Fund distribution under MiFID II

Strategic considerations for investment managers distributing funds across the EU

David Strachan
Partner, EMEA Centre for Regulatory Strategy

Joy Kershaw
Manager, EMEA Centre for Regulatory Strategy

Katya Bobrova
Assistant Manager, EMEA Centre for Regulatory Strategy

MiFID II[1] will have a significant impact on the distribution of investment funds, and this impact will vary across distribution channels. Firms managing funds which are sold across the EU will need to consider how this will affect their business.

Under MiFID II, distribution will be reshaped by new rules on product governance, the appropriateness test, inducements and disclosures to investors[2]. In October, Deloitte[3] published a paper looking at the strategic impacts of MiFID II on investment managers across different parts of their business[4]. On distribution we concluded that MiFID II may further drive an increase in direct-to-client (D2C) offerings and digital services. However, the impact will vary across the EU depending on local distribution models. This article looks at these differences in more detail and considers how firms could position themselves in light of the impact of MiFID II on each distribution channel[5].

1 *The revised Markets in Financial Instruments Directive and a new Regulation.*

2 *As this article was going to print, the EU institutions were discussing a potential delay of the MiFID II implementation deadline, which was originally set at 3 January 2017.*

3 *Deloitte LLP*

4 *Navigating MiFID II: Strategic decisions for investment managers, Deloitte, Oct 2015*

5 *For this article, we have spoken to Deloitte client teams in Belgium, France, Germany, Italy, the Netherlands, Spain and the UK. In addition, we gathered views from Deloitte practitioners in Ireland and Luxembourg, jurisdictions with largest numbers of funds domiciled (in the EU).*

What are the main changes to the investor protection rules under MiFID II?

- **Product governance:** Product providers will be required to ensure that products and distribution strategies are consistent with the needs of identified target markets and that distributors have the information needed to understand and sell the product properly. Distributors are expected to be required to pass sales information back to product providers. There will be increased costs due to the need to renegotiate agreements between providers and distributors and the ongoing exchange of information required.
- **Appropriateness test:** A wider range of products, including structured UCITS[6] and AIFs[7], will be deemed complex and subject to the appropriateness test. This requires an assessment of an investor's knowledge and experience before a sale is made.
- **Inducements:** Independent advisers and portfolio managers will be prohibited from receiving third-party inducements[8]. Other firms can continue to receive inducements if they are designed to enhance the quality of service to the client and do not impair the firm's ability to act honestly, fairly, professionally and in the best interests of its clients. The rules on what constitutes enhancing the quality of service are expected to be stricter than under MiFID I.
- **Disclosures to investors:** MiFID II introduces an EU-wide definition of independent investment advice and requires firms to disclose to clients whether they provide such advice. MiFID II will also require more detailed disclosure of costs and charges.

Current distribution landscape in the EU

Fund distribution models differ across EU countries. This results from a range of factors, including different supervisory regimes, historic distribution structures and consumer preferences.

In many EU countries, **banks are the biggest distributors of retail funds**, offering in some cases predominantly in-house funds (e.g. Belgium, France and Spain), and in other cases a wider range of funds (e.g. Germany and the Netherlands). By contrast, in the UK most distribution of funds to the retail market is done via platforms (89%), independent financial advisers, or a combination of the two[9]. The UK has seen a significant increase in the use of platforms over the past few years and is now seeing some interest from wealth managers in setting up platforms for their clients. In the Netherlands, the local regulator, the Authority for the Financial Markets, banned third-party inducements in January 2014 and the share of distribution via platforms has grown since then. Dutch consumers now have a wide range of options to invest via online platforms; all offer execution-only sales and some also offer automated advice. In other EU countries, platforms are slowly taking off but the market share of retail clients buying directly is still relatively low (see the chart).

6 *UCITS are undertakings for collective investment in transferable securities. In Article 36(1) of the UCITS IV Directive, structured UCITS are defined as UCITS which provide investors, at certain pre-determined 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.*

