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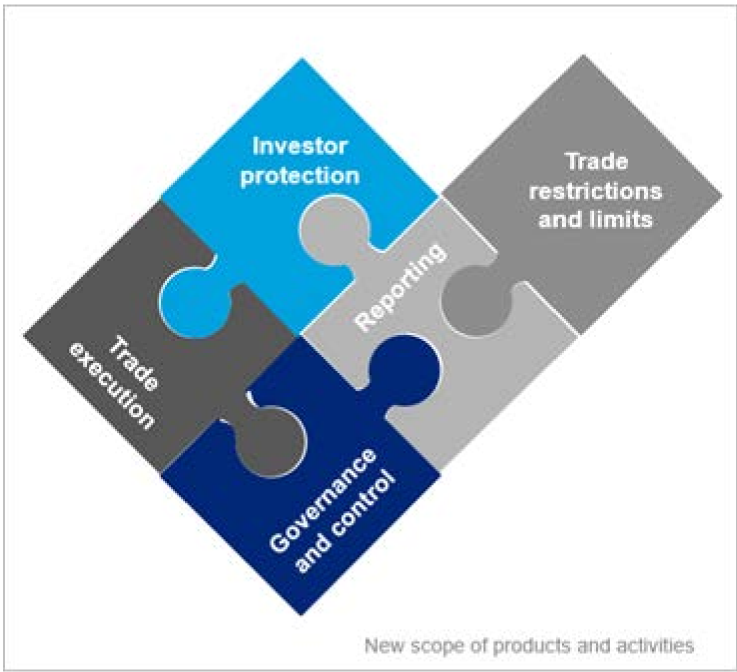
MiFID II - From a compliance to a business challenge

After intense discussions between the European Commission, Council and Parliament (the "Trialogue"), the new MiFID II package, which runs to more than 700 pages, was adopted by the European Parliament (EP) on 15 April 2014.

While primary objectives of the initial directive (MiFID I) were to increase the competition, improve investor protection and EU passporting, MiFID II package introduces a range of measures which seek to address consequences of MiFID I and issues raised by the financial crisis, such as making financial markets more efficient, resilient and transparent, improving investor protection, as well as addressing commitments made by the G20 on these topics.

From MiFID I to MiFID II, what are the main changes?



Extended scope of products and activities	**Products and activities** Additional financial instruments will be brought into the scope of MiFID II, such as: • Structured deposits issued or sold by credit institutions • Certain packaged retail investment products (PRIPs) • All emissions allowances (such as carbon) • The sale of financial instruments issued by the investment firm. **Insurance-based Investment products** Insurance-based Investment products will remain regulated under the current version of IMD (Insurance Mediation Directive) that will be updated after new parliament is in place. Nevertheless, MiFID II introduces specific rules on conflict of interest on Insurance-based Investment products and give the possibility to EU Member States to introduce inducement restrictions on those products.
Prohibited payment and retention of inducements (MiFID article 24)	Out of the whole MiFID package, a single article has sent shockwaves throughout the industry: article 24, which prohibits the common practice of retrocessions (inducements) for discretionary asset management and ‘independent’ advice. Article 24 creates significant difference between MiFID I and MiFID II: while the first generated compliance costs, the second puts significant revenue at risk. In other words, MiFID I was mainly a compliance matter for the financial industry, but MiFID II poses challenges on revenue and therefore on organisations strategy and business model. By end-2016, all 28 EU member states will be on a level playing field, unless certain countries go for more stringent rules (gold plating). In the meantime, national regulators throughout Europe have already taken tough measures to either ban trailer fees or strictly limit them. A number of countries, including the United Kingdom, Italy, Netherlands and Germany, already have requirements that go beyond MiFID II.

