MiFID II: The Next Big Challenge
Key Issues for Asset Managers

A Legal Update from Dechert's Financial Services Practice

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Introduction

Background

The Markets in Financial Instruments Directive (“MiFID II”) and the related Regulation (“MiFIR”) is the next big re-write of EU legislation, due to take effect at the beginning of 2017. Although its greatest impact will be on sell-side broker-dealers and markets there will also be significant changes for asset managers, ranging from internal organisation and conduct of business to marketing and disclosure. This update outlines the relevant provisions and what issues asset managers should now be considering.

MiFID II is a major re-write of the original MiFID I legislation which originally came into force in November 2007. It is also considerably more detailed and prescriptive than the original regime.

The new Level 1 provisions of MiFID II were published in June 2014. Lengthy Level 2 provisions, in the form of technical standards and delegated acts, have been under consultation since 2014 and are due to be published in July-September 2015. They must be transposed into national law by member states by summer 2016 and the new structure will come fully into force on 3 January 2017. There is no transitional period.

Applicability to asset managers

Asset managers authorised in the EU to provide investment advice and portfolio management for AIFs and/or UCITS within the definition of a MiFID investment firm will be directly subject to all aspects of MiFID II in relation to these activities.

AIFMs or UCITS managers which solely carry out collective portfolio management are not within the scope of MiFID II itself. However, to the extent that they are also authorised to carry on advisory and portfolio management activities these will be subject to the MiFID II rules, which are now in some places more onerous than the corresponding AIFMD/UCITS regimes. In addition, where an AIFM or management company distributes its products through MiFID firms it will need to assist those firms in meeting a range of new disclosure and compliance requirements.

Third country managers may be indirectly impacted by MiFID II requirements where they distribute their products in Europe and where they receive services from or provide services to MiFID firms in the EU.

Key changes for asset managers

1. Enhanced conduct of business and organisational requirements

General Application

Directly applicable to (i) MiFID authorised investment firms, and (ii) to AIFMs and management companies when providing MiFID services such as individual portfolio management or investment advice.

Inducements

Portfolio managers will not be permitted to accept and retain fees, commissions or any monetary benefits from third parties such as issuers and product providers relating to the services provided to their clients. This compares with the current MiFID I rules under which such payments or benefits may be received so long as they comply with the rule on inducements.

Under additional changes to the inducements rule the requirement for quality enhancement will be more strictly construed; disclosure on a generic basis will not be allowed; and the payment of placing fees is confirmed to be within the scope of the inducements regime.

Dealing commission

Probably the biggest single change in MiFID II is the proposed abolition of payment for research with dealing commission. Although such payments are currently "unbundled" in the sense that they are separately identified and accounted for by managers, ESMA is proposing "full" unbundling under which managers must either (a) pay for research out of their own pockets or (b) agree with each client a separate research payment account ("RPA") with its own budget which will be directly paid by the client as its contribution to the manager's overall research budget. This is intended to decouple the manager's research spend from its clients' trading volumes and ensure that the manager only pays for research it actually wants.

If the manager has to pay for its own research this is expected to lead to a decline in the amount of research used, with a knock on impact on investment performance. If research is funded through RPAs there will be significant client/client conflicts on matters such as how the research budget is allocated by the manager among its clients, how it is administered, what happens if one client does not accept its part of the budget, or if the size and number of a manager's client accounts changes during the period. UK managers will be potentially disadvantaged in competing with non-EU managers who are not bound by the new restrictions, while international firms running global soft dollar accounts will have to determine how to reconcile practice in the rest of the world with the new EU restrictions.

The effect of extending the new restrictions to the bond markets, where the FCA believes that a research cost is hidden in bid-offer spreads, is also very unclear.

The final regime is likely to be copied over into the UCITS and AIFM Directives when they are next revised. National regulators such as the FCA may apply the new restrictions on a super-equivalent basis before then.

Financial collateral arrangements

A manager may not commit a retail client to any title transfer collateral arrangement ("TTCA") (including stock lending or repos involving TTCAs) and must justify the use of any TTCAs for professional clients.

Best execution

Execution and order placing policies will need to contain more details of the venues and brokers used for particular classes of instrument (and selection criteria), and consider total costs associated with trading methods.

Firms that execute client orders will be required to publish annually the top five execution venues by trading volume they use for execution purposes. It is proposed to extend this at level 2 to include disclosure of the number and volume of orders executed on each venue as a percentage of the firm's total executed orders. It is unclear to what extent these requirements may impact on portfolio managers.