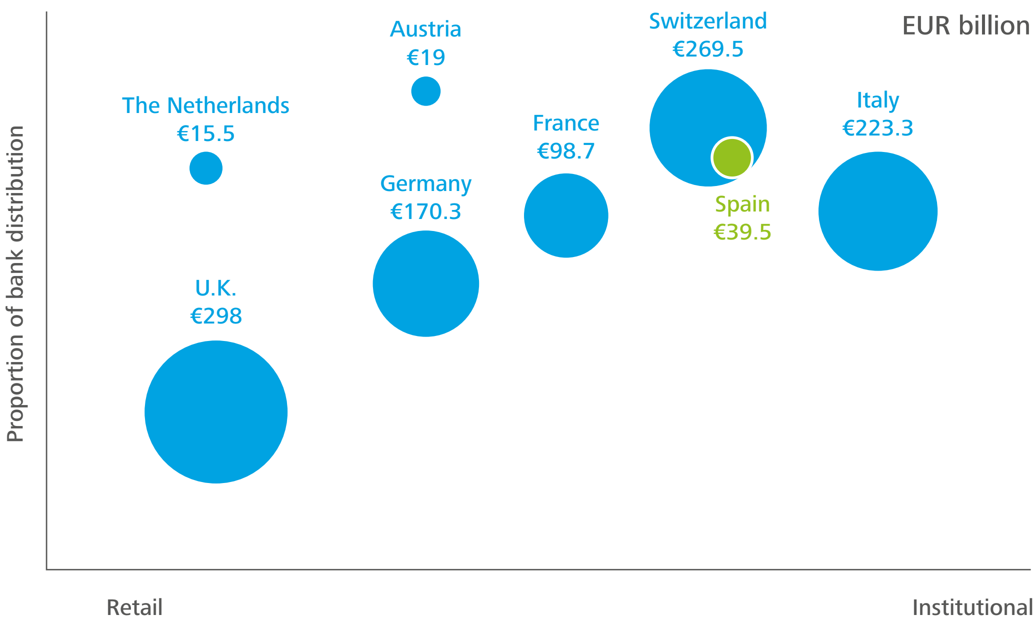
7 *Alternative investment funds as defined in the Alternative Investment Managers Directive.*

8 *Independent advisers and portfolio managers will still be able to receive minor non-monetary benefits subject to certain conditions.*

9 *Asset Management in the UK 2014-2015, The Investment Association Annual Survey, Sep 2015.*

The chart below provides an overview of fund distribution via platforms in the EU and indicates the amount of platform-distributed funds (in € bn) in each country[10]. While there is demand for platforms across all the countries included in the chart, many of these focus on institutional clients (e.g. Italy and Spain). Platforms in the UK and the Netherlands mainly cater for retail customers.

Figure 1: Fund platforms - Market positioning



Source: The Platforum "European platforms and open architecture 2014: A traveller's guide to the galaxy", March 2014

Some countries have also seen investment managers setting up their own D2C platforms. For example, in Spain a few private and universal banks have set up online platforms as personalised advice is less cost-effective for retail clients. These platforms offer execution-only services and in some cases also generic advice; investors pay a subscription fee. In Germany a small number of investment managers have platforms selling their own funds.

Independent advice makes up only a small proportion of retail distribution in many EU countries but is more common for high net worth clients. A small but growing number of platforms offer "robo-advice"[11]. In its Green Paper on retail financial services, the European Commission looks at how digitisation can improve competition and choice for consumers[12]. In its Discussion Paper on automation in financial advice, the Joint Committee of the European Supervisory Authorities seeks input from stakeholders on what, if any, action is required to harness the potential benefits of automated advice and mitigate its risks[13]. In the UK, Her Majesty's Treasury and the Financial Conduct Authority are also examining whether firms face any barriers to providing advice to those with less complex financial needs as part of their Financial Advice Market Review[14].

In many EU countries, **retail investors** are sold AIFs as well as UCITS. The types of AIF sold to retail investors include funds compliant with local retail fund regimes (such as UK Non-UCITS Retail Schemes) and closed-ended funds. For example, AIFs sold to retail investors include German real estate funds, French capital investment funds and Belgian capital protection funds. In some countries, such as France, the majority of retail investment is via life insurance products. The Insurance Distribution Directive will regulate the distribution of insurance-based investment products and aims to achieve a similar level of investor protection to MiFID II.

In some countries, local supervisors have already taken action to reduce the sales of **complex products** to retail clients. For example, in Belgium, a moratorium on the distribution of particularly complex structured products[15] has resulted in a substantial reduction in the complexity of structured products. In Italy, a regulatory communication on the distribution of complex financial products to retail investors[16] has led to many firms reducing the complexity of some of their products.

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11 "Robo advice" is an online service that provides automated, algorithm-based portfolio management with minimal human intervention.

