MiFID II
Should we have to fix what is not broken?

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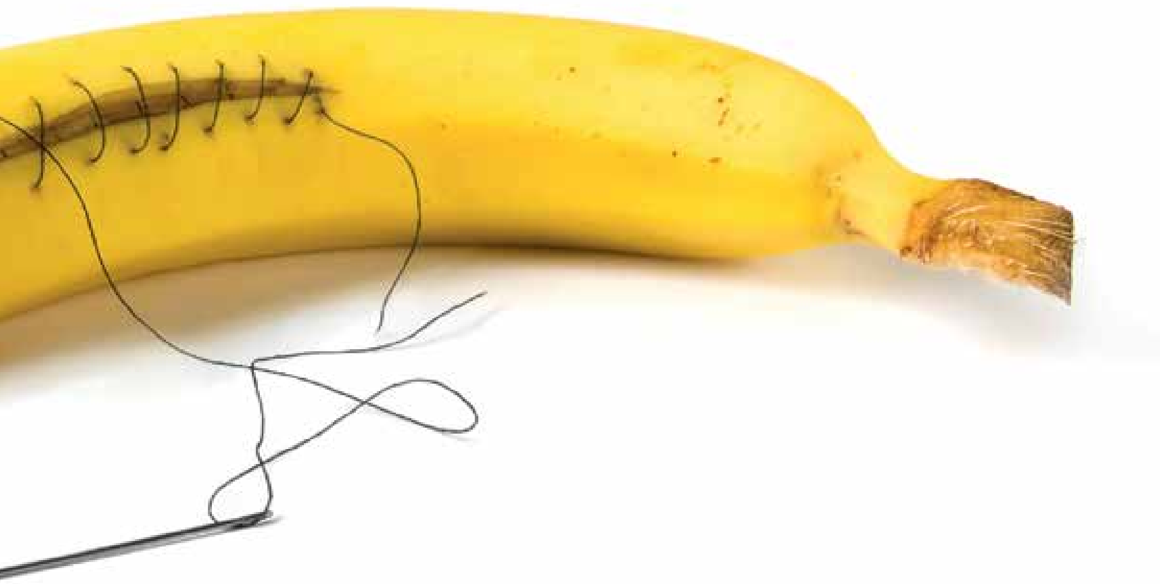
Barely three years after the entry into force of the Markets in Financial Instruments Directive[1], the Commission launched a review not only of its 'financial market regulation' aspects but also of 'investor protection' aspects.

1 *Directive 2004/39/EC MiFID*



The liberalisation of financial markets and their opening up to competition has led to poorer visibility of financial instrument pricing mechanisms and the development of trading areas lacking transparency. Conversely, the definition and oversight of investment services provided to retail and professional investors alike has led to a marked improvement in assistance provided and knowledge of the client.

The review of this Directive should therefore have focused more on financial market regulation than on investor protection. Nonetheless, the Commission wished to improve the model by seeking in particular to resolve potential conflicts of interest highlighted by CESR[2] on good and poor inducement practices[3].

As in many sectors, the distribution of financial instruments is partially financed by product providers. Then this distributor provides the product to the investor directly. The distributor therefore provides a service both to the product provider (by seeking investors) and to the investor (by offering access to the product corresponding to his needs and objectives and potentially by providing advice). MiFID I transformed the distribution activity into a solely investor service, obscuring the product 'placement' aspect[4]. As the distributor now exclusively serves the investor, the business model involving remuneration by the producer becomes an obvious source of conflict of interest. How can the distributor, now exclusively a service provider to the client, offer an objective service while being remunerated by product providers?

In response to this question, MiFID I called for transparency on third-party payments. The authorities now condemn this model without truly having assessed the good or bad implementation of MiFID I. An entire 'investor protection' section, whose key provisions cover the management, or even suppression, of this conflict of interest, is therefore included in the draft review of the MiFID Directive.

A new model…

Accordingly, the new MiFID II Directive[5] includes organisational and information and reporting provisions aimed at guaranteeing investor protection. These provisions will be supplemented and clarified by delegated acts adopted by the Commission based on technical advices issued by ESMA[6]. Although not yet definitive, the Consultation Paper presented by ESMA[7] provides insight into what could be implemented.

2 *Committee of European Securities Regulators*

3 *CESR/07-228 'Recommendations on Inducements under MiFID', May 2007; CESR /10-295 'Inducements: Report on good and poor practices', April 2010*

4 *This view of marketing differs from that presented in the Directive 2011/61/EU (AIFMD) which defines marketing as* "a direct or indirect offering or placement at the initiative of the AIFM or on behalf of the AIFM of units or shares of an AIF it manages to or with investors"

5 *Directive 2014/65/EU*

6 *European Securities and Markets Authority. At the time of drafting of this article, these technical advices are in the consultation phase. They should be published at the end of 2014*

7 *This article is based on the MiFID II Directive and the Consultation Paper published by ESMA on 22 May 2014 and does not anticipate any delegated acts or level 2 measures not yet finalised*

On the ESMA point of view, all financial incentives that could alter the objectivity of the service provided to the investor must be strictly controlled or forbidden

Without anticipating which of the ESMA technical advices the European Commission will decide to adopt, the regulations impacting the distribution of financial instruments in the future can be grouped into three categories:

1. The most objective service

Drawing in particular from the British and Dutch models, the European authorities sought to eliminate all conflicts of interest that could bias the service rendered to the client. Accordingly, MiFID II forbids independent financial instrument advisors and individual portfolio managers from being remunerated by third parties for services provided. In order to avoid any bias, the independent advice or portfolio management services must be remunerated exclusively by the investor to whom the services are rendered.