Reporting to clients

The frequency with which asset managers must provide clients with portfolio statements will be increased from six monthly to quarterly. The report must include valuations, if necessary on a best efforts basis, a review of activities and performance during the relevant period, any depreciation in the value of the portfolio that exceeds 10%, and certain prescribed information on ownership issues such as assets subject to title transfer or security arrangements.

Internal organisation

Governance

There will be:

- new formalised requirements for the composition and qualifications of a firm's management body, and its responsibilities;
- new prescriptive rules on the organisation and duties of internal compliance and its interaction with other business functions, reflecting ESMA's 2012 guidelines.

Compliance

Operations and Compliance procedures

Prescriptive complaint handling rules will be extended to complaints by professional clients and potential clients. There will be a formal requirement to establish a complaints management policy and function, publish details of the policy and provide reports to national regulators.

More detailed record keeping requirements will be introduced. Records of decisions to deal will become more detailed with the initial decision covered by 16 fields and another 40 thereafter.

There will be enhanced record keeping requirements for telephonic and electronic-based communications relating to client orders. Records will include relevant internal communications and a new requirement for written records to be kept of face to face client meetings. Certain exemptions under the existing UK regime will be discontinued and there will be a new requirement to monitor call recordings.

There will be new high level requirements on governance and design of remuneration policies, including balance between fixed and variable remuneration, applicable to all persons who can have a material impact, directly or indirectly, on the firm's services.

Algorithmic trading

Algorithmic trading is any trading where a computer algorithm automatically determines individual parameters of orders with no, or limited, human intervention. It covers decision making as well as execution algorithms. Any firm using an algorithmic strategy, including a manager, will be subject to new prescriptive organisational requirements; and new regulatory notification, reporting and record keeping requirements.

Other

Other changes under MiFID II include amendments to the rules on client cash and custody, meaning of fair clear and not misleading in particular contexts, more prescriptive conflict management procedures, a formal requirement to provide suitability reports to advised retail clients and new requirements for the content of client agreements.

2. Sales and Distribution

General Application

Directly applicable to MiFID investment firms and to AIFMs and UCITS management companies when providing MiFID services.

Indirectly applicable to any other managers or product providers – AIFMs, UCITS management companies or third country managers - using MiFID firms in their distribution network.

Product Governance

MiFID firms which manufacture investment products must:

- ensure those products are designed to meet the needs of an identified target market of end clients (in effect an appropriateness assessment at generic client level) and carry out a product scenario analysis including the risk of poor investor outcomes;
- ensure that the distribution strategy is compatible with that target market, take reasonable steps to ensure that the product is distributed to that target market;
- make appropriate information available to distributors and carry out regular reviews of events that could affect the potential risk or return to the target market.

MiFID firms which distribute such products and/or services must identify appropriate information on such product or services, have regard to the identified target market, give appropriate disclosures and make appropriate assessments of clients' needs, regularly review the products they distribute and services they provide, and provide information to support manufacturer's product reviews.

On the face of it this new product governance regime resembles the regime applied under the FCA's "treating customers fairly" ("TCF") initiative. However, it (i) does not extend to life assurance products, (ii) does not have any direct application to AIFMs or UCITS management companies when acting in that capacity (ESMA thinks the EC should extend the AIFMD & UCITS regimes to harmonise with this); (iii) extends in the case of distributors to services such as fund platforms; (iv) is referenced to clients rather than investors generally; (v) applies to professional clients as well as retail clients; (vi) applies to both primary and secondary market products; and (vi) is generally more detailed and prescriptive than TCF.

Disclosure requirements

The MiFID I obligation on firms to provide clients with appropriate information on financial instruments and investment strategies is expanded in a number of respects.

A firm providing an advisory service must tell its clients:

- the nature and type of advice it will provide;
- whether or not its advice will be "independent";
- how broad or restricted the range of that advice will be;
- whether the service will include a periodic assessment and if so details of how this will be conducted.

Information on instruments and investment strategies must include:

- appropriate risk warnings including how the client may exit the investment and any risks relating thereto;
- the functioning and performance of such instruments in different market conditions;
- additional disclosures where an instrument is composed of two or more instruments or services.

Information on costs and charges must be provided to both professional and retail clients:

- covering both investment and ancillary services including the cost of advice and where relevant the cost of the instrument recommended or marketed and how it will be paid for;
- separately identifying third party payments and rebates;
- in the case of a service including an illustration showing the cumulative effect of costs on return.

