the College of Commissioners officially announced its final position concerning the delayed entry into force of the revised Markets in Financial Instrument Directive (“MiFID II/MiFIR”). As anticipated, the one-year delay will apply to the package in full, leaving a more realistic timeline to *“take account of the exceptional technical implementation challenges faced by regulators and market participants”* as stated by the European Commission.

In the course of April 2016, the European Commission has adopted the MiFID II Delegated Directive covering investor protection, and the MiFID II Delegated Regulation covering organisational requirements and operating conditions for investment firms. Generally, the published delegated acts confirmed the high regulatory maturity of several subjects but we are still waiting for the totality of level 2 measures and potential further clarifications. The Commission has notably taken its final position on some critical topics as costs & charges, target market definition and the independent advisory model. Therefore, given the regulatory maturity of most subjects, it is already possible to start the implementation process.

On that basis, we believe that the one-year delay should not lead investment firms to delay the MiFID II implementation project:

- For those which have already initiated the project, maintaining their momentum will allow them to leverage the project team and knowledge already acquired while planning the important IT developments over two years instead of one
- Additionally, delaying implementation would leave more time to take strategic decisions (instead of the tactical ones already undertaken to be compliant in a shorter timeframe). Such strategic decisions would likely imply an additional implementation workload. It is thus important to appropriately balance effort between long-term strategic analyses and the time required to take decisions vs. short-term tactical and mandatory implementation.

For CEOs: shining a spotlight on two key questions to address MiFID II challenges.

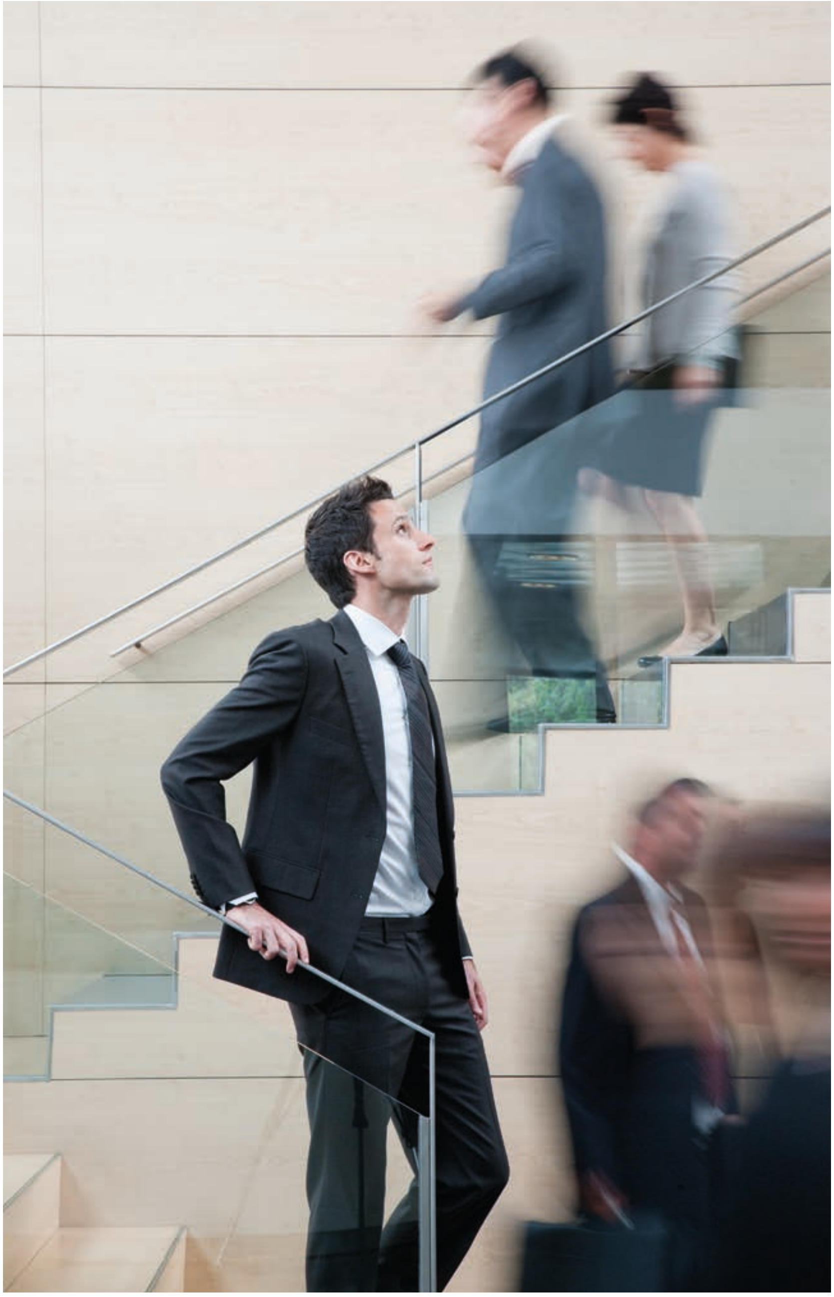
As part of their continuous efforts to increase investor protection and make financial markets more efficient, transparent and resilient, regulators have introduced measures that are likely to reshape the financial landscape. From the standpoint of a CEO in the banking industry, we want to address two key questions that need to be answered.

What products and services?
MiFID II introduces the obligation for investment advisors to categorize the investment advice delivered to their clients as either "independent" or "non-independent." This leads to important strategic considerations: which advisory model should be chosen and what drivers should support this decision?

Firms wishing to provide independent advice will be required to set-up a selection process to assess and compare a sufficient range of financial instruments available on the market. With regard to in-house products, their amount should be proportionate to the total amount of product considered in the assessment. Therefore, the availability of in-house products represents a key criterion for the selection of the advisory model and could potentially lead to a decrease in current open architecture offerings.

