MiFID II
Changing the distribution landscape

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Who would have predicted Sir Callum McCarthy's Gleneagles speech in 2006[1] would have led to the most radical shake up of retail distribution in the UK, and eight years later largely motivate and inform MiFID II from a retail distribution perspective?

It was one of those ‘I was there’ moments—an epiphany for many—as he made a compelling argument against the inevitable conflicts of commission-led product supply with client suitability. It was of course particularly relevant in the UK, where the Independent Financial Adviser (IFA) channel accounted for a significantly higher proportion of sales than most other European markets, but the principles have now been recognised and enshrined at EU level.

MiFID II covers a huge range of topics beyond distribution. It has been referred to as the ‘paella Directive’ as it took a long time to prepare, has a bit of everything in it and involved too many chef—but ultimately it should taste good. It requires a thorough read to identify the articles that will influence the way retail savings and investment products are delivered to European investors. In particular, if you read nothing else in MiFID II, read Article 24. Hidden away amongst dark pools, commodity derivatives and high frequency trading, the so-called ‘Jack Bauer’ clause has the potential to create the same degree of disruption to the European distribution landscape as the character from the TV series with the same numerical reference.

MiFID II is open to member state interpretation, and we are already seeing variations on the theme. The UK’s Retail Distribution Review (RDR) provides an extreme example, featuring a complete ban on inducements and very prescriptive competency qualifications intended to professionalise advice.

Another challenge for MiFID II was coping with a wide variety of distribution models across Europe, a situation that it struggles to reflect. It adopts the simplistic view that manufacturers make and distributors sell, and fails to recognise the concept of distribution as a service facilitating access, such as with B2B platforms. In Spain, the concept of distribution is separate from investment advice, while in Italy distribution services are classified as ’placement’ in an agency capacity to the manufacturers. MiFID II also strays into territory covered by existing Directives, e.g. UCITS and AIFMD.

1 Speech by Sir Callum McCarthy, the then Chairman of the Financial Services Authority in the UK, at the Gleneagles Savings and Pension Industry Summit, 16 September 2006

It has therefore clearly been difficult to achieve the right compromise, but ultimately the policymaker's primary goal is to re-establish consumer confidence by ensuring appropriate safeguards are in place at point-of-sale for retail investors. In this article we shall focus only on the following aspects of MiFID II:

- What the policy makers are trying to achieve and why
- The key elements with respect to distribution included in the Directive
- What this could mean for distribution across Europe

Background – What motivated the distribution elements of MiFID II?

Consumer protection is a central theme for the Commission and MiFID II seeks to address the growing complexity of services and products offered, ensuring consumer interests are safeguarded. Much of the debate on distribution centres on 'inducements' paid by product manufacturers to distributors, motivating product push rather than client suitability. The Commission wrestled with whether this should apply across all distribution models (as is the case in the UK) or just independent advisory models, compromising with detailed obligations around transparency and disclosure in circumstances where rebates are permitted. In the end, a complete ban was regarded as too disruptive in some markets, and considered likely to result in large numbers of retail clients being unable to access advice.

What you need to know from the MiFID II text and ESMA Consultation Paper – Key Points

To frame our discussion of consequences and the possible impact on the distribution landscape, the following elements are most relevant:

- Key principles – investment firms must:
  - Act in the best interests of clients at all times
  - Disclose the cost of advice
  - Clarify and explain the basis of advice
  - Apply a competency assessment to its advisory staff
- A ban on inducements for independent advice and discretionary management
- Prescriptive disclosure to clients of all costs, whether advised or not
- Definition of independent advice, essentially requiring an assessment of a sufficient range of different providers that are not closely linked entities
- A distinction between advised and execution-only models

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- Complex products (including structured UCITS and non-UCITS) only available through an advised offering
- Similar investor protection requirements should apply to investments packaged under insurance contracts but remain subject to detailed rules still to be developed

The Directive mirrors the MiFID obligation on investment firms to *"act honestly, fairly and professionally [...] in the client's best interests,"* but ESMA is now proposing substantial prescription to define this further.

Such over-prescription, on top of clear and unambiguous principles, may result in a proliferation of inadvertent breaches, the stifling of innovation, and dumbed-down products, none of which is in the best interests of the consumer. Better to use sanctions as a big stick, with a few early examples, in situations where the core overarching principles are broken, than to try to micro-manage with prescription.

How will this change the distribution landscape?

