IM industry
The MiFID II paradigm shift

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Despite the fact that MiFID II is not directly legally applicable to investment management companies or AIFMs, a brief overview of the asset management industry after MiFID II implementation demonstrates beyond doubt that **the new rules will have a profound influence on its products, structures and future**. As instruments, funds are subject to MiFID II and are therefore affected by the MiFID II framework on every possible level.

MiFID II: one era ends and another begins

Although the entry into force of MiFID II and MiFIR (hereafter referred to as "MiFID II") on 3 January 2018 affected all entities in Luxembourg, it is clear to us that institutions have approached MiFID II very differently. Specifically, when we consider asset management, despite the fact that MiFID II is not directly legally applicable to fund industry management companies or AIFMs—thanks to an explicit exclusion in the regulation—the **products, structures and future of the industry will be heavily influenced by the new MiFID II rules**. As instruments, funds are subject to MiFID II and are therefore affected by the MiFID II framework at every possible level.

Until now, as is often the case at the start of a trend, the changes have not necessarily been obvious to asset managers, oftentimes because of their focus on their large institutional clients, which obscures the fact that these clients are themselves intermediaries to retail clients.

We believe that MiFID II marks the start of a new era of transparency at three levels: pre-trade, trade and post-trade. The new transparency rules affect all stakeholders, and none more so than product managers and manufacturers.

01. Before the trade
Pre-trade information will cover performance and risk information, as well as costs and charges, and information on the target market

02. During the trade
The market transparency requirement implies that more firms will look at "auditable" solutions with public prices (often via trading platforms), as these will facilitate compliance

03. After the trade
Clients will be informed about the quality of execution and costs, including the amount of any retrocessions charged by their financial institutions

Another key element to factor in is that advice will no longer be free of charge in most cases, and this may prompt clients to monitor performance even more closely.

The direct consequences of MiFID II for the IM industry

Distribution

Many in the UCITS/AIF communities seem to have been caught by surprise, barring a few—albeit notable—exceptions. In fact, although nearly everyone had heard of MiFID II, it was not at the center of the fund industry's radar. The IM industry is drawn to MiFID II for commercial reasons rather than legal imperatives: they are looking to facilitate distributors' lives under MiFID II. Even though, from a legal perspective, MiFID II does not apply directly to UCITS or AIF management companies/AIFMs, the fact that their products fall within the scope of the directive has dragged them into the MiFID II maelstrom.

In the short term, for reasons of product governance (and costs/charges) including the availability of KIID/PRIIPS, many products were set aside or simply dropped from retail offerings at the beginning of the year and will not be reintroduced

until they produce adequate information. However, while this short-term impact is significant for some product providers, they are in a position to mitigate its effects over the course of the year by providing the requisite information. Nevertheless, the potential difficulty of re-entering the distribution circuit should not be underestimated. As difficult as this might be, we expect that more important longer-term consequences will challenge the entire industry.

In the medium and longer term, the new approach to inducements will provide a major impetus for restructuring the industry. At present, whereas the "independent adviser" status is not extensively used, the paid-for advisory management and DPM (discretionary portfolio management) models have become entrenched.

Coupled with price transparency, these models will be game-changers, because:

- Clients will be more aware of the costs (as stipulated by the EU Commission) as financial institutions will have to disclose their cost structure
- On top of this, financial firms will push in the same direction. Their support might come from less direct factors falling into two broad categories, one of which will be related to business imperatives: why pay high fees for a product that negatively affects portfolio performance, then legal and compliance incentives to switch from off market execution to on market trades (with ETFs)

The end of retrocessions from independent advice, DPM or paid-for advice will make performance even more of a priority within the industry. In this scenario, only top performers will attract attention and a steady flow of business. This trend has an additional potential consequence for portfolio management, in that there may be a shift towards defining the strategic allocation of assets and considering products as a pure commodity from the current stock or instrument-picking perspective.

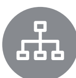
The way services will evolve at distributor level represents a challenge for the IM industry. Funds under DPM and independent advice will not be able to pay retrocessions, hence selection and product appraisal will have to rely on a new set of factors, chiefly service and performance. For good but undifferentiated products, the new norm will definitely be for passive andindex-linked funds to be managed cheaply. There are difficult times ahead for funds whose investment strategies do not stand out from the crowd, because they will not be able to justify their pricing; conversely, commoditization will be a boon for top performers, which might even be in a position to increase their management fees in response to increased demand (access to top managers will be even more sought after). This trend is rooted in a basic tenet: "why pay X basis points for a fund when the firm can buy an ETF for a fraction of the cost?" In addition to the pricing difference, ETFs (for example) have the additional benefit of being easier to manage from a compliance perspective, since they are traded in real time on public stock exchanges with public prices.