For other investment services (dependant advice, but also RTO and order execution, etc.), the level 2 proposed by ESMA will supplement the model, clarifying the conditions in which monetary or non-monetary third-party payments (inducements) may be considered legitimate.

Four criteria have currently been submitted:

1. These payments do not remunerate an essential part of the Investment Service Provider (ISP) activity
2. They enhance the quality of the service provided above as required by regulations
3. They do not benefit the ISP or its employees directly, without tangible benefit to the end investor
4. There ongoing, they remunerate an ongoing service

Depending on the interpretation of these criteria, the impact on the distribution of financial instruments as a whole may be more or less significant. Numerous uncertainties remain.

In a consistent manner, these measures are supplemented by the oversight of employee remuneration policies. No more 'product of the month'!

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2. Abundant information

In order to reach an investment decision, the investor, whether a retail or professional client, must be correctly informed. MiFID II therefore strengthens the provisions already introduced by MiFID I regarding the provision of information that is fair, clear and not misleading, at the risk of overwhelming the investor:

Information to be provided to the client on	
Investment advice	• Whether independent or not, scope of products proposed, ongoing or not service, etc. • Objective of the suitability test • Where ongoing advice, changes in the allocation initially recommended • Suitability and disadvantages of recommendations (via a suitability report)
Order execution	• Transactions performed, including for professional clients
Portfolio management	• Actions undertaken and portfolio performance, etc.
Costs and charges	• One-off charges, ongoing charges and transaction costs relating to both the service and the products proposed • Euro amount • Ex-ante and also ex-post, where there is a continuing relationship between the ISP and the investor
The product proposed	• Risks, operation of the product under different market conditions, any guarantee, etc.

The investor must have exceptionally comprehensive information on the service and the product, clearly setting out the disadvantages.

3. A targeted client base

While still aimed at limiting as far as possible any mis-selling, MiFID II seeks to control product governance for both the producer and the distributor.

In the ESMA Consultation Paper, the product manufacturer[8] ISP must implement an efficient product approval process. In particular, it must identify a target market whose needs and objectives will be compatible with the characteristics of the financial instrument. In order to ensure effective distribution, the producer must also provide the distributor with all relevant information for a good understanding of the product.

The distributor ISP must also ensure the suitability of the instruments proposed with respect to the needs and objectives of its client base. To ensure the consistency of this model, the distributor must provide the manufacturer with a certain amount of information and in particular whether or not the product reaches the target market.

8 Note however that collective management is not an investment service

Despite being required to limit ties with manufacturers, the distributor ISP must contact the latter in order to determine the target market for products.

… Far-reaching consequences

It is difficult to say what upheavals or opportunities could result from a model that is not yet stabilised. It is up to the players to interpret the score. Nonetheless, studies[9] performed in the United Kingdom and the Netherlands provide some insight into the main principles that may develop. We fully understand the willingness of European regulatory authorities to protect investors as much as possible, whether retail or professional, but it is highly possible that the saying *"don't fix what is not broken"* proves true once again.

1. A two-speed distribution model

Under this new model, the receipt of third-party payments is contingent on enhancing the quality of the regulated service. However, the minimum required for the provision of such services has been significantly strengthened. What additional services could distributors propose to justify third-party payments? Access to a wide range of products or ongoing services could be a possible line of approach.

However, by significantly restricting the ability of distributors, including dependent distributors, to receive remuneration from producers, the regulation transforms distributors into providers of impartial services to investors. The business model of such service providers can only therefore be based on fees paid directly by the investor. It is therefore logical that the issue will be more critical for the most costly services (typically investment advice).

The model of third-party payments by manufacturers based on assets under management enables the mutualisation of advisory costs. The larger portfolios pay for the smaller ones. The move to a fee-based model would cancel this mutualisation, as fees are generally invoiced on an hourly basis. While it is obviously possible to base fees on the level of assets under management, this remains commercially difficult. For example:

9 Particularly, CFA Institute "Restricting Sales Inducements – Perspectives on the Availability and Quality of Financial Advice for Individual Investors" December 2013; Deloitte "Seismic shift in investment management – How will the industry respond?" 2014

Distribution/investment advice costs		
Before Assume to be 1% of assets under management		**After** Assume to be 5 hours at an hourly rate of €300 for the suitability tests, wealth analysis, product information, etc.
€500 for a portfolio of €50,000	**€2,500** for a portfolio of €250,000	**€1,500** for each investor
Giving a total of €3,000		Giving a total of €3,000

Tax friction specific to each country has not been taken into account.