Three predictions are commonly made:

Myth number 1: a significant number of Independent Financial Advisers (IFAs) will disappear from the industry

Reality: The IFAs who leave the industry are most likely the commission junkies who have gorged on a diet of rebates for years, and were more akin to salesmen or product pushers than advisers. It was this group in particular that McCarthy railed against in his speech; in his analogy, these were the captains of the ships paid based on the number of convicts loaded onto vessels at the port of departure, while the new model requires them to be paid based on the outcome at port of arrival. Often, the clients of these advisers were clueless as to precisely what they were paying for 'advice'. MiFID II does not use the word 'inducement' by accident. EU Memo 14/2992[2] on KIDs quotes examples discovered by the Ombudsman in one member state of 12-year bonds being sold to the very elderly, and in another member state a survey suggested 50-80% of consumers were terminating long-term investments early, indicating they were not suitable in the first place. The industry was tarnished by those amongst them searching for the latest product commission offer to churn into client portfolios. New discipline around competency standards will also initially result in reduced numbers.

Frankly, the disappearance of these 'advisers' would be a welcome consequence of the Directive.

Myth 2: Retail clients with smaller portfolios will be unable to afford advice or be denied access to it, as IFAs will exclusively focus their efforts on mid and high net worth individuals

Reality: If such clients have used advisers in the past they will have paid for advice, but were probably unaware how much. The 'advice' was often generic and paid for largely by trail commission. Many of these clients received no ongoing advice and probably never saw their 'adviser' again. For the adviser, the real difficulty here is that they must now explain the true cost of advice and charge an explicit advisory fee. The client must decide if the cost is still justified based on the perceived value of that advice.

For portfolios below a certain threshold (probably around €75,000), it is difficult to see how the cost of advice in any model (commission or fees) could justify enhanced yields which may (or may not!) accrue. Such clients may be better off using an execution-only platform offering a guided approach to suitability and directing the client towards an appropriate panel of investment choices.

It must be recognised that giving financial advice is now a profession, no different to giving legal advice. Upskilling through competency qualifications and statutory obligations is crucial. Advice will then be channelled to where it should be: around complex, higher-value portfolios. No-one should pay for advice on which Individual Savings Account (ISA) to invest in, any more than you would pay a lawyer for advice on a parking fine.

MiFID disclosure obligations were too general, and practice varied by member State and channel. For too long, retail clients have been under the impression that advice was free, as the adviser often explained that it was paid for by commissions from the product provider; a factually correct but not very transparent disclosure. The problem therefore is not a matter of affordability but discovery, and many clients will realise the bargain has been weighted against them.

So will the MiFID II changes mean smaller retail clients will be excluded from the advised market? Empirical studies[3] in the UK show there has been a marginal shift (2%) of clients from advised to non-advised following

2 European Commission Memo 14/299, published on 15 April 2014, on Key Information Documents (KIDs) for packaged retail investment and insurance products, frequently asked questions

3 Financial Conduct Authority guidance consultation on Retail investment advice, published in July 2014, paragraph 2.7, referring to research involving over 4,000 respondents

RDR, but a greater shift from non-advised to advised (4%). Perhaps it is too early to tell, and the full impact of a trend amongst retail banks to exclusively focus 'advice' on higher-end clients has yet to be felt, but so far the UK is not reporting a seismic departure of clients from an advised model.

However, even under the current model where clients believe they get advice for free, only 11% of European households own a fund, and cash accounts for 40% of European household assets. Contrast that to the US, where 62% of households with an income of less than US$100,000 own a fund but rarely pay for advice. Perhaps the lesson here is that sometimes our industry gets lost in its own rhetoric, and what the vast majority of savers with smaller portfolios really want is a simple product offering slightly better yield than a bank account. That option should be accessible to everyone, without the need to pay for advice

Myth 3: Open architecture is at risk, and we will see a retrenchment into a rebate-remunerated tied advice model, particularly by the retail bank channel

Reality: It is true that MiFID II will still permit a commission-based remuneration model, as the ban on inducements applies only to independent advice. However, the words 'tied advice' are an oxymoron — how can it be 'advice' in the context of suitability when the solution is selected from a tied panel? Banks selling tied products have a history of suitability issues, with Payment Protection Insurance in the UK perhaps being the best example.

The open architecture model emerged within the bank channel because banks realised their own in-house products generally produced inferior performance to third party funds, and they had to offer better performance. Their initial solution was to offer sub-advisory mandates to bank-branded products. Even then, client demand for choice meant those banks had to offer more than a single branded range. New B2B infrastructures emerged, facilitating easy access to an open architecture shelf with attractive economics.

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Why should this change now, just because rebates are banned? The banks can either elect to continue with an advised service, with a fee payable by their clients (presumably equivalent to the previous commission flow), or offer an execution-only option and continue to be remunerated through rebates, albeit with full and explicit disclosure to their clients.