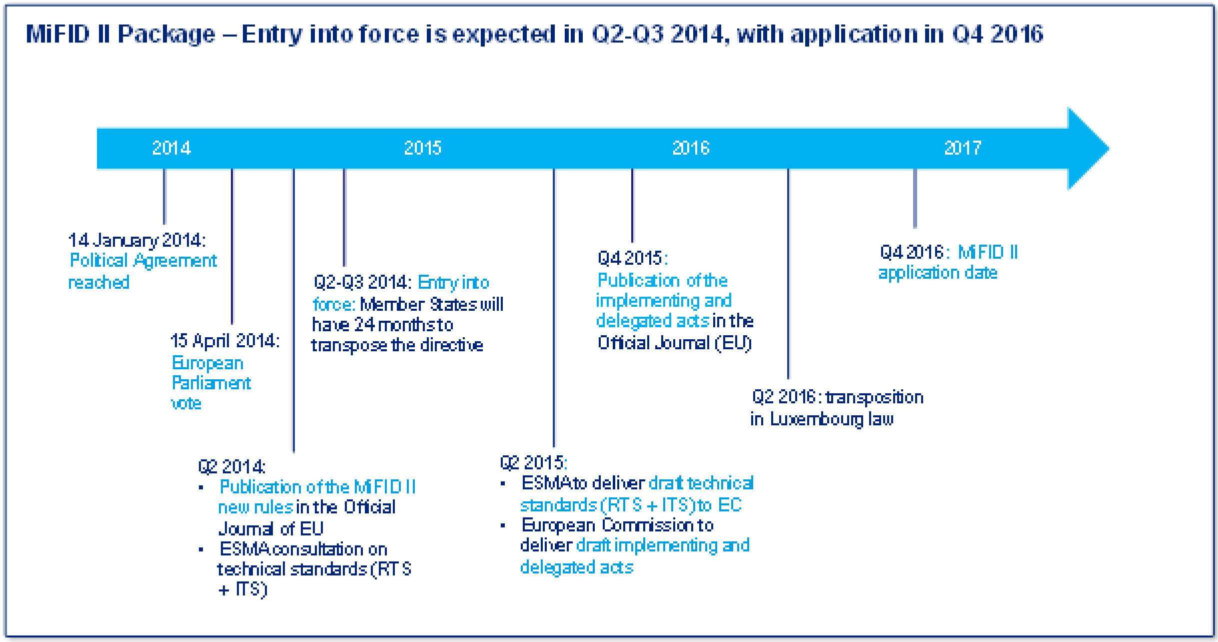
Enhanced investor protection	A series of measures will reinforce investor protection, including the following: • Advice from investment firms must meet two criteria in order to be 'independent': (i) assess a sufficient range of financial instruments (i.e. not limited to in-house products and (ii) refrain from accepting or retaining inducements from third parties). • Discretionary portfolio management will also refrain from accepting or retaining inducements from third parties. • Advisory and portfolio management clients will receive a detailed suitability assessment in a periodic performance report. • Pre- and post-trade information to clients will be enhanced, in particular detailed information on fees and commissions paid and received by the investment firm. • Definition of non-complex instruments will be amended and exclude structured UCITS. This implies that an assessment of appropriateness will be required before selling any structured UCITS. In other words, 'execution only' will not be possible anymore for structured UCITS, regardless of the product risk profile.
Creation of a new execution venue - the OTF	• In order to capture 'dark pool' operators and other alike trading systems (e.g. inter-broker dealing systems), a new category of trading venue called Organised Trading Facility (OTF) will be introduced for non-equity instruments (e.g. bonds, derivatives, structured products). • Derivatives, which are sufficiently liquid and eligible for clearing, will need to be traded on eligible platforms: OTFs, MTFs (Multi-lateral trading facilities) or RMs (Regulated Markets) instead of OTC trading. • Requirements will be imposed on operators of OTFs (e.g. clients orders on an OTF cannot be executed against proprietary capital) and transactions concluded on an OTF will be submitted to pre- & post-trade transparency provisions similar to RM and MTF, creating a level-paying field. • The scope and obligations of systematic internalisers will be amended
Stricter governance requirements and more accountability on Senior Management	• New requirements for corporate governance and (non-) executive directors, in addition to other texts (e.g. CRD IV or CSSF circular 12/552). • Introduction of the new concept of "management body": governing body of an investment firm or a data services provider, including the supervisory and the managerial functions (i.e. all persons who effectively direct the business). • Strengthened criteria for qualified senior management, the role of directors and supervisors who must commit sufficient time to perform their function and take into account diversity in their composition. • Stricter control of remuneration of staff (e.g. bonus criteria) advising or selling to clients, which cannot prevent staff from complying with obligations to act in the best interest of clients. • Strengthened role of the compliance officer