12 Green Paper on Retail Financial Services, European Commission, Dec 2015.

13 Discussion Paper on automation in financial advice, Joint Committee of the European Supervisory Authorities, Dec 2015

14 Financial Advice Market Review, Call for input, Her Majesty's Treasury and Financial Conduct Authority, Oct 2015.

15 Moratorium on the distribution of particularly complex structured products, FSMA, 2011.

16 Comunicazione sulla distribuzione di prodotti finanziara complessi ai clienti retail, Consob regulation n.0097996/14, Dec 2014.

How will MiFID II affect different distribution channels?

Banks receiving commissions for distributing funds will be affected by the new inducements rules, which are expected to require them to do more to demonstrate an enhanced quality of service to the client. In many cases banks do not provide independent advice so will be less affected by the outright prohibition on inducements to independent advisers. Banks distributing funds from a wide range of providers may face significantly increased costs under the product governance rules and may look to reduce the number of providers whose funds they distribute. This could advantage in-house funds over external funds. Where banks are selling AIFs or structured UCITS on an execution-only basis they will need to incorporate the appropriateness test into their sales process.

Financial advisers which are not part of banks or insurance companies may currently label their services as "independent advice" even where no local regulatory definition exists. These firms will be affected by the MiFID II ban on inducements for independent advice and many are likely to re-label their advice as non-independent. However, in the UK and the Netherlands, both independent and non-independent advisers are already prohibited from receiving inducements under local rules. Advisers which are deemed non-independent under MiFID II but distribute funds from a wide range of providers may look to reduce the number of providers whose funds they distribute due to increased costs per provider under the product governance rules.

In the UK, the major **platforms** provide funds from a large number of investment managers and may become more selective about the providers whose funds they include on their platform as a result of increased costs under the product governance rules. In many other EU countries, platforms often host a single investment manager's funds or a smaller range of providers so the product governance rules may be less costly. Where platforms sell complex products on an execution-only basis they will need to introduce the appropriateness test, which will increase their costs and change the user experience. Investment managers distributing via platforms may consider moving towards non-complex product structures where this can be achieved without significantly altering investment strategies. Platforms receiving inducements will have to demonstrate that these enhance the quality of service to their clients if they wish to continue receiving them. UK and Dutch platforms will be less affected by the inducements rules as they are already subject to domestic inducements rules.

Wealth managers carrying out portfolio management will be prohibited from receiving commissions from product providers. As with other channels, the product governance rules may lead some wealth managers to reduce the number of providers they deal with in order to reduce costs. In countries where independent advice is not currently defined, MiFID II may create new opportunities for them to provide this as a premium service to high net worth clients.

Where investment managers **sell funds directly to clients** they will need to comply with the product governance rules but the absence of a separate distributor will reduce the complexity of the process. They will also need to introduce the appropriateness test for complex products.

Sales to **institutional investors** are less likely to be affected by the MiFID II rules on investor protection since in many cases no inducements are paid to distributors, mandates are agreed with individual clients and investment managers can generally assume that professional clients have the level of knowledge and experience required under the appropriateness test[17].

Across all these channels, the **increased disclosure of costs and charges** required in MiFID II and PRIIPS[18] may increase competition in the market as it becomes easier to compare different products side by side. These may work in tandem with existing market trends towards low-cost, less complex and passive funds. Firms may continue to rationalise their product range as the new product governance rules increase the costs to firms per fund[19].

To the point:

- Distributors selling funds from a wide range of investment managers may look to reduce the number of investment managers whose funds they sell as costs increase under the product governance rules. This is likely to particularly affect the large UK platforms but may also affect other distributors such as banks and financial advisers across the EU. Investment managers which may be affected by this could look to build D2C solutions.
- Banks receiving inducements to distribute funds will need to ensure that the inducements they receive sufficiently enhance the quality of service to the client. This may involve providing more ongoing services, such as market insight or personalised reporting.
- In view of the MiFID II appropriateness requirements, investment managers of AIFs and structured UCITS which are sold on an execution-only basis may consider moving towards products which are deemed "non-complex" where this can be achieved without significantly altering the fund's investment strategy.
- In many EU countries where independent advice is not currently defined, MiFID II may provide a new opportunity for some firms to provide this service to high net worth clients.
- As MiFID II will increase distribution costs, increase the transparency of costs and charges, and require the appropriateness test for a wider range of products, investment managers will need to make strategic decisions about their offering. This may include moving to lower cost, less complex and passive funds and/or developing robo-advice solutions.

17 *Article 36 of the MiFID Implementing Directive.*

18 *Packaged Retail and Insurance-based Investment Products Regulation.*

19 *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.*