The costs information must be aggregated to show the overall cost to the client.

Point of sale disclosure should be refreshed periodically where there is a continuing relationship with the client.

Disclosure should include transaction costs, including costs embedded in a bid-ask spread and mark-ups and mark downs, and expressed as both a percentage and a monetary amount. The monetary amount may be based on an assumed investment rather than the precise amount the client is investing. Where precise information is not available disclosure can be on a best efforts basis. Any assumptions on which an estimate is based should be explained.

ESMA would like the EC to extend these disclosure requirements to the UCITS regime and the retail disclosure regime to be introduced by the PRIPS Directive. Meanwhile, where the information required to be disclosed is contained in a UCITS KIID (or when the PRIPS Directive comes into effect, a PRIPS KID) this does not need to be re-disclosed for MiFID II purposes. However, information which is not included in the KIID (such as quantitative information on transaction costs, and a monetary as well as a percentage figure for costs) must be separately obtained and disclosed.

Where an investment service is offered as a package (for example portfolio management and custody) the firm must identify the cost of each component and any related risks, and advise whether the component parts can be obtained separately.

Client classification and appropriateness tests

Public and local authorities must be classed as retail clients rather than professional clients.

New, more prescriptive tests will make it harder to classify retail clients as elective professional clients.

Where a firm sells to a retail client on a non-advised basis the range of products for which the firm must carry out an appropriateness test is being extended. Structured UCITS and non-UCITS funds (hedge funds etc.) will automatically be classed as complex products.

New sales regime for Independent advisers

A firm providing an advisory service must tell its clients whether or not it is acting as an independent adviser. Where it holds itself out as independent it must meet appropriate requirements as to the scope of its advice. This bears a good deal of similarity to the old FSA packaged product polarisation regime, abolished in the UK in 2002 as of no practical benefit.

An independent adviser will not be allowed to accept any payment or benefit EU can no longer be paid by third party product providers for advised sales, but must charge their fees to the client directly. However, third party inducements may still be paid for non-advised sales and where products are distributed by a tied sales force or on a basis where the range of products advised on is insufficient to qualify as independent. This ban on third party payments was prefigured in the UK by the FSA's retail distribution review reforms ("RDR"), introduced in 2012, though RDR (i) only applies to advice given to retail investors and (ii) applies to all advised sales, not just sales by independent advisers.

3 Provision of MiFID Services by third country managers

MiFID II goes some way towards harmonising access to the EU markets by third country firms.

The following will apply to any third country firm providing MiFID services (such as investment advice or portfolio management) to an EU-based client.

Retail clients

EU states will be able to require third country managers located outside the EU but providing portfolio management or other MiFID II services to EU retail and elective professional clients in their jurisdiction to establish a branch and obtain local authorisation.

The branch will then be eligible for a passport to provide its services in other EU jurisdictions, something not currently possible under the MiFID I passport regime.

The UK Treasury has indicated that it is not planning to introduce this requirement in the UK.

Professional clients

A third-country firm providing portfolio management or other MiFID services to professional clients may do so if its home jurisdiction meets certain equivalence requirements and it registers with ESMA.

MiFID II allows reverse solicitation by a third country firm without authorisation or registration but defines this narrowly as being at the "exclusive initiative" of the client.

4. Trading and markets

General application

MiFID II introduces significant structural changes to EU financial markets. They are designed to improve transparency but may also increase the cost and complexity of trading and reduce liquidity.

The changes will impact anyone dealing in the EU markets, whether or not they are MiFID II firms and whether or not they are based in the UK or the EU.

The main provisions apply directly to the way sell side firms do business in the EU and indirectly to managers and other buy side firms who deal with or though EU sell side firms.

A number of provisions such as commodity position limits, transaction reporting and algorithmic trading reporting will apply directly to any MiFID II or other manager operating under a MiFID II permission.

Trading venues

MiFID II currently regulates three types of trading venue: Regulated Markets ("RMs"); Multilateral Trading Facilities ("MTFs"); and Systematic Internalisers ("Sis").

Under MiFID II:

- the definition of an SI will be more strictly applied, as will the obligations of an SI to publish firm quotes;
- a new category of venue, known as an organised trading facility ("OTF") will be introduced for organised multilateral discretionary systems for non-equity order matching and agency crossing. Sell side firms may need to obtain extended authorisation to carry on such activities and be subject to more detailed regulations;
- new operating requirements will be applied to trading venues, moving the regulation of MTFs and OTFs closer to the RM model.