If a retrenchment occurs it would go some way to proving why the inducement ban is necessary, as it would suggest the bank-advised open architecture model was driven more by commission than suitability. Market forces and consumer demand should determine whether such a retrenchment would be successful or not. I suspect it will prove unattractive, and new open architecture models and channels will emerge and prevail, perhaps through cross-border web-based tools able to switch rebate models depending on whether a member state has adopted a full or partial inducement ban, rather than the branch model. Consumers want and demand choice, and retail outlets will ignore this at their peril. The bank outlet will increasingly look like a direct-to-consumer (D2C) platform, which can only be a good thing for consumers.

What changes can we anticipate in the way retail clients access savings and investment products in the future?

Perhaps the best place to look is the UK, where RDR has been in place since early 2013. Some general observations emerge that may indicate how these may spread across Europe:

Platforms and channels:

- 'Platform' refers to client-facing platforms operating a D2C execution-only or advisory model, which are increasingly used by IFAs to facilitate product access for their advice solutions[4]. The D2C platforms appear to be in a good position to gather new clients, especially orphans falling out of the IFA model. The big will get bigger, as they use their buying power to negotiate lower fees ('superclean' share classes) from product providers, attracting more clients whose assets are 'influenced' or corralled into the superclean share class through a list of promoted funds. As a result, big funds able to offer superclean will just get bigger, as best-seller funds become a self-fulfilling prophecy, preordained by platform-promoted lists. Of course the key question here is whether a superclean share class is a new form of inducement used by platforms to gain volume, for which they may charge a higher platform fee to their clients
- The integrity of promoted funds lists is an issue that is likely to be scrutinised by regulators, as they are increasingly realising that the cost of a product is only one part of the equation, and the value added through performance must also be taken into account
- With fund houses eager to access asset-gathering machines – increasingly recognised as aggregators rather than distributors – a price war has emerged. This may squeeze out boutiques unable to compete purely on price but whose performance may be better than the best-sellers
- Execution-only platforms may need to reconsider their commercial model, moving towards a transaction and safekeeping fee rather than an ad-valorem fee. The cost to execute an order for €10,000 is no different to the cost to execute a €50,000 order, so why should a basis point fee apply? Similarly, how can this model continue to take trail commissions when by definition 'execution-only' implies no ongoing relationship with the client?
- The FCA in the UK has issued an excellent consultation paper[5] seeking to encourage the industry to provide access to simple savings products for clients with straightforward needs. This should open the way for innovative new channels, offering filters to enable most people to find the right product without the channel straying into 'advice', like buying insurance from a comparison website

- IFA usage of platforms will increasingly focus on pre-constructed model portfolios aligned to risk ratings. This is driven partly by simple economics and partly by fear of liability for tailored portfolios which prove to be unsuitable
- This concept is being taken a stage further by innovations such as Nutmeg, offering advised discretionary management of pre-packaged portfolios via a web-based service, at affordable (and transparent) prices
- Lessons will increasingly be learned from other retail commerce sectors, especially web-based services. Features including peer group recommendations (consumers trust other consumers more than experts), unsolicited prompts or calls to action, ease of use (e.g. shopping baskets, one-click buttons) and superb customer service through a trusted and ubiquitous brand will emerge on D2C platforms once there is clarity around the boundary of the personal recommendation definition

How will the fund houses react and evolve?

- The winners may be the larger fund houses that have the muscle to pay for aggregation via heavily discounted share classes
- Performance and brand will also become more important in filter-driven D2C execution-only channels
- Share class proliferation will continue, bringing with it naked exposure through prospectus disclosure to the best deals offered by each fund house
- Passive funds and low-cost ETFs will continue to gather more assets than before, as fee-based IFAs will seek to keep the cost of a client portfolio as low as possible to justify the additional adviser fees
- Perhaps the very large fund houses – with a broad range of funds and the financial strength to build their brand – will enter the platform market with their own offering. Thousands of orphan clients remain on the share register of these funds, and could form the initial substance of such a move
- New commercial models may emerge, such as the zero-cost share class (sometimes known as 'distributor pays'). This new idea is yet to gain traction but essentially allows a fund house to open a new share class, made available only through selected outlets, where the distributor pays a fee directly to the fund house on a bi-lateral arrangement rather than the fund manager taking a fee from the fund