Product intervention & strengthened supervision with stricter sanctions	• In coordination with ESMA, national regulators (i.e. CSSF in Luxembourg) will have powers to permanently ban financial products, activities or practices. • Administrative sanctions, fines and penalties will be made public, sufficiently high to offset any benefit and to be dissuasive also for larger institutions. • Position limits for products, such as commodity derivatives, will be introduced. This will include powers for regulators to require existing positions to be reduced or to limit the ability of any person from entering into commodity derivatives.
Harmonised regime for third country firms	• When serving retail or professional clients on request in the EU, third-country firms will have to establish a branch in each EU country where they operate. Branches will be subject to authorisation and supervision in the member state. • When serving eligible counterparties or per se professional clients in the EU, investment firms will directly register with ESMA. This registration will be first subject to the third country receiving a positive equivalence assessment from the European Commission. No EU branch is required. The EU passport will be available.
Extended market transparency and transaction reporting	• Transparency requirements will be extended to additional instruments, such as bonds and derivatives. • Trade reports will need to be published through Approved Publication Arrangement (APA) firms, which will also be subject to authorisation and certain organisational requirements. • Transaction reports will need to capture additional information (including identification of individuals – or computer algorithms where relevant – responsible for the investment decision). • Key system changes will be required to capture additional reporting requirements (including new instruments). Static data may require cleansing in order to ensure additional information is reported correctly. • As such, the reporting will be impacted in 4 dimensions – the format – to be aligned with EMIR – the frequency (i.e. near real time) – the content – the audit trail

Notwithstanding the above elements, it is important to note that the MiFID II implementation will need to be considered in line with other regulatory developments such as CRD IV (Capital Requirements Directive), EMIR (European Market Infrastructure Regulation) and MAD (Market Abuse Directive).

MiFID II timeline

The following key milestones are expected in the next coming months:



Preparing for MiFID II: consequences and challenges

Though MIFID II will not be transposed and applied before end 2016, impacts will be significant especially with the ban of inducements. Certain countries in Europe (e.g. UK, IT, NL or DE) have already implemented similar inducement measures in their national legislation. Other EU countries either followed or will follow this trend. Lessons can be learned from the recent experiences in the UK and Netherlands and by looking at models in the US where similar rules also exist.

It is now time for the industry (credit institutions, investment firms, asset management) to assess first strategic but also operational impacts, by estimating which of their revenue is at risk and how this loss of revenue can be compensated in their value chain.

ESMA is expected to publish a number of Technical Standards that will be necessary to start an effective implementation.

Impacts of MiFID II will vary from one business model to another. The industry may expect the following consequences:

Independent advisors and discretionary asset managers (DAM)

Banning inducements may remove a significant portion of their revenue. This may lead those asset managers to:

- increase advisory/DAM fees transparently charged to clients, as far as the client agrees to pay them
- increase the minimum portfolio size to make advisory/DAM services economically viable, thereby excluding many investors from accessing affordable advice
- promote in-house funds (in the case of DAM), since buying third-party funds would provide limited advantage

- encourage clients to shift to 'non-independent' advisory, where inducements are not banned

It is tough times for Independent Financial Advisory (IFAs) who are unable to revise their remuneration model and offset the loss of retrocessions.

Fund distributors

Typical distribution models are likely to evolve towards diversification of revenue. Asset platforms could provide other ancillary services that can be charged for separately, such as investment advice (e.g. fund screening and selection, provision of factsheets), transaction management, risk reporting and other types of reporting, and analytical services. Going beyond a pure model of operating as a logistical hub, platforms will broaden their revenue sources and re-establish their position on the market.

Product providers

Passively-managed investment products may receive more attention. While they were disregarded by certain advisors because the products did not generate sufficient income to pay retrocessions, such products may now appeal to customers who object to paying advisory fees. New share classes have emerged, as investment managers have had to develop clean share classes that strip out commission and platform fees.

Those firms that go first through awareness and assessment exercises sooner rather than later will find that they are well positioned to plan for the necessary changes to their business model and their operations, create new opportunities to further increase their market position while minimising business disruption and compliance costs.

In fact, while MiFID I was mainly a compliance matter for private banking and many investment firms, MiFID II questions strategy and business models. Times of hefty inducements are definitely gone. Because changing a business model may take months, investment firms need to clearly assess now the impacts given the nature of their activities by asking now the right question and notably:

- Adopt the status of independent advisor or not
- Re-evaluate the fee structure and find innovative solutions
- Increase use of technology as a response to lower fees
- Adapt their product offering
- Assess compliance of the remuneration policy of their staff

What do you need to do now?

Depending where you sit in the MiFID industry and if you are more involved in the financial instruments or execution venue areas, or if you are involved in the distribution of financial products, or even having a significant proprietary activity, the gaps can be multidimensional and a MiFID compliance strategy is necessary.

You need to assess as of now:

- the impact of MiFID II on your distribution model,
- the operational synergies with CRD IV, EMIR and MAD.

Deloitte Contact

Deloitte experts in regulatory matters offer assistance on specific areas such as regulatory awareness, impact assessment for your organisation, definition of tailored solution for efficient implementation production and in particular in management of the MiFID II regulatory developments.

We trust this information is of assistance and remain at your disposal for any further questions.

Please contact your usual Deloitte representative project leads for further information.

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