Equities

All trading in shares must be carried out on RMs, MTFs or SIs or equivalent third country venues, subject to certain exceptions.

OTC trading of equities is likely to be substantially limited, with sell side broker-crossing networks effectively shut out of the market. Managers will need to check the impact of the new rules on their internal crossing systems.

OTC Derivatives

Cleared OTC derivatives which are deemed "sufficiently liquid" will be required to be traded on a regulated trading venue.

Transparency

Currently, pre-trade transparency requires the publication of real time orders and quotes (subject to certain exceptions). Post-trade transparency requires the immediate publication of the price and volume of executed transactions (with some deferred publication allowed). Currently under MiFID I these rules only apply to equities traded on an RM.

Under MiFID II:

- all trading venues (RMs, MTFs and OTFs) must publish current bid and offer prices and depth of trading interest, on a continuous basis for equities, equity-like instruments (depositary receipts, ETFs, certificates); and certain non-equity instruments (bonds, structured finance products traded on a RM or for which a prospectus is published, emissions allowances and derivatives traded on an RM, MTF or OTF);
- systematic internalisers must make public firm quotes on a regular and continuous basis;
- the types of trade for which national regulators will be able to grant pre-trade transparency waivers is reduced to restrict dark pool trading;
- a European consolidated tape for post-trade data will be introduced from 2019 giving the price, volume and time of trades as close to real time as possible.

Commodity Derivatives

National regulators will be able to set position limits for commodity derivatives traded on RMs, MTFs and OTFs, as well as economically equivalent OTC derivatives. The limits will apply to investment funds as well as to clients of portfolio managers and are expected to be applied at the level of the fund rather than the manager.

There will also be new reporting requirements for commodity derivatives. Trading venues will publish weekly reports on aggregate positions and firms trading OTC must make daily reports of their positions to the regulator.

Direct Electronic Access ("DEA") and algorithmic trading

Firm providing DEA to a trading venue will be required to ensure that their clients comply with applicable MiFID II requirements. Algorithmic traders pursuing a market making strategy must provide continuous prices.

(5) Transaction Reporting

General application

Directly applicable to MiFID firms. Likely to be extended to AIFMs and UCITS management companies by the FCA. Some possibility of indirect impact on non-EU firms in terms of information gathering by EU counterparties.

The new reporting regime

Under MiFID I, transaction reporting applies only to investments traded on RMs. Current UK rules extend this to investments traded on a UK prescribed market and any related derivatives. Under MiFID II the reporting requirement will be extended to all instruments traded on RMs, MTFs or OTFs (or to which the underlying is so admitted), and the number of reporting fields will be increased from 23 to 81.

Under current rules, reports may be made by third parties acting on behalf of a firm. Asset managers are covered by a general portfolio manger exemption where the broker or counterparty is itself subject to the reporting obligation. Under MiFID II this will be replaced by a narrower exemption for receiving and transmitting orders which (i) will not cover direct execution with counterparties; (ii) will require the manager to enter into an explicit reporting agreement with the broker that covers the responsibilities of both parties; (iii) still requires the manager to transmit certain detailed information to the broker; and (iii) still holds the manager responsible for the accuracy of the reported information.

Where the manager delegates reporting responsibility to its brokers it will still have to have new reporting arrangements in place in order to transmit relevant information to those brokers. This, together with related documentation and liability issues, and reporting experiences under EMIR, may lead to more managers assuming direct responsibility for their own reporting rather than continuing to seek to rely on brokers.

6. Summary

MiFID II is 18 months way. Many issues are still uncertain but managers need to begin assessing the potential impact on their businesses and how they will deal with them. This will include reviewing:

- internal processes and procedures;
- distribution strategies; and
- relationships with clients and other third parties;

and deciding what follow up action is required.

Resulting work streams may include:

Technological requirements:

- Transaction reporting
- Telephone recording and monitoring
- Algorithmic reporting obligations
- Use of research payment accounts
- Collection of costs and execution information to meet disclosure obligations

Documentation:

- Transaction reporting agreements
- Point of sale disclosure materials
- Ongoing disclosure materials (services, strategies, costs, best execution etc)
- Client agreements
- New policies and procedures generally

Policies and Procedures:

- Board level governance
- Telephone monitoring
- Client categorisation
- Product governance
- Range and independence of investment advice
- Complaints handling
- Periodic reviews of products and services,
- General compliance procedures
- Use of title transfer collateral arrangements
- Algorithmic monitoring and reporting
- New record keeping requirements

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