Moreover, the minimum required for the provision of such services has been significantly strengthened

On the one hand, the smaller investors will not wish to or will be unable to pay fees of €1,500 (compared with €500 under a commissioning model) and, on the other hand, advisors will limit this activity as unprofitable. These fees could be partially offset by product performance, as distribution costs will no longer impact performance. However, any such changes would be more or less significant depending on the market context.

A two-speed distribution model would therefore arise, with wealthier clients benefiting from investment advice and more modest clients being deprived of such services. The only recourse for the latter would be to invest without the benefit of advice through RTO or order execution platforms whose business models are primarily based on entry fees. Such business models are only viable if they process significant volumes. It would not be surprising to see substantial concentration of players in this sector, as already suggested by the Deloitte study.

2. Asset management heavily affected

The model governing commission payments to distributors set out in the new MiFID Directive only limits third-party payments, without providing any further clarification. If a third party is assumed to be any legal entity other than the investor, what savings products will ultimately be affected by this model?

Insurance products, governed by the Insurance Mediation Directive (IMD), were ultimately not considered financial instruments and as such are not covered by MiFID II. As the insurer is the legal holder of the products placed in the units of account, it is potentially to a holder, albeit a rather special one, that any commission could be paid. As to monetary ties between the insurer and any brokers, it will be for the review of the IMD to decide the legitimacy or not of these commissions.

Banking products issued by the same legal entity as the distribution network should not be concerned, as it is only a question of internal management accounting. This leaves asset management products which must, particularly in France, be managed by specific legal entities. Banking networks are a preferred distribution channel of funds in Europe, but will they continue to propose such funds if they can no longer be remunerated by the management subsidiary?

As the final text of level 2 measures has not yet been finalised and changes in the IMD are still uncertain, it is difficult to assess the real impacts of this new regulation. If insurance products remain outside the scope, this distribution channel is likely to develop in the coming years. However, only the ban on independent advisors and fund managers is currently certain. As long as other investment services, and particularly dependant advice, are not affected, distribution via the banking networks can continue.

While this new version of the MiFID Directive would appear to penalise primarily asset management, it may also offer the opportunity to establish asset management as a separate sector in the eyes of the general public. By making investors the focus of attention of management companies and obliging them to shorten the distribution chain, or even distribute their own products, will MiFID be the catalyst for change in this sector?

To the **point**:

- The retrocession model and its potential conflict of interest are highly questioned by European authorities
- The fund distribution channels will completely change. It is likely to benefit a vertical integration
- The open architecture is expected to disappear
- A two-speed distribution model is likely to be implemented to respond to the ban on inducement

In conclusion, a two-speed distribution model would therefore arise, with wealthier clients benefiting from investment advice and more modest clients being deprived of such services

Open architecture must remain a fundamental right of the European investor
The point of view of Guillaume Dard

Chairman and CEO of Montpensier Finance since January 2004 and previously Chairman of Banque du Louvre, a pioneer in multi-management in France.

The European investor has progressively gained freedom of choice of investment over the last 20 years, in the same way as the consumer was previously offered a wider choice of products and brands with the arrival and development of hypermarkets and specialist stores in the 1960s and 1970s.

Investors under 45 years of age cannot imagine that in the past they would have been obliged to subscribe only 'in-house' products offered by their banks. The consumers of 2014 would similarly not accept to be limited to 'distributor' brands!

Today investors potentially enjoy an immense choice: the European investment solutions offering is extremely abundant. For example, the European asset management industry proposes over 55,000 funds totalling assets under management of approximately €8,000 billion[10]. It is of course crucial to guide savers in their choices.

Enabling each investor, and particularly retail investors, to find the allocation corresponding to their needs must be a priority for professional and regulatory players. It is therefore necessary to incite distributors to offer the widest possible range of products, thereby encouraging an open architecture; while ensuring investors are assisted by professionals of the highest calibre.

Are these priorities fully taken into account in the new Directive? It is not clear as it is feared that the new provisions on retrocessions may lead major banking distributors to bring management products back in-house, resulting in the progressive disappearance of the open architecture.

It is also essential to ensure that financial investment advisors, who currently propose external products, do not seek to develop 'in-house' product offerings for their clients and are not encouraged to change their legal status.

The initial intention of the European legislator is surely to protect the investor. The risk is that the latter is inadequately assisted in his choices, that is, if there remains a real choice in the long term.

A solution involving real transparency on third-party payments received by distributors would probably have been the best way forward. This model has the major advantage of truly favouring an open architecture and therefore the possibility for the investor to easily find a sufficiently diversified offering to meet his needs and characteristics. The open architecture must remain a fundamental right of the European investor.