At present, many funds managers are still simply considering their basic needs to ensure compliance with MiFID II rules. Among the most MiFID II remote communities of PERE funds, the notions of costs and charges and/or product governance come as surprises. One reason for this is that these funds target large private banks or insurers, sometimes overlooking the fact that they do not invest for themselves but for end clients. Because the MiFID II definition of "retail client" encompasses high-end private banking clients, prime end targets for these products, distributors and intermediaries (the entities doing business with these PERE funds) also have to meet product governance requirements (KIID/cost and charges).

In addition, in terms of the impact on management, anecdotal evidence for the trend comes from the robo-advice segment of the market. The driving forces behind this new breed of advisers are real-time, personalized, and efficient, cost effective products that are easily traceable and tradable, not "obscure" retrocession arrangements, and this might offer new drivers for the industry.

From a pure policy perspective and in the longer term, the evolution of inducements might lead member states to converge upon a Netherlands/UK-style ban (or a cap as envisaged in Poland), which would change the industry dynamic. Interestingly, the impact on the fund industry might only be half that seen under MiFID II. Funds are offered via banks and other managers, but a large proportion of distribution services are provided by insurers that will undergo similar changes to those seen under MiFID II (with IDD) by the autumn. This may deal yet another blow to the industry before the end of the year, coming at the same time as cost and charges disclosure.

The new transparency rules affect all stakeholders, and none more so than product managers and manufacturers.



Management

As we have seen, MiFID II will change the dynamic of distribution, and there are also direct implications for the asset management industry. The cost of trading may increase because of regulations (MiFID/MIFIR and EMIR); as these force market participants to use exchanges or clearing platforms, fund managers may be required to place more collateral, margins, etc. with their intermediaries. This stems from the fact that more products will become both clearable and tradable with the interaction of MiFID II and EMIR.

On the positive side, funds stand to benefit from best execution information about trading venues, listing, quality of execution, etc.

One key new factor is that MiFID II greatly enhances the tools at the regulator's disposal to influence products, from suspension to outright bans. In January, ESMA conducted a consultation on CFDs (contracts for difference)/binary options in order to restrict their use or fully ban them for retail investors across the entire EU. This new supervisory power triggers naturally a question: "what's next?"

There are many gray areas at the juncture between MiFID II and fund management. For example, from a UCITS/AIFMD perspective, product governance is not a requirement, and yet MiFID II requires ex-post reporting of trades for each product, coupled with management of the "negative target market" and potential sanctions. At this moment, these ex-post sales reports are still closer to myth than reality for many providers, but that leaves the product manager responsible for when products are sold outside of a target market or—worse—offered without checking for such a target market.

Investment pricing: "each service has price, transparency has a cost"

This maxim perfectly summarizes the implementation of MiFID II and its consequences for the IM industry. At the beginning, MiFID II proponents had a very clear picture of their objectives, which included putting **pressure on the fee level across the financial industry and specifically in the funds/structured products arena**. What we see now is that the trend seems to be following the desired trajectory.

Products without governance or target markets aside (at least for retail investors), costs have increased to cover the massive compliance burden, and in many cases MiFID firms have opted for paid-for advisory contracts. That leads to two consequences:

- Leaving the world of free advice means that clients will be more demanding, hence putting pressure on firms to improve their product/service offering and the performance of their investments
- To demonstrate that they have chosen the optimal product, firms will have to rely on demonstrable/auditable and public information, which might lead to clients opt for a trading platform

Finally, price increases implemented by distributors are primarily a reflection of increased costs. These costs are easily justified as compliance investments, but it is harder to make this argument in the IM industry.

Case study: management company A

Management company A offers some MiFID II services, including managing direct client accounts. As a result, it must fully comply with MiFID II requirements, such as reporting and the processing of investment research. If management company A has both a MiFID license and "management company" status, it will face organizational challenges stemming from the fact that it is partly under MiFID II but some of its activities are not covered by the directive. Clear and strict barriers will therefore have to be put in place, and this will make the overall structure costlier to manage.

Conclusion

MiFID II paves the way for new asset management industry drivers

Product governance, the pressure on retrocessions and transparency requirements are reshaping the asset management industry, forcing the commoditization of more standardized products. In light of MiFID II, the IM industry needs to fundamentally rethink its:

- Cost drivers
- Real-time performance
- Distribution model

The start of this year only brought the first stage of change, with the removal of products from distributors' lists of available instruments.

For the IM firms that have not yet woken up to these profound changes, action must now be taken urgently, since MiFID II will be closely followed by the IDD regulation for the insurance industry, which will restrict access to the insurance sector. Not complying with MiFID II requirements is a very bad path for meeting IDD. Providers should consider what would happen if these two types of client were to become inaccessible.

The areas to address in the IM industry are based on commercial and client requirements, and not necessarily only from regulations. In fact, we are at the **outset of a new era, not at the end of MiFID II. On 3 January, we witnessed the arrival at the starting line for departure, not the finish line.**