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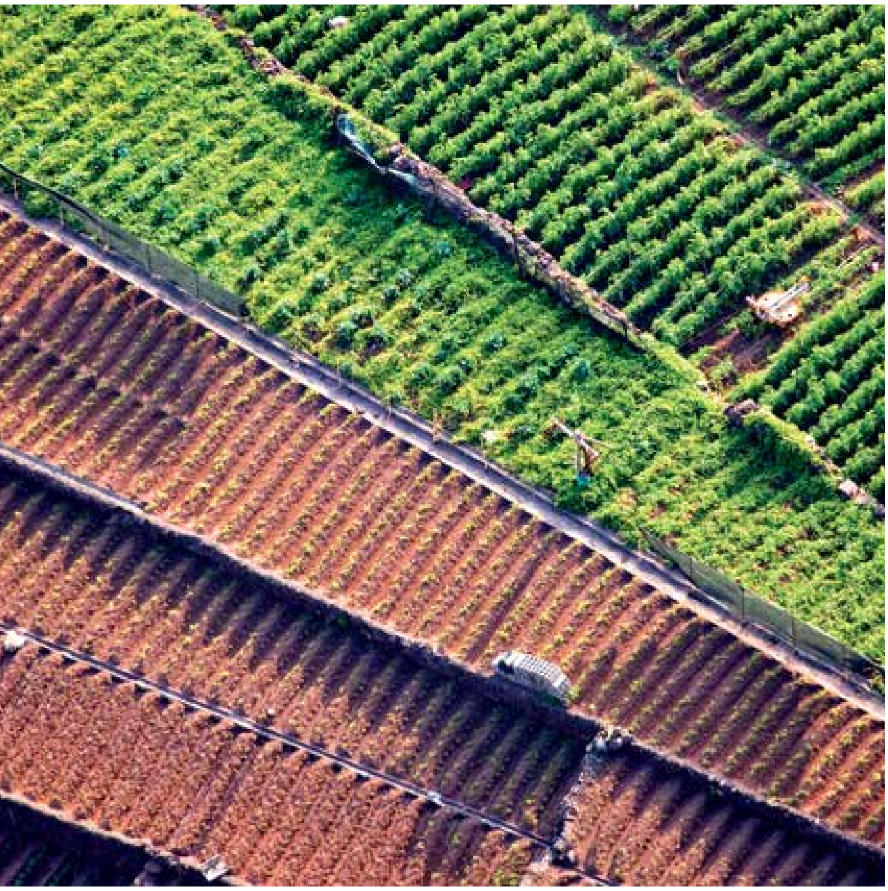
4 It is acknowledged that other member states may not impose the blanket ban on inducements the UK has adopted, and that execution-only platforms may be permitted to continue to receive rebates. This may result in different outcomes to those described in the UK

5 Financial Conduct Authority guidance consultation on Retail investment advice, published in July 2014



Conclusions

MiFID II is a complicated Directive covering a huge range of subjects, each substantial in their own right. Coupled with the ESMA consultation documents, reading the two together reminds me of Churchill's *"riddle, wrapped up in a mystery inside an enigma"*. There is clearly some way to go before the ESMA Level Two text is finalised, and I have rarely seen the responses to ESMA consultation questions begin so often with the phrase *"no, we do not agree with ESMA"*.

However, policymakers want to create an environment where consumer trust and confidence can be restored. The industry now needs to deliver on choice and integrity of channels and products to encourage the transfer of the 40% of European household wealth still held in cash into more suitable savings and investment products. If the European ratio of household wealth held in funds reached US levels, some €3.9 trillion of new assets could be gathered into funds. Forget China, Europe is where the distribution and asset gathering opportunity is!

Policymakers want to create an environment where consumer trust and confidence can be restored

To the **point**:

- MiFID II is a complex Directive covering a huge range of topics, from dark pools to commodity derivatives and high frequency trading. This article breaks it down to the elements designed to further enhance consumer protection at point-of-sale for retail savings and investment products
- It started with RDR in the UK, and now MiFID II enshrines the same principles around the removal of the inevitable conflict between commission-led product supply and client suitability
- For too long, European retail clients have believed that advice was free, explained through minimal disclosures as paid for by product commissions. This is factually correct but hardly transparent
- MiFID II seeks to professionalise advice and harmonise its definition across Europe. The industry needs to adapt by commercialising the new reality
- Three predictions are often made about the consequences of a shift from commission to fees:
  - There will be significantly fewer independent advisers
  - An 'advice gap' will emerge for clients with modest portfolios
  - The bank-dominated open architecture models will retrench into rebate-remunerated tied advice
- All three of these predictions are challenged as myths, with an alternative reality proposed
- Changes in the distribution landscape will occur:
  - Large D2C platforms will become bigger
  - Simplified advice will move online, encouraged by regulator-led clarity on where the boundary of personal recommendation lies
  - Independent advisers will increasingly use pre-packaged model portfolios
  - New commercial models will emerge
- Across Europe, if the industry delivers on choice and integrity of channels and products and this results in the same ratio of household wealth held in funds as in the US, nearly €4 trillion in additional assets could be gathered into funds. Forget China, Europe is where the opportunity lies