Another major element to be considered is introduced by Article 24 of the MiFID directive: the future ban on perceived inducements for both independent advisory and discretionary portfolio management services. Inducements will be tolerated for non-independent advisory services if the remuneration flows are clearly disclosed to investors and the advisor's offering enhances the quality of the service delivered to clients. As retrocessions may represent a significant part of firms' revenues, completely removing them from business models could adversely affect the firm's financial situation or at least reduce its profits.

Whereas an independent advisory model was almost inconceivable a few months ago, we see a growing number of actors reconsidering the opportunity to propose both services through hybrid offerings. In fact, such a "double-hatted" offering would allow firms to not restrict their horizon in term of market segment and potential business development. However, from an operational perspective, structuring such an offer may not be easy as independent and non-independent advisory services must be performed by two different teams and be clearly traceable in IT systems.
A hybrid model would also raise additional strategic concerns regarding the range of application of this duality and how to segment models between different group entities: should entities develop both independent and non-independent services or specialize their offering based on a single advisory model? What rationales should be considered for the offering: client segment, local market, in-house products? This raises the question on the branding and marketing of each investment firm: how will clients react to a non-independent or hybrid model?



Similarly, in the investment funds industry, we might observe an increasing number of fund distribution platforms (e.g., as observed with the enforcement of Retail Distribution Review in the UK) which target end-customers directly, bypassing the current distributors' network.

Generally speaking, investment firms will need to make sure that their distribution partners (e.g., private banks, IFAs, family offices, "apporteurs d'affaires," etc.) will still bring in business without inducement incentives. In other words, a strong partnership is needed between product manufacturers and distributors so as to efficiently address the challenges linked to the ban on inducements.

The pricing strategy between manufacturers and distributors, and also with the end client, will need to be carefully reviewed to reflect the business model evolution and avoid disruptions in ongoing business as well as a cannibalization effect induced by the proliferation of services.

Finally, MiFID II provisions relating to third country regimes could also raise questions as to the way in which non-EU entities will serve EU clients. Will non-EU entities be allowed to continue servicing EU clients in a proactive way (i.e., reverse solicitation)? If so, should they apply for a third country passport? Should they set up a branch?

For international companies, the third country regime might call into question the approach undertaken regarding the domicile of clients (EU vs. non-EU) serviced by non-EU entities, which might have some significant P&L consequences at local level.

Which clients and relating distribution strategy?

Depending on the type of client serviced and the type of service provided, the distribution strategy could be adapted. For instance, it is likely that retail clients will not be willing to pay for an advisory service. Following this, maximizing automation of distribution processes in order to reduce the costs could be considered. As such, we could see a trend towards the use of robo-advisors for retail or mass-affluent clients.

Concerns for the COO: key objectives to achieve operational and organizational efficiency

Besides all strategic decisions to be taken, MiFID II requirements imply significant operational and documentation/ contractual changes, as well as organizational adjustments.

Firstly, databases will need to be enriched. The quality and exhaustiveness of data will be even more crucial:

- The product databases will need to store information such as costs and charges, target market definition, product complexity and product performance-related information.
- The client databases will need to be enriched with KYC information such as the client's ability to bear losses, sensitivity to risk, etc.

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- The transactions databases will need to include all data requested for MiFIR reporting and post-trade transparency requirements (e.g., price, size, timing and venue).

Then, additional important IT developments will need to be performed, covering core banking systems, but also front office, reporting, data warehouse, MIS and finance systems:

- Implementation of additional controls required as per MiFID II: suitability and appropriateness tests being the most important
- Implementation of additional reports: transaction reporting, 10 percent depreciation of portfolio overall value from the beginning of reporting period, top five execution venues, pre- and post-trade transparency obligations, etc.
- Implementation of information monitoring process regarding instrument database for complex vs. non-complex products, target markets, risk level, etc.

Finally, the review of contracts with distributors, documents within client onboarding packs, and product marketing materials is expected to require a significant amount of time.

It is also to be noted that there are overlaps between MiFID II provisions and other regulations such as the EU Packaged Retail and Insurance-based Investment Products Regulation (PRIIPs) and the Insurance Distribution Directive (IDD). In that respect, it is critical to avoid duplicating the implementation workload that could be incurred by managing each project on a stand-alone basis. The same applies in investment firms with operations in Switzerland: a possible overlap with the LsFIN should be taken into account in the MiFID II programs.

Not only does the COO have to ensure that the project will be run efficiently, but he/she also has to make sure that post-implementation running costs will remain reasonable. Indeed, the incremental workload needed to perform the maintenance of databases and controls and the production of reports will generate additional costs that may negatively impact the profitability of the business.

In that respect, investment firms have started to investigate opportunities to reduce operational costs by:

- Launching efficiency projects such as increased process automation to minimize manual processing (e.g., robo-process automation)
- Setting up internal shared service centers between market participants
- Setting up internal hubs such as client data maintenance, product maintenance and governance, etc.
- Outsourcing activities to specialized actors and/or to offshore low-cost centers

From an organizational standpoint:

- Appropriate trainings will need to be delivered to the staff with a focus on client-facing employees who are the most impacted by MiFID II
- Any organizational change will need to be supported by a proper change in management processes so as to ensure smooth transition toward future business models
- Finally, a number of internal policies (i.e., conflicts of interest, compliance, remuneration, etc.) will require adequate review and update.

Conclusion

MiFID II requires investment firms to take a number of strategic decisions with regards to their service offering and distribution strategy. However, such decisions should not prevent firms from starting the implementation project, which will require significant effort. Firstly, to identify the gaps and design an efficient remediation plan, but also to implement the changes (in terms of the organization, operations and processes, documentation and IT) in a timely and efficient way.